



ISLAMIC FINANCIAL SERVICES BOARD

**GUIDANCE NOTE ON THE
RECOGNITION OF RATINGS BY
EXTERNAL CREDIT ASSESSMENT
INSTITUTIONS (ECAIS) ON *TAKĀFUL*
AND *RETAKĀFUL* UNDERTAKINGS**

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ACRONYMS

BCBS	Basel Committee on Banking Supervision
ECAI	External Credit Assessment Institution
EIOPA	European Insurance and Occupational Pensions Authority
GN-1	Guidance Note In Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Shari'ah</i> -Compliant Financial Instruments
IDB	Islamic Development Bank
IFSB	Islamic Financial Services Board
IFSB-2	Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services
IOSCO	International Organization of Securities Commissions
PIF	Participants' Investment Fund
PRF	Participants' Risk Fund
TO	<i>Takāful</i> Operator

Bismillahirrahmanirrahim
Allahumma salli wasallim ‘ala Sayyidina Muhammad wa’ala alihi wasahbihi

OBJECTIVE

The objective of this Guidance Note is to facilitate the emergence of generally accepted criteria for the recognition by national supervisory authorities and the wider financial community of credit ratings on *Takāful* and *ReTakāful* undertakings.

SECTION 1: BACKGROUND

1. In March 2008, the Islamic Financial Services Board (IFSB) published a “Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Sharī’ah*-Compliant Financial Instruments (GN-1)”. The GN-1 was prompted by the issuance in December 2005 of the IFSB’s “Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services” (IFSB-2). The IFSB-2 provided for national supervisory authorities to allow banks to use credit ratings issued by recognised ECAIs (commonly referred to as “rating agencies”) when calculating their risk-adjusted capital ratios. The question therefore arose as to what criteria the supervisory authorities should use to recognise ECAIs. The March 2008 GN-1 aimed to specify such criteria.
2. The IFSB-2 and the GN-1 did not include recommendations related to the calculation of capital levels for *Takāful* or *ReTakāful* undertakings, or, more generally, recommendations on the use of ratings on such undertakings.
3. In November 2008, the IFSB organised two seminars addressing different, though related, aspects of *Sharī’ah*-compliant insurance undertakings. The first—was titled “Seminar on the Rating of *Takāful* and *ReTakāful*”, and the second, “Seminar on the Regulation of *Takāful*”.
4. During the two seminars, differing opinions as to how *Takāful* and *ReTakāful* undertakings should operate were observed. It was also observed that ECAIs used different approaches when analysing *Takāful* and *ReTakāful* understandings, and that they had different ways of presenting their rating methodologies.
5. As a result of the seminars, the IFSB Secretariat concluded that it might be useful to provide guidance for national supervisory authorities and other market players on how to assess the quality of ratings assigned to *Takāful* and *ReTakāful* undertakings, and in particular, to suggest criteria by which national supervisory authorities and other market participants could decide which ECAIs’ ratings to use when assessing the creditworthiness of *Takāful* and *ReTakāful* undertakings.
6. The IFSB Council-approved the preparation of a “Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Takāful* and *ReTakāful* Undertakings”.
7. The preparation of this Guidance Note forms part of broader efforts by the IFSB to promote standards for the conduct of *Takāful* business. In December 2009 and December 2010 the IFSB released Standard IFSB-8, “Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings”, and IFSB-11, “Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings”, respectively.

8. For the purposes of this Guidance Note, a *Takāful* undertaking is defined as a hybrid structure comprising a *Takāful* Operator (TO) and one or more underwriting funds, also known as Participants' Risk Funds (PRFs), that belong in substance to the *Takāful* participants; or as a mutual company discharging the functions of both the TO and PRFs. An equivalent definition is accorded to *ReTakāful* undertakings.
9. The IFSB trusts that this Guidance Note will serve, *inter alia*, to:
- a) facilitate greater use of credit ratings on *Takāful* and *ReTakāful* undertakings;
 - b) provide supervisory authorities with minimum standards and criteria for their recognition of ECAs;
 - c) foster convergence among supervisory authorities supervising *Takāful* and *ReTakāful* undertakings;
 - d) facilitate discussion on the appropriate role, if any, which ratings by ECAs on *Takāful* and *ReTakāful* undertakings might play as part of a wider supervisory process; and
 - e) promote further discussion about ECA methodologies and enhance the transparency of those methodologies.¹
10. The IFSB believes that guidance on the recognition of credit ratings by ECAs on *Takāful* and *ReTakāful* undertakings is particularly relevant at the present time. *Takāful* and *ReTakāful* undertakings have grown in number in recent years and account for an increasing percentage of gross contributions written in countries with large Muslim populations.
11. Despite this positive growth, insurance penetration in many Islamic countries is low when compared to rates seen elsewhere in the world. There are many reasons for this, and the result is that Muslims are not benefiting from the increased financial security which an efficient and well-regulated insurance market can offer.² The IFSB believes that increased rating coverage of *Takāful* and *ReTakāful* undertakings will contribute to the growth of the *Takāful* industry, and that this in turn will bring benefits to the Muslim community.
12. Although insurance supervisory authorities currently incorporate credit ratings into their regulatory processes to a more limited extent than bank supervisory authorities, there are already areas where ratings on insurance undertakings (both conventional and *Takāful*) play an important role in regulatory oversight. For example, some national supervisory authorities specify minimum ratings for re-insurance companies eligible to receive ceded risks from primary insurance companies. In this context, if insurance supervisory authorities are unable to recognise *ReTakāful* undertakings because they have not been rated, then the *Takāful* and *ReTakāful* industry will be at a disadvantage vis-à-vis the conventional insurance industry. As a result, the opportunities for participants to use and benefit from *Takāful* and *ReTakāful* services will be constrained.
13. Within the last few years, there has been increasing interest in the role which ECAs play in international financial markets as a whole. The influence which credit ratings exert on international financial markets was particularly evident during the recent financial crisis. This has resulted in an increasing trend for national supervisory authorities, together with supranational bodies that are concerned with broad financial market stability and regulation, to bring ECAs into a formal regulatory or legal framework or, where ECAs are already subject to regulation, to strengthen that regulatory oversight.³ As part of this increased regulatory oversight of ECAs, the

¹ The Guidance Note may also serve as a tool for *Takāful* and *ReTakāful* undertakings, either as they decide which ECA ratings to use as part of their routine credit risk assessment, or when making a decision on which ECA to approach for a rating on their own operations.

² Such benefits include the ability of individuals and corporations to protect their assets against loss. For individuals, insurance also offers the opportunity to save money for the future, while at the same time providing financial security to family and dependants.

³ For example, the European Union's "Regulation on Credit Rating Agencies" came into effect on 7 December 2009 requiring the registration and regulation of rating agencies operating in the Union.

IFSB expects that national supervisory authorities and supranational bodies will take an increasing interest in the quality of ratings assigned to *Takāful* and *ReTakāful* undertakings.

14. As the national supervisory authorities extend or enhance regulatory oversight over ECAs, they are also reconsidering the role of ECAs in the regulatory function itself.⁴ The IFSB hopes that this Guidance Note will assist national supervisory authorities to determine the roles (if any) of ECAs in their supervision of Islamic financial industries in general, and of *Takāful* and *ReTakāful* undertakings in particular. More importantly, the IFSB hopes that the analytic questions posed in Section 2.3 of this Guidance Note will provide a framework through which national supervisory authorities are able to assess the general analytic competence of ECAs in the field of *Takāful* and *ReTakāful*. With this framework in place, the national supervisory authorities will be better able to make informed decisions on the advisability of embedding ratings by recognised ECAs into certain regulatory functions.⁵
15. The IFSB recognises that a large amount of work is being undertaken by international bodies such as the Financial Stability Board and the International Organization of Securities Commissions (IOSCO) to determine recognition criteria for ECAs and the extent to which, if at all, ratings should continue to be used as part of the supervisory process. This Guidance Note focuses primarily on ways in which supervisory authorities can determine the analytical competence of ECAs which assign ratings to *Takāful* and *ReTakāful* undertakings, although it also addresses issues of analytic process. In the same way that the IFSB will continue to monitor the development of analytic issues related to ratings of *Takāful* and *ReTakāful* undertakings, it will also monitor the development of thinking on analytic process.
16. This Guidance Note does not attempt to prescribe a fixed rating methodology to be used by ECAs in their assessment of *Takāful* and *ReTakāful* undertakings, nor does the IFSB expect national supervisory authorities to prescribe such methodologies. However, in view of the speed with which the *Takāful* and *ReTakāful* industries are changing, national supervisory authorities may wish to specify a basic list of areas in which ECAs should demonstrate analytical awareness during the process of rating *Takāful* and *ReTakāful* undertakings.
17. It should be noted that although an ECAI may have demonstrated that it is competent to analyse conventional insurance and re-insurance companies, this does not imply that it is necessarily competent to analyse *Takāful* and *ReTakāful* undertakings.
18. It is assumed that ECAs seeking recognition will already have demonstrated experience of rating conventional insurance and re-insurance.
19. In the opinion of the IFSB, the particular analytical areas to be addressed when analysing *Takāful* and *ReTakāful* undertakings, as opposed to conventional insurance firms, include, *inter alia*, the following:
 - a) legal and corporate structure;
 - b) support mechanisms between the PRFs and the TO's shareholders' fund;
 - c) transferability between PRFs;
 - d) underwriting surpluses and capital levels;
 - e) priority of claims in the event of a winding up;
 - f) *Shari'ah* compliance;

⁴ To be clear, these are two separate concepts. The first refers to the oversight which regulators exercise over the operations of ECAs, whatever those operations may be. The second refers to the practice of regulators incorporating ratings into their own regulatory processes – in effect, to delegate to rating agencies part of their regulatory function. For example, if a regulator states that insurance companies may not invest in assets which are rated less than "A", the regulator has effectively delegated to the rating agency part of the task of monitoring the credit quality of insurance companies' asset portfolios.

⁵ An example of such a regulatory embedding might be a rule that only *ReTakāful* firms enjoying ratings above a certain level are eligible to receive ceded business, or that *Takāful* firms may only benefit from capital relief for ceded risks if those risks are placed with a *ReTakāful* firm rated above a certain level.

- g) corporate governance;
 - h) limitations on investment opportunities;
 - i) accounting conventions and financial reporting;
 - j) analytic considerations which refer in particular to *ReTakāful*;
 - k) analytic considerations related to *Sharī'ah*-compliant “windows” offering *Takāful* and *ReTakāful* services; and
 - l) analytic considerations which are common to *Sharī'ah*-compliant insurance and conventional insurance.
20. It should be noted that this list is not exhaustive, and that this Guidance Note does not include guidance on the relative weights that these factors should be given in reaching conclusions or ratings. Rather, this Guidance Note aims to provide guidance to national supervisory authorities which may be licensing ECAs and that intend to issue ratings on *Takāful* or *ReTakāful* undertakings, or which may be deciding the extent to which ECAs' ratings on *Takāful* or *ReTakāful* undertakings may be used as part of a regulatory function.⁶
21. This Guidance Note recognises that national supervisory authorities retain ultimate authority in determining recognition criteria and whether such criteria have been met. The Guidance Note also recognises that national supervisory authorities may wish to require more stringent recognition criteria than those outlined here, drawing either on more detailed regulations or on the particular circumstances in their countries.

⁶ As previously noted (footnote 1), the Guidance Note will also serve to help *Takāful* and *ReTakāful* undertakings in their dealings with ECAs.

SECTION 2: CRITERIA FOR THE RECOGNITION BY SUPERVISORY AUTHORITIES OF RATINGS BY ECAIs ON *TAKĀFUL* AND *RETAKĀFUL* UNDERTAKINGS

2.1 ECAIs SEEKING RECOGNITION SHOULD EXPLAIN WHAT THEIR RATINGS ARE INTENDED TO MEAN AND DISCLOSE THEIR RATING METHODOLOGIES

2.1.1 ECAIs Should Make Clear what their Ratings are Intended to Mean

22. It is expected that ECAIs will have different types of ratings on *Takāful* and *ReTakāful* undertakings, and that these different types of ratings will predict or describe different things. As such, the ratings will have different meanings. For example, one type of rating might predict the ability of a PRF to discharge its obligations to *Takāful* participants, while another type of rating might predict the ability of the undertaking as a whole (including the TO's shareholders' fund and the PRF) to discharge obligations to its creditors. A third type of rating might predict the ability of the TO to discharge its obligations to creditors, taking into account any explicit or implicit obligations which it may have to the PRF.
23. It is possible that a single *Takāful* or *ReTakāful* undertaking could simultaneously receive high ratings and low ratings. For example, a PRF may be deemed to have a low ability to discharge obligations to *Takāful* participants, while the TO may at the same time be deemed to have a high ability to provide financial support to that PRF.
24. Some ratings may be "sub-sets" of other ratings. (Or to look at it another way, some ratings may already have "sub-ratings" embedded in them.) For example, an ECAI might issue a specific "Corporate Governance Rating" on a TO; and it may be the case that corporate governance is one among many analytic factors which make up a credit rating. In such circumstances, the ECAI should explain how the two ratings interrelate. In this example, it would be helpful if the ECAI could explain whether it could ever be possible for an undertaking to receive a low corporate governance rating but a high credit rating; and, if so, to outline what conditions would typically lead to such an apparent contradiction.
25. Precisely because different levels of rating may be assigned simultaneously to single undertakings, it is important that ECAIs make reasonable efforts to ensure that different types of rating are clearly distinguishable from one another (for example, by a clearly different title) and that the meaning of each different type of rating is explained in language which can be easily understood by the users of the ratings.
26. The requirement for ECAIs to make reasonable efforts to explain the meaning of their ratings does not absolve the users of ratings from making their own efforts to properly understand what is meant by any ratings they use. It is the responsibility of the users of ratings to ensure that they have sufficient understanding of the meaning of ratings before they use them.
27. The need to define precisely what it is that different types of ratings are predicting or describing is particularly important in the Islamic financial industry. This is because the concept of "default" is more complex in the Islamic financial industry than in the conventional financial industry. This is most evident in the case of banks' profit-sharing investment accounts, where a failure to repay the principal sum invested does not normally constitute a breach of a bank's contractual obligation to the investor.⁷

⁷ In the GN-1, the IFSB distinguished, in the case of profit-sharing investment accounts, between a "soft default" (a failure to repay the sum invested) and a "hard default" (the failure to repay the sum due). If \$100 was invested, but the investment value fell to \$90, then the bank's contractual obligation is to repay \$90, not \$100. Failure to repay the \$100 is a soft default, while failure to repay the \$90 would be a hard default. See paragraphs 26 and 27 of GN-1.

ECAls seeking recognition should define what they mean by an event of default when assigning ratings which predict the likelihood of default.

2.1.2 ECAls Should Make their Rating Methodologies Publicly Available

28. ECAls seeking recognition should make all of their rating methodologies publicly available in a form which is easily accessible and free of charge. They should also publicly disclose, as promptly as possible, any material changes to their rating methodologies.

2.2 ECAls SEEKING RECOGNITION SHOULD PRODUCE RATINGS WHICH ARE ACCURATE

29. It is reasonable to suppose that national supervisory authorities will expect recognised ECAls to produce accurate ratings. An ECAI should therefore state publicly how the accuracy of its ratings should be assessed and then publish evidence as to whether its ratings have in fact been accurate.
30. Supervisory authorities may, at their discretion, choose to employ different criteria to those cited by an ECAI to define the concept of rating accuracy and to substantiate whether an ECAI's ratings have in fact been accurate.
31. Most ratings take the form of predictions. As such, they are nothing more, or less, than the opinion of the ECAI on an institution's (usually a legal entity's) ability to discharge its financial obligations. Such ratings always contain a prediction of the relative likelihood that a certain event will occur. As an example, a rating on Company X provides a prediction of whether Company X is more or less likely to discharge a given set of obligations as compared to Company Y over a specified time period, and in so doing it provides an input to the users of the ratings as they make their own judgment about those companies.
32. The accuracy of such ratings can easily be judged from historical data, provided that such data exist. Therefore, ECAls seeking recognition should have systems in place to capture relevant data as they become available. The data will show whether, in practice, the rating agencies' predictions were accurate – did companies which received higher ratings default less frequently than those receiving lower ratings?
33. Ratings by ECAls also contain, either explicitly or implicitly, a prediction of "absolute probability" of default, as opposed to "relative probability". That is to say, they predict how frequently a class of rated entities is likely to default over a given time period, as opposed to simply predicting that one class of rated entities will default more, or less, frequently than another class of rated entity.⁸
34. The IFSB recognises the limited data on defaults of *Takāful* and *ReTakāful* undertakings. It will therefore be a challenge, even for the most competent ECAls, to publish statistics which are robust enough to establish the accuracy of their ratings.
35. When sufficient data exist, ECAls should publish statistics on transition trends; that is to say, how frequently ratings change, and the direction and magnitude of those

⁸ An example of such an "absolute" prediction could be: "Entities rated 'A' have a 1% likelihood of defaulting within three years of the rating being issued." The Basel II Capital Accord, which allows banks to use ECAls' ratings as an input to calculating risk-based capital ratios, equates rating levels to default frequencies, so creating an absolute meaning for each rating level. ECAls' ratings are not incorporated in this way into international solvency accords for insurance operators, so no such internationally recognised meanings for insurance ratings exist. However, ECAls may choose to equate their own ratings to absolute probabilities of default (an "explicit" prediction). Even if they do not choose to do so, the default studies, which all the larger ECAls publish, provide indications of approximate levels of default likelihood attributable to those agencies' ratings (so providing an "implicit" prediction).

changes. In the absence of sufficient data, ECAs should provide some guidance on expected transition trends.⁹

- 36. All such data and guidance should be made publicly available, free of charge. It may be useful to note that large credit rating agencies publish studies of default trends.
- 37. If an ECA issues a rating that is based solely on information in the public domain, it should make this clear.¹⁰

2.3 ECAs SEEKING RECOGNITION SHOULD DEMONSTRATE ANALYTIC CLARITY AND COMPETENCE

- 38. ECAs seeking recognition should publish one or more rating methodologies explaining how they analyse *Takāful* and *ReTakāful* undertakings prior to assigning ratings.
- 39. These methodologies should demonstrate that the ECAs understand the specific characteristics of *Takāful* and *ReTakāful* undertakings.
- 40. ECAs should also demonstrate their understanding of the characteristics of underlying insurance businesses – whether *Takāful* or conventional. Examples of such characteristics include the actuarial valuation of long-term liabilities and assets, the calculation of solvency, and the strength of market share and product distribution strategies.
- 41. It is not the intention of the IFSB to recommend or prescribe a particular methodology or methodological tools. However, in view of the rapidly developing nature of the *Takāful* and *ReTakāful* industry, and the possibility that uncertainty and misunderstanding exist as to how *Takāful* and *ReTakāful* undertakings are permitted to operate under different national laws and *Shari'ah* law interpretations, as well as to how they are practised operationally, the IFSB believes that it is useful to specify some of the areas where an ECA should demonstrate analytic competence when seeking recognition from a national supervisory authority.
- 42. The analytic areas outlined below are not exhaustive. They are reflective of the current developments in the *Takāful* and *ReTakāful* industries. Since these industries are developing rapidly, new areas may need to be added in future and existing ones changed.
- 43. Many of the analytic issues outlined below are relevant to both *Takāful* and *ReTakāful* undertakings, but there are some issues of particular relevance to *ReTakāful*, and they are outlined in Section 2.3.10.
- 44. To demonstrate their analytic understanding of *Takāful* and *ReTakāful* undertakings, ECAs should be asked to incorporate comments on the following issues in their methodologies.¹¹

⁹ An example of “transition” data would be: “Entities rated ‘A’ have a 1% likelihood of being rated lower than ‘A’ within 12 months of a rating being assigned.”

¹⁰ ECA ratings are normally commissioned and paid for by the rated institution (ratee), and thus reflect information obtained from the ratee that is not in the public domain. Such ratings thus perform a function of information intermediation that is not performed by ratings based purely on public-domain information.

¹¹ The IFSB is aware that no simple answers to these questions exist, but in posing the questions, the IFSB (along with the national supervisory authorities) is trying to ascertain the ability of ECAs to address complex and shifting issues related to *Takāful* and *ReTakāful*, and to articulate a robust and defensible position.

2.3.1 Legal and Corporate Structure

According to the ECAI's rating methodology, how might the legal and corporate structure of a *Takāful* or *ReTakāful* undertaking affect the rating assigned to that undertaking or to component parts of that undertaking?

45. The legal and corporate structures for *Takāful* and *ReTakāful* undertakings are quite well established: a PRF is usually managed by a TO, which operates either as a *Wakīl* (agent) or a *Muḍārib* (entrepreneur).¹² Remuneration of a *Wakīl* is different from remuneration of a *Muḍārib*.¹³ This may have implications for the financial strength of both parties, and may also result in different incentives for the *Wakīl*/*Muḍārib*. This may, in turn, also affect the way in which both parties conduct their operations. ECAIs should state whether undertakings of one particular *Takāful* model are likely, other things being equal, to receive higher or lower ratings than undertakings using a different *Takāful* model.¹⁴
46. The PRF and the TO generally comprise components of a single legal entity. In such cases, an ECAI should make clear its understanding of how the relationships between the component parts are managed and governed, both on a “going-concern” basis and in an insolvency. If the PRF and the TO comprise different legal entities, an ECAI should make clear the legal entity to which its rating applies.
47. It should be noted that ownership rights in *Takāful* or *ReTakāful* undertakings differ in some important respects from those in conventional insurance undertakings. (For example, *Takāful* and *ReTakāful* undertakings typically accumulate PRFs, which belong to the participants and to no one else.) ECAIs seeking recognition should explain how such ownership rights may affect the creditworthiness of rated entities and demonstrate awareness of differences in ownership rights between *Takāful* and *ReTakāful* undertakings and conventional insurance companies.
48. ECAIs should also make clear whether they apply any rating “ceilings” or “floors” when rating different components of a corporate structure. For example, if an ECAI has a policy stating that a PRF may not be rated higher than its TO, or that a subsidiary may not be rated higher than its parent, then the ECAI should state its reasons for applying such rating “ceilings” or “floors”.

2.3.2 Support Mechanisms between the PRF and the TO's Shareholders' Fund

How could the existence (or non-existence) of an explicit or implicit agreement that, under certain circumstances, the TO will provide support to the PRF affect the ratings which the ECAI assigns to both PRFs and TOs?

49. In the event that a PRF suffers an underwriting deficiency which makes it probable that the undertaking will not be able to discharge its obligations to its participants, it is a common practice in the industry for the TO to extend a *Qard* to the PRF. There has been considerable discussion on this issue. ECAIs seeking recognition should not only demonstrate an understanding of such issues, and the potentially conflicting claims between regulators/national laws on one hand and *Shari'ah* compliance on the other; they should also explain the analytic process through which they will reach a decision on whether such support is likely to be forthcoming to the PRF and the assumptions that they have made in doing so.¹⁵

¹² This model is employed in some *Takāful* operations, but the *Shari'ah* Committee of the Islamic Development Bank (IDB) does not agree with the TO taking any percentage of an underwriting surplus in *Takāful* contribution, because an underwriting surplus is not a profit.

¹³ Strictly speaking, the *Muḍārib* is not “remunerated”. The *Muḍārib* receives a share of profits.

¹⁴ The *Wakālah* and *Muḍārabah* models are cited here by way of example. The IFSB recognises that other models exist.

¹⁵ It is worth noting that regulators may require the TO to provide support to its PRFs.

50. It should be noted that the point of time when *Qard* is appropriate is *ipso facto* a time when the PRF is in some form of distress. Hence, it is only reasonable to assume that the TO will be hesitant in such a situation to provide the *Qard*. The inter-reliant relationship between the TO and the PRF, the PRF's long-term prospects, and the strength of profits which the TO stands to earn from the PRF are all factors which ECAs should take into consideration in their ratings, with appropriate weighting.
51. As part of this analysis, ECAs should elaborate on how they will assess whether and to what extent the capital strength of the TO could be compromised if it extends a *Qard* to the PRF.

2.3.3 Transferability between PRFs

How might the ability, or inability, to transfer surpluses between various PRFs affect rating levels assigned to PRFs and TO?

52. "Transferability", in this context, refers to the possibility that surpluses on well-performing funds can be transferred to the less well-performing funds. ECAs seeking recognition should make clear in their methodologies whether ability to transfer within or between PRFs will affect the rating to be assigned to a particular undertaking, fund or product. In their reports on specific undertakings, ECAs should indicate the extent to which transferability was a factor in enabling that specific undertaking to reach its rating level.

2.3.4 Underwriting Surpluses and Capital Levels

How does the ECA evaluate underwriting surpluses and other reserves when assessing the capital adequacy of a Takāful or ReTakāful undertaking?

53. Attribution of surpluses and accumulated reserves may differ between *Takāful* undertakings and conventional insurance companies. For a conventional company, surpluses are generally attributable to the owners of the company (rather than policyholders) and may, subject to regulatory limitations, be appropriated by the owners.¹⁶ In contrast, surpluses accumulated within *Takāful* undertakings are retained in the PRF to strengthen capital funds or to be attributed in some other manner, such as by rebating contributions or donating to charity.¹⁷
54. In certain Family *Takāful* products, participants contribute both to a Participants' Investment Fund (PIF), in which the contributions belong to the individual members (like an individual savings account), and to PRF, in which the contributions are used to meet claims made by any of the participants. ECAs seeking recognition should provide details on how they assess the adequacy of the PRF to meet claims, as well as a Family *Takāful*'s capital adequacy, taking into account the different obligations of the PIF and the PRF.
55. Capital levels may also be affected by changes to regulations. For example, if a supervisory authority decides to impose more stringent reserving requirements against in-force business, a PRF's surplus could be depleted.
56. ECAs should explain their views on capital structures of *Takāful* and *ReTakāful* undertakings and the quality of different types of capital. Specifically, they should state whether, in their view, certain capital structures are likely, other things being

¹⁶ An exception is "participating business" under which part of the underwriting surplus is attributed to policyholders, rather than to the owners.

¹⁷ Note that some *Takāful* arrangements provide for the TO to receive part of the surplus as a reward for good performance.

equal, to be more conducive to higher or lower ratings; and whether they deem certain types of capital to have higher capacity to absorb losses than others.¹⁸

2.3.5 Priority of Claims in the Event of a Winding Up

What is the likely priority with which claims will be settled in the event of a Takāful or ReTakāful undertaking being wound up?

57. Under some national legal frameworks, the precise priority of claim on the winding up of a *Takāful* or *ReTakāful* undertaking is unclear because national insolvency law does not contemplate the *Takāful* model. It is accepted that an ECAI is not in a position to pronounce on the likely applicability of insolvency law to a *Takāful* or *ReTakāful* undertaking, where the law is not clear. An ECAI seeking recognition should nonetheless demonstrate an understanding of the factors which typically will come into play during a winding up, and explain how they will arrive at the assumptions on which their ratings are based where the resolution is not clearly provided for.

2.3.6 Shari`ah Compliance

How does the ECAI address the issue of Shari`ah compliance when analysing Takāful and ReTakāful undertakings?

58. ECAIs frequently assert that they do not assess the quality of a rated entity's *Shari`ah* compliance, since ECAI analysts are not *Shari`ah* scholars. However, ECAIs cannot be silent on the issue of *Shari`ah* compliance since there are several ways in which the nature of an undertaking's *Shari`ah* compliance may contribute to the level of rating assigned. It is important to set out what aspects of *Shari`ah* compliance ECAIs should be expected to take into account when assigning ratings to *Takāful* and *ReTakāful* undertakings. To avoid any doubt, this Guidance Note does not suggest that rating analysts should express an opinion on whether products or practices are *Shari`ah* compliant or not.
59. It is reasonable to suppose that an ECAI would consider relevant to its rating analysis a statement by an undertaking's *Shari`ah* board that the undertaking had not complied with the *Shari`ah* during the previous year.¹⁹ From that, it is reasonable to suppose that an ECAI would want to take a view on whether the *Shari`ah* board might make such a statement of non-compliance at some point in the future. ECAIs seeking recognition should therefore state how they assess the *Shari`ah* governance structure of an undertaking, as a way of assessing the likelihood that the undertaking will remain *Shari`ah* compliant in future. ECAIs may wish to refer to the IFSB's "Guiding Principles on Shari`ah Governance Systems for Institutions Offering Islamic Financial Services" (IFSB-10), which was published in December 2009, when drawing up their rating methodologies on this issue.
60. Furthermore, ECAIs seeking recognition should show that they are aware of underlying trends in *Shari`ah* scholarship and new decisions as they apply to *Takāful* and *ReTakāful* undertakings. This is particularly important at a time when there is great interest in the *Takāful* and *ReTakāful* sectors and they are growing rapidly. For example, due to the lack of *ReTakāful* capacity, some *Shari`ah* scholars have permitted *Takāful* undertakings to re-insure some of their risks with conventional re-insurers, provided that the *Shari`ah* requirements related to re-insuring with conventional re-insurers are adhered to. If, at some point in the future, *Shari`ah* scholars were to withdraw that permission, *Takāful* undertakings might have to

¹⁸ In December 2010, the IFSB issued a Standard on "Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings". ECAIs may find it useful to consult this Standard when preparing their rating methodologies on *Takāful* undertakings.

¹⁹ Such a statement could lead to customers withdrawing their business from the undertaking, with the result that the undertaking's revenues fall. In consequence, its ability to discharge its financial obligations might be weakened.

re-insure risk with *ReTakāful* undertakings that are less financially strong, or simply forgo re-insurance altogether. That might have negative implications for the rating of the *Takāful* undertaking. This hypothetical example illustrates the need for ECAs to be aware of potential changes in *Sharī'ah* approaches.

2.3.7 Corporate Governance

How does the ECAI analyse the quality of corporate governance in Takāful and ReTakāful undertakings, and what role does this analysis play in the overall credit rating being assigned?

61. The quality of corporate governance is a particularly important issue for both *Takāful* and conventional insurance. The insurance industry reverses the normal production cycle by taking payment upfront for a service which may, or may not, be provided in future, depending on whether certain pre-defined events occur. As a result, customers are exposed to their insurance provider from the moment they enter into a contract. (In contrast, a more normal production cycle entails a company producing a product which it may or may not be able to sell to a customer. In that circumstance, it is the company which is exposed to its (potential) customer.)
62. In December 2009, the IFSB published a Standard entitled "Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings" (IFSB-8). The Standard notes, *inter alia*, that the sharing of risks among *Takāful* participants, rather than the transfer of risks from the participants to the TO, creates contractual relationships within *Takāful* undertakings which are different from those in conventional institutions. Paragraph 18 of the Standard concludes that "fiduciary relationships between the [TO] and *Takāful* participants differ substantially from those in conventional proprietary insurance".
63. The Standard notes a number of other areas where the relationships between participants of the PRF and the TO, and relationships between the participants themselves, may differ from those seen in conventional insurance companies. (Paragraphs 55, 56 and 83 of "Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings" (IFSB-11) illustrate this.²⁰)
64. ECAs seeking recognition should explain how they take account of different stakeholders in *Takāful* and *ReTakāful* undertakings, and how they assess the framework of systems and controls that such undertakings establish to manage conflicts and risks of non-compliance with regulations and the *Sharī'ah* on this subject.

2.3.8 Limitations on Investment Opportunities

How, if at all, does the requirement for Takāful and ReTakāful undertakings to invest only in Sharī'ah-compliant instruments act as a constraint on rating levels assigned to such undertakings? Similarly, how does the ECAI assess the quality of the Sharī'ah-compliant instruments in which undertakings do invest?

65. *Takāful* and *ReTakāful* undertakings may only invest in assets which do not violate the principles of the *Sharī'ah*. Examples of such forbidden investments include interest-bearing bonds, shares in companies which manufacture alcoholic drinks, or shares in companies which are highly leveraged and so are heavily involved in the paying or receiving of interest. These restrictions limit the range of investment options for *Takāful* and *ReTakāful* undertakings, as compared to the range of options available to conventional insurance firms. ECAs seeking recognition should demonstrate that they understand the restrictions to which Islamic financial institutions are subject. They should state in their rating methodologies what the

²⁰ However, one should note that some conventional insurance models, such as mutual insurers or participating life insurers, contain many of the same relationship structures as *Sharī'ah*-compliant insurance.

rating implications of such restrictions are likely to be in general, and in reports on specific undertakings they should state how a specific undertaking's ratings have been affected, if at all, by these restrictions.²¹

66. ECAs seeking recognition should also demonstrate that they understand the nature and risks associated with the *Shari`ah*-compliant instruments in which *Takāful* and *ReTakāful* undertakings do invest. For example, a conventional insurer may invest in a portfolio of bonds, and a *Takāful* undertaking may invest in a portfolio of *Sukūk*, but the performance and liquidity of *Sukūk* may be different from (either better or worse than) those of bonds (or it could be the same). Such performance of an undertaking's investments could have a significant impact on its solvency and profitability.

2.3.9 Accounting Conventions and Financial Reporting

How does the ECAI incorporate different accounting conventions and financial reporting systems into its analysis of an undertaking's financial condition?

67. In view of the long-term nature of insurance liabilities, and the resulting long-term nature of some of their assets, the method used to measure revenues and the value of balance sheet items assumes particular importance for all insurance firms. ECAs seeking recognition should make clear, with reference to accounting processes and statutory reporting requirements (including those set by supervisory authorities and other standard setters), how they measure assets, liabilities and exposures when arriving at rating decisions, and how the features of *Shari`ah*-compliant financial instruments are accommodated within that measurement framework. They should also disclose any adjustments which they routinely make to an undertaking's published accounts when making their own calculations of its financial condition.²²

2.3.10 Analytic Considerations which Refer in Particular to *ReTakāful*

68. The issue of credit ratings is particularly important to *ReTakāful*, since by re-insuring its liability with another firm, an insurance company is effectively exchanging insurance risk on its own books for the credit risk of the re-insurance company. National supervisory authorities sometimes set minimum credit ratings which re-insurance firms must have if they are to receive ceded risk from insurance firms, or if insurance firms are to receive regulatory capital relief for re-insured risks. Lack of rating coverage on *ReTakāful* undertakings may therefore impede the ability of *Takāful* undertakings to cede risk, which in turn impedes their ability to actively manage their risk portfolio and to expand their business. Ratings which are assigned, but assigned at a very low rating grade, may have a similar effect.

2.3.10.1 Credit risk of *ReTakāful* undertakings

How does the ECAI assess the impact on a *Takāful* undertaking's rating of re-insuring *Takāful* risk with a *ReTakāful* undertaking?

69. In many cases, ECAs will not be able to use credit ratings on a *ReTakāful* undertaking as an input to their analysis of the risk profile of a PRF. In such circumstances, ECAs should explain how they assess the credit quality of the *ReTakāful* undertaking which has assumed risk from the *Takāful* undertaking, and consequently how they assess the value to the *Takāful* undertaking of ceding that risk.

²¹ Examples of ways in which such investment limitations may impact a *Takāful* undertaking include: the undertaking may be tempted to invest in riskier assets; it may invest in low-yielding assets; the concentration of its investments may be greater; and it may hold large amounts of illiquid assets. Although it may seem obvious that such restrictions would have negative rating implications (as a result of less diversification and less liquidity), they might also have some positive aspects – avoiding highly leveraged companies can sometimes be beneficial.

²² For example, if undertakings in a particular jurisdiction conventionally classify a particular type of liability as "long-term", but the ECAI considers that such liabilities are short-term, the ECAI should disclose this fact, assuming that such differences are material.

70. ECAIs should disclose any policies or practices regarding the use of other ECAIs' ratings in their own assessments and, in particular, any policies or practices related to the use of local rating agencies which are unaffiliated with the larger international agencies.²³

2.3.10.2 Sharī'ah admissibility of different types of re-insurance

How, if at all, does the possibility that opinions may change on the permissibility of different types of re-insurance affect the ratings assigned both to Takāful and ReTakāful undertakings?

71. It is widely accepted that proportional re-insurance can be written in conformity with the *Sharī'ah*, while non-proportional insurance may not. Proportional insurance generally takes the form either of "quota share" or "surplus relief", and in both cases the primary insurer has a claim on the re-insurance firm for re-imbursement of the entire loss of a proportion of a portfolio. In contrast, non-proportional re-insurance entails the primary insurer meeting claims on a portfolio (or on a specific risk) up to a certain amount, after which the primary insurer has a claim for re-imbursement on the re-insurer. (Catastrophic risk insurance is one form of non-proportional re-insurance.) ECAIs seeking recognition should explain how the unwillingness of a *Takāful* undertaking to engage in certain types of re-insurance may affect the ratings which it assigns to that undertaking, and how a propensity by a *ReTakāful* undertaking towards one type of re-insurance rather than another may affect the ratings assigned to that *ReTakāful* undertaking.
72. In view of the limited capacity of the *ReTakāful* business, some *Sharī'ah* scholars have permitted *Takāful* undertakings to re-insure a proportion of their business with conventional insurers, provided that *Sharī'ah* requirements are maintained. ECAIs seeking recognition should demonstrate awareness of conditions under which such re-insurance with conventional firms is generally permitted in the jurisdictions where they are assigning ratings, and any trends in *Sharī'ah* scholarly thinking which may alter the ability of *Takāful* undertakings which they rate to use conventional re-insurance and remain *Sharī'ah* compliant.

2.3.10.3 Limitations on types of re-insurance business written

How might the limitations on the types of business which ReTakāful undertakings may accept affect (if at all) the ability of those undertakings to achieve the same rating levels as conventional re-insurance firms?

73. *ReTakāful* undertakings may have a narrower business mix than conventional re-insurance firms as a result of the restrictions on the types of business which they may write, as outlined above. Narrower franchises are typically seen by ECAIs as a negative factor for a rating, although an inability to write catastrophic risk insurance may at times lead to *ReTakāful* undertakings suffering lower claims levels than their conventional peers. ECAIs seeking recognition should explain how these factors are incorporated into their rating analysis.
74. ECAIs should also demonstrate awareness of *Sharī'ah* scholarly opinions on the admissibility of "retrocession".²⁴

²³ When assigning ratings to pools of individual assets, ECAIs sometimes use ratings assigned by other firms on those individual assets as part of their analysis of the pool as a whole. When doing this, ECAIs sometimes equate the other company's rating to a lower rating on their own scale. (For example, ECAI X might say that a rating of A1 by ECAI Y is equivalent to a rating of A2 by its own analytic team.) This practice is known as "notching". It would, of course, be quite unreasonable to require an ECAI to accept without question the ratings of other firms, but it is entirely reasonable to require ECAIs to disclose any such notching practices as part of the general explanation of their rating methodology.

²⁴ When a re-insurance company re-insures some of its own business, this is known as "retrocession".

2.3.11 Analytic Considerations Related to *Sharī`ah*-Compliant “Windows” Offering *Takāful* and *ReTakāful* Services

75. Some conventional financial institutions offer *Sharī`ah*-compliant financial services as part of a broader product offering which includes conventional financial services. Such *Sharī`ah*-compliant offerings are often referred to as “windows”, and they have been recognised as acceptable by *Sharī`ah* boards, provided that certain conditions are met; for example, procedures must be in place to prevent commingling of *Sharī`ah*-compliant and conventional funds.
76. ECAs seeking recognition, and who aspire to assign ratings to *Takāful* and *ReTakāful* undertakings which operate as “windows”, should make explicit reference in their methodologies to how they will rate such entities, explaining in particular how the credit rating assigned to the *Takāful* undertaking is likely to relate to the credit rating of the parent entity. When assigning ratings, they should clearly explain how they believe arrangements for provision of *Qard* to the PRF would work, and how this affects the ratings assigned.

2.3.12 Analytic Considerations which are Common to *Sharī`ah*-Compliant Insurance and Conventional Insurance

77. There are many aspects of ECAI rating analysis which are common to both *Takāful* undertakings and conventional companies. Examples include: the predictability of the legal environment in which the firm operates, and the ability to enforce contracts; the competitive environment in which the firm operates; and the quality of the firm’s product distribution capability. There are also some financial ratios which can be used for both types of firm.
78. ECAs seeking recognition should demonstrate broad competence to analyse the insurance business and the firms which operate in it. Information on how ECAs analyse conventional insurance companies may be incorporated by reference to existing rating methodologies for conventional insurance firms, but ECAs should also show that their approach to analysing *Takāful* and *ReTakāful* undertakings is holistic and coherent – that is to say, that the analysis of *Takāful* and *ReTakāful* undertakings does not entail simply adding a discrete layer of *Sharī`ah*-related analysis on to a conventional rating methodology.
79. In recent years, some ECAs have made more explicit the quantitative factors which they use in their rating analysis. For example, some ECAs have begun using scorecards to calculate a preliminary or underlying rating level, on top of which qualitative factors are added to arrive at the final rating. When ECAs use scorecards, or similar tools of quantitative analysis, they should ensure that such scorecards and tools reflect the characteristics of *Sharī`ah*-compliant financing.

2.4 ECAs SEEKING RECOGNITION SHOULD HAVE RATING PROCESSES WHICH ARE ROBUST AND INDEPENDENT

80. The preceding sections referred to issues of disclosure, accuracy, and analytic clarity and competence. This section refers to the internal processes by which ratings are produced.
81. ECAs seeking recognition should have rating processes that are robust and independent. By way of example, ECAs should have defined processes, which are consistently applied, for making rating judgments; rating judgments should be based on the ECAs’ published methodologies; rating analysts should be held to high standards of integrity, and their pay should not be linked to fees which are received from companies they rate; ECAs should have procedures for protecting the confidential nature of information which rated entities disclose to them; and ECAs

should have procedures in place to ensure that an internal review of ratings is conducted at least annually.

82. Considerable work has been done in this field by international bodies and this work has intensified as a result of the recent global financial crisis. In particular, the International Organization of Securities Commissions published a "Statement of Principles Regarding the Activities of Credit Rating Agencies" in September 2003, and in May 2008 it published an updated version entitled, "Code of Conduct Fundamentals for Credit Rating Agencies". In May 2010, IOSCO published a consultation document regarding regulatory implementation of its Code of Conduct, and further work is being undertaken by a newly created standing committee charged with addressing issues related to rating agencies.
83. IOSCO's Code, and its broader work on rating agencies, is designed to guide the work of national supervisors and, through them, the work of the credit rating agencies themselves, and to be applicable in all types of regulatory environments and to credit rating agencies of different sizes and with different business models.²⁵
84. The IOSCO Code is designed to be incorporated by individual ECAs into their own codes of conduct. The Code also recommends that ECAs' own codes should be published, so that anyone can assess whether an ECA's own code does indeed conform to the IOSCO Code.²⁶
85. The IFSB believes that the IOSCO Revised Code is a good basis upon which national supervisory authorities can appraise the internal processes of ECAs seeking recognition for their ratings on *Takāful* and *ReTakāful* undertakings. The IFSB notes that the IOSCO Code focuses on the following four issues: the quality and integrity of the rating process; independence and conflicts of interest; transparency and timeliness of ratings disclosure; and the use of confidential information.
86. ECAs seeking recognition should state whether their codes of conduct conform to the IOSCO Revised Code, and provide explanations for any areas of the Code with which they do not conform. They should also provide evidence that their practices do in fact comply with their codes of conduct.

2.5 ECAs SEEKING RECOGNITION SHOULD HAVE SOUND RESOURCES AND FINANCIAL CONDITION

87. ECAs seeking recognition should show that they have sufficient resources to conduct high-quality analysis both when assigning ratings for the first time and when maintaining ratings after they have been assigned. ECAs should also describe their ongoing training programs, specifically as they relate to ensuring that analysts engaged in rating *Takāful* and *ReTakāful* undertakings have appropriate understanding of issues related to these types of entities.
88. ECAs should show that they have information technology systems capable of collecting and analysing data related to the accuracy of their ratings. Such data would include, for example, statistics on default frequency and rating transitions.
89. ECAs seeking recognition should be able to make a credible case that they will have the financial resources to remain in business over the time horizon of their ratings.

²⁵ It should be noted that IOSCO is not a regulator. It sets standards which national supervisory authorities may choose to incorporate into their own regulatory regimes.

²⁶ The IOSCO Code and Revised Code are presented on a "comply or explain" basis. That is to say, ECAs should either comply with the Code or provide an explanation of why they do not. The option to "explain" is one way of increasing the flexibility of the Code, since if an ECA does not comply with a particular aspect because it is not relevant to its individual circumstances or is impracticable to apply, then it has the option to provide an explanation.

DEFINITIONS

The following definitions are a general understanding of the terms used in this document. It is by no means an exhaustive list.

<i>Muḍārabah</i>	A contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib</i> 's misconduct, negligence or breach of contracted terms.
Participants' Investment Fund (PIF)	A fund to which a portion of contributions paid by <i>Takāful</i> participants is allocated for the purpose of investment and/or savings.
Participants' Risk Fund (PRF)	A fund to which a portion of contributions paid by <i>Takāful</i> participants is allocated for the purpose of meeting claims by <i>Takāful</i> participants on the basis of mutual assistance or protection.
<i>Qarḍ</i>	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period.
Shareholders' fund	The part of the assets and liabilities of a <i>Takāful</i> Operator that is not attributable to participants in the form of a participants' risk fund or participants' investment fund.
<i>Takāful</i>	<i>Takāful</i> is derived from an Arabic word which means "solidarity", whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as <i>Tabarru'</i> commitment into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
<i>Takāful</i> operator (TO)	Any establishment or entity that manages a <i>Takāful</i> business.
<i>Takāful</i> participant	A party that participates in the <i>Takāful</i> product with the <i>Takāful</i> operator and has the right to benefit under a <i>Takāful</i> contract (similar to a "policyholder" in conventional insurance).
<i>Takāful</i> undertakings	A hybrid structure comprising a <i>Takāful</i> operator and one or more underwriting funds (participants' risk funds) that are attributable to the <i>Takāful</i> participants.
Technical provisions	The value set aside to cover expected obligations arising on <i>Takāful</i> contracts. For solvency purposes, technical provisions comprise two components, namely the current central best estimate of the costs of meeting the <i>Takāful</i> underwriting obligations, discounted to the net present value (current estimate), and a margin for risk over the current estimate.
Underwriting	The process of evaluating new applications, carried out by a <i>Takāful</i> operator on behalf of the <i>Takāful</i> participants based on an established set of guidelines to determine the risk associated with an applicant. The <i>Takāful</i> operator could accept the application, or assign the appropriate rating class, or decline the application for a <i>Takāful</i> contract.
Underwriting surplus or deficit	The participants' risk fund's financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contribution income and adding the investment returns (income and gains on investment assets).
<i>Wakālah</i>	An agency contract where the <i>Takāful</i> participants (as principal) appoint the <i>Takāful</i> operator (as agent) to carry out the underwriting and investment activities of the participants' risk fund on their behalf.