Sukuk Rating Methodology

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1 Introduction

1.1 Islamic Finance Overview

Islamic finance is a financial system that operates in accordance with the principles of Islamic law, or Shari'ah. The main principles of Islamic finance are based on the prohibition of interest (riba), prohibition of excessive uncertainty (Gharar), encouraging the use of the sharing of risk and profit instruments, and the avoidance of investments in businesses that are considered haram (forbidden), such as those involved in alcohol, gambling, or pork.

In Islamic finance, transactions must be based on real economic activities, and financial products must be structured in a way that complies with Shari'ah principles. Islamic finance seeks to promote a more equitable and ethical financial system that is rooted in the principles of justice, fairness, and transparency.

Islamic finance is made up of the following components: Islamic banking, Islamic microfinance, Islamic insurance (Takaful), Islamic capital markets products such as Sukuk (Islamic bonds), Islamic collective investment schemes (iCIS), and Islamic real estate in trust (iREITs).

Islamic finance products are simply Shari'ah transactional contracts and some of the most common Islamic financial products include Murabaha (cost-plus profit financing), Musharakah (joint venture or partnership financing), and Ijarah (lease) financing.

Islamic finance principles include:

- **Prohibition of Interest (Riba):** Islamic finance prohibits the charging or paying of interest (riba) on loans, as it is considered to be exploitative and unfair. Instead, the lender and the borrower agree on a predetermined profit margin to be applied to the loan amount.
- **Risk-Sharing (Mudarabah):** In Islamic finance, profits and losses are shared between the parties involved in a business venture. This encourages investors to carefully evaluate their investments and promotes a more equitable distribution of risk.
- **Prohibition of Uncertainty (Gharar):** Islamic finance also prohibits transactions that involve excessive risk or uncertainty. Contracts must be clear and transparent, and all parties must be aware of the risks involved.
- **Asset-Backed Financing:** Islamic finance requires some financing to be backed by tangible assets. This ensures that investments are made in real, productive enterprises and not just in speculative ventures.
- **Ethical Investment:** Islamic finance promotes ethical and socially responsible investment, avoiding businesses that engage in activities that are considered to be harmful to society or the environment.

- **Profit-and-Loss Sharing (Musharakah):** This principle involves two or more parties sharing the profits and losses of a venture. The parties contribute capital, and each party is rewarded based on their contribution.
- **Prohibition of Speculation (Gambling/Maisir):** Islamic finance also prohibits speculative transactions, such as gambling or betting, as these are considered to be based on chance and involve uncertainty.
- **Prohibition of Impermissible Goods and Services (Muharramaat):** This includes alcohol, pork, and animal meat from slaughter methods that are inconsistent with the rules of ethics prescribed by Shari'ah.

2 Sukuk Bonds

A Sukuk bond is a financial instrument that follows Islamic finance principles. It is a type of bond that allows investors to earn a return on their investment without going against Islamic prohibitions on interest (riba) and other forbidden activities.

Sukuk is a Latinised Arabic word in plural form, with the singular being **Sakk** meaning a financial certificate. The first time Sukuk was used was in the 1st century Hijri. In the 7th century Hijri, under the Umayyad dynasty, the government issued Sukuk (commodity coupons) to soldiers and public servants, calling those **Sukuk Al Badal**. Imam Malik[1], a renowned Islamic scholar, also cited accounts of Sukuk in his book Muwatta.

Sukuk bonds are structured as ownership stakes in tangible assets such as real estate or infrastructure, rather than as debt. The issuer of a Sukuk bond sells a certificate to investors, who become owners of a share in the underlying asset. The issuer agrees to pay the investors a return on their investment based on the income generated by the underlying asset or other existing Sukuk underlying assets. At maturity, the issuer repurchases the Sukuk certificates at their face value.

The AAOIFI[2] issued standards for various types of Sukuk, classifying some as tradable and others as non-tradable, equity-based, debt-based or lease-based on the type and characteristics of the issued Sukuk. There are also other diversified and mixed-asset Sukuk, such as hybrid Sukuk, where the underlying pool of assets can comprise Murabahah, Ijarah, and Istisna'a. In any Sukuk transaction, the issuance of Sukuk certificates will raise a cash amount required by a Sukuk Originator. The issuance itself will not entitle investors to a

[1] Malik ibn Anas, whose full name is Mālik bin Anas bin Mālik bin Abī ʿĀmir bin ʿAmr bin Al-Ḥārith bin Ghaymān bin Khuthayn bin ʿAmr bin Al-Ḥārith al-Aṣbaḥī al-Ḥumyarī al-Madanī, reverently known as al-Imām Mālik by Sunni Muslims, was an Arab Muslim jurist, Theologian, and Hadith traditionist.

[2] AAOIFI: The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1991 and based in Bahrain, is a not-for-profit organisation established to maintain and promote Shari'ah standards for Islamic financial institutions, participants, and the overall industry.

return on their investment and, therefore, must be supplemented with another Islamic financing structure.

2.1 Ijarah Sukuk

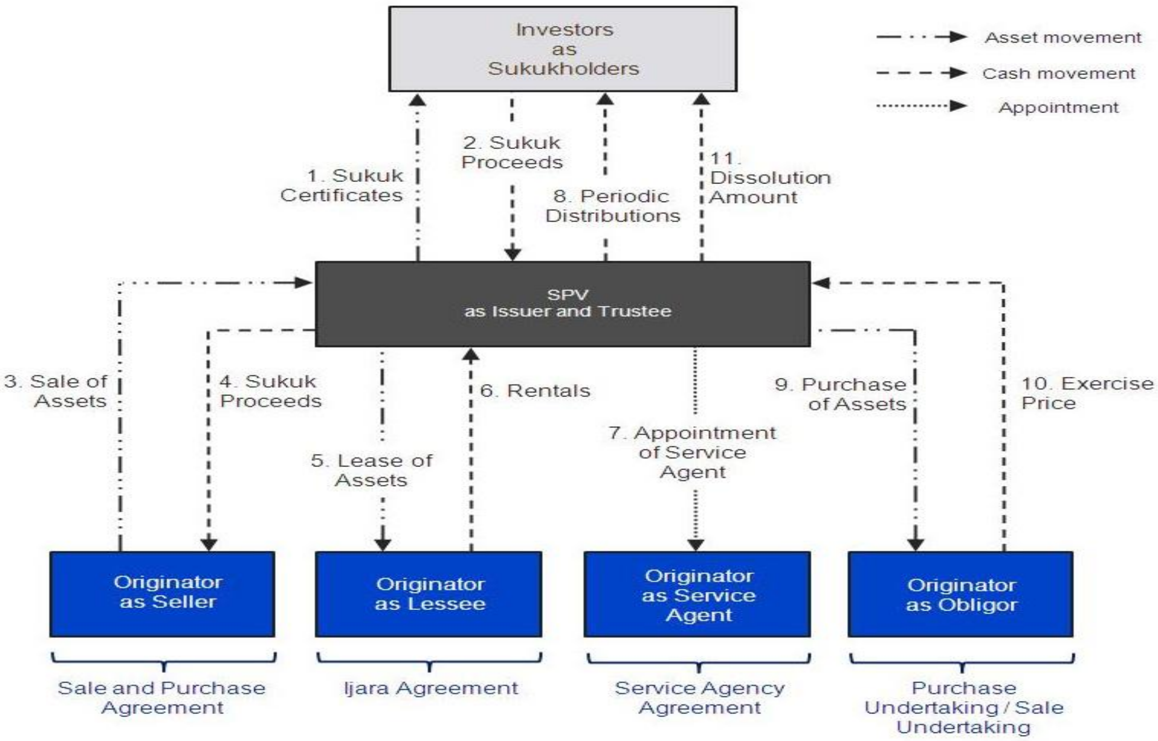
This structure involves the issuer leasing an asset to the Sukuk Originator and issuing Sukuk certificates (Ijarah Sukuk) to Sukuk holders, who then are entitled to receive periodic rental payments. The Sukuk Originator has the option to repurchase the asset(s) backing the Sukuk at a predetermined price at the end of the lease term.

Ijarah Sukuk is a hybrid of an operational lease and a finance/capital lease, with certain 'ownership' risks such as the obligation to undertake capital maintenance of the leased asset and the obligation to insure the asset (where possible via Islamic insurance – Takaful), remaining with the lessor (the Sukuk Issuer). The lessor may appoint an agent, usually the Originator (as lessee) itself, to carry out these duties on its behalf under a servicing agency agreement.

In a simple Ijarah Sukuk, the Originator or a third party connected to the Originator will sell certain physical assets to a Special Purpose Vehicle (SPV). The SPV will finance this acquisition with cash raised by issuing Sukuk certificates. The SPV will then lease the same physical asset to a third party, often the Originator itself. The lease rental payments will 'mirror' the coupon payments due under the Sukuk certificates, and the cash flow from the lease rentals will be used to service those coupon payments.

Holders of Ijarah Sukuk have the right to own equal shares of contractual ownership in a rented real estate or the usufruct of the real estate, receive the rent, and trade their Sukuk in the secondary markets. In exchange, they bear all the costs of maintenance and damage to the real estate. The rental rates of return on those Sukuk can be fixed or floating depending on the agreement, and it does not need to be linked to the period of taking usufruct by the lessee. The Sukuk certificates are tradable in the secondary markets.

Figure 2: The figure below illustrates the structure of an Ijarah Sukuk Structure[3]:



2.2 Mudarabah Sukuk

This structure is a joint venture between the Sukuk holders (as capital financiers-Arbaabul Maal) and the Sukuk Issuer (Mudarrib) in which the Sukuk Issuer entity (SPV) acts as an active partner while the Sukuk holders are silent partners in the venture. The SPV is responsible for managing the underlying Mudarabah assets. The profits generated are shared between the two parties according to a predetermined profit-sharing ratio (PSR).

Mudarabah Sukuk are investment Sukuk that represent common ownership of units of equal value in the Mudarabah equity; the Sukuk holders in Mudarabah Sukuk, as the suppliers of capital, own shares in the Mudarabah equity and its returns according to the percentage of ownership share. Mudarabah Sukuk holders have the right to transfer the ownership by selling the deeds in the securities market. Mudarabah Sukuk should not contain a guarantee on returns from the Issuer or the manager for the fund, from the capital or a fixed profit, or a profit based on any percentage of the capital.

[3] Source: http://www.financialislam.com/Sukuk-structures.html#:~:text=Ijarah%20Sukuk%20is%20a%20hybrid%20between%20an%20operational,to%20insure%20the%20asset%2C%20remaining%20with%20the%20lessor.

2.3 Murabaha Sukuk

In the case of Murabahah Sukuk, the Sukuk investors are the sellers of the Murabahah commodity, the Sukuk Issuer (SPV) is the buyer of the Murabahah commodity. The buyer buys the assets/commodity with a profit mark-up and payment is deferred. At maturity, they are entitled to its final sale price upon the re-sale of the commodity. Murabahah Sukuk is a debt-based Sukuk hence it cannot be legally traded at the secondary market, as the certificates represent a debt owing from the subsequent buyer of the commodity to the Sukuk holders and such trading in debt on a deferred basis is not permitted by Shari'ah.

The issuer purchases an asset (on behalf of the Sukuk holders) and sells it to the Sukuk Originator at an agreed amount made up of the principal price plus a profit margin, with payment deferred to a later date. The Sukuk holders receive a profit on the deferred payment amount. The seller must be in actual or constructive ownership of the commodity in question and the subject matter must be physical items and commodities, such as a mortgage(s) or a commodity Murabahah.

The price must be predetermined (by lump sum/percentage). Determining the payments and due date is necessary if the purchase is to be postponed rather than paid upfront. If the price is fixed, it cannot be increased in the event of default and cannot be dropped in the event of an earlier payment. Price fluctuation is not permitted. However, it is acceptable to employ benchmarks at the time of the financing agreement.

Since this Sukuk is not tradable in the secondary market, it is not commonly used by non-governmental Sukuk Issuers as investors would prefer to sell their Sukuk certificates any time they feel or need to do so.

2.4 Musharakah Sukuk

In this structure, the investors participate in a joint venture or partnership with the issuer, with each party contributing capital and sharing profits or losses. The Sukuk holders receive a portion of the profits generated by the underlying assets.

Musharakah Sukuk are investment Sukuk that represent ownership of Musharakah equity. It does not differ much from the Mudarabah Sukuk except in the organisation of the relationship between the party issuing such Sukuk and Sukuk holders, whereby the party issuing Sukuk forms a committee from the holders of the Sukuk who can be referred to for investment decisions (the Sukuk delegates).

Musharakah Sukuk is ideal for borrowing to finance large commercial ventures, such as factory expansion or construction projects. A Special Purpose Vehicle (SPV) can purchase, commission or construct Musharakah assets owned, or to be bought or constructed, by the issuing entity.

The SPV pays cash towards the capital of the Musharakah and then leases the underlying Musharakah assets to the Originator for a period equal to the maturity of the Sukuk, at agreed regular fixed or floating rentals.

Normally, the Sukuk Originator issues a promise to pay for Musharakah units from the SPV at an agreed price upon default or maturity. Musharakah Sukuk can be treated as negotiable instruments and can be bought and sold in the secondary market.

However, in 2008, AAOIFI issued a statement criticising the use of fixed-price purchase undertakings to guarantee returns in Mudarabah and Musharakah structures. AAOIFI stated that these structures are intended to be similar to equity-based instruments and therefore any returns to the investors cannot be fixed at the outset – the investors must share any losses arising out of the Sukuk assets. Subsequently, this led to a significant decline in Musharakah and Mudarabah-based Sukuk issuances as investors in the market were not prepared to invest in instruments that exposed them to risks that are not normally associated with debt-based instruments. As a consequence, since 2008, the Ijarah Sukuk structure has become the predominant structure, with other structures, such as Wakalah Sukuk, also being increasingly utilised.

2.5 Wakala Sukuk

This structure involves the issuer appointing the Originator as an agent to manage the underlying assets on behalf of the Sukuk holders. The agent charges a fee for their services, which is deducted from the profits generated.

In a special Wakala Sukuk, an Islamic financial institution can package its Ijarah contracts, Murabahah receivables, and any shares or Sukuk certificates held by it into a portfolio, which is then sold to the investors. The income derived from the portfolio is used to service the coupon payments due under the Sukuk certificates.

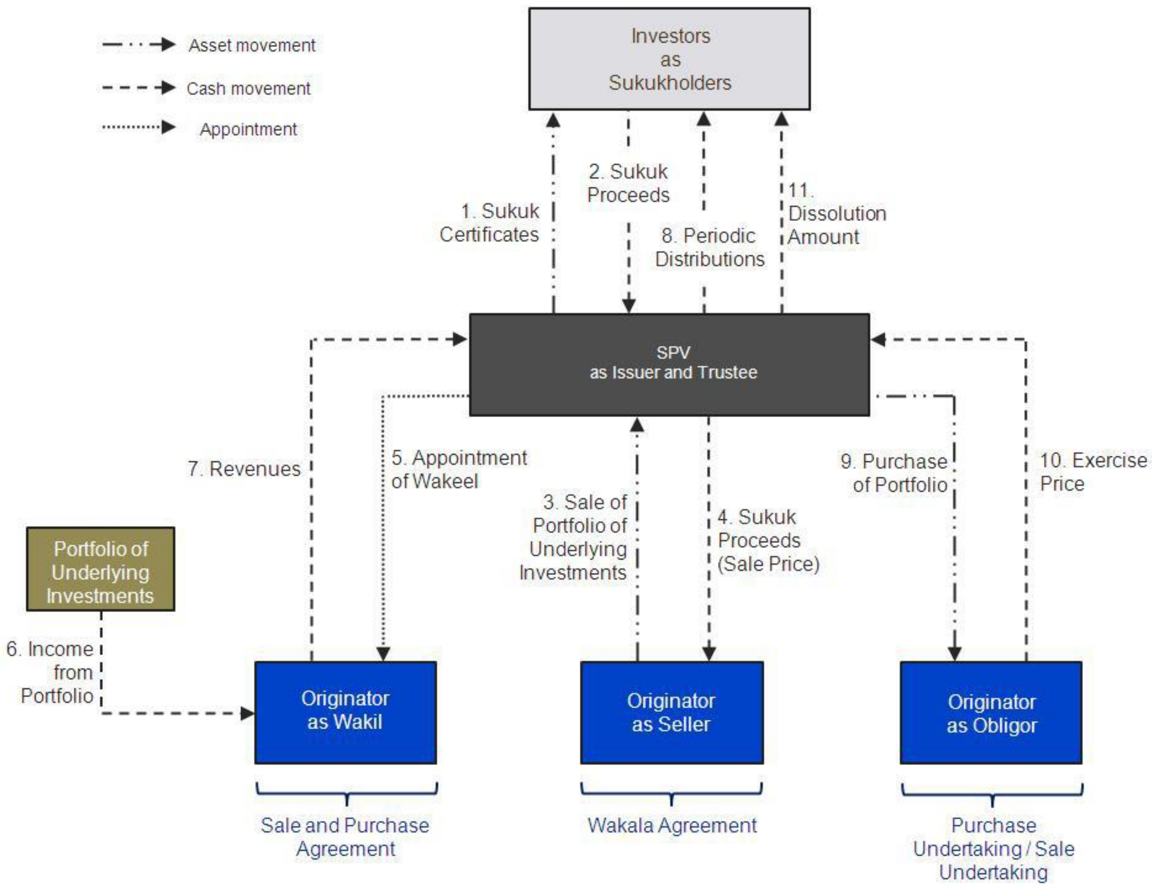
However, in a normal Wakala Sukuk structure, a Sovereign, Quasi-Sovereign or Corporate can issue a Wakala Sukuk for a new project, and Sukuk investors would purchase its investment certificates with a promise to have their return on their investments in the form of periodic coupon payments.

The trustee (Sukuk Issuer) will typically appoint the Originator as its agent (Wakeel) to manage the portfolio. Unlike a Musharakah or a Mudarabah Sukuk, where the managing partner or the Mudarrib has some investment discretion, the Wakeel's role in a Wakalah Sukuk is generally limited to collecting income generated by the portfolio, maintaining the underlying assets comprised in the portfolio, and acting on the instructions of the Trustee to replenish the portfolio with additional underlying assets from time to time.

Given the limited nature of the Wakeel's role, the Wakeel is not held to be a partner or a Mudarrib in the arrangement for Shari'ah purposes and therefore does not need to share the risk of loss in the arrangement. As a consequence of this, the Originator in its corporate capacity is permitted, under Shari'ah, to grant a fixed-price purchase undertaking to purchase the portfolio on redemption of the Sukuk certificates.

Wakala Sukuk structure is the most suited for a new business venture in which there is no asset to back up the Sukuk as in other Sukuk structures. Normally, it is referred to as Wakala Bil Istithmar. However, it is the riskiest one because no one knows for sure whether the Wakala pool of assets is going to create a sufficient stream of cash flows to cater for periodic payments to Sukuk holders and their final Sukuk dissolution amounts.

Figure 1: Example of a Wakala Sukuk Structure



2.6 Istisna'a

An Istisna'a Sukuk is a type of financing arrangement in which a financier (Sukuk holders through the SPV/ Sukuk Issuer) orders for the construction, manufacturing or production of an asset or a portfolio of assets.

The Originator creates the specifications for the asset (such as a factory, power plant, or piece of machinery), and will typically be more familiar with the technical and commercial requirements than the financiers (Sukuk holders). The financier promises to buy the asset when it is delivered and makes one or more downpayments for it.

Meanwhile, a forward Ijarah (lease-Ijarah Mawsuufa Fii Dhimma) contract is signed between the SPV (on behalf of the financiers) and the Originator. Thus, the combination of Istisna'a and Ijarah allows for advances to finance the initial stages of manufacturing and construction as well as their continuing use with payment in instalments. If the asset is not completed, the papers often call for the forward lease arrangement to be terminated.

2.7 Hybrid Sukuk Bonds

A hybrid Sukuk bond structure combines one or more Sukuk structures, enabling issuers to access a wider range of investors and funding sources. Specifically, hybrid Sukuk structures may include features of both a conventional bond and a Sukuk, such as:

1. **Asset-backed Securities:** Like traditional Sukuk, a hybrid Sukuk bond may be structured as an asset-backed security, where the bond is backed by underlying assets that generate revenue. This ensures compliance with Islamic finance principles, which prohibit the payment or receipt of interest.
2. **Profit-sharing Mechanism:** A hybrid Sukuk bond may also incorporate a profit-sharing mechanism, where the issuer agrees to share a portion of the revenue generated by the underlying assets with the bondholders. This ensures that the bondholders receive a return on their investment without violating the principles of Islamic finance.
3. **Convertible Features:** A hybrid Sukuk bond may include features that enable the bondholders to convert their bonds into shares of the issuer's equity. This provides additional flexibility to the issuer, while also enabling the bondholders to potentially benefit from the growth of the issuer's business.
4. **Credit Enhancement:** A hybrid Sukuk bond may also include credit enhancement features, such as a guarantee or collateral, to enhance the creditworthiness of the bond and attract a wider range of investors.

This is normally done using hedging mechanism like Takaful (Islamic Insurance)

3 Sukuk Credit Rating Methodologies Overview

Sukuk bonds are financial instruments that adhere to Islamic principles and are structured in compliance with Shari'ah law. Like traditional bonds, Sukuk bonds are also rated by credit rating agencies to evaluate the Sukuk Originators' creditworthiness (in the case of Asset-based Sukuk bonds) and the likelihood of default.

In the case of asset-backed Sukuk, the rating is done at the point of the Sukuk underlying asset or a portfolio of assets to gauge whether it is Shari'ah-compliant and whether it can generate enough income to pay for periodic returns and final dissolution amount. The Sukuk Originator is also rated for its creditworthiness.

The credit rating methodologies used to assess Sukuk bond structures are similar to those used for traditional bonds, but some key differences need to be considered.

- **Understanding the Sukuk Structure:** The first step in assessing the credit rating of a Sukuk bond is to understand its structure. Unlike traditional bonds, Sukuk bonds are asset-backed or asset-based and do not represent a direct debt obligation. Instead, they represent an ownership interest in an underlying asset or a portfolio of assets. The Sovereign Africa Ratings (SAR) needs to assess the Sukuk nature and the underlying assets, the legal structure of the Sukuk, and the cash flow mechanism used to generate returns for investors.
- **Compliance with Shari'ah Law:** Another important factor that needs to be considered when rating Sukuk bonds is compliance with Shari'ah law. SAR need to evaluate whether the Sukuk structure complies with the principles of Shari'ah law, including the prohibition of interest-based transactions (riba) and speculative investments (Gharar).
- **Creditworthiness of the Issuer:** The creditworthiness of the issuer is another important factor in assessing the credit rating of Sukuk bonds. SAR need to evaluate the financial strength of the issuer, including its credit history, debt levels, and ability to generate cashflows.
- **Market Risk:** Sukuk bonds are exposed to market risk, just like traditional bonds. The rating agencies need to evaluate the level of market risk associated with the Sukuk structure and the underlying assets. This includes assessing factors such as interest rate risk, currency risk, and liquidity risk.
- **Legal Risk:** SAR evaluates the legal risks associated with Sukuk bonds. This includes assessing the legal and regulatory environment in the jurisdiction where the Sukuk is issued, as well as the enforceability of the legal documentation related to the Sukuk structure.

- **Environmental, Social, and Governance (ESG) Risks:** SAR evaluates the exposure to environmental, social, and governance risks and the entity's ability to manage these risks effectively.
- **Natural Endowments Factors:** If the entity being rated possesses natural resources such as oil, gas, or minerals, SAR evaluates the entity's contribution to the economic growth, industrial development, fiscal stability, and susceptibility to commodity price fluctuations of the country based on its natural endowments.

3.1 Key Rating Elements

In rating Sukuk bonds, we do both Qualitative and Quantitative Shari'ah assessments. There could be various underlying contractual arrangements for every Sukuk structure[4]. Therefore, each structure must be examined separately to determine whether it satisfies Shari'ah requirements.

This Sukuk rating methodology goes through how the most prevalent Sukuk characteristics affect the ratings of asset-based and asset-backed Sukuk issues. Due to the variety of Sukuk structures, not all factors listed in this methodology may apply or be present in every situation.

- **Rating Based on Originator:** For Asset-backed/Asset-based Sukuk, SAR examines the Originator/Originator/Issuer of the transaction through the Sukuk structure. The entity looking to raise capital (the Originator) must normally create a Special Purpose Vehicle (SPV) and transfer the assets underlying the Sukuk to the SPV.
- The rating is based on the Originator's rating. The rating would normally be in line with the Originator's rating for senior unsecured obligations.
- **Full Recourse to Originator:** Under this methodology, SAR's analytical premise is that the Sukuk's structure and the underlying transaction(s) allow for full recourse to the Originator, just like with a traditional bond issue, and that the Sukuk rating is solely determined by the Originator's creditworthiness. Sukuk analyses and ratings will represent SAR's opinion that, in line with SAR's rating definitions, the entity would default if these senior unsecured obligations under the Sukuk's legal framework and documentation were to default.
- **Sukuk Forms Affect Ratings:** There are two main forms of Sukuk, Asset-based and Asset-backed. Sukuk can come in several structures, which may have an impact on their recourse and recoveries in the event of issuer default – and, ultimately, on the rating of the financial instrument under analysis.

[4] Sukuk al Musharakah, Sukuk al Istisna'a, Sukuk al Wakala, Sukuk al Salam, Sukuk al Ijarah, Sukuk al Mudarabah, Sukuk al Murabahah, Sukuk al Mudarabah.

- A financial guarantee on all or a portion of the obligations under the Sukuk documents could also have an impact on the Sukuk ranking (senior, subordinated, or Pari passu with other liabilities), which could affect recoveries and, in turn, the ratings.
- For asset-backed Sukuk, SAR will evaluate the true sale of assets and commitment of assets and the SPV's bankruptcy remoteness. SAR will also assess the investors' recourse to the assets or the Originator, depending on the Sukuk structure and transaction documents.

3.2 Rating Approach

SAR will assess all Sukuk Originators/Obligors, Issuers and transactions for Shari'ah compliance in line with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari'ah Screening Criteria.

Cash	Debt	Receivables	Impermissible Income
Interest-taking deposits/Market Capitalisation < 30%	Interest-based debt/Market Capitalisation < 30%	(No longer applicable as per AAOIFI Shari'ah Standard No. 59)	<5% of total revenue (including interest income)

According to this methodology, SAR's analytical presumption is that the Sukuk's structure and the underlying transaction(s) give the investors full recourse to the assets for Asset-backed transactions where there is a transfer and true sale of assets to the SPV as well as the SPV being bankruptcy remote. If it is thought to be useful for its review, SAR will also go into the legal opinions given by the attorneys representing the parties to the transaction. The Sukuk analysis and rating consider the Sukuk's legal structure and documentation.

Sukuk backed by the assets are frequently rated as senior unsecured claims against the Issuer. In light of this, SAR will give the instrument a senior unsecured rating that is anchored on and typically at the same level as an Originator's ratings. Sukuk documents may also be organised as subordinated, short-term, or secured claims; in this case, the ratings will be assigned in accordance with SAR's established standards, with the ratings once more based on the Originator's ratings.

An Originator places well-defined, identifiable asset(s) (which, in the case of a financial institution, could also comprise a pool of transactions) into a single-purpose SPV, the shares of which are often held in a trust, in a standard international Sukuk structure (this could be a charitable trust). The SPV then enters into a unique "Declaration of Trust" (through a Trust Deed) on behalf of the holders of Sukuk. Since the concept of a trust in Shari'ah is not what it is typically understood in common law regimes, this is sometimes stated as a statement of agency. The SPV gets compensated with the sale revenues from the Sukuk offering.

Sukuk holders will not have any rights of enforcement against the trust assets in the event of an unsecured transaction since their rights are restricted to enforcement against the Originator of the obligation to purchase the assets at Sukuk maturity in accordance with the conditions of the purchase undertaking. The documentation will typically state that the Originator is the sole party with whom the investors have recourse and contractual claims.

The SPV is the entity that actually issues the Sukuk and is also the entity that distributes investors' proportionate shares of the profits. Investors purchase the Sukuk certificates and pay the SPV's principal in order to channel it to the Originator. According to the documents, such as an agency agreement with the SPV, the Originator is usually in charge of maintaining the assets and making prompt and consistent transfers of the proceeds to the SPV.

With this arrangement, the SPV often keeps legal possession and control of the assets, and the Originator often has the obligation to keep the value of the Sukuk assets constant throughout the term of the Sukuk. Additionally, the Originator may be required to replace the assets, provide insurance or Takaful coverage for the underlying assets, and make up any insurance or Takaful coverage gaps. Additionally, the Originator's business is not adversely affected as much, and the SPV avoids getting involved in operational issues.

The investors are still entitled to dividends that represent a portion of the earnings generated by those assets. Typically, transaction documents include a benchmark rate of return or pre-agreed profit-sharing ratios (in line with the Sukuk structure). The Originator is in charge of repurchasing the assets upon agreement maturity, which results in the return of the principal payment to investors.

Since Sukuk include contractual responsibilities and methods to share the risk to both the Originator and the investor, the investor shares in the gains or losses produced by the underlying assets, but the risk associated with those assets has traditionally been contractually limited. Contractual obligations for Sukuk include the timely full payment of the Sukuk principal, regular distributions throughout the Sukuk's existence (including the profit equalisation ratio), and distributions upon maturity or any dissolution or default event.

In order to match receipts to the contractual periodic payouts and remove any volatility in the cashflows derived from the assets, the Originator may first offer a liquidity facility profit equalisation ratio facility. Second, the documentation typically includes a sale/purchase undertaking, in which the Originator commits unreservedly to repurchase the assets at maturity or at any dissolution event (or earlier in the event of any dissolution or default by the Originator or a total or partial loss event), covering the outstanding principal and periodic distributions made throughout the life of a Sukuk or at any dissolution event.

Depending on the Sukuk structure, a different set of models may be used to determine the buyback price. Shari'ah scholars have the propensity to favour fair market value as the standard for repurchase upon maturity or following a default event.

Additionally, if the periodic distribution amounts are not entirely legally guaranteed by the Sukuk, SAR will evaluate alternative safeguards in place to protect the Sukuk holders in the event of late or incomplete periodic distribution amounts payments. The Originator would be required to pay the accrued but unpaid periodic distribution amounts as well as the outstanding principal amount in the case of non-payment, which may result in an event of dissolution or default unless the same is settled through a profit equalisation reserve.

A specific guarantee from the Originator could strengthen the buying commitment even more. Instead of guaranteeing the SPV's responsibility to pass payments to the holders of Sukuk, it is typical for the Originator to guarantee the obligations arising under the underlying contracts (such as Ijarah or Murabaha). Additionally, according to SAR, an explicit assurance may not always be upheld in all relevant jurisdictions. However, SAR takes into account in its review whether it thinks the Originator will still fulfil its duties under the guarantee and other legal commitments in the Sukuk documents.

Conversely, SAR will rate favourably any Sukuk instrument which is of Sovereign, Quasi-Sovereign nature (Government Related Entities-GREs) or those with Sovereign guarantee due to their nature of being secured from default since governments are ongoing concern legal entities.

In order to avoid an Originator/Obligor from contesting the validity and enforceability of the Sukuk, warranties and waivers sections relating to the Shari'ah-compliant character of the Sukuk have been improved and are now included in the Sukuk documents as of 2018. Regarding the validity of the relevant transaction documents under any relevant laws, SAR takes into account the Sukuk Originator's intention to sustain said documents and its obligations.

3.3 Covenants

Covenants and events of default are included in Sukuk documents, just like they are in conventional bond documentation.

These events of default commonly include failure to carry out any obligations stipulated in the agreements, failure to pay any amounts due (both periodic distributions and repayment upon maturity), failure to abide by any notices, illegal actions, non-compliance with Shari'ah, cessation of operations, insolvency or any arrangements/deferments in relation to any indebtedness as well as force majeure events. Negative pledge and cross-default clauses, which further connect the performance of the Originator and the Sukuk, may be used to reinforce these events of default.

As a result of some Shari'ah requirements, Sukuk-specific triggers such as put options, dissolution events, and covenants relating to tangibility events are increasingly being included in Sukuk documents.

For instance, the Sukuk documents may require the Originator/ Obliged to keep track of and maintain the tangible assets that make up more than 50% of the Sukuk asset base for the duration of the issuance (Asset-Light Sukuk). Investors may exercise put options to redeem the dissolution dividend sum, and the certificates may be delisted, if this tangibility ratio falls below 33% (According to AAOIFI Shari'ah ruling).

3.4 Transaction-Specific Disclosures

The following information will be disclosed by SAR in its rating action commentaries:

- The justification for the rating action, the rating anchor, and the Originator/obligor's right of redress;
- Assets recourse;
- The principal parties to the transaction, the mechanics, and who is responsible for paying the Sukuk principal, profit (periodic distributions), and asset(s) servicing throughout its term as well as in the event of dissolution (or earlier, in the event of any dissolution or default by the Originator or in the case of a total or partial loss event);
- The ranking of the Sukuk (senior, subordinated, or Pari passu with other obligations);
- Sukuk terms and conditions.

3.5 Variation from Methodology

SAR's standards are intended to be used alongside skilled analytical judgement utilised in a committee setting. SAR's rating process is strengthened by the mix of methodology, analytical judgement used on a transaction-by-transaction or issuer-by-issuer basis, and complete disclosure via rating commentary. This also helps market players understand the reasoning behind our ratings.

In order to take into account the risks associated with a given Sukuk transaction or company, a rating committee may modify how this methodology is applied. Variations describe these modifications. All differences, including their effects on the rating when applicable, will be stated in the relevant rating action remarks.

The risk, feature, or other factors that affect the assignment of a rating and the methodology used to determine it must all fall under the purview of the methodology for a variation to be approved by the rating committee, but the analysis outlined in the methodology must be modified to take into account factors unique to the given transaction or entity.

3.6 Limitations

Shari'ah scholars may argue that in some configurations the buyback price upon maturity or a default event should be at fair market value rather than a set amount (e.g., the original sale price). SAR will review the documentation regarding the buyback price upon maturity and determine whether it should be at fair market value or a set amount in accordance with the documentation.

The Sukuk would become unrateable if the Sukuk structure permits skipping periodic distribution payments and if the principal does not fall due as a result or is not structured along the 14 major Sukuk structures sanctioned by AAOIFI Shari'ah Standards No 17 and 29. However, if the issues are subordinated, then only those issues that have contractual clauses allowing for flexibility in periodic distribution payment would be regarded as rateable.

3.7 Shari'ah Advisory

SAR has its own Shari'ah-Compliance Department (SCD) with its own Internal Shari'ah-Compliance Officer (SCO) and Shari'ah Advisory Council (SAC), which conducts its business of advising SAR according to a Shari'ah Charter recognised by SAR's Board of Directors (BOD).

The Shari'ah council members convene quarterly to perform a Shari'ah review on SAR and issue their reports to SAR's BOD and a copy to SAR management.

SAR has developed its Sukuk rating methodology as per AAOIFI Shari'ah Standards, AAOIFI Governance Standards, AAOIFI Accounting and Auditing Standards as well as Islamic Financial Services Board's (IFSB) various Standards as benchmarks.

4 Appendix 1: Converting Scores into Ratings

The SAR methodology model generates a score calibrated on a scale given below, between 1 000 to 0, ranging from AAA and D in comparison to traditional rating scales. The scores are convertible to letter-based rating scales. A rating of AAA is assigned for scores of 800 points and above out of 1 000, whilst the least rating of D is assigned to scores less than 200 points.

The table below is used to convert scores into ratings. The points are from 0 up to 1000 while the corresponding ratings are from D to AAA. Scores from 500 and above are investment grade while scores lower are in the speculative grades.

Sovereign Africa Ratings (SAR): Converting Scores into Ratings

SAR Tier Grade		Points Allocation			Long Term	Short Term
Investment Grade BBB- and Higher	1-Exceptional (Prime): ≥ 80%	Tier 1 – 800+	1	≥800	AAA	A+
	2-Very Good (High Grade): 70%-79%	Tier 2 – 700-799	2	767-799	AA+	
			3	734-766	AA	
			4	700-733	AA-	
	3-Above Average (Upper Medium Grade): 60%-69%	Tier 3 – 600 - 699	5	667-699	A+	A-
			6	634-666	A	
			7	600-633	A-	
	4-Average (Low Medium Grade): 50%-59	Tier 4 – 500 - 599	8	567-599	BBB+	B+
			9	534-566	BBB	
			10	500-533	BBB-	
Speculative Grade BB+ and Lower	5-Below Average (Non-Investment Grade Speculative): 40% -49%	Tier -5 – 400 - 499	11	484-499	BB+	B
			12	467-483	BB	
			13	451-466	BB-	
			14	434-450	B+	
			15	418-433	B	
			16	400-417	B-	
	6-Poor (Substantial Risks): 31%-39%	Tier 6 – 300-399	17	467-499	CCC+	C
			18	434-466	CCC	
			19	400-433	CCC-	
	7-Very Poor (Extremely Speculative): ≤ 16%-30%	Tier 7 – 200-299	20	267-299	CC+	
			21	234-266	CC	
			25	200-233	CC-	
	8-Default: ≤ 15%	Tier 8 – 0-199	26	0-199	D	D