TRUST . TRANSPARENCY . INDEPENDENCE

SUPRNATIONAL ENTITIES – CONCEPT NOTE ON NOTCHING CRITERIA

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الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency
Serving the Islamic Ummah

In this document, IIRA has laid down specific factors that apply to supranational entities, and the manner in which these are assessed while evaluating ratings for such entities. The approach can be applied to all types of multilateral agencies - typically financial institutions in banking, investment banking, investment guarantees, and insurance agencies. Guidelines provided herein serve as framework for arriving at appropriate notching from standalone ratings which serve as base assessments.

Generally, supranational institutions are established by several sovereigns, quasi sovereigns and sometimes international institutions, to support social and economic development, promote cross-border trade between member states and generally provide assistance in areas, where commercial enterprises may not be able to serve. These institutions are not subject to regulations of the jurisdiction of incorporation and usually are not subject to local taxes and commercial laws. With the mandate to serve multiple economies, they enjoy strong business access in many jurisdictions, with their risk profile reflecting the aggregate risks embedded in such diverse economic systems.

A Unique Business Model: Even while multilateral institutions are structured as banks or assurance agencies, their business model is often unique, in as much as the services and products that these institutions operate through, are often differentiated from commercially offered services and products. The terms of lending may be considerably longer or soft in nature, or the types of counterparties or purposes that exposures are extended towards maybe highly specialized, and/or the services offered may themselves be unique, given that commercial operators cannot viably meet specialized needs of member countries. This introduces another differentiating aspect in terms of risk evaluation and may not fit the typical rating methodology for the sector. On an as needed basis, IIRA will evaluate the unique risks and risk mitigants embedded in the product and financial structure of the multilateral institution being rated, while assessing the standalone risk.

Moreover, a usual focus on emerging economies, implies larger business risks than general commercial operators; however, risk mitigating factors are structurally embedded in these entities, a brief description of which, along with their implication for ratings, is produced below:

Shareholder Support: Most of the funds are generally sourced in the form of unsecured borrowings either from parent multilateral institution or other quasi-sovereign shareholder institutions, rather than accessing direct deposits or other liquidity management options enjoyed by the financial institutions. Given that multilateral agencies are usually sponsored by sovereign and quasi sovereign entities, with sovereign assets having been proven to be the least risky asset class, the support of shareholders is a significant rating driver. In assessing the degree of shareholder support, key factors to be evaluated have been enumerated below.

1. The nature of shareholder agreements, considered more supportive where capital is callable. Callability of capital is common to several multilateral agencies, and represents a commitment to the agency,
2. The strength of capital providers and their ability to supply capital on demand, is generally evaluated as a function of their individual economic strength with average credit ratings of shareholders serving as a proxy for financial capacity to extend support in times of need. IIRA is mindful of the fact that the combined risk profile of the shareholders may not be a simple average of their individual resilience. It may therefore be more practically useful to consider shareholder strength as being considerably higher than that suggested by an average of individual sovereign probability of default, with little likelihood of multiple sovereigns backtracking from their commitments at the same time.
3. The independence of the key risk drivers and the divergence in the nature of risks being faced by each sovereign, can also be an important parameter in judging the benefits of diversification obtained from being owned by multiple sovereign shareholders.

The average financial capacity of the largest stakeholders or the most resilient shareholders, likely to be able and willing to extend support as a key driver to shareholder support expectation, may therefore be the more practical approach to assessing overall shareholder support.

Preferred Creditor Status and Unparalleled Market Access: In addition to enhanced support factors, several other structural features of multilateral agencies are important when considering the extent of notching from baseline assessment. Amongst these is the business access granted by sovereign level engagement in member countries. Even though these institutions carry more risk compared to a commercial entity, given the nature of segments and markets they cater to, an inherent preferential treatment, built into agreements, benefits such agencies with preferred creditor status being a common feature.

Diversification of Risk Base: Despite the riskiness of the markets and segments being served, the diversification in business jurisdictions, itself offers a natural mitigant to risks. These institutions, given their mandate and structure, are largely set up as large corporations, able to extend business in several markets broad basing risks being taken. IIRA looks at not just the degree of concentration in type, source and geography of risks, but also the propensity of these risks to develop correlations.

Absence of regulatory constraints: Regulatory risks are minimal, given that these institutions are not subject to commercial laws in jurisdictions of operations, although a sound regulatory environment can also serve as a positive driver of ratings. If the self- regulatory mechanism is well embedded and may not benefit materially from externally imposed regulations, a benign regulatory environment may also work to the benefit of ratings.

Primarily on account of strong shareholders, the nature of commitment of these shareholders reflected in callable capital, preferred business partner status and strong outreach, and diversification in business sourced, uplifts the risk profile of these entities three or more notches vis-a-vis its baseline assessment. The baseline assessment is in turn reflective of the financial risk profile, the business risks undertaken and governance mechanisms instituted in the agency, similar to our assessment of any other commercial operator in the same segment.

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