

## Introduction

The Shari’ah Compliance and Fiduciary Rating aims to provide information and independent assessment regarding the Shari’ah governance framework of Islamic Financial Institutions (IFIs), or of conventional institutions providing Islamic banking or financial services. These ratings are aimed to set a reference for investors in terms of IFIs’ (banking and takaful) adherence to “Shari’ah” (Islamic Law) rules and principles for financial services marketed as “Islamic or Shari’ah compliant”.

The Shari’ah Compliance and Fiduciary Rating (SCFR) framework, as detailed within the following sections has been adapted to the Governance Standard of Islamic Financial Institutions (GSIFI 10) titled ‘Shari’ah Compliance and Fiduciary Rating for Islamic Financial Institutions’ put forth by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The scope of the rating evaluation detailed herein, encapsulates all areas of coverage laid out in GSIFI 10, and extends beyond the referenced standard. Moreover the policy and processes internal to IIRA, in as much as these are relevant to IIRA’s Shari’ah Compliance and Fiduciary Ratings, though not referenced in this paper, corroborate with those advised by GSIFI 10.

The Shari’ah Compliance and Fiduciary Rating differs from a Credit Rating in that the latter is an evaluation of an issuer’s capability and willingness to repay financial obligations. An SCFR on the other hand, is concerned with issuing an independent opinion about the system of checks and balances put in place to ensure that a culture of good governance and compliance with Shari’ah principles is enabled.

The Shari’ah governance and accounting & auditing standards of AAOIFI, and other relevant standards setting bodies like the International Financial Services Board (IFSB) are employed extensively as benchmarks. Best practices recommended by these standard setting bodies are viewed as a reference point for IIRA’s assessment. Nevertheless, regulatory and private sector developments in multiple countries that IIRA covers, allows IIRA to develop comprehensive guidance for best practices, resulting in a continuously evolving framework of governance for Islamic financial institutions.

## Rating Objectives

A distinguishing characteristic of Islamic financial institutions and their services is that these are marketed as being 'legitimate' as a 'Unique Selling point' of such services. Therefore, it must be subject to a third party review process and direct communication to investors regarding the relative state of adherence to Shari'ah should be enabled, i.e. transparency should be effected through ratings. While recognizing the investors right to know, IIRA is also mindful of the possibility that the confidence or the lack of it, in the 'purity' of Islamic financial services, is an inhibiting factor to the growth of the industry, underscoring the need for an external review process to stimulate growth in Islamic finance.

The rating however is not an audit and cannot be viewed as a verification of transactional compliance. It is rather an opinion of relative adherence to best practices and utilizes an audit opinion as a key input to the process, allowing investors to discriminate among institutions which may claim adherence to regulations and internal policies governing Shari'ah compliance.

It is IIRA's belief that no two Shari'ah pronouncements may be compared for 'correctness'. Therefore the fundamental objective of ratings is to evaluate the process of compliance to a pronouncement, as put in place, more than evaluate the 'correctness' of the underlying structure itself. Taking this a step further, product structure (or fund or service structure in case of Takaful providers) is expected to corroborate to universally accepted principles of Shari'ah, which allows for classification of key structural elements in terms of what is referred to herein as the 'Hierarchy of Acceptance' being 'permissible' or 'permissible but not preferred' or 'permissible on the basis of necessity, for a limited time period or in a specific situation or jurisdiction'. IIRA further evaluates Islamic financial services or products of an institution against a 'hierarchy of standards of Compliance', being 'international', 'local' or 'institution' level, as laid out in further detail later in this document. This allows IIRA to opine on the degree of adherence to a range of products offered by IFIs against a disclosed benchmark, as part of the holistic approach undertaken to arrive at a rating.

By thus demonstrating the state of compliance of IFIs with the standards, regulations and best practices related to Shari'ah principles and rules, ratings serve to inculcate a higher level of discipline and transparency in the industry. Such an evaluation would also in due course of time lead to corrective processes, and the industry as a whole will move towards a higher standard of Shari'ah governance.

## Hierarchy for Standard of Compliance

In addition to the 'Hierarchy of Acceptance' as referred above, the benchmarked parameters with regard to the Shari'ah principles and rules shall be defined by the following hierarchy, as appropriate:

- a. International Best Practices: As an international standard setting body, the Shari'ah standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and standards issued by the IFSB serve as an international level benchmark for IFIs. Moreover best practices, particularly in the area of Shari'ah and corporate governance as advised by regulators or developed through private sector initiative, across Islamic countries are evaluated from time to time, selecting superior practices to serve as a global benchmark. International Shari'a Compliance and Fiduciary Rating Scale is illustrated in 'Appendix-A'.
- b. Country (National) level guidance: GSIFI 10 provides for a national level assessment which gauges compliance with guidance provided by a local Central body. The relevant rating scale is illustrated in 'Appendix-B'
- c. Approvals and rulings given by the Shari'ah Supervisory Board of the IFI.

**Note:** As such national level assessments are embedded in international assessments. Illustratively, the highest national scale rating "SCFR (national) 1", even when not explicitly assigned, may be assumed for any entity assigned an international scale rating in the 3 uppermost bands on the rating scale. Like-wise, it would be rare to see high national scale ratings and low international scale ratings, unless the local regulatory regime is exceptionally weak.

## Scope of the Methodology

The ultimate beneficiaries of the SCFR ratings are unrepresented investors being depositors, other fund providers, minority shareholders and most significantly, investment account holders. In Takaful firms, takaful participants are a noteworthy stakeholder, and being often underrepresented in the governance structure, may potentially benefit from such ratings.

An international scale rating goes beyond a compliance check against local regulations. Local regulations still serve as a starting point of an evaluation and therefore while contravention of regulations is viewed negatively, compliance with regulations does not guarantee the highest rating, given that the rating evaluation is benchmarked to international best practices. Nevertheless, legal impediments to fulfillment of certain preferred practices in Shari'ah compliant finance are given consideration in the sense that these do not result in depressing ratings. Best practices remain universal and even if local regulations do not prescribe a higher standard of Shari'ah compliance, the ratings will be benchmarked to international best practices, save in areas where regulations or commercial law bars an institution from instituting such practices. By the same token, in terms of product structure and design, where permitted practices are notably weaker than internationally relevant guidance, ratings may become capped at a relatively lower rating than those of an institution which follows international best practices.

In contrast to the more commonly understood credit ratings in finance, Shari'ah ratings are essentially an evaluation of current practices. While consideration is given for positive and improving measures which are in process of being effected, thus introducing an element of judgment in the process, it is less reliant on forward looking estimates.

Following the initial evaluation, ratings will be reviewed on an annual basis, to allow for a prompt response to the institution's adoption of, or deviation from best practices.

## Key Parameters of Assessment

Shari’ah Compliance and Fiduciary Rating reflects a combined assessment of an IFI’s relative state of compliance, duly reflected on a rating scale, with standards, regulations and best practices (collectively called benchmarked practices) with regard to (A) Compliance with Shari’ah principles and rules (B) Shari’ah Governance Framework (C) Corporate Governance Practices (D) Transparency and Disclosures (E) Ethics and Values (F) Fiduciary Responsibility and Performance.

**(A) Compliance with Shari’ah principles and rules 45%**

- A.1 Compliance with Shari’ah principles and rules in terms of product structure,
- A.2 Adherence to approved structures and policies evidenced in the generation of non-halal income as a consequence of inconsistent implementation of A.1 above,
- A.3 Asset Manager Quality, i.e. quality of business generated and avoidance of unnecessary risk backed by a sound, business screening process, reflected in risks and return characteristics vis-à-vis peers.

For the purpose of determining compliance with Shari’ah principles and rules, IIRA will evaluate transactions or exposures which are material in the sense of being more than 5% of total exposures and assess all asset structures, outstanding positions under which, comprise more than 10% of assets. For the purpose of determining materiality, latest, publicly available financial year results, shall be used.

IIRA will also superficially evaluate the Shari’ah compliant status of third party service providers such as insurance providers for banking and Retakaful providers in Takaful. The terms of service and the volume of business allocated to non-compliant service providers is taken into account.

The level of overall Shari’ah governance derives in significant measure from the degree of acceptance attributed to key elements of product or service structure in terms of their alignment with internationally preferred practices. The degree of acceptance is judged against the ‘hierarchy of acceptance’ referred to earlier in this methodology and the ‘hierarchy of standard of compliance’ to yield a 9 point scale for each product, as given below:

Hierarchy of Standard of Compliance	Hierarchy of Acceptance		
	Permissible	Permissible but not Preferred	Not permissible except in specific situations and jurisdictions
International Best Practices	9	7	3
Country Level Guidance	7	5	1
IFI level Guidance	3	1	0

## **Shari'ah Compliance and Fiduciary Rating**

---

The overall score for each product is weighted in accordance with the weight of the product type in total on and off balance sheet business of an IFI.

Financial parameters of risk in business transactions are also employed to assess the IFI's adherence to the prudent man's rule, as is the process of business screening. While these are also covered under the governance framework, the overall quality of business and risks being passed on to stakeholders, is the subject of evaluation here. Also aligned with business screening policies are methods and funding structures and their effectiveness in terms of passing risk and reward to investors.

The quantum of non-compliant income may also be used to assess the implementation of product policies governing Shari'ah compliant activities of an IFI. IIRA examines the amount and source of non-compliant income. In terms of the source of such income, IIRA takes a view on the frequency of transactions yielding such income as well as the nature of such deviance.

In case of an Islamic branch or window, the Shari'ah Compliance and Fiduciary Rating Committee of IIRA examines the procedures and safeguards against commingling of funds. Complete segregation of funds and financing activities is the desired benchmark.

### **(B) Shari'ah Governance Framework**

**20%**

- B.1 Empowerment, Independence, Competence and Integrity of Providers of Shari'ah Guidance through Shari'ah Supervisory Board and Management engaged in the enabling of Shari'ah compliant finance,
- B.2 Organization wide acceptance and respect for faith based finance,
- B.3 System of checks and balances through internal and external audit, enabling the roll out of Shari'ah principles in business.

An important pillar of the evaluation is whether there is a mechanism within the institution to evaluate its compliance to Shari'ah, i.e. whether an independent committee or board has been instituted at an elevated level in the organization to guide the self-supervisory process within. The level of authority and independence granted to such a body, through constitutive documents, and its exercise of such authority is an important initial step.

IIRA believes that the integration of the Shari'ah Supervisory body with institutional governing bodies and the functions instituted to enable Shari'ah adherence, as well as the policy framework of the institution is integral to an effective Shari'ah governance framework. Despite direct reporting to the shareholders via an Annual General Meeting, Shari'ah Supervisory bodies are often devoid of the power to influence the Board of Directors, which possesses the most elevated levels of authority in general company structure. The mechanism instituted by an institution, to integrate the Shari'ah Supervisory system, with the General Corporate Supervisory Mechanism, is therefore a focal point of our evaluation. This is also the primary justification of evaluating

corporate practices and Shari'ah governance in tandem with one another and because Shari'ah must not be compartmentalized, rather must guide corporate practices throughout the organization. IIRA's 'Fiduciary Rating Methodology' (available on our website) particularly brings to light the inter-related nature of business conduct, governance practices and Shari'ah governance and may be referred for further illustration of the concept. [http://iirating.com/resource/Fiduciary Methodology.aspx](http://iirating.com/resource/Fiduciary%20Methodology.aspx)

Shari'ah committee/board must as a matter of principle, have requisite authority to conduct an independent review/examination and also be able to access necessary information and have the resources to do so. The examination also involves a review of the procedures of authentication of the products and schemes offered by the institution as Islamic. The qualifications/experience and eminence of the scholars issuing the Fatwa have a bearing on the overall evaluation.

IIRA also reviews the internal control and audit system for ensuring compliance and for dealing with non-compliance related instances. Particular emphasis is placed on ensuring that no self-review threats or conflicts of interest are evident in the structure or operations of these functions. Reporting lines must ensure independence of review processes. Rigor employed in the audit and review processes, the resources deployed – both human and technological - and the competence of such resources are subject to evaluation.

**(C) Corporate governance practices related to Shari'ah governance 10%**

- C.1 Empowerment, Independence, Competence and Integrity of Leadership to enable a system for protection of rights of stakeholders including unrepresented shareholders, customers, takaful participants, depositors who place deposits in custody of the IFI, and most significantly investment account holders, by recognizing the difference in nature of claim of investment account holders in IFIs vis-à-vis that of depositors in conventional banks.
- C.2 System of Internal Control enabling A.3 and C.1 above,

Corporate Governance standards and their evaluation is undertaken to ensure that the organization fairly protects the interest of all stakeholders, as also described in section B above. Board of directors plays a vital role in a governance framework, as it has the responsibility of endorsing the business strategy, monitoring performance, appointing, supervising and remunerating senior executives and ensuring accountability and transparency.

While evaluating overall governance structure, IIRA reviews independence, composition, profile and commitment of board members. Strategic direction set by the board, selection of management and succession planning, risk targets set and oversight mechanisms enforced, are factors which provide important information regarding governance standards. An effective board is expected to select a strong management team and implement proper oversight of financial matters.

## **Shari'ah Compliance and Fiduciary Rating**

---

An effective control infrastructure is in place is central to protecting investors and fulfilling fiduciary responsibilities. Presence of an independent and vigilant audit committee facilitates a sound internal financial control environment. A strong internal audit and risk management function builds the institution's self regulation capacity. Reporting lines, organizational positioning of control functions and authority provided to senior control personnel are important indicators. Presence of a policy framework, and its ability to guide management decision making is to be evaluated by review of actual business practices as reflected in business decisions taken and quality of deliberations preceding these decisions.

The Board's role in reviewing and approving related party transactions is an important consideration for ensuring that one party is not given preferential treatment and all conflicts of interest are avoided in line with the Shari'ah framework within the institution. IIRA determines whether the issuer has policies in place to ensure that related party transactions are carried out at arm's length, are appropriate in terms of quantum and do not expose the organization to undue financial or non-financial risk. Limited related party transactions are considered positively along with proper board oversight.

### **(D) Transparency and disclosure**

**5%**

- D.1 Disclosure of practices and performance through published and web based media,
- D.2 Investor engagement and in particular communication with takaful participants in Takaful firms and investment account holders in Islamic banks, by recognizing the difference in nature of claim of investment account holders in IFIs vis-à-vis that of depositors in conventional banks.

IIRA considers high quality and timely financial reporting indicative of robust governance standards as it ensures that investors can assess the financial condition of subject entities and associated risk. Comprehensive disclosures, made via both, the printed materials and the website can play an important role in communicating to investors.

The reporting of financial and non-financial information by an IFI must meet the requirements of internationally recognized disclosure principles and which are applicable to the Islamic financial services industry. IIRA will evaluate the level of detail in the disclosures and the frequency and timeliness of reporting.

Acknowledging IAHS' or Takaful participants' right to know the profile of their investments, making them aware of their contractual rights and associated risks, and efforts to meet the return expectations is one of the foremost objectives of a comprehensive disclosure policy. IIRA believes that the performance of funds contributed by IAH should be adequately disclosed to facilitate IAH in monitoring their returns for any volatile trends which may be attributable to risky investments.

Similarly disclosure of surplus generated by a Takaful participation Fund, and distribution policy, where relevant, should be prominently disclosed.

**(E) Ethics and Values**

**10%**

E.1 A code of ethics and values should be adopted at all levels within the organization,

E.2 An appreciation of environmental and social ecosystems as a tenet of faith based investing should be incorporated in investment screening processes,

E.3 Entity level adoption of practices that respect the environment and social causes.

The Rating Committee examines if a code of ethics is adopted by the institution and how well it is understood by the executives and employees and what system is in place for its compliance.

IIRA believes that good governance and dispensation of prudent discharge of corporate responsibilities is central to faith based investing. In the light of Quran and Sunnah, kindness for all things living and respect for the environment, are a part of good conduct. This factor therefore finds way in all of IIRA's methodologies including the Shari'ah Compliance and Fiduciary methodology. Pursuit of social causes both directly by own institutional participation and indirectly by directing business resources towards such endeavors are assessed in this section.

**(F) Fiduciary Responsibility and Performance**

**10%**

F.1 Methods employed for distributing returns,

F.2 Comparison of returns or losses transferred to investors.

An evaluation of measures employed by the subject entity to enable fairness of conduct, are a key area of study. IIRA employs financial ratios to determine the effectiveness of such practices, for instance a comparison of returns earned by the institution vis-à-vis those distributed to shareholders and investment account holders over a timeline. Considerable deviation may point to a lack of fairness in distribution. Use of methods considered for smoothing of profits, such as 'Hiba', variations to Mudarib rates or withdrawals from reserves, previously created, to serve such interests and frequency of such application is evaluated.

In a similar manner, depending on the takaful fund structure deployed, the distribution of takaful surplus generated, its timeliness and its stability should be considered while rating on this aspect.

### **Bringing it all Together**

At extreme ends, i.e. significantly low or high scores may call for any one or more factors to become overriding considerations and drive the rating significantly above or below indicative ratings arrived at through weighted considerations, as indicated above. IIRA's rating committee reserves the right to deploy its professional judgment in arriving at the final ratings.

IIRA's evaluation lays the ground through an assessment of the ecosystem in which the institution operates and whether it creates a conducive environment for enabling the laws of Islamic jurisprudence. It must be noted that the absence of a conducive environment does not result in a lower rating by itself but forms an important consideration in the evaluation. Measures adopted by an institution to adhere to Shari'ah principles, despite an absence of requisite regulation may be over weighted for institutions in such jurisdictions, resulting in a balanced and comparable evaluation of institutions in various jurisdictions.

The final output in the form of an Alpha-numeric symbol is indicative of the rank order classification of a financial institution in terms of compliance of and fulfillment of the Fiduciary responsibilities of Shari'ah based investing.

## Appendix-A: SCFR International Scale Definitions

Score	Grade	Compliance level
91-100	SCFR (Global): Exceptional	Exceptional conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
81-90	SCFR (Global) : Very High	Very high level of conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
71-80	SCFR (Global): High	High level of conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
61-70	SCFR (Global): Above Average	Above average conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
51-60	SCFR (Global): Average	Average conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
41-50	SCFR (Global): Basic	Basic level of conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance
< 40	SCFR (Global): Inadequate	Inadequate conformance to global standards in terms of fulfilling fiduciary obligations of Shari'ah compliant Finance

## Appendix-B: SCFR National

Grade	Compliance level
SCFR (national) 1	No material deviations from national regulatory framework and/or domestic sector norms
SCFR (national) 2	Minor deviations from national regulatory framework and/or domestic sector norms
SCFR (national) 3	Noteworthy deviations from national regulatory framework and/or domestic sector norms

## Rating Process

IFI	Signs agreement for rating with IIRA
	Submits preliminary information materials to IIRA
IIRA	Conducts a preliminary study and submits a detailed questionnaire to IFI
IFI	Provides detailed information in response to detailed questionnaire
IIRA	Conducts due diligence meetings
	Conducts post due diligence analysis
	Submits report to Shari'ah Quality Rating Committee
Rating Committee	Decides the preliminary/initial rating
IIRA	Notifies IFI of the preliminary/initial rating
	Discusses the rating rationales and issues with IFI
IFI	May appeal based on any new facts or information
Rating Committee	Deliberates on appeals by IFI and assigns final rating
IIRA	Notifies the decision of the Shari'ah Rating Committee to the IFI
IFI	Consents to release of the rating to the public – Consent required only for initial release
IIRA	Releases the rating to media