

# AWQAF RATING METHODOLOGY

BY

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*Serving the Islamic Ummah*

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### 1. INTRODUCTION

Social enterprises and third sector<sup>1</sup> organizations are growing in significance, globally, amidst frustrations with mounting violations of socio-economic justice. If managed efficiently and effectively, these institutions can have a positive impact on collectivities through shared prosperity. With a similar mission for community benefit rather than mere private profit, Waqf, a classical institution of Islamic philanthropy, has also witnessed a revival of interest and increased awareness of its untapped potential.

#### 1.1. WHATS IS WAQF?

According to AAOIFI's Shari'ah Standard No. 33 on Waqf:

*"In Arabic language the word Waqf or Habs means preventing something from movement. In Shari'ah terminology, Waqf refers to making a property invulnerable to any disposition that leads to transfer of ownership, and donating the usufruct of that property to beneficiaries."*

In other words, waqf (plural - Awqaf) is an endowment of property of permanent nature by a person who is called a waqif<sup>2</sup> (donor) to be held in trust as an ongoing charity (Sadaqah jaariyah). Awqaf purposes are ultimately charitable. However, they are not limited to a finite list and often include the advancement of religion, education, healthcare, poverty alleviation, social welfare, disaster relief and any other cause that Islam regards as socially-beneficial.

The classification of awqaf is based on the type of beneficiaries for whom the waqf asset (Al Mawqoof 'alaiyhim) is dedicated. The three main categories are:

- **Charitable (Khairy) waqf:** This waqf is established for general charitable purposes. The beneficiaries are unrelated individuals or groups of people or charitable bodies. In many ways, waqf Khairy is comparable to the common law charitable trust.
- **Familial (Ahli) waqf:** The beneficiaries are specific individuals or their posterity. A Familial Waqf may devolve to a general Charitable Waqf if the family lineage becomes extinct.
- **Joint (Mushtarak) waqf:** This is a combination of both familial and Charitable Waqf.

Awqaf assets are also divided into the following three categories:

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<sup>1</sup> Non-profit institutions have come to be known as the third sector of the economy, as distinct from both the government sector and the private sector.

<sup>2</sup> Waqif is comparable to the settlor in the common law trust.

- **Restricted assets:** the usufructs of which are used for the purpose specified or defined by the donor (Waqif).
- **Temporarily restricted assets:** assets which are initially dedicated to a specific purpose and later to general charitable purpose.
- **Unrestricted assets:** assets which are not restricted by any condition of the waqif and may be used for any charitable purpose deemed appropriate by the administrator or the Board of Trustees (BoT) of the waqf organization.

## 1.2. WAQF MANAGEMENT

Waqf management has evolved over the years. Today, Mutawalli (Waqf manager) can be any of the following:

1. Government agency (eg. Ministry of Awqaf, directorate of Awqaf, etc.)
2. Quasi government Awqaf authorities and foundations
3. General charitable Awqaf organization.
4. Public or private trustees (nazirs) of Awqaf organization.

Assets donated as awqaf should be free from all encumbrances such as mortgages, liens, caveats or other restrictions. They can be religious, social or investible assets. These include:

- Land/real estate
- Cash and other liquid assets (marketable securities, shares, sukuk, etc).
- Intangibles such as patent rights, trademarks, intellectual property etc.
- Other (This includes other assets such as agricultural land, orchards, plant and equipment, tools, furniture and fittings.)

The main characteristics of waqf are, therefore, irrevocability, perpetuity, and inalienability. On the one hand, the conditions of perpetuity and inalienability of awqaf assets have led over the years to a considerable accumulation of societal wealth. As a result of this, Awqaf has traditionally been a source of development and an instrument of change in improving the lot of the Muslim society. According to some historical accounts, more than one-third of agricultural land, and up to half buildings in major cities in Algeria, Egypt, Iraq, Morocco, Palestine, Syria and Turkey were Awqaf properties.

On the other hand, the same conditions of perpetuity and inalienability have given rise to the issues of effective management and development of Awqaf across the Muslim populated regions from South East Asia to Eastern Europe. The first duty of Waqf managers (Mutawalli) is to preserve the Waqf property. This is followed by a duty to maximize the revenue for the

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benefit of the beneficiaries. Over the course of history, a number of changes occurred in Waqf regulation. These included the establishment of a register to record and supervise Waqf in Egypt and, later, a Ministry of Awqaf in the Ottoman Empire. The majority of these changes were intended to better control Waqf managers who were corrupt or incompetent.

Notwithstanding these changes and the fact that Waqf still represents a considerable wealth of lands/properties, mostly in prime locations at present times, embezzlement and appropriation have reduced the share of Waqf in the Islamic economy to a relatively nominal amount. The immensity of the challenge deserves new approaches. It is against this background that a rating methodology is proposed to provide transparency in Awqaf management through monitoring and information dissemination. As Harvard Business School's Robert Kaplan and Allen Grossman argue, investments in social causes will remain chronically inefficient unless transparent ways to measure, report, and monitor social outcomes are innovated<sup>3</sup>.

## 2. AWQAF RATING METHODOLOGY

The primary objective of Awqaf rating is to establish accountability in the conduct and management of Awqaf properties through independent third party evaluations. This is envisaged to enhance the level of fiduciary responsibility and competence wielded by managers through strengthened society discipline, rather than through regulatory intervention. Awqaf rating is to consist of three broad components:

- i) Waqf governance;
- ii) Shari'ah governance; and
- iii) Social impact.

### 2.1 WAQF GOVERNANCE

Governance standards and their evaluation is undertaken to ensure that Waqf management fairly protects the interest of all stakeholders. A board of trustees, or its equivalent, plays a vital role in endorsing the Waqf strategy, monitoring performance, appointing, supervising and remunerating direct managers and ensuring accountability and transparency. IIRA evaluates the governance standards of the assessed Waqf entity and assesses the composition of the BoT and experience of the board members. Moreover communication with the BoT also carries importance. Transparency (absence of 'Gharar'), is a fundamental pillar of Islamic Financial transactions, as well as a key principle of good governance. The BoT exercises its powers

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<sup>3</sup> Recognizing the need for transparency, the Global Impact Investing Network, a non-profit created in 2009, took the first step toward the development of common standards for reporting social outcomes by issuing the Impact Reporting and Investment Standards (IRIS).

directly and possibly through various committees functioning at the board level to provide a broad policy framework and maintain independent oversight of operations. Timely provision of information and transparency in disclosures allows all stakeholders to make informed decisions and is considered an overriding necessity. Waqf governance covers a broad spectrum of activities of the BoT and the management of a Waqf organization. Waqf governance practices of an individual institution will be evaluated against global best practices in the non-profit voluntary sector. IIRA will aim to determine the extent to which governance practices put in place by management help in achieving the ultimate goals of transparency, accountability and fair play. A BoT comprising a blend of professionals with relevant industry experience is viewed positively as it can provide better guidance in strategic matters to the management team, to benefit all stakeholders. IIRA will be reviewing not only the degree of oversight exercised by the Board itself but also the Terms of Reference (ToRs) and functioning of Board level committees for their effectiveness, if existing<sup>4</sup>. Following are the key areas IIRA examines while conducting Waqf governance assessment:

### **Board Effectiveness**

While evaluating overall governance structure, IIRA reviews independence, composition, profile and commitment of the BoT 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. IIRA also studies compliance with the applicable standards pertaining to governance. An effective board is expected to select a strong management team and implement proper oversight of financial matters.

An effective management is critical for implementation of the strategic direction of an entity as laid down by the board. Meanwhile, risk appetite of the organization is expected to be kept in line with board directives.

### **Management Profile and Operations**

Management and organizational structure are another important element in the evaluation of governance quality. Experience and skills of upper management, its stability and its compatibility with the strategic vision of the board is closely evaluated.

Furthermore, management's relationship with donors, regulators, staff and Waqf is further an area of consideration.

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<sup>4</sup> In Awqaf, the Waqf deed (the Waqfiah) and the conditions of the Waqif should be observed before anything else. There is the rule that says "The conditions of the Waqif have the same force as the law". If there is any deviation, these should be authorized by the Waqif (if still alive) or the court if not.

### **Financial Information Transparency**

IIRA considers high quality and timely financial reporting indicative of robust governance standards as it ensures that stakeholders can assess the financial condition and associated risk. Both, printed materials and website can play an important role in communication.

### **Self-regulation**

This area deals with the control mechanisms in place to facilitate Waqf self-monitoring and oversight. Mechanisms may include the appointment of governance and investment committees at the BoT level to encourage foresight and stewardship of Waqf assets. Long-term stewardship requires considering investments in light of future evolution, and planning for future capital needs over and above careful review of annual budgets. Furthermore, strong disclosure and information dissemination channels are also central to Waqf's self-regulation capacity. Investment reports, review of costs and expenditures, lists of beneficiaries are important indicators.

### **Related Party Transactions**

BoT's role in reviewing and approving related party transactions is an important consideration while forming an opinion. IIRA determines whether Awqaf 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 Awqaf to undue financial or non-financial risk. Limited related party transactions are considered positively along with proper board oversight.

## **2.2 SHARI'AH GOVERNANCE**

Shari'ah governance primarily focuses on the systems and procedures that ensure Shari'ah conscious business processes and a system of checks and balances embedded to verify such compliance. Shari'ah governance standards are evaluated in the light of best practices, as also laid down by the Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI)—an eminent standard setting body in Islamic Finance. Standard includes conditions pertaining to the Waqf contract, supervision and management of Waqf, controls on leasing of Waqf assets and clauses on the maintenance, renovation, replacement and exchange of Waqf assets..

IIRA will evaluate the governance arrangements, systems and controls employed by the Wqaf to ensure Shari'ah compliance and how these meet applicable international standards. IIRA places utmost importance to Shari'ah governance. Shari'ah is central to Waqf.

A relevant point in this regard is that IIRA does not impose its own interpretation of Shari'ah governance but rather focuses on determining the gap if any between the guidance provided by AAOIFI and the rules and regulations in the relevant jurisdiction.

It may be pertinent to note that meeting minimum statutory requirements will not necessarily qualify a Waqf for a high score in any area. Besides the areas discussed above, IIRA will track the following broad areas in its Shari'ah Governance Assessment:

### **Transparency and Disclosure Standards<sup>5</sup>**

The reporting of financial and non-financial information must meet the requirements of internationally recognized standards. IIRA will evaluate the level of detail in the disclosures and the frequency of reporting.

### **Ensuring Purity of Profits**

Waqf profit purification mechanism and its implementation is a key area under consideration. This has two major aspects to it. First is the business screening process, i.e. ensuring the appropriateness of counterparts, screening of investments and establishing the transactions to be largely in line with Shari'ah. The process of identification of deviant transactions is noted.

The second aspect of this concern is the purification of earnings by identifying non-compliant income and attributing it to charity and satisfactory reporting of the same. IIRA will also evaluate the volume of such income over the years, redundancy in sources of such income and the gravity of issues noted.

## **2.3 SOCIAL IMPACT**

As a faith-based charitable institution, Awqaf's contribution cannot be counted purely in monetary terms. Awqaf cater to various social needs on voluntary and non-profit basis. Any assessment is incomplete without due regards to the following performance evaluation standards that are commensurate with the nature of the sector and which may differ from those applicable to the competitive for-profit sector. These performance standards include:

- **Preservation of awqaf assets** - measured by the average rate of growth in size and value of awqaf assets.
- **Profitability benchmark** - measured by the average actual returns.
- **Risks related to investment of awqaf assets** – measured by the degree of diversification.
- **Balance of generational interests of beneficiaries** - measured by degree of diversification of investment tenors.

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<sup>5</sup> While advocating transparency and disclosure, IIRA is cognizant of the fact that these principles should be handled with a great deal of discretion. In particular, when reporting on beneficiaries, Awqaf may have to protect the identity or social circumstances of its beneficiaries (for example, the poor, the elderly, the orphans, and other people in necessitous circumstances).

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- **Contribution to social development** - measured by the degree of balance between economic and social returns.
- **Contribution to environmental protection** - measured by role played by the waqf in environmental preservation.

In addition to establishing accountability in the conduct and management of Awqaf, the enhanced transparency can be a major driving force in integrating Awqaf with Islamic finance. Such integration can be instrumental in mobilizing currently idle resources towards bridging the gap in long-term financing and achieving sustainable and inclusive socio-economic development in OIC member countries.

### 3. RATING SCALE

Ratings will be assigned in accordance with the following 100-point scale:

<b>(91-100) - Very Strong Fiduciary Standards</b> (91-93), (94-97), (98-100)
Rights of various stakeholders are well protected and the overall Waqf governance framework is strong.
<b>(76 - 90) – Strong Fiduciary Standards</b> (76-80), (81-85), (86-90)
Rights of various stakeholders are protected. Minor weaknesses have been identified in the overall Waqf governance framework.
<b>(61 – 75) - Adequate Fiduciary Standards</b> (61-65), (66-70), (71-75)
Rights of various stakeholders are adequately protected. Certain weaknesses have been identified in a few Waqf governance related areas.
<b>(40 – 60) – Basic Fiduciary Standards</b> (40-46), (47-56), (54-60)
Rights of various stakeholders are relatively vulnerable. Significant weaknesses have been identified in the overall Waqf governance framework.
<b>(Less than 40) – Low Fiduciary Standards*</b>
Rights of various stakeholders are at high risk and the overall Waqf governance framework is weak.

\* Apart from the lowest score range, all score ranges have been split into three sub-divisions for further clarity

## CONTRIBUTORS



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In 2001, Faheem participated in the establishment of Islamic International Rating Agency (IIRA) in Bahrain. In 2011, he developed and launched 'Fiduciary Ratings'; capturing Mudarib's quality, governance and compliance with Shari'ah principles.

In 2002, he a member of the founding team that established the Association of Credit Rating Agencies in Asia (ACRAA), with an office in Manila.

Mr. Ahmad served as the Chairman of the Board of Directors of ACRAA from 2014-17. He is now serving as the Ambassador for International Relations.

Mr. Ahmad in 2012, conducted a study, funded by ADB, for the development of 'Idealized Default Curves' for mapping national scale ratings to facilitate cross border fund flows.

In 1997, he formed a JV with a leading rating agency of USA, to form DCR-VIS. Japan Credit Rating Agency, Limited (JCRA) joined VIS subsequent to the DCR's merger with Fitch.

As a founder in 2003 and 2005, he helped to establish CRISL, Bangladesh and Islamic International Rating Agency. He is also the founder of Borhan Credit Rating Agency Iran.

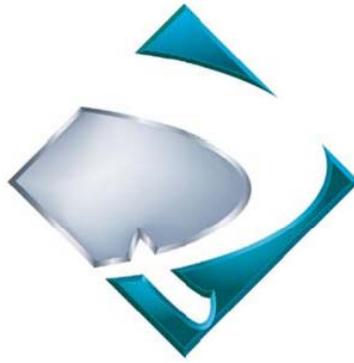


Alaa Alaabed holds a senior financial analyst position with IIRA. She has earned her PhD in Islamic finance from INCEIF, Malaysia where she also won the President's Award in 2012 and 2016. She qualified as a Chartered Islamic Finance Professional (CIFP) in 2011. Alaa was awarded Bachelor of Commerce; major in Finance from Macquarie University, Australia in 2007. Her work experience includes Treasury products' development in HSBC Amanah, Malaysia, buy-side research analysis in SICO investment bank, Bahrain, education in the College of Banking and

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