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METHODOLOGY FOR SHARI'A QUALITY RATING



الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

Serving the Islamic Ummah

Introduction

The “Shari’a” (Islamic Law) Quality Rating aims to provide information and independent assessment regarding the Shari’a governance framework of Islamic financial institutions or conventional institutions providing Islamic banking or financial services, as well as non-financial corporate issuers and Islamic Capital market instruments.

One of the goals of the Islamic International Rating Agency (IIRA) is to become a reference on which investors and financiers can rely, to obtain information in terms of adherence to Shari’a rules and principles for financial services marketed as “Islamic”.

The Shari’a Quality Rating differs from a Credit Rating in that the latter is an evaluation of an issuers’ capability and willingness to repay financial obligations. A Shari’a Quality Rating, on the other hand, is not related to the solvency or financial capability of the institution or to the credit quality of securities or financial products. It is rather 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 adherence to Shari’a principles is enabled.

The governance and Shari’a standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), or other standards setting bodies like the International Financial Services Board (IFSB) are employed extensively as a reference point. In particular, best practices recommended by these standard setting bodies are viewed as a minimum benchmark for IIRA’s assessment. Nevertheless, regulatory developments in multiple countries, also allow IIRA to develop comprehensive guidance for best practices, resulting in a continuously evolving framework of governance for Islamic financial institutions.

The Need for Shari’a Quality Rating

A major element characterizing Islamic financial institutions and products is that they are legitimate and that investors prefer them over conventional products in order to avoid “Haram” (what is forbidden by Shari’a). Therefore, it must be subject to third party review processes and onward communication to investors, i.e. transparency must be effected through ratings. It is IIRA’s belief that no two Shari’a pronouncements may be compared for accuracy or superiority over one another. Therefore the fundamental objective of ratings is to evaluate the process of compliance to a pronouncement, as put in place, rather than the structure of an approved product or a policy. IIRA aspires to serve all Muslims, belonging to different sects and schools.

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’a governance.

Financial Institutions

This methodology is based on the following key factors, indicative of the extent to which a financial institution strives to adhere to Shari'a rules and principles in their activities.

IIRA's evaluation of Shari'a governance begins with an evaluation 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 serves as the starting point of the evaluation. Measures adopted by an institution to adhere to Shari'a 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.

IIRA also examines whether there is a mechanism within the institution to evaluate its own compliance to Shari'a, 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'a Supervisory body and the functions instituted to enable Shari'a adherence, with the legal and policy framework of the institution is integral. Despite direct reporting to the shareholders via an Annual General Meeting, Shari'a 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 effort made by an institution, to integrate the Shari'a Supervisory Mechanism, 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'a governance in tandem with one another and because Shari'a 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'a governance and may be referred for further illustration of the concept.

Shari'a 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 resources to do so. The Shari'a Quality Rating of IIRA evaluates the structure of key asset and liability products/schemes and the corresponding pronouncements of the applicable Shari'a Board, either at institutional or jurisdictional level, to ascertain their compliance with respective pronouncements. The product structures are also related to best practices as laid down by the Shari'a standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Deviations are noted and evaluated vis-à-vis the opinions and/or reservations of the esteemed Shari'a scholars engaged by the subject institution. This allows IIRA to qualitatively assess policies and products and accordingly evaluate the overall product profile of the entity. In cases, where a product while permitted is considered 'not preferred' by a vast majority of Shari'a scholars, IIRA evaluates the circumstances of its use and the extent of its deployment to fine-tune its assessment. The use of such products in the normal course of business tends to have a negative impact on overall ratings.

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. Rigour employed in the audit and review processes, the resources deployed – both human and technological - and the competence of such resources are subject to evaluation.

An evaluation of risk management practices and any measures employed by the subject entity to enable fairness of conduct, are a key area of study. IIRA frequently employs financial ratios to determine the effectiveness of such practices, for instance a comparison of returns earned by the institution vis-a-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 carefully evaluated.

IIRA also seeks to scrutinize the amount and source of non-compliant income and its distribution to charity. 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 deviant transactions.

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

Disclosure of information to the clients/investors regarding operations of the institution and method of calculation of profit or loss and its sharing and the type of businesses undertaken have an impact on the Shari'a Quality Rating assigned.

The Shari'a Quality 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.

Corporate Shari'a Governance Assessment

IIRA also extends its Shari'a quality assessment to non-financial corporates, as part of its Fiduciary ratings referred in earlier sections. Shari'a Governance assessment opines on the mechanisms in place within the subject entity to ensure adherence to Shari'a principles, although given the limited range of financial transactions in these corporations, the scope of Shari'a assessments is accordingly limited.

IIRA's Shari'a evaluation mechanism for non-financial corporates employs the use of a two-tiered system which views the company from a qualitative and quantitative perspective.

- In the first tier, we review the business of the company and comment on its general acceptability in Shari'a or any areas of non-compliance within segments of business undertaken. This assessment is followed by the recognition of Shari'a principles as a way of public life and business in the company's constitutive documents. This must also be incorporated in the company's policy framework. Inter alia, this must entail ready access to a panel of Shari'a scholars, which should be maintained in order to consult in relevant matters from time to time. All matters pertaining to financing and investments must be screened by this panel, as should all new business contracts for any elements repugnant to Shari'a. Furthermore, for disposal of potential non-compliant income the company should maintain a Shari'a approved policy, in addition to a board approved approved list of charitable institutions.
- Quantitatively, the most significant area of study is the reliance on interest bearing debt. The extent of utilization of interest bearing debt and extent of deployment in interest yielding investments is an integral part of the Shari'a rating assigned. The policy for acquiring interest bearing debt, and limits/thresholds on the same, should be in place. In addition, IIRA also reviews the ratio of illiquid assets to total assets, to ensure limited use of cash as an underlying asset, for the issue of underlying liability. Also subject to screening is the quantum of non-compliant income if any, and its disposal thereof.

IIRA's evaluation process is carried out at the request of the institution and in cooperation with it. The rating will not be announced before being discussed with the concerned institution. IIRA's aim is to have a positive impact on the Islamic banking industry, globally and believes that a transparent rating approach is an important element in the achievement of this objective.

Rating Definitions

AAA (SQR)* – In IIRA's opinion, an entity/instrument rated AAA (SQR) conforms to highest level of standards of Shari'a requirements in all aspects of Shari'a quality analysis.

AA (SQR) – In IIRA's opinion, an entity/instrument rated AA (SQR) conforms to very high level of standards of Shari'a requirements in all aspects of Shari'a quality analysis.

A (SQR) – In IIRA's opinion, an entity/instrument rated A (SQR) conforms to high level of standards of Shari'a requirements and has very few weaknesses in some areas of Shari'a quality analysis.

BBB (SQR) – In IIRA's opinion, an entity/instrument rated BBB (SQR) conforms to moderately high level of standards of Shari'a requirements and has few weaknesses in some areas of Shari'a quality analysis.

BB (SQR) – In IIRA's opinion, an entity/instrument rated BB (SQR) conforms to satisfactory level of standards of Shari'a requirements and has some weaknesses in some areas of Shari'a quality analysis.

B (SQR) – In IIRA's opinion, an entity/instrument rated B (SQR) conforms to adequate level of standards of Shari'a requirements and has weaknesses in some areas of Shari'a quality analysis.

Shari'a Quality Rating Process

Issuer/Client	1	Signs agreement for rating with IIRA
	2	Submits preliminary information materials to IIRA
IIRA	3	Informs the Secretariat of the Shari'a Board to formulate the Shari'a Quality Rating Committee
	4	Conducts a preliminary study and sends the preliminary information to the Shari'a Quality Rating Committee
Shari'a Quality Rating Committee	5	Liaises with IIRA to submit a detailed questionnaire to the issuer/client
Issuer/Client	6	Provides detailed information in response to detailed questionnaire
IIRA	7	Sets up with Shari'a Quality Rating Committee the points to be covered during the due diligence
	8	Conducts pre due diligence meeting analysis
	9	Conducts due diligence meetings
	10	Conducts post due diligence analysis
	11	Submits report to Shari'a Quality Rating Committee
Shari'a Quality Rating Committee	12	Decides the preliminary/initial rating
IIRA	13	Notifies issuer/client of the preliminary/initial rating
	14	Discusses the rating rationales and issues with issuer/client
Issuer/Client	15	May appeal based on any new facts or information
Shari'a Quality Rating Committee	16	Deliberates on appeals by issuer/client and gives decision
IIRA	17	Notifies the decision of the Shari'a Quality Rating Committee to the issuer/client
Issuer/Client	18	Consents to release of the rating to the public
IIRA	19	Releases the rating to media



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