METHODOLOGY FOR
FIDUCIARY RATINGS

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

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Preamble

The evolution of Islamic Finance as a parallel to conventional finance has gained significant global recognition in the past few decades. Islamic Finance is recognized as fundamentally different from conventional finance. Its rapid growth in recent years has coincided with the evolution of regulatory framework and guiding principles by international standard setting bodies. These developments bear cognizance of the unique nature of Profit Sharing Investment Accounts (PSIAs) in an Islamic Financial Institution (IFI) and the rights & obligations unto same. The role of Islamic bank as 'Mudarib' (Investment Manager) and 'Ameen' (Custodian) has also increased the importance of good governance.

Islamic finance actually 'reassigns rights and obligations of all stakeholders'. The presence of mushariks in an Islamic bank reassigns the role of capital providers (banks are no longer directly responsible to absorb loss on PSIAs) and the mushariks (whose capital may not be entirely protected in absolute terms, but should have a higher right to disclosures). Similarly, it is the obligation of a Mudarib to not just select risks wisely, but also ensure that the businesses it invests in are also Shari'ah-compliant, thereby adding another dimension to the set of his obligations unto his stakeholders.

The unique nature of IFIs necessitated the development of an assessment methodology that captures the various dimensions of IFIs. Recognizing this need, Islamic International Rating Agency (IIRA) has developed the 'Fiduciary Rating System'. This is a two-dimensional rating offering for IFIs. In contrast to conventional rating offerings that focus either on credit or governance aspects, the Fiduciary Rating System developed by IIRA recognizes the mutually dependent nature of credit & fiduciary risks in an IFI. The presence of sound governance structure does not guarantee strong financial performance and Fiduciary Scores may be faced with downward pressure on account of credit-related developments notwithstanding the absence of any negative developments on the fiduciary front. Poorly governed institutions may however be more susceptible to the risk of failure.

All of the information contained herein is obtained by IIRA from sources believed to be accurate and reliable. IIRA does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided without any representation or any warranty of any kind. IIRA's ratings reflect IIRA's opinion and are not a warranty of a rated entity's current or future ability to meet contractual obligations, nor are they a recommendation to buy, sell or hold any security.

Rating Methodology

The Fiduciary Rating System consists of two broad pillars: Credit Rating & Fiduciary Score.

I. Credit Rating:

The credit rating assessment is focused on the ability and willingness of an institution to meet its contractual obligations in a timely manner. In case of IFIs, the nature of liability in various modes of financing differs. For PSIAs, the failure to meet the terms of the contract will be construed as default, i.e. if the bank pays an amount that is less than what is due after adjusting for profit or loss, if any, the bank is considered to be in default. The IFI is not obliged to bear all losses unless the losses are a result of misconduct or negligence on the part of the Mudarib or entrepreneur. For other liabilities, such as Amanah accounts, the terms of the contract require payment in full of the invested amount. Likewise, ability to honor other liabilities such as L/Cs, money market placements, etc. will be accounted for in credit ratings.

Credit ratings will be assigned on the issue/issuer scale available on IIRA's website. The complete rating methodology for 'Bank Ratings' is published as an independent document.

II. Fiduciary Scores:

The analytical framework for Fiduciary Scores has been developed to accommodate the unique features of IFIs and jurisdictional differences in Shari'ah standards. Key concepts presented in this methodology can be adapted to other types of IFIs as well, such as takaful and asset management companies. Aggregate fiduciary score is derived from three elements, which are:

The Fiduciary Score reflects IIRA's current and prospective assessment of the above elements and will incorporate on-going efforts to address deficiencies or to elevate existing standards. The above three elements will be scored independently and then a weighted score will be computed as the final Fiduciary Score. This rating methodology is expected to ensure a much higher degree of transparency, through enhanced disclosures, thereby giving a higher degree of value addition to investors.

Disclosure on component scores forms an important part of the ratings communication. For some stakeholders, fiduciary risk considerations may assume greater significance (as in the case of PSIA holders) while for others, credit risk could be the primary risk consideration. The Fiduciary Rating System is designed to cater to all stakeholders. It will appeal to the Shari'ah conscious investors who wish to compare between institutions in terms of their ability to remain compliant with internal Shari'ah rulings as well as the PSIA holders who are concerned with the IFI's potential to safeguard the value of their investments. At the same time it will assess the ability of the institution to manage banking business in a way that all liabilities are met in a timely manner to the extent that their specific contracts require. The Fiduciary Rating Framework is an on-going exercise. The rating process is expected to facilitate IFIs to track their own evolution over time.

RATING SCALE – FIDUCIARY SCORES

(91-100) - Very Strong Fiduciary Standards
(91-93), (94-97), (98-100)*

Rights of various stakeholders are well protected and the overall governance framework is strong.

(76 - 90) – Strong Fiduciary Standards
(76-80), (81-85), (86-90)*

Rights of various stakeholders are protected. Minor weaknesses have been identified in the overall governance framework.

(61 – 75) - Adequate Fiduciary Standards
(61-65), (66-70), (71-75)*

Rights of various stakeholders are adequately protected. Certain weaknesses have been identified in a few governance related areas.

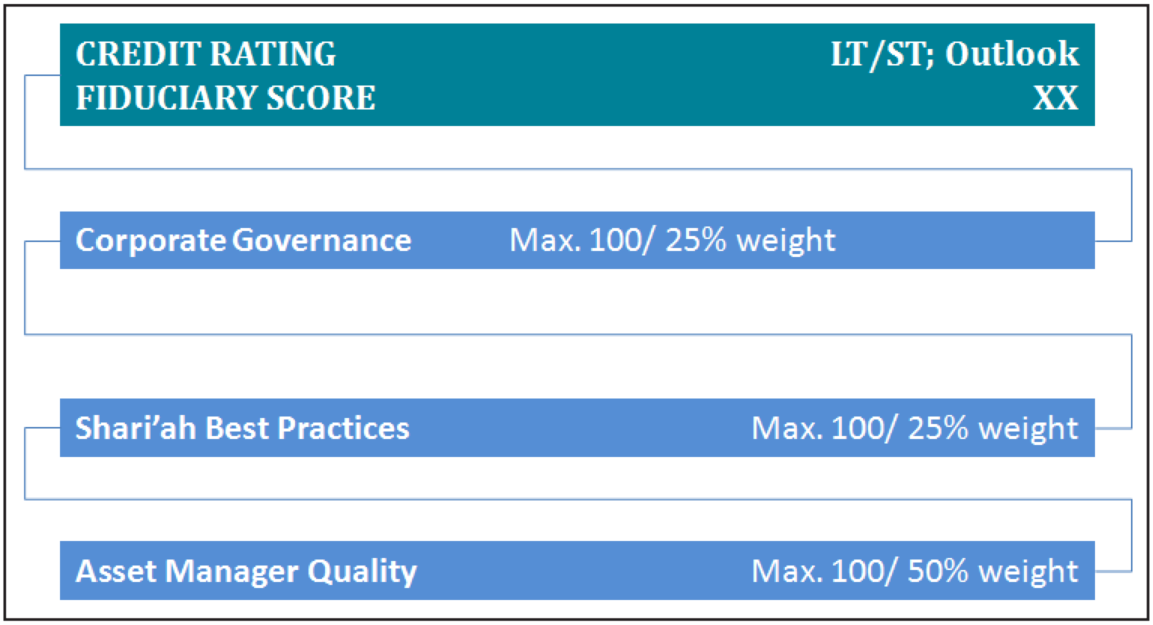
(40 – 60) – Basic Fiduciary Standards
(40-46), (47-56), (54-60)*

Rights of various stakeholders are relatively vulnerable. Significant weaknesses have been identified in the overall governance framework.

(Less than 40) – Low Fiduciary Standards

Rights of various stakeholders are at high risk and the overall governance framework is weak.

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



FIDUCIARY SCORE

1. Corporate Governance

Corporate Governance standards and their evaluation is undertaken to ensure that the organization fairly protects the interest of all stakeholders. Board of directors plays a vital role as it has the responsibility of endorsing the business strategy, monitoring performance, appointing, supervising and remunerating senior executives and ensuring accountability and transparency. IIRA evaluates the governance standards of the assessed entity and assesses the composition of the board and experience of the board members. Presence of independent directors is considered positively. Moreover communication with the board also carries importance.

Transparency (absence of 'Gharar'), is a fundamental pillar of Islamic Financial transactions, as well as a key principle of good governance. In Islam, a transaction becomes void if it is not transparent in its conduct. The role of an Islamic bank as 'Mudarib' and 'Ameen' has increased the importance of governance and an independent opinion on the same highlights the organizational system in place to safeguard the interests of all concerned. This is the first of the three elements of a fiduciary score that will be assigned by IIRA.

The Corporate & Shari'ah Governance structure is the result of the interaction between the Rabb-ul-Mal, the Board of Directors and the Management, which acts on behalf of the shareholders. The form of ownership structure also has bearing on corporate practices. The Board exercises its powers directly and 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. The term corporate governance covers a broad spectrum of activities of the Board of Directors (BoD) and the management of an organization. The corporate governance practices of an individual institution will be evaluated against global best practices. IIRA will aim to determine the extent to which corporate governance practices put in place by management help in achieving the ultimate goals of transparency, accountability and fair play.

A BoD 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. For Islamic banks, and to facilitate the development of a governance culture in keeping with the Shari'ah compliant nature of banking, the presence of Islamic finance related expertise on the board is particularly appreciable. 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. Following are the key areas IIRA exam- ines while conducting corporate governance assessment:

Board Effectiveness

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. IIRA also studies compliance with the applicable standards pertaining to corporate 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 the bank 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 most 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 are closely evaluated. Furthermore, management's relationship with shareholders, regulators, staff and customers is further an area of consideration.

Financial Information Transparency

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

Self regulation

This area deals with the control infrastructure in place. Presence of an independent and vigilant audit committee facilitates a sound internal financial control environment. A strong internal audit and risk management function is central to an 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 decisions being taken.

Related Party Transactions

Board's role in reviewing and approving related party transactions is an important consideration while forming an opinion. 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.

2. Shari'ah Best Practices

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 compliance with the internal guidance provided by an institution. Shari'ah governance standards of the bank are evaluated in the light of best prac- tices, as also laid down by the Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) – two eminent standard setting bodies in Islamic Finance. These stan-

instability in management will discount the assessment of the strategy. To avoid ambiguity, the organization's hierarchical pattern must be distinctly defined so that employees are aware of their job definitions, responsibilities and authorities. It is important to have an opinion as to whether management will lead the IFI through new avenues or manage it as a follower of market trends. The resource base of the IFI also plays its due role in determining the strength of the management to maneuver within the market.

A fundamental responsibility of an IFI is to conduct the business in an honest, diligent and transparent manner and thereby fulfill the rights and obligations of financial stakeholders. For example, while it may not be legally binding on the Mudarib to maintain the amount invested by an investment account holder, the competence with which these amounts are invested and the level of disclosure to IAHs assumes much greater importance in the context of an IFI. Therefore, there is basically no concept of shareholders absorbing the first loss. Instead, to a certain degree, shareholders have the right to a return similar to PSIA holders, with whom they act as musharikss or co-investors. IIRA would look into the returns given to PSIAs versus the return to shareholders i.e. ROE, and if there is significant difference, then the reasons for those would be evaluated.

Control measures undertaken by the management including contingency plans in effect and the degree of centralization will be separately analyzed. The IT systems deployed play a key role in facilitating timely decisions and appropriate staff training in this respect is considered essential.

Risk Management Framework

In order to gauge the efficacy of Risk Management Framework deployed in an institution, its processes shall be reviewed in context of its ability to identify, measure, monitor, report and control various aspects of risks. IIRA believes that a strong risk management framework flows from adequate oversight by the BoD and senior management. A Board level/Senior Management Risk Management Committee may be constituted and assigned the task of overseeing this function.

a. Credit Risk

Credit risk exposures arise in connection with accounts receivable in Murabahah contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisna` contracts and lease payments receivable in Ijarah contracts. It is for this reason that evaluation of underwriting standards and counterparties in an IFI assumes just about as much importance as in a conventional bank.

The product mix of any institution will determine its exposure to various sources of risk. As Islamic products are characterized by varying facets of risk at different stages of financing, the policies developed by IFIs regarding credit risk should reflect the same. Evaluation of underwriting standards and counterparties in an IFI assumes significant importance.

An important consideration in the assessment will be the quality of due diligence process of counterparties carried out by the IFI, to determine the suitability of financing product, prior to approving the financing agreement. IIRA will also look at security selection criteria for income instruments. Legal enforceability of pledged assets continues to pose a challenge in Islamic finance, given the lack of precedence of such transactions.

In some jurisdictions, IFIs are prohibited from imposing any penalty other than in the case of willful delay by the counterparty, which may increase the probability of default. Thus, Credit Risk Mitigation as practiced by the IFI becomes an important area of Islamic finance and its techniques may vary from one country to another depending on the legal and Shari'ah rulings. Ratings will therefore be accordingly impacted, depending on the applicable regulatory framework.

The financial indicators that will be used to evaluate asset quality will be similar to those used in conventional banks, such as level of infection, extent of provisions held, forced sale value of available collateral, diversification in operations and concentration by asset type and by sector, entity or a business group. In addition to this, the mix of financing products used by an IFI also has implications for its risk profile, given the varying nature of risks inherent in each of these. Investment policy of an IFI must be based on the risk expectations of the IAH.

b. Business Risk

Business risk pertains to two Islamic products, namely, Mudarabah and Musharakah, held for investment purposes. Exposure in investments made under profit-sharing and loss-bearing mode, i.e. Mudarabah and profit and loss sharing mode, i.e. Musharakah, are also exposed to capital impairment risk. Important considerations in equity investments is the extent of thoroughness employed by the management in assessing the expertise of the partner, nature of business activities, operations and exit strategy of the IFI. IIRA believes that identification of risks prior to entering into a partnership will prepare the IFI in terms of what to expect from the partnership and accordingly introduce risk mitigating structures in a timely fashion.

c. Liquidity Risk

Two major sources of funds for an IFI are current account holders and unrestricted IAH. Policies in place for managing liquidity risks arising from each category of funding (current accounts, unrestricted investment accounts and restricted investment accounts) and on an aggregate basis, will be reviewed. Since IIRA believes that liquidity risk needs to be evaluated in the overall institutional context, the adequacy of liquid assets will be gauged in relation to all of an Islamic bank's liabilities, such as non-remunerated Amanah accounts, asset backed liabilities and profit sharing investment accounts. In addition to this, IIRA will also evaluate maturity mis-match between assets and sources of funds.

Diversity in sources of funds, granularity in the funding base and size of retail base are considered positive rating factors while analyzing the funding mix of an IFI. Nature and quantum of liquid assets maintained by an institution will be evaluated in context of its funding mix and quality of assets.

While liability arising from PSIAs is different from conventional liabilities, in view of the mutability of these accounts into pure conventional credits in case of lower than expected returns or loss and negative perceptions regarding Shari'ah compliance status of the IFI, we at IIRA believe that liquidity risk needs to be examined in the overall institutional context. The adequacy of liquid assets will be gauged in relation to all of an Islamic bank's liabilities, such as non-remunerated Amanah accounts, asset backed liabilities and profit sharing investment accounts.

d. Rate of Return Risk

Upward movement in market benchmark rates may increase the expectations of PSIA holders regarding expected return. To meet the expectations of IAH, the IFI may pay a higher return than actually earned on the assets funded by IAHs, resulting in displaced commercial risk. Policies for sharing returns with PSIAs should be well-defined and duly approved by the BoD. Moreover, consistent implementation of the same will be examined, in addition to the earlier mentioned policies on establishment & use of PER & IRR.

e. Market Risk

On and off-balance sheet exposures of an institution are susceptible to movements in market prices. The IFI is exposed to similar risks as faced by conventional financial intermediaries, with regards to assets held in the trading book, in addition to foreign exchange risk and commodity risks. However, on the financing side, analysis of market risk requires a more in-depth approach as IFIs may be exposed to Inventory Risk, as IFIs may be holding assets with a view to re-selling or leasing them. The mix of such assets including real estate, commodities and consumer goods carried by an Islamic bank and resultant price risk carried on books will be evaluated.

Various Shari'ah compliant hedging techniques may be used to limit the IFI's exposure to market risk; however, permissibility of such measures may vary from one jurisdiction to another. The availability and use of such hedging techniques will be factored into ratings.

f. Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The operational risk infrastructure would be evaluated for key risks and their controls residing in each business unit and its impact on overall risk profile of an institution. In addition to managing the risk of loss arising from failures in internal controls, an IFI is also expected to ensure compliance with Shari'ah rules and principles and fulfill fiduciary responsibility. Shari'ah compliance risk is a type of operational risk facing Islamic banks which can lead to non-recognition of income and resultant losses. This includes failure by IFI to act with due care when managing investments resulting in the risk of possible forgone profits to IAH. In evaluating the exposure to operational risk, IIRA will look at the mechanisms developed to safeguard the interests of all fund providers. Within this context, IIRA will also look at how well policies & procedures are documented and disseminated within the organization, the checks in place to ensure compliance, among other things.

IIRA also recognizes the overlapping nature and transformation of risks that exist between and among the categories of the earlier mentioned risks. For instance, in a non-binding promise to purchase, failure of counterparty to purchase its share of assets, which is a source of credit risk, may transform into market risk, as the bank will be left with the underlying asset and hence exposed to its changing market price. Ability of the systems to capture the changing risk profile allows management to make timely decisions.

An IFI's earning potential is a culmination of its exposure to various sources of risk, dictated by the investment policy in place. As far as funds of IAH are concerned, exposures of an IFI must be aligned with the risk-return expectations of IAH. The ability to preserve capital is a function of the actual risk profile of assets as discussed earlier.

Ability to preserve capital and return on PSIAs

The third and most pertinent element, likely to concern all stakeholders is the degree of competence and diligence exercised by an IFI in his role as asset manager of the investment account holders and the amanah account holders. This capability translates into the ability of the asset manager to return amanah in its entirety and preserve the value of investment of PSIAs, against foreseeable and manageable risks (mostly un-systemic risks like business risks, etc). This is regardless of the fact that the IFI may not be contractually liable to ensure that principal investment of PSIAs does not experience any degree of erosion.

It is important to reiterate that investment policy of an IFI must be based on the risk-return parameters as predetermined with the IAH, in as far as the funds contributed by IAH are concerned. Other than managing funds raised by way of Amanah accounts and those contributed by PSIAs, an Islamic bank also has to manage funds contributed to IRR & PER. The investment policy of PER & IRR and the level of risk assumed in managing these funds has implications for the availability of funds when required, i.e. for absorbing losses on PSIAs and smoothing returns.

While an IFI has not committed to provide a pre-determined return, it has to strive to meet the expectations of its PSIAs, to avoid attrition of funds. Adverse trends in macroeconomic variables have implications for the industrial and financial sector as a whole. Some are affected more than others. In such an event, returns offered by an IFI may come under pressure.

Unrestricted PSIAs are investment accounts with no specific asset allocation. The bank uses the funds as it sees fit. Thus, the unrestricted PSIA holder faces the risks attached to all the businesses of the bank. Restricted PSIAs are accounts with an investment mandate. The investor can choose the nature, but not necessarily a specific asset, for investment. The funds of restricted PSIAs are therefore like conventional assets under management. Use of PER & IRR may apply to assets financed by both unrestricted and restricted PSIAs, unless the practice of income smoothing by the IFI has been confined to unrestricted PSIAs. The size of pool of such funds in relation to PSIAs therefore determines the extent to which PSIAs will be protected from the effects of adverse changes in risk profile of assets.

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