

Honorable speakers and respected guests, Assalam-o-Alaikum

It is indeed a pleasure to be here and talk of the now much debated issue of ratings for Islamic Financial Institutions. It has long been felt that Islamic finance is more than just finance as we know it, in an Islamic outfit. We at IIRA believe that Islamic finance is fundamentally different and actually “reassigns rights and obligations of all stakeholders”. Therefore assessing the ability of an institution to fulfill those rights and obligations requires a completely different approach.

It is a well documented fact that when credit ratings became embedded in global financial environment in the later part of the last century, the emphasis was on the financial ability of companies to pay back their credits. As a number of corporate debacles emerged in the 90s and later, investors became more conscious of the role of good governance in meeting expectations of creditors and often the next largest financial stakeholder, i.e. shareholders. In response to this need, corporate governance ratings took root as a distinct area of assessment in addition to becoming an area of greater emphasis in the traditional approach to ratings. Subsequently management quality ratings for fund managers also came to the fore.

Governance ratings assess non-financial risks or the risks associated with ‘dishonest’ management. Transparency (absence of ‘Gharar’), is a pillar of Islamic Financial transactions, as well as a key principle of good governance. In Islam, a transaction becomes void (fasid) if it is not transparent in its conduct. A fundamental responsibility of an IFI, who plays the role of ‘Mudarib’ and ‘Ameen’, is to conduct the business of an IFI 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 mushariks or co-investors.

The presence of mushariks in an Islamic bank, reassigns the role of capital providers (they 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 halal, thereby adding another dimension to the set of his obligations unto his stakeholders.

Keeping in mind these new roles of each stakeholder, we at IIRA have attempted to lay down a methodology that doesn’t try to fit IFIs into the traditional approach to ratings. Our Fiduciary Scores capture the nature of Islamic banking better than before. As was said earlier,

the role of 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 interest of all concerned. This is the first of the three elements of a fiduciary score proposed to be assigned by IIRA, as part of the fiduciary rating.

Another important obligation that distinguishes an Islamic bank from the rest is being accountable for engaging and investing in businesses that are halal, and in accordance with the directives and with permit from the institution’s own Shari’ah Guidance System, i.e. by way of a committee or an advisor. A Shari’ah compliance score will serve to provide an independent judgment on the degree of compliance with these precepts.

The third and most pertinent element, likely to concern all stakeholders is the degree of competence and diligence exercised by the mudarib 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. The above three elements will be scored independently and then a weighted score will be computed as the final fiduciary score. The key advantage to this rating methodology is that it allows a much higher degree of transparency, through enhanced disclosures, thereby giving a higher degree of value addition to investors.

The fiduciary scores will form an integral part of fiduciary ratings, which would also include, in addition to the fiduciary scores, an assessment of the IFIs ability to fulfill its contractual liabilities, i.e. be able to fund L/Cs and guarantees, repay amanahs and repay PSIAs the amount due to them after adjusting for profit or loss.

The fiduciary rating system therefore caters 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.

We have developed a broad scale for Fiduciary Scores as illustrated here.

Now we will examine the Fiduciary Rating System and its pillars in greater detail.

From a credit rating perspective, we at IIRA will evaluate the ability and willingness of an institution to meet its contractual obligations when due. The nature of liability in various modes of financing differs. In case of 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. 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, guarantees, etc. will be accounted for in credit ratings.

While liability arising from PSIAs is different from Amanah accounts, in case of lower than expected return or loss to PSIAs and negative perceptions regarding Shari'ah compliance status of the IFI, the PSIA liability may mirror a conventional deposit like liability. In view of this, liquidity risks and operational risks and their likely impact on the IFI's ability to pay on a timely basis are to be examined on an institution wide basis. Also, the possibility of primary risks including impairment in investments of an IFI, intensifying secondary risks like liquidity shortages are to be considered likewise.

A key distinguishing feature in Islamic finance is the fact that Hiba or Gift is not legally binding. This implies that the extent of sponsor support that may be built into ratings of Islamic banks may be limited. Given the changing nature of risks in case of financing by an IFI, CAR has to be tracked over relatively frequent intervals to provide a more accurate picture of an institution's exposure to various sources of risk.

The amount of capital required to serve as cushion to absorb losses in case of an Islamic bank is a function of the funding mix; the higher the proportion of current accounts, the larger the capital base required. Contractually, shareholders are not liable to absorb any losses against PSIAs. Funds mobilized under profit-sharing and loss-bearing mode, i.e. Muḍārabah and profit and loss sharing mode, i.e. Mushārah, allow losses to be passed on to the investors, unless management negligence is proven. PSIAs act like quasi equity, in their ability to absorb losses. The adjustment made to Risk Weighted Assets for assets funded by PSIAs in calculating CAR reflects this very loss absorbing capacity of PSIAs. This also implies that all else remaining same, an IFI may exhibit greater capacity to absorb risks vis-à-vis a conventional bank, operating in the same environment.

The second pillar of the Fiduciary Rating System is the Fiduciary Scores, which is a combination of three elements.

The Corporate & Shari'ah Governance structure is the result of the interaction between the Shareholders, i.e. Rab-ul-Mal, the Board of Directors and the Management, which acts on

behalf of the shareholders. The Board exercises its powers directly and through various committees functioning at the Board level to provide broad policy framework and maintain independent oversight of operations. The Shari'ah Board is an additional supervisory body. 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 matched against global best practices. We will aim to determine as to what extent the 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. We will be reviewing not only the degree of oversight exercised by the Board itself but also the ToRs and functioning of Board level committees for their effectiveness. Given that IFIs are also accountable to IAHs, we will specifically review the measures taken for the preservation of rights of IAHs. In cases where the funds of IAHs and shareholders are commingled, there could be some perceived conflicts of interest between shareholders and IAHs. An independent committee established at the BoD level could be assigned the role of monitoring such issues. If assets funded by a given pool of PSIA are not identified separately, there is possibility of adjusting returns within pools. Such practices may not be viewed favorably, as they compromise the basic concepts of fair play.

In an Islamic bank, the Shari'ah Governance System is expected to complement the governance, control and compliance functions in a conventional bank. We will review the consistency of Shari'ah pronouncements and the systems developed for dissemination of Shari'ah resolutions to both the staff engaged in day-to-day activities and also the staff responsible for ensuring compliance. A satisfactory independent Shari'ah audit is expected to provide greater level of comfort as regards the practices within an organization.

As shareholders are entitled to vote in general meetings, pass resolutions and to access the documents of an Islamic bank, we believe that the IAHs' right to monitor the performance of their investment should also be recognized. Under a Mudarabah contract, the Islamic bank has a fiduciary duty to the IAH to acknowledge their interests at par with those of the bank's own shareholders. Moreover, shareholders and IAH rank pari passu as residual claimants in regard to assets financed by funds commingled in the same asset pool. Therefore, an institution which establishes such procedures so as to accord the IAH their due rights will be viewed positively.

An Islamic bank may establish a PER for “smoothing the returns” for IAH. However, use of PER masks any volatile trends in the performance of funds. Thus, we believe 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. The establishment of IRR does not preclude IAH from monitoring their investments; however, inter-generational problem arises both in IRR and PER. While, in principle, shareholders have some controls over a bank’s dividend policy and use of reserves, IAHs have no control over the use of PER and IRR. In view of these issues, the fiduciary responsibility of an Islamic bank in terms of developing a distribution policy for PER and IRR and ensuring its implementation in a fair manner, becomes extremely important and will be critically reviewed. The IAHs also need to be aware of the distribution policy of PER at the time of liquidation of the IFI.

The reporting of financial and non-financial information by an Islamic bank must meet the requirements of internationally recognized accounting standards which are in compliance with Shari`ah rules and principles and are applicable to the Islamic financial services industry. We will look at the level of detail in the disclosures, the frequency of reporting and the quality of the auditors. It must be noted here that meeting minimum statutory disclosure requirements will not necessarily qualify a bank for a high score in this area.

Considering the nature of contract with the IAHs, we believe that disclosures pertaining to the funding provided by IAHs should be comprehensive. These may include information on policies, procedures, product design/type, basis of allocation of assets, expenses and profit in relation to IAH funds. Share of profits earned by unrestricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested), average declared rate of return or profit rate on unrestricted PSIA by maturity (3-month, 6-month, 12-month, 36-month) are some of the disclosures considered important.

An Islamic bank should also disclose the framework, policy and practices for managing the risk-return mix of the IAH and the resulting DCR and provide indicators that enable the stakeholders to assess the aggregate risks facing the IAH and the extent of risks transferred to the shareholders.

The second element in Fiduciary Scores is Compliance with Shari'ah principles. The idea of Shari'ah governance has become an important element in ratings. Shari'ah non-compliance can affect the earning potential and more importantly an institution’s franchise value. The spirit of this exercise is to evaluate compliance with Shari'ah rules & principles, as dictated by an institution’s governing body, which may be the entity’s own Shari'ah Board or a central authority that has the power to issue such pronouncements. The practices of different IFIs may vary by different jurisdictions or by the views of their respective Shari'ah Boards and we will limit our evaluation to the extent of compliance with the applicable pronouncements. For

example, a binding bilateral promise in an exchange of currencies, equivalent to a forward contract, is prohibited by Shari`ah jurists in most (but not all) countries as the delivery of one or both counter values is deferred. If such a transaction is undertaken by an institution after being approved by its Shari`ah Board, it will not be considered a non-compliance issue, just because it is not allowed in other jurisdictions.

In order to evaluate Shari`ah Compliance, we will look at the governance arrangements, systems and controls employed by the bank to ensure Shari`ah compliance and how these meet applicable international standards. If there is less than full compliance with desirable standards, an explanation of the reasons for non-compliance will be sought. In countries where national guidelines on Shari`ah governance in IFIs exist, and the related governance requirements of the IFSB's Corporate Governance Standard are followed, a statement of compliance with these standards (and reasons for any non-compliance) will be taken.

By evaluating an Islamic bank's income against its stated policy of how Shari`ah non-compliant earnings and expenditure can occur, the volume of such income over the years will be tracked. The manner in which such income may be disposed off may also be a subject of Shari`ah ruling. By looking at the nature, size and number of violations of Shari`ah compliance during the year, we will be able to determine as to how effectively an IFI has been able to disseminate the Shari`ah policy framework throughout the organization.

An Islamic bank's role is far greater than simply that of a borrower and lender. Likewise, the management of an Islamic bank is expected to possess greater degree of business acumen. The ability to manage diverse asset classes is of key interest. On the one hand, the management must work to optimize the risk return proposition for IAHs, funds contributed by Amanah accounts may need to be managed on a conservative note.

The control procedures of the bank and the future of the entity as envisioned by the top management is the most significant and intangible of all rating factors. The stability of management as indicated through succession plans and employee turnover ratios affect the continuity of the management's long-term plans, and instability in management will discount the assessment of the strategy. The quality of IT systems deployed play a key role in facilitating timely decisions. Control measures undertaken by the management including contingency plans in effect and the degree of centralization will be separately analyzed.

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

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 IFI 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. We 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.

Business risk pertains to two Islamic products, namely Mudarabah and Musharakah held for investment purposes. 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. We believe 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.

Two major sources of funds for an IFI are current account holders and unrestricted IAH. 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. In addition to this, we will also evaluate maturity mis-match between assets and sources of funds.

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 PSIA should be well-defined and duly approved by the BoD. Moreover, consistent implementation of the same will be examined.

On and off-balance sheets 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. *Risk Weight on such inventories is 15% of carrying value.* 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.

In addition to managing the risk of loss arising from failures in their internal controls involving processes, people and systems, 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, we will look at the mechanisms developed to safeguard the interests of all fund providers. Of course, the scope of operational risk is very broad and here we have listed only a few areas that we will be evaluating.

It is important to reiterate that investment policy of an IFI must be based on the risk-return parameters as pre-determined with the IAH, in as far as the funds contributed by IAH are concerned. While liability arising from PSIA's 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.

Other than managing funds raised by way of Amanah accounts and those contributed by PSIA's, 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 PSIA's and smoothing returns.

We also recognize 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.

While an IFI has not committed to provide a pre-determined return, it has to strive to meet the expectations of its PSIA's. 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. In such a scenario, PER & IRR may be used to smooth returns or absorb losses. The size of pool of such funds in relation to PSIA's therefore determines the extent to which PSIA's will be protected from the effects of adverse changes in risk profile of assets. Adequacy of capital in relation to obligations other than PSIA's determines the extent to which losses may be absorbed before the ability of the bank to meet its obligations is impaired.

Having discussed all the elements of Fiduciary Score, let us compare two banks illustrated here. In addition to providing an aggregate score for a bank, scores for each of the three elements will be an integral part of the rating communication, to allow market participants in making informed decisions as per their own set of priorities, which may be preservation of capital for some, while for others it may be compliance with Shari'ah principles.

Fiduciary Ratings are proposed to be conducted at two levels; i.e. we propose two scales for Fiduciary Ratings. Firstly, IIRA will assign Local Scale Ratings within a domestic context. This may be particularly useful in case where sovereign ceiling cap is very low. Secondly IIRA will assign Fiduciary Ratings on the basis of a Regional Scale, which would allow more granular distinction between ratings vis-à-vis global rating scale.

Thank You.