

# METHODOLOGY FOR FIDUCIARY RATINGS



الوكالة الإسلامية الدولية للتصنيف  
Islamic International Rating Agency



# METHODOLOGY FOR FIDUCIARY RATINGS

## 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.

## 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.

**CREDIT RATING**  
**FIDUCIARY SCORE**

**LT/ST; Outlook**  
**XX**

**Corporate & Shari'ah Governance**  
(including transparency & disclosures)

Max. 100/ 25% weight

**Compliance with Shari'ah Principles**

Max. 100/ 25% weight

**Asset Manager Quality**

Max. 100/ 50% weight

## FIDUCIARY SCORE

### 1. Corporate & Shari'ah Governance (including transparency & disclosures)

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 if it is not transparent in its conduct. 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 that will be assigned by IIRA.

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 form of ownership structure also has bearing on the ways governance is conducted in an organization. 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, which assumes significant importance in an IFI. Timely provision of information and transparency in disclosures allows all stakeholders to make informed decisions and is considered an overriding necessity. The role of these two bodies must be distinctly defined for effective governance to prevail. IFIs may pursue different Shari'ah Board structures, varying from in-house expertise to out-sourced arrangements. Any regulatory requirements specific to a particular jurisdiction will be considered in this context.

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. IIRA 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.

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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. 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. Given that IFIs are also accountable to Investment Account Holders (IAHs), IIRA 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 PSIAs 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. IIRA 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.

IIRA 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. 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.

As shareholders are entitled to vote in general meetings, pass resolutions and to access the documents of an Islamic bank, IIRA believes 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 Profit Equalization Reserve (PER) for "smoothing the returns". Use of PER masks any volatile trends in the performance of funds. Thus, 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. The establishment of Investment Risk Reserve (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. IIRA will look at the level of detail in the disclosures, the frequency of reporting and the quality of the auditors. It may be pertinent to note that meeting minimum statutory disclosure requirements will not necessarily qualify a bank for a high score in this area.

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Considering the nature of contract with the IAHs, IIRA believes 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 Displaced Commercial Risk (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.

## **2. Compliance with Shari'ah principles**

Another important obligation that distinguishes an Islamic bank from the rest is being accountable for engaging and investing in businesses that are Shari'ah-compliant, 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. This would include compliance with Shari'ah requirements with respect to product design and development, legal documentation and processes.

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 IIRA will limit its evaluation to the extent of compliance with the applicable pronouncements.

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.

## **3. Asset Manager Quality**

An Islamic bank's role is far greater than simply that of a borrower and lender. The IFI also invests funds made available by PSIA holders like an asset manager would. IIRA believes that the investment acumen of the IFI's management and their ability to manage a wide range of investment mandates and asset classes are fundamental to the IFI's performance as an asset manager. On the one hand, the management must work to optimize the risk return proposition for IAHs, while funds contributed by Amanah accounts may need to be managed on a conservative note.

The control procedures of an IFI and the future of the entity as envisioned by the top management is the most significant and intangible of all rating factors. The trickle down of the top management's vision and the clarity of the strategy identified, are factored into the ratings. The stability of the 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. 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



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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 mushariks or co-investors. IIRA would look into the returns given to PSIA holders 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 busi-

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ness 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 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.

#### **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 PSIA's 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.



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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 pre-determined 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

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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.

While an IFI has not committed to provide a pre-determined return, it has to strive to meet the expectations of its PSIA's, 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 PSIA's 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 PSIA's are accounts with an investment mandate. The investor can choose the nature, but not necessarily a specific asset, for investment. The funds of restricted PSIA's are therefore like conventional assets under management. Use of PER & IRR may apply to assets financed by both unrestricted and restricted PSIA's, unless the practice of income smoothing by the IFI has been confined to unrestricted PSIA's. 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.



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