

Shari'ah Rating of Islamic Financial Products

First draft

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الحمد لله والصلاة والسلام على نبينا محمد وعلى آله وصحبه وسلم وبعد :-

What is Shari'ah rating:

Shari'ah rating is a process the purpose of which is to provide the public with an independent appraisal that assesses the commitment of the management of a financial institution to follow Shari'ah injunctions in their business and to avail Muslims with an unbiased opinion on the Shari'ah quality of the Islamic banking and financial products offered to the public by that institution.

Shari'ah rating is fundamentally different from traditional “credit rating” which assesses the ability of a bank, a company or a bond issuer to fulfill its obligation with respect to debt repayment or determine the credit quality of a negotiable paper. It is not concerned with performance, nor addresses banks ability to satisfy its contractual obligations. Being accepted as Shari'ah compliant by the agency says nothing about the financial strength of the institution or the management quality of the

same or investors ability to receive back their money or the expected profits.

Why Shari'ah rating:

Islamic banking goes back to over a quarter century ago. However, Islamic banking really took off during the last few years and especially in the 21st century. The rate of growth of Islamic banking during the last decade was remarkable.

Two elements contributed to this exceptional achievement: The entrance of conventional banks into Islamic banking and the phenomenal growth in Islamic Investment Funds.

With the process of globalization of financial services gaining momentum, the players in Islamic banking became very diverse and truly global, competing in every market and reaching out via modern means of communications to people in every corner of the globe. Without a question, these are all positive developments. However Muslims are finding themselves increasingly in need of a means to differentiate among a growing number of Islamic banks, Islamic banking product providers and products labeled as Islamic. Information and analysis on the credit standing, management quality are readily available from international rating agencies. Nevertheless,

rating on the “raison d’être” of Islamic banking which is Shari'ah aspects of the business is non-existent.

Many studies and surveys have been done on different aspects of the market for Islamic banking products. Without going into details, they very clearly show that the most important motivation for a client to come to an Islamic bank (or buy an Islamic banking product) is the perception that they are “Islamic”. However, until today there is no “standard of quality” for Shari'ah implementation. Certainly, those who come to a bank or buy a security in the market because they are Islamic would prefer to know that Shari'ah quality has been assessed by an independent third party. Furthermore, because the market for Islamic banking is now quite sizeable and growing, we need a level playing ground for competition. Competition will not be meaningful with a level playing field where it is possible to find common denominators between players. Rating goes a long way in accomplishing that.

Who is to be rated:

Potential beneficiary of the rating of the Islamic financial products are numerous:

- 1- Islamic Sukuk.
- 2- Islamic banking products offered to the public.

How Shari'ah rating:

The primary objective of Shari'ah rating is not to make a judgment on the “Islamicity” of a banking operation or on the permissibility (or otherwise) of a financial product. This is completely left to the Shari'ah board that approves the product. Products that have not been approved by a Shari'ah board are not accepted for rating. Such an undertaking is not only unfeasible, but it is not very productive.

On the one hand, coercing people to follow one Shari'ah vantage point (that of the rating agency) is not correct and is destined to fail any way. On the other, second-guessing Shari'ah advisors of the issuing institution about what is and what is not permissible serves no useful purpose.

Shari'ah rating is an attempt to provide an added assurance of the Shari'ah compatibility of a product on the basis of a criterion that is basically transparent and known in advance, done by an institution that assures neutrality, fairness and concern for both future of the industry and consumer protection. More importantly, rating help improve the quality of the business by

inciting institutions to improve their Shari'ah quality and to be able to measure the improvement in the quality. In our case the "Shari'ah quality" should be improved by the efforts of this rating agency.

Methodology:

No rating program will gain acceptance and appreciation unless it adopts an objective method and an unbiased means of reaching its conclusions. By the same token, no rating program will gain any respect if it turns out to be a mechanical process done by disinterested people applying life-less procedures to reach their conclusion.

Therefore, Shari'ah rating while it should be mostly objective, it should also include subjective elements. In the final analysis it is an opinion derived by set procedures and based on facts but embodies other factors that are deemed important by the rating agency and its advisors.

For example, the extent of the involvement of the Shari'ah board functions would be an essential part of the rating program. Nevertheless, the rating agency in its endeavor to evaluate the Shari'ah quality should not make a priority to attempt to make a judgment on the qualification of the Shari'ah board members, or the correctness of their *Fatwas*. That Shari'ah quality can be measured by objective yardstick, such

as, the number of Shari'ah board members, frequency of their meetings, extent of the involvement of the Shari'ah board in the development of the products and compliance procedures. The non-approval of the product by a Shari'ah board shall be a negative thing, may be limiting the ability of such product to attain acceptance by the agency.

Grading:

We may follow collage rating of Excellent, Very Good, Good, Satisfactory and Unsatisfactory or go on a scale of 1000.

The proposal of product rating is to adopt a scale of 1000 points where anything above 600 is pass. The rating form will be just "accepted" if points attained are 600 or above. The seal of acceptance by the agency means that a second Shari'ah opinion is added to the original accepting Shari'ah board. However, this second opinion is independent and this is where value is added.

Methodology:

We have to list all important elements contributing to the Shari'ah quality of the product being offered to the public, and give a weight to each and every element. The total sum should be 1000. These elements are many and they may be subject to revision later. However, once they are adopted they should be announced, and whenever they are changed such change should also be announced. Because the whole purpose of the exercise is to improve the Shari'ah aspects of Islamic finance, institutions should be encouraged to try to attain as high a grade as possible by making sure all these elements are in place. A partial list of these elements is found below. They have been given scores to total 1000 points. The following is only an example of possible scoring system. It will certainly be developed later, and would include much more details.

The grading system should consist of 1000 points distributed as follows:

1- Has the product been approved by a Shari'ah board 200 Points

- a) For approval the Shari'ah board had met:
- | | | |
|-----------------------|-----|--------|
| - Once | 50 | Points |
| - 2-3 times | 70 | " |
| - 3 or more times | 100 | " |
| - By circulation only | 00 | " |
- b) Minutes and Fatwa of the Shari'ah board,
(subjective grading by the adhoc committee
at Islamic Rating Agency.) Max 100 Points
- d) Subjective review of documentation of the product by the
adhoc committee. Max 50 Points
- e) Is fatwa based on the principles that are widely accepted by
contemporary *fuqaha*.
- | | | |
|-----|----|--------|
| Yes | 50 | Points |
| No | 00 | " |

2- Product marketing and distribution:

- The product is marketed as Islamic 70 Points
- Not marketed as Islamic but assurance
is given to investors that it is Shari'ah complaint 50 "
- None of the above, only if buyers enquire
will be told it is Shari'ah compliant. 30 Points
- It carries the seal of approval of the Shari'ah board
50 Points

**3- The product have been given sufficient administrative support
by qualified Islamic bankers and financial experts (including
the existing of a dedicated department for Shari'ah products.**

Subjective judgment by the adhoc committee. Max 70 Points

4- Shari'ah compliance.

- a- Does the issuer have any Shari'ah Compliance procedure for the pool.
- | | |
|-----|-----------|
| Yes | 50 points |
| No | 00 " |
- b- Is there an dedicated staff for Shari'ah complaint.
- | | |
|------------------------------------|-----------|
| Yes | 50 Points |
| No, but part of regular compliance | 30 Points |
| No | 00 " |

5- An overall evolution of the profit by the adhoc committee to cover:

- Effect on Islamic market.
 - Does it promote the *Maqased* of Shari'ah.
 - Other.
- Max. 50 Points