RATING METHODOLOGY

ISLAMIC FINANCIAL INSTITUTION GOVERNANCE RATINGS METHODOLOGY

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EXECUTIVE SUMMARY

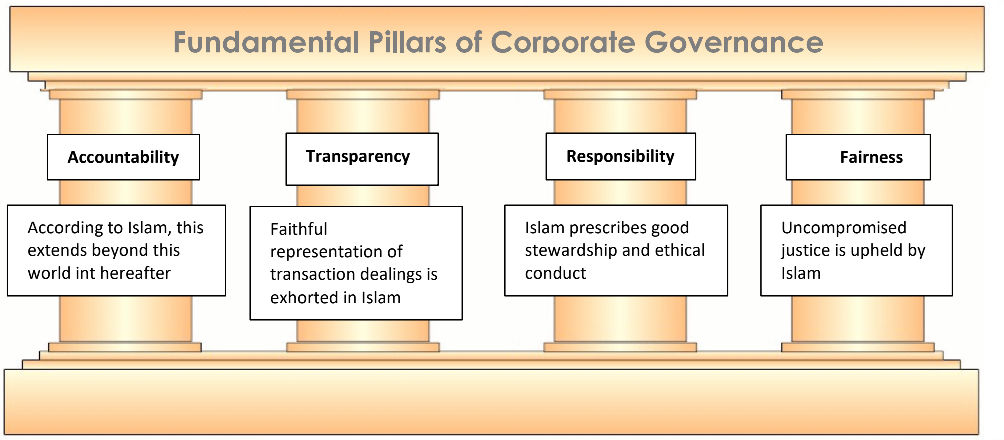
This methodology paper details our approach to rating the corporate governance of an Islamic financial institution (IFI). This methodology report aims to build understanding of what IFI governance ratings are and how they may promote sound governance transparency and accountability, and institutional capacity building for improved governance.

The common thread linking corporate governance of an IFI and any other organization is the responsibility of the board of directors (Board), and executive management for sound governance. Good corporate governance dictates that an institution is governed in a manner that maintains and increases shareholder value and the satisfaction of other stakeholders in the context of its corporate mission. The overarching widely accepted principles of good corporate governance which include accountability, fairness, responsibility and transparency are expected to permeate the business conduct of the IFI in addition to Shariah rules and principles. The aforementioned principles are highly congruent with Islamic values as represented in Exhibit 1. One may reasonably expect these values to form an integral component of the IFI's rules of conduct as opposed to being subordinate to shareholders' and stakeholder's value-maximization.

Our rating focuses on the IFI's systems, processes, controls and accountabilities which support the board of directors and management in the conduct of the institution's business and discharge of their stewardship responsibilities. The rating framework also acknowledges the role of legal, regulatory and institutional environment in shaping corporate governance practices of an institution. MARC Ratings assesses the adequacy of the IFI's governance structure, systems, processes and practices (its operational capacity) together with the outcomes of such internal arrangements (its effectiveness). MARC Ratings intends that a governance rating should provide an independent and objective assessment of the rated entity's governance quality with a view to identifying areas in need of improvement which may predispose the IFI to higher corporate governance and Shariah non-compliance risks.

The framework for our governance ratings is built on commonly accepted key principles and elements of good corporate governance as the governance rating may also be conceived of as a Shariah-compliant corporate governance rating. It draws heavily upon the work of different initiatives, agencies, international standard-setting bodies and regulators, and incorporates commonly accepted components of sound Shariah governance and best practices. The key dimensions can be adapted to different contexts (banking, takaful, asset management) and entities including Islamic mutual funds.

Exhibit 1: Corporate Governance Pillars from Islamic Perspectives



CORPORATE GOVERNANCE AND RISKS AND FINANCIAL INSTITUTION

Our rating analysis also touches on tangible commitment made by the IFI towards attaining higher governance standards for each of the key dimensions in its governance rating framework, where evidenced by material ongoing initiatives.

The global financial crisis of 2008 has highlighted the importance of corporate governance in the financial services industry, particularly with respect to banks. Weak corporate governance in financial institutions increases the potential for a misalignment in risk capacity and tolerance. The highly confidence-sensitive nature of bank operations and balance sheet profiles which are characterized by high leverage and large short-term liabilities, meanwhile, increases the susceptibility of a bank to a run. The large public safety net which financial institutions benefit from unlike non-financial corporations and cost of failure (in particular, government support) underscores concerns about moral hazard and beliefs that higher requirements on corporate governance should be imposed on financial institutions. The foregoing also implies a wider duty of care for bank directors and management.

MARC Ratings believes that the call for corporate governance reform in the financial sector which began in the U.S. and has since spread to many parts of the globe should ultimately contribute to improved financial market stability. There is increasing pressure from investors, exchanges and regulators to improve corporate financial transparency with the realization that short-term financial performance and longer-term financial viability may be in conflict. In light of the foregoing developments, MARC Ratings is of the view that greater attention to corporate governance will be necessary at the IFI as compared to their conventional counterparts due to more pronounced asymmetric information and principal-agent conflict of interest issues.

SYARIAH COMPLIANCE RISK AND IFI CORPORATE GOVERNANCE

In most jurisdictions, the articulated mission statements, corporate objectives or policies of IFIs provide assurance of compliance with Shariah while in a relatively select few, financial institutions offering Islamic banking services face regulatory disincentives and/or display ambivalence in positioning themselves as institutions advancing Islamic principles. For financial institutions which have clearly identified themselves as IFIs, compliance with the Shariah is both explicit and implicit, whatever the IFI's business model might be. IFIs have a responsibility towards the providers of Muslim capital who have placed their trust in the IFI's Islamic credentials in addition to supporting and developing Islamic financial services.

Failure to comply with the Shariah may cause the IFI to come into disrepute. Non-compliance may also have financial consequences. The income from non-permissible sources such as interest would have to undergo 'purification', i.e. the prohibited revenue is donated to charity.

Until recently, the main focus of an IFI's internal and external Shariah review processes has been on the compliance of its transactions with Islamic rules and precepts. Our governance ratings will encompass a current and prospective evaluation of the institution's Shariah governance in addition to an assessment of its overall corporate governance performance.

Our ratings consider not only the IFI's end goal of Shariah compliance but also the systems and processes in place and the actions and risk mitigation measures taken to bring about Shariah compliance. The working hypothesis which underlies our approach is that the Shariah governance structure, systems and people are the ultimate drivers of Shariah compliance on an ongoing basis.

IFI GOVERNANCE RATING DIMENSIONS

Box 1
Conducting activities in accordance with the Shariah

IFIs are expected to conduct their financial business in conformity with Islamic Shariah rules and principles. While scholars of fiqh exhibit a varying reliance on substance or form on in their interpretation of permissible Islamic finance structures and transactions, there is broad consensus on the following basic principles of Islamic finance and corresponding implications:

- *Money has no intrinsic value and is regarded merely as a measure of value, not the subject matter of trade. Implication: IFIs cannot conduct pure financial transactions that do not support real economic activity.*

- *Islamic finance is asset-based, meaning that transactions are structured on exchange or ownership of assets between borrowers and lenders. Implication: The underlying asset which is the subject of the financial transaction must be tangible and identifiable.*

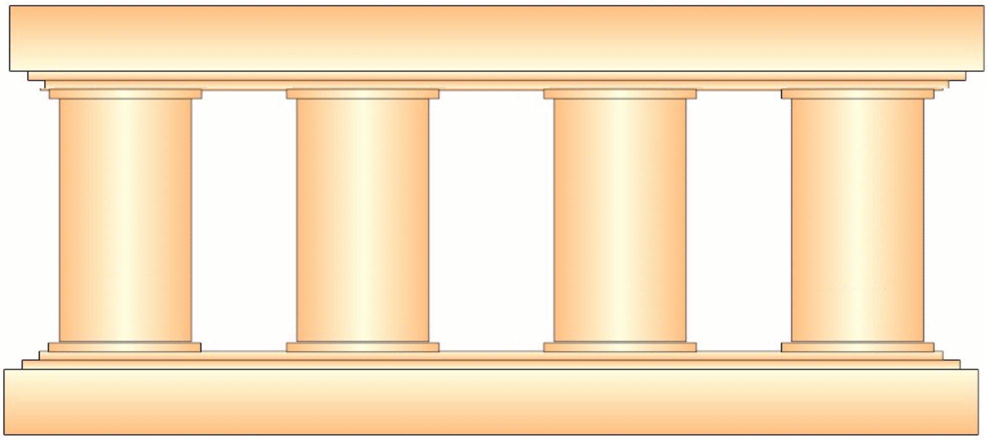
- *Transactions with elements of Maisir, i.e. speculation, gambling or excessive risk taking. There may be some degree of overlap between gharar and maisir if a particular transaction possesses a highly uncertain outcome. Conventional derivatives such as options, swaps and futures remain controversial.*

- *Financing for activities deemed as haram or incompatible with Shariah law. These include alcohol, pork, tobacco, weapons, conventional financial services and gambling. In broad terms, Islam forbids morally objectionable and socially harmful forms of economic activity.*

IFIs have an obligation to ensure that all aspects of its operations are in compliance with Shariah rules and principles. By virtue of their very nature, there is an implicit representation on the part of every IFI that its operations are conducted in accordance with Shariah rules and principles.

MARC Ratings' governance rating framework consists of seven dimensions as shown in the exhibit below. The seven areas of focus are: Governance Structure, Management and Processes, Internal Control and Compliance Framework, Equitability in Stakeholder Treatment, Disclosure and Financial Reporting, Corporate Social Responsibility Conduct and Ownership Structure & External Influences.

Exhibit 2 Dimensions of IFI Governance Ratings



Each rating dimension receives an undisclosed component score from 1 (one) to 5 (five) which falls within one of five grades, namely, A - Very Good, B - Good, C - Satisfactory, D - Weak and E -Very Weak. Although the component score is not revealed, the relevant grade is disclosed. Each individual component score is based on an analysis of factors related to the rated component. A numerical composite or unified score will be given to the IFI, also from 1 to 5.

Component	Grades
A	*Very Good*
B	*Good*
C	*Satisfactory*
D	*Weak*
E	*Very Weak*

The composite score does not represent a simple arithmetic average of all the scores of the individual components. In determining the composite score, some individual components will be given more significant importance than others. The individual scores for Governance Structure, Management and Processes, Internal Control and Compliance Framework will each account for 20% of the composite score while the component scores for Equitability in Treatment of Stakeholders, and Disclosure and Financial Reporting will each account for 15% of the composite score. The score for Corporate Social Responsibility Conduct will account for 10% of the overall score.

The overall score assigned will therefore be the weighted average of component scores for six rating dimensions, namely Governance Structure, Management and Processes, Internal Control and Compliance Framework, Equitability in Treatment of Stakeholders, Disclosure and Financial Reporting and Corporate Social Responsibility Conduct unless constrained by a component score of above 3 for one or more of the first three dimensions. A weak score for one or more of the first three rating dimensions could have a ceiling effect for the overall score as these components are regarded as critical to achieving sound IFI governance.

Sample Scorecard

Weighted Dimensions	**Weight**	**Disclosed Grade**
Governance Structure	20%	A
Management and Processes	20%	B
Internal Control and Compliance Framework	20%	B
Equitability in Treatment of Stakeholders	15%	B
Disclosure and Financial Reporting	15%	C
Corporate Social Responsibility Conduct	10%	C
Ownership Structure and External Influences	-	C
Overall Governance Score		B

The overall governance score maps to a rating on a scale which runs from 'GR-1' to 'GR-5'. An IFI governance rating reflects MARC Ratings' current opinion on the prospective relative strength of the IFI's overall governance practices measured against market standards and emerging best practices on this scale.

Rating Definitions	
GR-1	*IFI has very good corporate governance processes and practices overall. An IFI rated GR-1 offers its counterparties, customers and investors the highest protection against potential governance-related losses and/or diminished sustainable value creation.*
GR-2	*IFI has good corporate governance processes and practices overall. There are few weaknesses in the rating dimensions in MARC Ratings' opinion. An IFI rated GR-2 offers its counterparties, customers and investors a high level of protection against potential governance-related losses and/or diminished sustainable value creation.*
GR-3	*IFI has satisfactory corporate governance processes and practices overall. There are meaningful weaknesses in several rating dimensions and a fair amount of corrective action that has been or is being taken to address identified weaknesses. An IFI rated GR-3 offers its counterparties, customers and investors moderate protection against potential governance-related losses and/or diminished sustainable value creation.*
GR-4	*IFI has weak corporate governance processes and practices overall. There are significant weaknesses in most rating dimensions in MARC Ratings' opinion and little or no corrective action has been or is being taken to address identified weaknesses. An IFI rated GR-4 offers its counterparties, customers and investors insufficient protection against potential governance-related losses and/or diminished sustainable value creation.*
GR-5	*IFI has very weak corporate governance processes and practices overall. There are significant weaknesses in a number of rating dimensions in MARC Ratings' opinion and the corrective action that has been or is being taken to address identified weaknesses is inadequate or ineffective. An IFI rated GR-5 offers its counterparties, customers and investors marginal protection against potential governance-related losses and/or diminished sustainable value creation.*

DIMENSION ONE: GOVERNANCE STRUCTURE

MARC Ratings believes that the IFI's governance structure plays a key role in ensuring sound governance, implementing best practices and creating the environment of accountability. MARC Ratings views good corporate governance as the shared responsibility of those who are entrusted with the effective oversight of the entity. Effective oversight requires coordinating the respective roles and responsibilities of the management, board of directors (Board) and its committees and its internal Shariah Committee. MARC Ratings believes that a balanced relationship among these parties must be present for effective governance to prevail. The path to a balanced relationship lies in establishing structures, mechanisms and communication channels that promote collaborative participation, as well as interaction and engagement between the Board, its committees and management. MARC Ratings considers the following to be critical: clarity and a shared understanding of respective roles and responsibilities of each party; the allocation of decision-making powers; and an effective flow of communication throughout the IFI's governance organs.

Boards are obligated to review and guide the strategy of the IFI, monitor management's performance, ensure compliance with relevant laws and regulations, and the effectiveness of its governance practices and making changes as needed. The Board is also charged with the responsibility of identifying principal risks, including Shariah compliance risk and ensuring that appropriate risk management and internal control procedures are in place to manage risks.

Management should be given sufficient latitude to run the IFI and is responsible for implementing the directions determined by the Board, within the vision, purpose, values and policy context and budget determined by the Board. The management of an IFI would be expected to possess an appropriate understanding of the Shariah to the extent it is responsible to promote Shariah compliance with regard to the IFI's products and operations. The Shariah Committee, a key participant in the governance structure of an IFI, is usually the final authority in Shariah matters of the IFI as outlined below in Box 2. In certain institutions, the Shariah Committee/Board's decisions and fatwās are binding on the IFI's management. The tasks of the Shariah Committee could also be defined by the guidelines issued by national regulators, as is the case for IFI in Malaysia. A confusion of roles could compromise the IFI's execution.

In the area of Shariah compliance, the Board's oversight role may include setting the tone by stating that the IFI is committed to high standards of Shariah governance; establishing policies related to Shariah compliance; ensuring that structures are in place such as the Shariah Supervisory Board to establish procedures that provide comfort that business is conducted in accordance to Shariah principles; and monitoring Shariah compliance.

Box 2

Roles and responsibilities of the Shariah Committee

The roles and responsibilities of the internal Shariah Committee or Board may vary according to their terms of reference and may be advisory in nature and/or supervisory or even executive.

The internal Shariah Committee's roles and responsibilities would include but would not be limited to the following:

- *To approve the Shariah aspects in the memorandum of association, articles of association and regulations as well as the forms and policies used by the IFI.*
- *To approve the standard agreements and contracts pertaining to the IFI's financial transactions.*
- *To give a Shariah opinion regarding the products introduced by the IFI and issue fatwas on the questions and transactions submitted to it.*
- *To study unprecedented situations not covered by fatwa with a view to developing alternative products or procedures.*
- *To ensure Shariah compliance in the implementation of all banking transactions and to resolve any breaches.*
- *To write-off the profits earned through Shariah non-permissible means and donate the same to charity.*
- *To ensure that the distribution of the profit and bearing of loss are calculated in accordance to Shariah principles.*
- *To ensure that zakat is appropriately calculated and distributed in accordance with the provisions of Islamic Shariah.*

BNM's guidelines for IFIs on the governance of the Shariah Committee charges the Shariah committee with the responsibility for ensuring that the operations of the institution are conducted in accordance with the Shariah, including the approval of new products, the vetting of legal documents. The Shariah Committee is also responsible for formulating Shariah policy and procedures, the Shariah review as well as the endorsement of financial statements.

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MARC Ratings considers the following in assessing the effectiveness of an IFI's governance structure:

- The governance framework of the IFI, in particular the extent to which it clarifies the roles and responsibilities of the board, management, Shariah Committee and other members in the governance structure such as the audit committee.

- The IFI's success in creating a balance of power within the governance structure.

- The extent communication channels within the IFI support information flow throughout the IFI's governance organs and promote engagement between the Board, committees, and management.

- The extent board processes ensure sound governance is practised, risks are managed and accountability is promoted throughout the institution.

- Structure and membership of the board and criteria for board membership.

- The extent the Board and management supports the conduct of business in accordance to Shariah principles.

- The Shariah Committee's role and mandate, its capacity to perform a strong and independent oversight role and reporting structure.

- The composition of the Shariah committee, the frequency of meetings and attendance by committee members and compensation arrangements for members.

- The extent to which there are well-ordered procedures for the conduct of meetings and decision-making as well as the Shariah Committee's access to timely and relevant information on an ongoing basis.

- The process for resolving differences of opinion between the Shariah Committee and the board.

MARC Ratings shares Islamic Financial Services Board (IFSB)'s view that there is no single governance structure that is appropriate for every IFI and does not endorse any one structure. (IFSB's view is clearly expressed in IFSB-10 Guiding Principles for Governance for Institutions offering only Islamic Financial Services.) An IFI's governance structure should be appropriately matched to the size, complexity and nature of the IFI's business. This point is well illustrated by the number of alternative configurations of the Shariah Committee and differences in the scope of responsibility currently observable around the globe. A Shariah Committee may exist at the IFI's level or its function could be outsourced to a specialist Shariah advisory firm or advisor while the IFI's role could be advisory, supervisory, executive or a combination of the foregoing in nature.

DIMENSION TWO: OWNERSHIP STRUCTURE AND INTERNAL INFLUENCES

Ownership warrants inclusion in our rating framework as an unweighted dimension given its long-acknowledged influence on the quality of corporate governance. The 'Ownership Structure and External Influences' is scored to provide a measure of MARC Ratings' assessment on a scale of 1 to 6 of the overall supportiveness of the IFI's regulatory environment and ownership structure in advancing good IFI governance.

The form of ownership – private, public, government, semi-government, multi-national company (MNC) often has a bearing on managerial autonomy and the commercial orientation of the IFI and affects the way governance is conducted by different IFIs. MARC Ratings will look at the dispersion of shareholdings, management and director shareholdings, and transparency of the IFI's ownership structure including, where relevant, information on beneficial ownership behind nominee holdings). We will also enquire about contingencies in ownership, or puts, calls or buyout options pertaining to the owners.

The concentration of ownership could, meanwhile, place the IFI at risk of inappropriate actions or influences of dominant or controlling shareholders that are detrimental to, or not in the best interest of the IFI and minority shareholders. MARC Ratings reviews the nature of the relationship between the dominant or controlling shareholder and the IFI to assess the extent to which the former would act in the interest of all shareholders. Conversely, institutional shareholders would play an important role in overseeing and engaging management where share ownership is widely dispersed. MARC Ratings considers high potential dilution from share options, unequal share voting rights, significant related party transactions, unified control over the board and noteworthy recent governance lapses as red flags. MARC Ratings will also evaluate the likely impact of significant changes in ownership or composition of ownership on the IFI's strategic direction and operations, where relevant.

Apart from shareholders, external stakeholders can also exert significant influence on the IFI's governance process. Regulators have issued guidelines for Shariah compliance while standard setting bodies such as AAOIFI and the IFSB have published governance standards and guiding principles on governance for IFIs, respectively. Compliance with IFSB and AAOIFI guidelines is voluntary in most jurisdictions and remains, for the most part, best practice guidelines. Adoption of IFSB and/or AAOIFI guidelines by the IFI is generally viewed as a rating positive. MARC Ratings believes that the approach taken by the national regulators to regulate Shariah compliant finance can either be a positive or neutral impact on Shariah governance of a particular IFI.

In Malaysia, a central regulation model is currently practised in relation to Shariah matters pertaining to the Islamic finance market. Financial institutions licensed under the Islamic Banking Act 1983 or Islamic banking windows established by financial institutions licensed under the Banking and Financial Institutions Act 1989 are required to ensure that all banking transactions comply with the Shariah. The Shariah advisory councils (SACs) of Bank Negara Malaysia (BNM) and Securities Commission, the regulators of the banking, insurance and takaful industry, and securities market respectively, have final authority over new products and Shariah interpretation in Islamic finance. BNM's SAC issues Shariah Resolutions on the compliance of transaction mechanics to the Shariah and the permissibility of certain concepts and practices in relation to Islamic financing contracts, amongst others which are applicable to all IFI regulated and supervised by the BNM. The 'seal of approval' of the national level SACs provides assurance of Shariah compliance at the product development level.

BNM also requires Shariah Committee appointments to any IFI to be endorsed by the Central Bank and subject to proper due diligence. The Shariah scholars/experts cannot serve on the Shariah committee of more than one institution in the same industry and their roles and responsibilities are clearly set out in guidelines. MARC Ratings is of the view that the governance quality of domestic IFIs benefit greatly from a strong Shariah supervisory regime and state-regulated governance model which effectively lower Shariah compliant governance risks.

DIMENSION THREE: MANAGEMENT AND PROCESSES

MARC Ratings believes that the paramount duty of the Board is to select a well-qualified Chief Executive Officer (CEO) and to oversee the CEO and other senior management in the operation of the IFI. Management, in turn, owes a fiduciary duty to the institution and its shareholders to run the institution's business in an effective and ethical manner, and therefore plays an important role in creating an enabling environment for sound governance. Achieving good corporate governance is not solely the responsibility of the Board. It needs to be a core objective of senior management. MARC Ratings believes that the starting point for creating an effective 'tone at the top' resides with the character of the IFI's senior management.

The composition of the IFI's management and personnel determines to a large extent its ability to mitigate operating risks and to execute stated strategy and policies. MARC Ratings expects the IFI to be appropriately staffed, managed and organized. The background and experience of key management, management's view of its competitive environment and articulated strategies will be considered in MARC Ratings' assessment of management's ability to lead the IFI now and in the future. A related area of focus under this rating dimension is the IFI's organizational structure, in particular the extent to which it promotes accountability and effective management oversight. Management needs to be capable of anticipating events and changes in their operating environment rather than being surprised by them.

MARC Ratings believes the IFI's financial statements and past financial performance to be insufficient by themselves for evaluating whether its business is being properly managed. MARC Ratings believes that the IFI's historical financial performance, taken together with an assessment of the IFI's strategic or business planning process and the robustness of its performance management process, will permit a more comprehensive measure of the IFI's capacity for sound governance. While there is no guarantee that sound governance will lead to strong financial performance, poorly governed institutions are undisputedly more prone to failure.

BOX 3:
How MARC Approaches 'Management and Processes'

Key areas in MARC's assessment of management's ability to creating the conditions for sound governance include management structures and reporting lines, strategy and planning, performance management, and the extent to which management sets the governance tone of the institution. Our expectations pertaining to these areas are set out below:

- *There should be a clearly defined management structure and job descriptions, in addition to suitable documentation on delegated authority.*

- *New staff should receive appropriate induction/training to perform their roles and existing staff have training plans in place to enable them to perform their function. Skill gaps identified through appraisals of management and staff performance, and performance improvement processes should be addressed by training plans. Training plans should include training on corporate governance, with appropriate emphasis on ethical conduct.*

- *A strategic plan should be formulated by management with the board covering a period of three years or more, which is updated annually. The strategic plan which is supported by divisional business plans should reflect a consideration of strategic issues the IFI is facing, corporate objectives and policies. The plans should incorporate performance indicators and clear measurable actions with evaluation criteria and implementation time frames. Performance should be monitored on an ongoing basis.*

- *There should be a clearly defined performance management framework that identifies: key performance indicators and their owners, recipients of reports on performance and reporting intervals, how poor performance is addressed and how performance will be driven upwards over time.*

- *There should be regular reporting of progress on delivering approved key performance indicators and action plans for improvement drawn up and monitored where necessary.*

- *Management should set the governance tone of the IFI through the institution's code of conduct which should prescribe appropriate business conduct and ethics that is congruent with Islamic ethical principles. Other appropriate ethics related control mechanisms such as whistle blowing systems, ethics committee employee training in ethics, and a system of rewards for good ethics should be established.*

DIMENSION FOUR: INTERNAL CONTROL AND COMPLIANCE FRAMEWORK

In common with any other organization, IFIs require internal controls to provide assurance that the organization will achieve their operating, financial reporting and compliance objectives. Internal controls help ensure that the directions, policies, procedures and practices designed and approved by the management and the Board are in place and functioning as desired. Good internal control supports accurate financial reporting, compliance with laws and regulations and organizational effectiveness and efficiency. It also reduces the possibility of significant errors and irregularities and aids their detection when they do occur. An institution's system of internal control should reflect its size, nature, complexity of its operations and risk profile.

The responsibility for establishing, maintaining and operating an effective system of internal control lies with management. Management establishes the control environment, assesses the existing and emerging risks in order to respond to them, specifies the information and communication channels and content, designs and implements control activities, and monitors, supervises, and maintains the controls. The board, meanwhile, ensures the effectiveness of the IFI's internal control is regularly reviewed by management.

How effectively an IFI manages its risks is critically important to meeting the expectations of its key stakeholders and to safeguarding its reputation and capital. MARC Ratings believes that the effectiveness of the risk management function of an IFI should be measured by the extent to which:

- risk-taking activities are aligned with corporate philosophy;
- risks that are taken are prudent in relation to the IFI's capital strength and remain within an acceptable threshold; and
- appropriate compensation is earned for risks taken.

MARC Ratings will also examine the IFI's approach to mitigating Shariah compliance risk under this rating dimension with focus on the two main sources of risk - product development and investments. An IFI's monitoring of Shariah compliance should cover both ex-ante and ex-post aspects of all financial transactions undertaken by the IFI. Ex-ante Shariah compliance is mostly concerned with ensuring that IFIs comply with Shariah rules and guidelines in the various stages involved prior to bringing any new Islamic product or service to market. It is acknowledged that product development entails a number of potential risks: inappropriate structuring that goes against Shariah tenets, legal and documentation risks, Shariah scholars' non-consensus risk and reputation risk. Diversity in Shariah interpretation across and within different regions throughout the world continues to contribute to a lack of homogeneity in Islamic finance products and practices.

Ex-post Shariah compliance, on the other hand, is focused on that which happens after the product or service is approved and launched. Ex-post Shariah compliance can also pose material challenges to an IFI given that opinions of Shariah scholars can change. The responsibility of ex-ante monitoring is usually assigned to the Shariah committee while ex-post monitoring is undertaken by Shariah auditors.

The increasing debate within the Islamic finance industry regarding the authenticity of mainstream Islamic finance product offerings has resulted in the Islamic finance products being labeled as either 'Shariah compliant' or 'Shariah based'. 'Shariah compliant' products are said to possess the same economic value proposition of conventional offerings and only differ in terms of their Shariah-compliant legal documentation. 'Shariah based' products, on the other hand, are deemed to be consistent with the spirit of Shariah in substance and encapsulate the core principles of Islamic finance, namely the sharing of risk and profit and loss. The relative proportion of an IFI's 'Shariah compliant' to 'Shariah based' product offerings does not affect MARC Ratings' assessment of Shariah compliance risk. Nonetheless, this is likely to influence our evaluation of corporate social responsibility conduct, in particular the IFI's fulfillment of maqasid al-Shariah or the goals and objectives of Islamic law.

MARC Ratings expects the Shariah Committee of an IFI to be proactively involved in all product development and investment decisions and to exercise oversight of the internal Shariah assurance function which assumes the responsibility for review and approval of the structures of each financial transaction and underlying component contracts.

Box 4

Internal Control Concepts and Components

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) produced an authoritative report on internal control under the title of "Internal Control – Integrated Framework" in 1992 ("COSO Report").

The COSO Report describes internal control as a "process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following three categories:

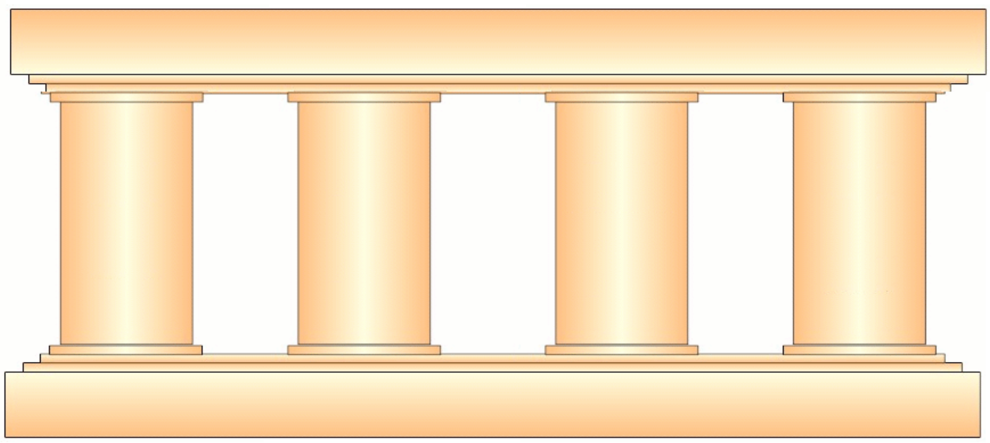
- *Reliability of financial reporting.*
- *Compliance with applicable laws and regulations.*
- *Effectiveness and efficiency of operations.*

The above definition encompasses the four fundamental concepts of process, people, reasonable assurance, and category objectives.

- *Internal control is a process, it is dynamic.*
- *Internal control is operated by people. People establish the objectives, put control mechanisms in place, and operate them.*
- *Internal control provides reasonable assurance, not absolute assurance.*
- *Internal control is designed to achieve objectives in three areas: operations, financial reporting and compliance as stated above.*

The COSO report outlines five interrelated components of internal control – management's control environment, management's risk assessment, management's control activities, management's monitoring, and the management information and communication systems that link all the components. All five components are prerequisites for effective internal control.

Exhibit 3: The Interrelated Components of Internal Control



Source: COSO Report on Internal Control – Integrated Framework 1992

MARC Ratings' evaluation of the IFI's internal control and compliance framework will rely largely on the IFI's internal control review process and the findings of the IFI's internal audit as well as compliance plans to address deficiencies identified during recent review cycles. Conclusions on internal control adequacy and effectiveness will be mostly drawn from such reviews of IFI's internal controls and management information systems.

Box 5

Areas at Focus in Evaluating IFI 'Internal Control and Compliance Framework'

Key areas in MARC Ratings' assessment:

- *The IFI's risk governance structure, reporting lines, mandate of risk committees, risk exposure measurement and risk limit management processes, as well as the nature of risk reporting to board-level committees and management.*

- *The nature of the IFI's internal audit or control review function and the internal audit reporting lines. Where internal audit activities are outsourced, MARC Ratings will likely inquire about the external audit firm and the underpinnings of the outsourcing decision.*

- *The terms of reference of the board's audit committee, its role and authority.*

- *The process in place for the board or board's committee to oversee internal control, audit or other control review activities and management's follow-up of control weaknesses as revealed by audit findings or other forms of control evaluation.*

- *The scope and frequency of audits or other control evaluation reviews, whether the scope of the audit or internal control review addresses all material controls, including financial, operational and compliance controls and risk management systems.*

- *Assignment of responsibilities for reviewing the internal audit report and the nature of follow-up conducted, with respect to control weaknesses identified by internal/external audits or other control reviews and recommended corrective actions. The frequency of follow-up reviews and likely time frame for corrective action.*

- *The frequency and comprehensiveness of information on internal control function and compliance-related reports received by the board or its committees and management.*
- *The manner in which IFI's compliance function is organized, its roles and responsibilities, reporting obligations and measures to ensure independence as well as its access to the board or a committee of the board.*
- *The institution's written compliance policy, relevant procedures and guidelines.*
- *The scope and frequency of compliance risk assessments.*

Consequences of nonconformance by the IFI's personnel

DIMENSION FIVE: EQUITIBILITY IN TREATMENT OF STAKEHOLDERS

A distinguishing feature between IFIs and their conventional financial institutions is the implied risk absorption role that investment depositors assume alongside shareholders. Depositors in a conventional bank have a right to a pre-determined return on their principal and guaranteed return of their principal, irrespective of the bank's performance. Conversely, profit-sharing investment account holders in an IFI are supposed to share in the bank's profits and losses alongside the shareholders, and could risk losing part or all of their initial investment. It is observed that IFIs are inclined to meet their investment depositors' reasonable expectations pertaining to returns, irrespective of their actual performance and profitability. Consequently, shareholders of an IFI could potentially have to bear part of the commercial risk attached to profit sharing investment accounts (PSIAs) and as a result, forgo some of the share of profit that would have been attributable to them. MARC Ratings believes that equitable treatment of stakeholders in the context of the institution's financial performance requires the rights and dues of both the shareholders and PSIA holders to be respected, recognized and protected. The Board, Shariah Committee and management would have to agree on a policy or policies determining how the IFI should relate to its stakeholders in areas of relevance.

Further, the accounting treatment of PSIAs and profits of investment account holders diverge greatly from one Islamic financial institution to another. AAOIFI, in recognizing this, released Financial Accounting Standard No 5: Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders which focuses on promoting transparency and uniformity in reporting.

MARC Ratings observes that the IFI usually faces less of an issue where serving the interests of other customers is concerned. Competition and regulation usually limits the extent to the IFI may maximize profit or rental payments through *murabaha* and *ijara* financing to customers/debtors while non profit and loss sharing depositors would ordinarily be protected by prudential capital and liquidity regulations.

Sound governance in the area of employee remuneration policies and practices, meanwhile, requires employees to be remunerated fairly and responsibly on the basis of their contributions.

The same stakeholder model of governance is also observed in takaful where the rights of stakeholders are recognized: takaful operator, consumers/policyholders and shareholders. The takaful business has an obligation to ensure that it is fair to its stakeholders. This is illustrated by their unique surplus sharing feature under which general takaful policyholders can expect a return even where there is no claim, provided the takaful fund is in surplus. Family takaful operators, meanwhile, are expected to segregate their takaful funds in a manner which reflects the ownership, purpose and risks associated with the contributions of the participants and to allocate income according to the underlying risks assumed. The overarching principle that should prevail in the treatment of surplus and deficit from the funds is that of fairness.

Under this dimension, MARC Ratings will also look at the treatment of minority shareholders, where relevant. Minority shareholders in a public-listed IFI have the rights to seek information, to voice their opinion and to seek redress. Where the IFI is listed and the shares of the IFI are closely held, the position of minority shareholders vis-à-vis their right to know can usually be improved by increasing the availability of information and transparency. The interests of minority shareholders is protected to some extent by regulatory requirements, which, in the Malaysian context includes disclosure requirements under Bursa Malaysia Listing Requirements, the requirement for shareholders' approval for related party transactions and major acquisitions and/or disposals and the provisions of the Malaysian Code on Corporate Governance.

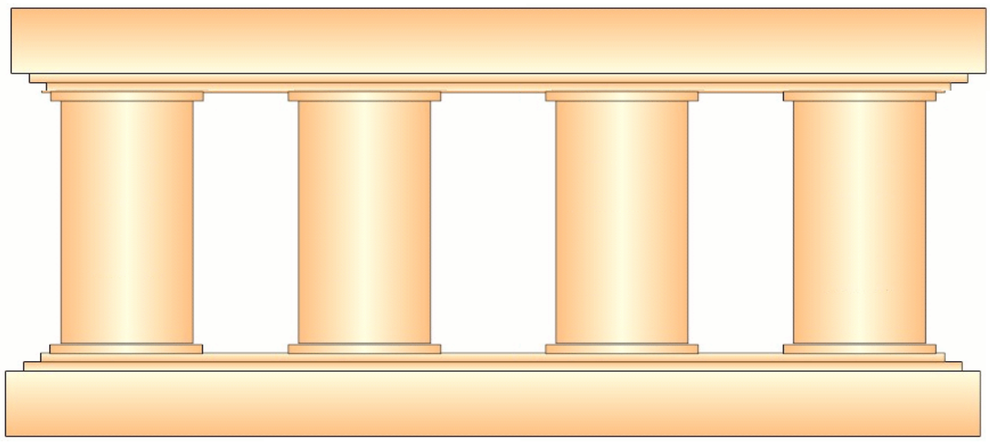
DIMENSION SIX: FINANCIAL REPORTING AND DISCLOSURE

This dimension concerns the IFI's past record of providing balanced and understandable financial reporting of its position and prospects. The board bears the responsibility for overseeing the financial reporting process while management is responsible for maintaining adequate accounting records. MARC Ratings believes that the objectives of financial reporting are met when the IFI's financial statements:

- provide information that is useful to present and potential customers, creditors, other transaction counterparties, rating agencies, regulators and other users in making rational investment, credit, and similar decisions;
- assist users in evaluating the performance of the institution; and
- portrays the economic resources of the institution, the claims to those resources, and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

To fulfill the above mentioned objectives, the IFI's financial statements and disclosures should possess the well-established accounting principles of understandability, accuracy, completeness, comparability, relevance and timeliness. These accounting principles are espoused in the financing reporting frameworks of the major accounting standard setting bodies. MARC Ratings uses the same principles to evaluate the financial reporting and disclosure quality of IFIs.

Exhibit 4: Desired Qualities of Financial Statements and Disclosures



In recent years, there is growing consensus among standard setters around the world that financial reporting should provide high quality financial information that is comparable and consistent. IFIs are unlikely to become an exception where convergence in financial reporting standards is concerned. In Malaysia, current financial statement requirements for IFI require the use of Financial Reporting Standards (FRS) issued by the Malaysian Accounting Standards Board (MASB), which have been developed with a view to converge with the International Financial Reporting Standards (IFRS). MASB plans to achieve full convergence with International Financial Reporting Standards (IFRS) by January 1, 2012. MASB provides specific guidance for domestic IFI through the issuance of Islamic accounting pronouncements with an aim to resolving interpretive issues arising from the application of MASB approved accounting standards to the financial transactions of IFIs. MASB's Technical Release *i*-3 Presentation of Financial Statements of Islamic Financial Institutions (TR *i*-3) is an example of authoritative guidance on accounting for Shariah compliant transactions that are not presently accommodated by MASB approved accounting standards. MARC Ratings takes cognizance that there could be significant variation in the treatment and presentation of certain income statement and balance sheet items across jurisdictions, as permitted by standard setters.

MARC Ratings' evaluation of the IFI's quality of financial reporting and disclosure encompasses, amongst others:

- income recognition bases and income recognition principles applied with respect to both Islamic sale transactions and profit-sharing instruments,
- the extent to which the IFI discloses non-permissible earnings and manner of disposal,
- valuation of assets in the IFI's balance sheet,
- recognition, measurement and presentation of investment accounts,
- consistency in application of accounting policies,
- the transparency of financial reporting with regard to provisions and reserves, income generated by Mudharabah and the allocation of profits between the IFI as Mudarib and investment account holders,
- whether a statement of sources and uses is provided in relation to Zakat funds, and Qard, if any,
- the extent to which the IFI discloses analytical and forward-looking information about the company, its external environment, industry dynamics and market positioning, and
- the extent to which the IFI communicates its financial performance targets and measures.

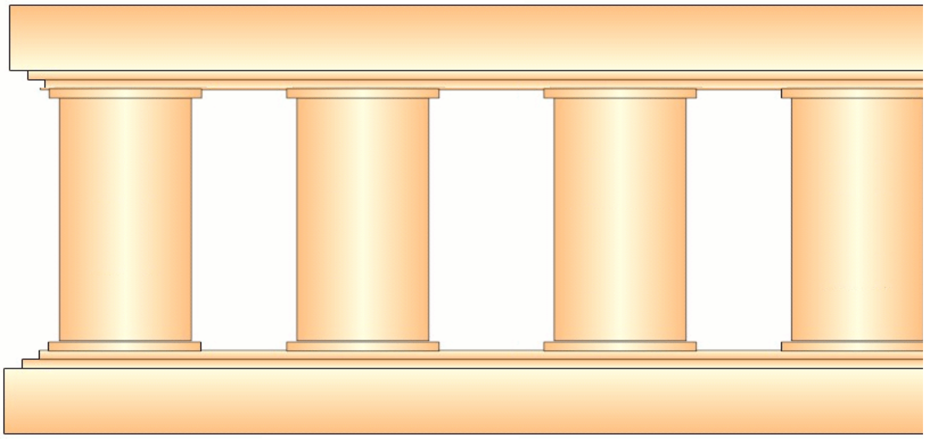
DIMENSION SEVEN: CORPORATE SOCIALIBILITY

Today's corporates, especially IFIs, have to contend with a much broader set of interests and expectations amid increasing public and stakeholder concern about the social and environmental impacts of business practices. An IFI which adheres to the Islamic law and principles contained within the Qur'an and Sunnah shares many commonalities with ethical finance and socially responsible investment. Rather than being solely oriented toward profit, an IFI is generally expected to incorporate social development objectives in all its dealings and operations, and to demonstrate commitment to corporate social responsibility (CSR) best practices.

Box 6

Maqasid-al Shariah and Maslahah- A Common Framework for Islamic CSR

Exhibit 5: The Maslahah Pyramid



Source: Asyraf Wajdi Dusuki and Nurdianawati Irwati Abdullah, 'Maqasid al-Shariah, Maslahah and Corporate Social Responsibility', The American Journal of Islamic Social Science 24:1.

While each IFI has its own mission and model, its social objectives should, in general, reflect the concepts of social responsibility drawn from the Shariah. At the heart of 'maslahah' and 'maqasid' (both concepts are often used interchangeably although 'maqasid' is usually taken to mean the objectives of Shariah) are the protection and enhancement of public interest. 'Maslahah' and its plural 'masalih' connote public or social interest. Maslahah can be arranged in a hierarchy of importance (depicted as a pyramid above), beginning with the most important, i.e. daruriyyat or the essential masalih at the bottom level, followed by hajiyyat or complementary masalih and finally, tahsiniyyat or embellishments at the top. The maslahah pyramid provides *guidance for an IFI to manage its business and CSR activities according to a hierarchy of importance or priorities. The IFI's social responsibilities can be divided into three levels as depicted by the maslahah pyramid.*

The daruriyyat or essential interests: faith, life, intellect, posterity and property are critical to preserving normal order in society and therefore represent the most fundamental responsibility to be fulfilled by an IFI. At the daruriyyat level, the IFI is to strive to preserve and protect their stakeholders' essential needs (religion, life, intellect, posterity and property) and public good in general. Examples of an IFI's responsibilities at this level are safeguarding employee welfare and providing adequate Shariah training needs to employees to protect the interests of the faith. IFIs should also refrain from financing or investing in activities which could have an adverse impact on the environment.

As soon as the IFI fulfills its responsibilities at the essential level, the IFI is expected to strive to meet its social responsibilities at the next level. Unlike the daruriyyat, the hajiyyat or complementary masalih concerns the removal of difficulties which do not pose a threat to normal order in society. A home financing product would be regarded as meeting a secondary maslahah, i.e. shelter for the family compared to an education financing product which addresses an essential public interest.

At the highest level, the IFI is expected to engage in activities that support the improvement of social welfare such as donating to the poor and needy, providing financial assistance to poor students by way of scholarships. Should conflict arise between the different levels of interest, the 'higher' interest will take priority.

MARC Ratings approaches this dimension by gaining an understanding of the IFI's CSR strategy and articulated CSR goals. MARC Ratings has taken into consideration the guidance provided to IFIs by AAOIFI's Governance Standard No. 7 Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions in its approach to assessing the IFI's corporate social responsibility conduct. Accordingly, the focus is on:

- the measures taken by the IFI to screen their investments for compliance with Islamic laws and principles and directs investments towards industries that benefit economic and financial stability, promote social justice and equitable distribution of income and wealth,

- the extent to which the IFI promotes responsible dealing with clients in the context of marketing ethics, develops product offerings consistent with Islamic, social and cultural norms, and adequately discloses the obligations and rights of each party to transactions with the IFI,

- the IFI's commitment to develop product offerings which fulfill the maqasid al-Shariah,

- the extent to which the IFI assesses the debt service capacity of its customers prior to granting financing and substantively follow Islamic prescriptions on how deal with debtors in financial difficulty,

- the IFI's policy to deal with earnings and expenditure prohibited by the Shariah,

- the extent to which the IFI reports information on its corporate social responsibility to stakeholders,

- the FIs policy on the fair treatment of employees, and

- charitable acts by the IFI.

Disclosure of the IFI's compliance with the principles and laws of Islam to stakeholders in a corporate social responsibility report allows the IFI to fulfill its *muamalat* duty of accountability. This enables stakeholders to assess whether the IFI is operating within the bounds of Shariah and fulfilling its stewardship responsibilities to the society and the environment.

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