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Your Excellency,

السلام عليكم ورحمة الله وبركاته،،

**CIBAFI Comments on the AAOIFI Exposure Draft on Governance Standard for
Islamic Financial Institutions No. 10: “Shariah Compliance and Fiduciary Ratings
for Islamic Financial Institutions”**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) presents its compliments to your Excellency and to the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and takes this opportunity to express its appreciation of the work that the AAOIFI does to promote and enhance the Islamic financial services industry (IFSI).

CIBAFI is the official umbrella for all Islamic financial institutions, whose services and products comply with the Shariah rules and principles. CIBAFI acts as the voice of the Islamic finance industry, and our members comprise more than 120 Islamic banks and non-bank financial institutions, both large and small, from over 30 jurisdictions.

We noted the request for comments on the Exposure Draft (ED) on the new Governance Standard for Islamic Financial Institutions No. 10: “Shariah compliance and fiduciary ratings for Islamic financial institutions”, and welcomed this opportunity to offer our comments and recommendations. The comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. We are also attaching more detailed comments in the Appendix of this letter for your Excellency’s and the AAOIFI’s kind consideration.

Firstly, some CIBAFI members raised some concerns on the purpose of the ED. It is unclear how far customers and other counterparties would understand and use ratings of this kind, and therefore whether they would have any commercial value. On the other hand, any regulator with a sufficient interest in Shariah governance to consider mandating such a rating would be more likely to impose Shariah governance requirements on firms and supervise them directly. It is therefore unclear how Shariah compliance ratings would fit into the Shariah governance structure in different jurisdictions. This in turn raises the question of what purpose a standard in this area would serve for the Islamic finance industry.

Secondly, CIBAFI’s members also noted that the standard was prepared with one particular rating agency. This may create a bias towards one rating methodology, especially as the ED contains detailed scoring, weightings, and rating scale. In turn, this might be problematic to other rating agencies in various jurisdictions.

Thirdly, CIBAFI recommends for more time to be spent on this standard on having discussions and views with different stakeholders from different jurisdictions.

We offer some more detailed comments on the text in the Appendix to this letter.

We would like to express our thanks to your Excellency and to the AAOIFI for its great effort and commitment with respect to developing standards that accommodate the interest of the global Islamic finance industry.

We remain at your Excellency's disposal should you need any further clarifications on the above or on the attached Appendix.

Yours sincerely,



Abdelilah Belatik
Secretary General

Appendix
**Comments on the AAOIFI Exposure Draft on Governance Standard for Islamic
Financial Institutions (GSIFI) No. 10: Shariah compliance and fiduciary ratings for
Islamic financial institutions**

CIBAFI’s analysis has identified the following comments with regards to the specificities in the GSIFI 10 ED.

Implementation of the standard

Under other international standards, principally those of the International Organization of Securities Commissions IOSCO¹, it is only credit rating agencies that are required to be regulated, and even the required regime is a light one. Ratings of the kind envisaged by this standard would not normally be regulated, and it is therefore difficult to see who might enforce the standard. It is therefore likely to be effectively voluntary.

Despite this, it is significantly more detailed than the international standards applying to credit ratings, for example in prescribing membership and operations of a rating committee, suggesting weightings of various factors and suggesting a ratings scale. We have some concerns about this, including whether the detail reflects too closely the practice of one particular agency and might therefore inhibit competition in the market.

Regulation

At some points (e.g. para 9c), the ED seems to assume that rating agencies will be regulated. As already noted, international standards do not require this except in relation to credit ratings, and even here the regime is a relatively light one which would not necessarily require, for example, formal “fit and proper” criteria.

¹ Notably IOSCO Core Principle 22 (2017) and its Principles Regarding the Activities of Credit Rating Agencies (2013).

Independence and Conflict of Interest

The requirements for independence are set out in different terms (in para 15 and 16) from those in the IOSCO document referenced, and it is unclear why this should be so. Para 15c in particular is somewhat unclear; it is hard to see exactly what investments are permitted by it, and very unclear why over-the-counter transactions should be privileged over on-exchange transactions.

Quality control/quality assurance

The ED uses the terms “quality control” and “quality assurance” essentially interchangeably. We suggest it should standardise on one of them and see “quality assurance” as marginally more appropriate to this context.

The elements and assessment scope for a rating service

The elements of Shariah compliance and fiduciary ratings in the ED include: Shariah compliance (i.e. compliance with Shariah principles and rules), Shariah governance, corporate governance, transparency and disclosure, ethics and values as well as fiduciary performance. CIBAFI noted that these elements are highly interrelated, for example transparency and disclosure with governance; while we see merit in being clear that all of these should be covered, there is also a need to ensure that overlapping areas are not rated twice and that use of standards is consistent. See below.

Shariah governance framework and corporate governance practices related to Shariah governance and other applicable hierarchies

The ED defines the applicable hierarchy for the benchmarked parameters in several areas with regards to Shariah principles and rules (para 20, 21). It begins with the AAOIFI Shariah standards, followed by local regulatory standards, Central Shariah Board rulings, relevant AAOIFI accounting standards, and Shariah Supervisory Board rulings. With regards to Shariah governance framework (para 22), the hierarchy starts with the AAOIFI governance standards, followed by the Islamic Financial Services Board (IFSB) Shariah governance standards, and finally the Shariah governance regulations issued by the respective jurisdiction’s regulator. The hierarchy for corporate governance practices is similar, but with the positions of the AAOIFI and

the IFSB reversed. There are minor variations of this ordering for transparency and disclosure (para 24) and ethics and values (para 25). In all hierarchies, the AAOIFI and the IFSB standards are put ahead of any national standards or framework. CIBAFI members have some concerns that this hierarchy of application may not be realistic in application in many jurisdictions, given that IFIs are likely to be legally obliged to follow local regulatory standards despite of these conflicts with the AAOIFI or the IFSB standards. In addition, some standards cover more than one area; for example, the IFSB's standard on corporate governance in Takaful (IFSB-8) covers aspects of general corporate governance, ethics and values, and transparency and disclosure. The different hierarchies in each area therefore give some scope for confusion in the areas of overlap.

Tiered and jurisdiction specific rating considerations

The ED states (in para 27-28) that ratings may be provided in a tiered manner or on a jurisdiction specific basis, which may reflect separately an international benchmark and a jurisdiction level benchmark. In both manners (tiered rating, or a jurisdiction specific rating), the benchmarked parameters, depending upon the respective jurisdiction's regulations (in para 20-26), may change the above hierarchy of resources or may ignore one or more of the resources

We have assumed that this is an attempt to cater for the possibility discussed above that local regulatory standards may not follow the international ones mentioned. However, these two paragraphs do not seem to be clear and therefore need more explanation. Moreover, the using of phrases such as "may change" and "may ignore" do not seem to provide the degree of clarity expected in a standard.

Relative weightage of benchmarked parameters

The ED provides (in para 30) a suggested distribution of weightage to benchmarked parameters as follows: a. Compliance with Shariah principles and rules (30% - 35%); b. Shariah governance framework (15% - 20%); c. Corporate governance practices related to Shariah governance (10% - 15%); d. Transparency and disclosure (10% - 15%); e. Ethics and values (10% - 15%); and f. Fiduciary responsibility and performance (15% - 20%). It is difficult to see what force this, and also the proposed rating scale (in para 36), have given that they are only "suggested". It may be that the standard should be silent on these points (which, as noted, are not covered in the international standards for credit ratings), if it cannot be definitive.

Rating Scale

The descriptions of the indicators (in para 36) are not sufficient and, if this scale is to be retained, they need more clarity. CIBAFI noticed that the ED use indicators such as “preferred options chosen and less preferred options avoided” and “controversial products avoided”. The preferred opinion in some jurisdictions might be less preferred in others, and in same context there is no consensus on controversial products.

Shariah experts

The ED is focused very much on Shariah compliance related parameters and refers at various points to Shariah experts (e.g. in paras 17/c and 52). However, it does not give any detail about their qualifications. CIBAFI members believe that the ED should provide some more information about the Shariah experts and some treatment of this issue might be welcome.

Rating committee

The ED requires the use of a rating committee, again going beyond the secular standards for credit rating agencies. It is also relatively prescriptive about matters such as membership, voting and meetings (paras 40-42; 50-52). There are some issues with its proposals; for example, the requirement (in para 52) that any Shariah compliance issues can be decided by a majority of the Shariah experts in the committee is difficult to operate if there are less than three experts, yet the committee is allowed to have as few as three members (para 41). We also note that at least a third of the members must be independent of the rating agency (para 41), but there is no description of what “independence” means in this context, given that members will presumably be paid for their work.