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Article

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Proposal for a new Sharī'ah risk rating approach for Islamic banks

New Sharī'ah
risk rating
approach

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Abstract

Purpose – Customers of Islamic banking industry continue to be skeptical on Sharī'ah compliance of Islamic banks despite receiving fatwa from the competent authorities. The purpose of this paper is to quantify the Sharī'ah risk taken by Islamic banks, so that customers are better informed on the level of Sharī'ah compliance that will help in removing the persistent level of skepticism toward Sharī'ah compliance.

Design/methodology/approach – This research has used the scorecard based modeling approach to build the Sharī'ah risk rating model, which consists of 14 factors that capture Sharī'ah risk and are grouped in 5 major areas revolving around regulatory support, quality of Sharī'ah supervision, business structure, product mix and treatment of capital adequacy ratio. The score calculated by applying the model is grouped into 4 tiers reflecting the level Sharī'ah compliance at bank as non-compliant, weak compliance, satisfactory compliance and high level of Sharī'ah compliance. Three case studies were conducted by applying the model to Islamic banks from Malaysia, Pakistan and Saudi Arabia.

Findings – The final Sharī'ah risk scores calculated by the model clearly differentiate the 3 banks on basis of their Sharī'ah risk. The underlying scores also highlighted the areas where banks need to improve to reduce their Sharī'ah risk.

Originality/value – This model can be applied by customers of Islamic banks who are interested in understanding Sharī'ah-related aspects of Islamic banking industry. This model can be applied on standalone basis or as an extension to the conventional counter party risk rating models. This model can benefit management of Islamic banks toward allocation of capital against Sharī'ah risk under Basel III, and regulators can apply the model to measure industry wide risk of Sharī'ah non-compliance.

Keywords Basel III, Sharī'ah non-compliance risk, Rating models, Islamic banking industry, Sharī'ah supervision

Paper type Research paper

Introduction

Islamic banking customers tend to pose a highly relevant question pertaining to the Islamic banking business: Are banks labeled as “Islamic banks” really Islamic? Dar's (2013) question “Is Islamic banking as exploitative as conventional banking?” reflects the fact that

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there is still skepticism among customers about the practice of Islamic banking and that it extends to the issue of Sharī'ah compliance of Islamic banks. Islamic banks address this concern by sharing the fatwas (Islamic legal rulings) of their respective Sharī'ah boards or other competent authorities on the Sharī'ah compliance of their business activities. Islamic banks tend to place high emphasis on the eminent personalities who constitute the members of their Sharī'ah boards to assure the public of their Sharī'ah compliance. In practice, bank customers do not rely solely on the fatwa or credentials of the Sharī'ah board members validating the banks' financial products in their decision to patronize Islamic banks. Nonetheless, the aspect of Sharī'ah risk – that is, the risk of Sharī'ah non-compliance – is an important factor to which customers pay special attention in their decision to endorse Islamic financial products. Moreover, it is argued that the level of Sharī'ah compliance of a bank cannot be qualified in absolute terms as “yes” or “no”; rather, there should be a rating system which scores an institution's Sharī'ah compliance across a range; for example, high, satisfactory, weak and non-compliant. This is deemed commercially attractive, as banks with higher levels of Sharī'ah compliance should be able to fetch higher ratings and enjoy a better market positioning in Islamic financial markets.

The issue of determining the level of Sharī'ah compliance, more specifically, measuring the Sharī'ah risk of Islamic banks, motivates this research. So far research in the area of quantifying Sharī'ah risk and allocating an adequate level of capital charge to mitigate this risk remains limited. A standardized Sharī'ah risk rating model is not available for Islamic banks to compare their levels of Sharī'ah compliance.

Research objective

The objective of this paper is to develop a Sharī'ah risk rating model to measure the Sharī'ah risk of Islamic banks. It aims at answering the question relating to Sharī'ah compliance of Islamic banks in a more satisfying manner to convince a larger set of customers that are still skeptical about the Islamic banking industry. The scope of this paper is limited to reviewing the existing risk rating models with respect to their relevance to measuring Sharī'ah risk, coming up with a more relevant Sharī'ah risk rating model, testing the model on Islamic banks for its accuracy, and finally providing a risk score that represents the Sharī'ah and financial risk of an Islamic bank. It is noted that the model does not calculate financial risk, which is already available from the ratings of conventional rating agencies. The overall score derived from the model can be used by customers to evaluate the level of Sharī'ah compliance of Islamic banks and by the banks to determine the adequate amount of capital that should be allocated to mitigate this risk.

Review of existing rating models

Existing market practices to evaluate banking sector risk and Sharī'ah compliance revolve around three areas, notably:

- conventional risk rating models;
- ratings by the Islamic International Rating Agency (IIRA); and
- guiding principles on Sharī'ah governance issued by the Islamic Financial Services Board (IFSB).

The existing rating models from three conventional rating agencies, namely Standard & Poor's (S&P), Fitch and Moody's, as well as from IIRA highlight the gap in measuring the Sharī'ah risk of Islamic banks, especially from the perspective of a standardized yardstick that can be applied on basis of publicly available information about an Islamic bank. A bank

rated AAA can be financially very strong and can have very low credit risk, but it can be Sharī'ah non-compliant as well. Similarly, a fully Sharī'ah-compliant bank can have a rating of C or D by Fitch or Moody's. As a result, these rating agencies are not effectively incorporating Sharī'ah risk rating into their risk rating systems. This calls upon the need to accommodate new risk rating factors which are important for Islamic banks to arrive at their overall credit score, including their Sharī'ah score.

Proposed methodology

The proposed rating model has two parts:

- Sharī'ah risk score; and
- overall counterparty financial risk score.

As highlighted above, the model calculates the Sharī'ah risk score only; the financial score, on the other hand, is taken from the rating of conventional rating agencies. The combined rating of Sharī'ah risk and financial risk is reported in a two-part format. The first part communicates the financial rating as calculated by the rating agencies, and it ranges from AAA to D or equivalent for all three conventional rating agencies. The second part of the rating reflects the Sharī'ah compliance score and, it is reported in four categories whereby the SSS category reflects the highest level of Sharī'ah compliance and SN corresponds to the lowest level, i.e. Sharī'ah non-compliant. As an example, the model output rating of AAA: SN means that bank is financially very strong, but its business is not Sharī'ah-compliant.

Proposed Sharī'ah risk rating factors

This model proposes to include five areas when measuring Sharī'ah risk. These are further sub-divided into 14 risk rating factors which are not quantified by conventional risk rating agencies from a Sharī'ah-compliance perspective. These factors provide detailed insight regarding the Sharī'ah risk of an Islamic bank and hence can provide valuable feedback to customers. A summary of these 14 factors is provided in [Table I](#).

These 14 factors are considered relevant to measure the Sharī'ah risk of an Islamic bank based on the following rationale.

Regulatory support. Islamic contracts used by Islamic banks must be recognized by the laws and regulations of a country. For instance, it is important to know whether a *murābahah* transaction documents will be given due consideration in the courts of law. Many countries provide little support for the execution of Islamic contracts. Therefore, Islamic banks that get support from the laws and regulations of a country are in a better position to conduct Islamic banking business. In case of dispute, customers have confidence that the laws and regulations of the country will uphold Islamic transactional documents.

Quality of Sharī'ah supervision. A bank with a single Sharī'ah advisor reporting to the CEO is likely to compromise on Sharī'ah standards as compared with a bank having a full-fledged Sharī'ah board which independently reports to the Board of Directors (BOD). Therefore, this framework effectively captures the independence of the Sharī'ah supervisory function at a bank. Sharī'ah opinion is the most weighted factor to measure Sharī'ah risk. If a bank has adverse Sharī'ah opinion in its annual report, the negative weight will simply turn the Sharī'ah compliance score of a bank into an overall negative score.

Business structure. Legal incorporation: A separately incorporated and publicly limited Islamic bank gets more weight than a branch of a conventional bank having a mixed pool of funds. This is because the former will be able to manage and implement Islamic banking laws in a better way when it comes to the requirement for segregation of funds.

Table 1.
Shari'ah risk rating
model

<i>Regulatory support</i>						
1	Legal support	Separate Islamic banking law in the country	Single law covering Islamic and conventional banks	Weak legal support for Islamic contracts	No legal support for Islamic contracts	
Score		10	6	3	1	
2	Central Bank Support		Independent supervisory board conducting Shari'ah audit	Shari'ah board with advisory function without audit	No Shari'ah board at central bank	
Score			10	8	3	
<i>Quality of Shari'ah supervision</i>						
3	Independence of Shari'ah supervisory function	Shari'ah advisory board reporting to BOD	Single Shari'ah advisor reporting to the BOD	Shari'ah advisory committee reporting to the Chief Executive Officer (CEO)	No Shari'ah committee/advisor	
Score		10	6	3	0	
4	Opinion of the Shari'ah supervisory committee/advisor	Full compliance with Shari'ah (unqualified)	Qualified (some exceptions)	Disclaimer (no opinion)	Adverse (Shari'ah non-compliant)	
Score		10	5	0	-150	
<i>Business structure</i>						
5	Legal identity of Islamic banking business	Separate legal entity	Separately incorporated legal subsidiary of a conventional bank	Division with separate pool of funds of a conventional bank	Branch operation of a conventional bank with mixed pools of funds	
Score		10	8	7	3	
6	Number of Years in Shari'ah-Compliant Business	10+ years	3-5 years	1-3 years	Less than 1 year	
Score		10	7	2	1	
7	Compliance with AAOIFI and IFSB standards	Regulatory full compliance	No regulatory requirement but individual compliance	Partial individual compliance	No compliance	
Score		10	8	5	3	
8	Profit equalization reserve (PER)			Yes	No	
Score				10	0	
						(continued)

9	Charity fund					No charity fund in place
	Score		Separate and independently expensed	Separate but not independent		0
			10	7		
<i>Composition of asset and deposit base (Width and depth of products)</i>						
10	Equity-based products (musharakah, mudarabah and ijarah)	More than 50% of total assets	10 to 25% of total assets	Less than 10% of total assets	No musharakah/mudarabah based assets	
	Score					
11	Width of asset Products	10 or more financing products	5 to 10 financing products	2 to 5 financing products	1 to 2 financing products	0
	Score					
12	Debt-based products (murabahah and tawarruq as % of total financing)	Less than 10%	10 to 33%	33 to 66%	Above 66%	2
	Score					
13	Structure of deposit		Separate deposit pools under mudarabah/musharakah partnership	Murabahah-based deposit	Current/saving deposit) contracts under qard	2
	Score		10	6		5
<i>Capital adequacy standards (as per IFSB)</i>						
14	IFSB CAR (capital/risk weighted assets (RWA) - RWA(profit sharing investment accounts (PSIA))	2% above the applicable Basel CAR (Basel II/III)	Equal to Basel CAR	Less than Basel CAR	Not available	
	Score					
		10	1	-10		1

Table I.

Years in Islamic business: Fitch & Moody's capture the total number of years in business but do not capture the total number of years in Shari'ah-compliant business. Therefore, this scorecard gives additional marks to the tenure that a bank has been involved in Shari'ah-compliant business.

AAOIFI & IFSB standards: Implementation of these standards at a bank adds to the Shari'ah compliance score. However, the scope of measurement is limited to the disclosure (auditor's certification) that the bank is following IFSB and AAOIFI standards while a check on practical compliance is outside the domain of the end user (customer).

PER: PER actually belongs to investment account holders and adds stability to their returns by mitigating displaced commercial risk. From the Shari'ah perspective, it adds to the Shari'ah compliance score because a bank has to develop different deposit and asset pools and adopt a Shari'ah-compliant profit-sharing ratio mechanism to apply PER. Therefore, chances of Shari'ah compliance are higher for a bank having a PER arrangement than a bank that is operating without PER.

Charity fund: The proper use of charity fund reflects the level of Shari'ah compliance of an Islamic bank. Islamic banks having documented charity policies and an independent committee that spends the charity fund get a higher score. This factor is particularly important, as some banks continue to rollover their bad loans without transferring the overdue income charge to the charity account. Furthermore, some banks have started to use the charity fund as a promotional fund by using the money for advertising purposes.

Width and depth of deposit products. Equity-based products: Banks that use products based on participation and profit/loss sharing get a higher score as compared to a bank which simply relies on *murabahah*-based products. This factor particularly helps in diversifying the risk of Shari'ah non-compliance from one product to multiple products.

Width of asset products: A bank which has more products is much likely to diversify its Shari'ah risk while banks that continue to rely on a single product (such as *murabahah*) are assigned a lower score under this model.

Debt-based products: A bank which is mainly relying on debt-based products is likely to rollover the credit deals and hence is exposed to higher levels of Shari'ah risk.

Structure of deposit: Many Islamic banking businesses operating as windows of conventional banks do not maintain separate deposit pools and hence are not fully Shari'ah-compliant as compared with those Islamic banks that maintain separate deposit pools and hence qualify for higher Shari'ah compliance scores.

Capital adequacy standards. External rating agencies calculate the Capital Adequacy Ratio (CAR) as per the applicable Basel definition and therefore penalize Islamic banks, especially when they have solicited deposits on the basis of profit/loss sharing and can pass the loss to depositors rather than charging it under equity. This scoring model calculates CAR as per the IFSB standards and adjusts the CAR premium/discount into the scoring according to the result.

Allocation of weights and scores

Scores and weights have been allocated based on the authors' own judgement. This judgmental approach has its precedence in conventional risk rating model-building practices. Top rating agencies had started building their models by allocating judgmental risks and weights and have refined factors over a period through statistical back testing. Historical data are not available at this point in time on Shari'ah non-compliance risk to back test these models on a statistical basis. These initial weights are subject to further calibration as large-volume data sets are tested by applying this model, and adjustments are made to improve the model's accuracy.

Sources of information: model input

All the sources of information required as an input for this model are publicly available. This gives the model flexibility and makes it very easy for any individual/customer of the Islamic banking industry to use the model and get the Sharī'ah compliance score.

New Sharī'ah
risk rating
approach

Interpretation of the Sharī'ah risk rating model score: model output

A bank can earn a maximum risk-weighted score of 150 and a minimum score of –138 under this Sharī'ah risk rating model. The interpretation of Sharī'ah risk rating scores is given in [Table II](#).

A bank having a risk-weighted score of above 80 per cent is considered highly Sharī'ah-compliant and hence gets SSS rating. S+ rating is quite wide, including banks meeting most of the Sharī'ah-compliance standards. S-rating is awarded to those banks which are barely meeting Sharī'ah standards and require significant improvements in implementing the Sharī'ah guidelines into their day-to-day business dealings. An SN rating stands for a Sharī'ah non-compliant bank. The Sharī'ah rating score can be sub-divided into further categories to reflect various degrees of Sharī'ah compliance, but this would obviously add complexity for banking customers. Banks may, however, add additional tiers for more refined monitoring of their Sharī'ah risk.

Testing of the Sharī'ah risk rating model

The newly developed Sharī'ah risk rating model was applied to three banks to evaluate their degree of Sharī'ah compliance. These ratings were conducted on an unsolicited basis. The summary of results is provided in [Table III](#).

Category	Maximum weighted score	Minimum weighted score
Regulatory support	30	6
Sharī'ah supervision	20	–150
Business structure	50	7
Product width and depth	40	9
CAR (IFSB)	10	–10
Model output score	150	–138
% degree of Sharī'ah compliance	(Achieved score × risk weight)/maximum achievable score	
Achieved degree of compliance	Rating table	
80% and above	SSS	High Sharī'ah compliance
50 to 80%	S+	Satisfactory Sharī'ah compliance
0 to 50%	S–	Weak Sharī'ah compliance
Negative score	SN	Sharī'ah non-compliant

Table II.
Interpretation of
Sharī'ah risk rating
scores

Bank	Achieved degree of Sharī'ah compliance	Awarded rating
Bank Alfalah Ltd, Islamic Banking Division, Pakistan	95/150 (63%)	S+ (Satisfactory Sharī'ah compliance)
Bank Aljazira, Saudi Arabia	66.5/150 (44%)	S– (Weak Sharī'ah compliance)
Bank Islam Malaysia Berhad, Malaysia	122/150 (81%)	SSS (High Sharī'ah compliance)

Table III.
Applying the
Sharī'ah risk rating
model on three banks

Conclusion

The Shari'ah risk rating model proposed in this paper includes 14 Shari'ah risk rating factors to determine the degree of Shari'ah compliance of an Islamic bank. The model has clearly differentiated the banks on basis of Shari'ah non-compliance risk. The weights assigned in the model were based on personal judgments, and these were correct to the extent that the end score calculated for each bank has clearly highlighted their strengths and weaknesses. This model can be used by individuals and the public to check the Shari'ah compliance score of any bank. This rating will introduce a healthy competition among Islamic banks to comply with Shari'ah laws and regulations. Further research is required to apply the model to more Islamic financial institutions.

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