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Sharī'ah-compliance ratings of the Islamic financial services industry: a quantitative approach

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Abstract

Purpose – This study aims to develop a Sharī'ah-compliance rating mechanism for the Islamic financial services industry (IFSI), with a special focus on banking. The banking sector is taken as the area of focus due to its leadership role in the volume of global Sharī'ah-compliant assets.

Design/methodology/approach – The objectives of the Islamic financial system (IFS) are selected as the basis for ratings. A range of performance indicators (leading to achievement of the objectives) is grouped into four broader categories and used in the study to allocate scores with a sum total of 100. Special considerations – including the amount of resources required in performing an activity, suitability of prevailing business conditions, the degree of compulsion/discretion in performing a task and linkage with the essence of the IFS – were taken into account in the allocation of scores.

Findings – This study groups multiple performance measures into four categories, including portfolio construction (deposits mechanism, participatory and asset-based modes of financing), access to finance (service to the less-privileged and sector screening), reputation (disclosures and stakeholders' survey) and Sharī'ah governance (Sharī'ah supervision and controls, charitable operations, human resources, product development and organization). The Portfolio, Audit, Reputation and System (PARS) rating system is then developed.

Practical implications – A Sharī'ah-compliance rating system is helpful in measuring the progress towards goal achievement of the IFS and in gaining stakeholders' trust. It is also important for Sharī'ah boards and regulators in policy formulation, for management in addressing weaknesses and taking corrective measures and potentially for standard-setting bodies.

Originality/value – This study presents a comprehensive quantitative Sharī'ah-compliance rating mechanism, taking into consideration the objectives of the IFS – equitable distribution of wealth and financial stability, in addition to Sharī'ah-compliance in operations. Development of Sharī'ah-compliance quality ratings for Islamic banking is essential to gain customers' trust; the suggested methodology is thus a contribution to the literature on Islamic finance.

Keywords Sharī'ah governance, Islamic banking portfolio, Sharī'ah-compliance ratings, Sharī'ah audit, Islamic financial services

Paper type Research paper



Introduction

The Islamic financial system (IFS) was proposed, as per the Islamic worldview, because of many violations of Sharī'ah norms in the conventional financial system. Major objections include practicing *ribā* (interest and usury), *gharar* (uncertainty regarding subject matter and price), *maysir* and *qimār* (speculation or any game of chance) (Ayub, 2007, p. 61). Adherence to Sharī'ah (Islamic law) is the sole justification to have a different financial system, and any weakness in this respect would jeopardize the future of the Islamic financial services industry (IFSI).

The operational tools (financial products) of the IFS are often classified into two groups, objectively, as Sharī'ah-based and Sharī'ah-compliant. Sharī'ah-based (or Sharī'ah-compliant in letter and spirit) tools include the suggested contracts in agreement with the spirit of the IFS. These tools, potentially, create a visible difference between the conventional financial system and the IFS through economic substance. Participation in risk and reward is the essence of the IFS; hence, financial contracts based on participatory modes are called Sharī'ah-based. These comprise *mushārahah* (a partnership between contributors of capital), *muḍārabah* (a partnership between capital and skill) and investment in equity securities. There are some other permitted, but not preferred, tools as well to facilitate operations of the IFSI. These financial products are not very much in line with risk- and reward-sharing and are, hence, considered Sharī'ah-compliant; application of such tools does not create a meaningful and visible difference in economic substance with the conventional finance industry. All non-participatory modes that result in debt creation are included in this category: *murābahah* (sale of an asset on deferred payment), *salam* (purchase of an asset with deferred delivery), *istiṣnā'* (manufacturing on demand) and *ijārah* (renting of an asset).

An analysis based on empirical data and current practices of the IFSI, especially the Islamic banking industry, reveals that Sharī'ah-compliant modes dominate in operations with a negligible share of Sharī'ah-based modes of financing (Shaikh, 2013). The economic substance has been taken over by the legal form. Put another way, permission to use a particular mode (e.g. *murābahah*) for a transitory phase has taken over the essence (profit-and-loss sharing) of the IFS. A deeper insight into prevailing practices of the Islamic banking industry depicts that, so far, a higher degree of focus has remained in Sharī'ah-compliance of financial products rather than enhancing the agenda of the IFS in its true spirit. Critical literature has documented the issue of preference for legal form over economic substance in the practices of the modern IFSI (El-Gamal, 2005; Shaikh, 2013; Hatta *et al.*, 2014; Hanif, 2016). Unless Sharī'ah-based financial contracts become operational, a visible and meaningful difference in economic substance cannot be generated. It is true that the practice of Sharī'ah-based financial contracts is difficult and challenging as compared to being Sharī'ah-compliant. One of the reasons the industry prefers Sharī'ah-compliant financial contracts to Sharī'ah-based ones is their greater similarity to conventional financial products.

Which mode (financial product) should be used in a particular situation in dealing with a particular customer is, of course, the discretion of a practitioner in an Islamic bank. However, to move towards an IFS, a bit of pressure, coupled with rewards (in the form of customers' trust for more Sharī'ah compliance), needs to be applied, indirectly. This is important because of the underlying reasons for having a different financial system. One way to do that is by launching a Sharī'ah-compliance ranking of Islamic banks. It is an empirically proven strategy of indirect motivation toward the achievement of goals that is practiced in sectors like academia, economics, politics and even the conventional financial system. For example, CAMELS ratings are used by regulators globally to gain customers' trust and protect them from probable loss of wealth. The mechanism of Sharī'ah-compliance

ratings of Islamic banks could potentially contribute to building an IFS in letter and spirit. Moreover, customers of the IFSI are interested in the quality of Shari'ah compliance, as it is an important decision criterion in the choice of a financial services institution (Hanif *et al.*, 2012). Development of a Shari'ah-compliance rating system will, therefore, be helpful for customers and Islamic investors in the identification of more Shari'ah-compliant institutions. It will also benefit policymakers – including Shari'ah boards and regulators – as well as the management of Islamic financial institutions (IFIs) and global standard-setting bodies in addressing weaknesses of the IFSI.

This study is planned in response to such aspirations and issues to develop a Shari'ah-compliance rating mechanism in light of the objectives of the IFS, notably equitable distribution of wealth, financial stability and Shari'ah-compliance in the operations. It is conducted to identify the key performance indicators, classify them, and allocate scores to each activity – contributing to the achievement of the Shari'ah-compliance goal.

The rest of the study proceeds in the following order. The next section justifies the application of the ranking system, followed by a brief review of developments in the area of ratings. The paper then presents important considerations that have been taken into account when assigning rating points. It further depicts a system of classification and score allocation, as well as presents steps/stages in ratings. The conclusion is then offered in the last section.

Why Shari'ah-compliance ratings?

It is well documented in the literature, based on the surveys of customers of the IFSI, that one of the primary reasons to transact business with these institutions is Shari'ah compliance (Bley and Kuehn, 2004; Haque *et al.*, 2009; Hanif *et al.*, 2012). Hence, the Shari'ah-compliance character of each institution needs to be documented for the broader benefit of stakeholders. Shari'ah-compliance rankings of IFIs – especially banks due to their leadership role based on asset volume – are justified for the following important reasons:

- A rating system would help in boosting customers' trust and confidence in the IFSI as a Shari'ah-compliant financial system, just as financial ratings boost the confidence of investors in a security/institution.
- A ranking system would generate pressure on the management of an Islamic bank to increase application of Shari'ah-based financial contracts, given the higher score reserved for them. It would also motivate them to adopt a mechanism to reduce the degree of violations of Shari'ah norms.
- The rating system will lead to rewards for those who score high in Shari'ah-compliance – in the form of more business from customers – and punishment for low scorers. In a survey conducted by Obaidullah (2005), participants showed a stronger preference (by expected customers and investors) for transacting business with a financial institution graded higher on Islamic ethics and values.
- The ranking system will separate high-quality, elite-class institutions from those of lower quality based on Shari'ah-compliance considerations, which would serve as a reference point in future institution-building under the IFS.
- The rating system will determine the comparative standing of institutions that are ranked so that customers can choose the best.
- The CAMELS rating system is used by regulators of financial institutions globally to boost the confidence of the public and save them from harm, as well as to spot weaknesses in the operations and financial health of financial institutions. Islamic

investors have double concerns in terms of financial stability and Sharī'ah compliance of underlying institutions. A Sharī'ah-compliance ranking coupled with a financial rating would address their concerns. [Obaidullah \(2005\)](#) documents that the objective of wealth maximization and risk minimization is grossly inadequate for IFIs, and market participants are equally [if not more] concerned about ethical performance as compared to financial performance.

- Certain professionals (accounting, business, finance and information and communication technology), based on religious linkages, have a passion to contribute to Sharī'ah-compliant organizations. Sharī'ah-compliance ratings of the financial industry will help them to choose the elite institutions for contribution with excellence. Excellence in performance in case of congruence between passion and job is well documented in the literature ([Carbonneau et al., 2008](#); [Vallerand et al., 2010](#); [Ho et al., 2011](#)).

Stock-taking

At present, ratings of the Islamic banking industry are provided by various traditional rating agencies. The CAMELS rating system is used by regulators (central banks) to ensure smooth operations of the Islamic banking industry, resulting in enhanced public confidence. In rating a Sharī'ah-compliant bank, even on the financial stability front, one has to take into account differences in the contractual relationship between a customer and an Islamic bank as opposed to that of a customer with a conventional bank. On the liability side of the balance sheet, there is a visible difference in the deposit collection mechanism. Current deposits are the same for both streams of banking; however, deposits with returns are different. Under the Islamic banking system, saving deposits are accepted as investments (from customers) based on profit- and loss-sharing – a meaningful difference with conventional banking, where such deposits are treated as interest-based borrowings/loans. The nature of risk is different for conventional and Islamic deposits. [Archer and Abdel Karim \(2009\)](#) document legal and governance implications of deposit collections under the profit- and loss-sharing mechanism, and identify a need to address associated problems. In addition, in the financing portfolio, financing modes used by an Islamic bank are different from conventional loans. Debt-based modes of financing used by Islamic banks include deferred sales (*murābahah*, *salam* and *istiṣna'*) and rental income (*ijārah*), resulting in additional risks such as obsolescence and price risk associated with ownership of assets. Meanwhile, equity-based contracts (*mushārahah* and *muḍārahah*) exist under Islamic banking only.

Various rating agencies, including the big three (Moody's, S&P and Fitch), issue ratings for the IFSI relating to financial strength. In addition, there are regional and country-specific rating agencies engaged in the process of rating IFIs and instruments. Examples include: Islamic International Rating Agency (IIRA) based in Bahrain; Malaysian Rating Corporation Berhad (MARC) and Rating Agency Malaysia (RAM) based in Malaysia; Pakistan Credit Rating Agency (PACRA) and Japan Credit Ratings-Vital Information Source (JCR-VIS) based in Pakistan. There are two important questions in the area of ratings of the IFSI:

- Q1. Are intricacies (difference in modes of financing) taken into account by traditional rating agencies (including regulators and private rating firms), with due modifications in rating methodology, when calculating financial ratings of the Islamic banking industry?

- Q2. Are factors representing the Sharī'ah-compliance character of the rated firm incorporated in traditional ratings? The market is interested in knowing the Sharī'ah-compliance status of a banking firm in addition to its financial strengths (Obaidullah, 2005; Ashraf and Lahsasna, 2017).

The first is an important research question; however, it is beyond the scope of this study. Radzi and Lonik (2016) document that there is no difference in the methodology of the “Big Three” while rating an Islamic or conventional institution. The agencies have stated as much in their methodologies[1]. Their focus is on credit risk; the Sharī'ah aspect is not part of their evaluation. However, prudence and due care in the selection of financial proxies, as well as qualitative assessment are expected from these professional rating agencies. Understanding the nature of risks in an organization is vital before expressing an independent professional opinion about it. This should be crystal clear after the asset-backed security-collateralized debt obligation (ABS-CDO) crisis, where rating agencies failed in depicting the true risks of tranches (Hull, 2009).

This study relates to Sharī'ah-compliance ratings of an IFI in the light of the objectives of the IFS. This study has a clear focus on Sharī'ah-compliance quality, depicted through an independent professional opinion, which is not addressed in the process of financial ratings. To the best of the author's knowledge, there are two rating agencies including IIRA and MARC engaged in this process.

IIRA issues Sharī'ah Quality Ratings (SQR) for IFIs. It covers many aspects of an Islamic bank in issuing quality ratings. These include Sharī'ah board, internal Sharī'ah-control, training and development of human resources, corporate social responsibility (CSR), accounting and disclosures, corporate image and financing modes (Merchant, 2013). MARC issues corporate governance ratings, focusing on four pillars of corporate governance while rating an Islamic bank: accountability, transparency, responsibility and fairness. Sharī'ah compliance by an Islamic bank is covered within these parameters. For scoring, performance of an institution is examined under six heads with allocated weights:

- (1) governance structure;
- (2) management and processes;
- (3) internal control and compliance framework (20 per cent each);
- (4) equality in treatment of stakeholders;
- (5) disclosures (15 per cent each); and
- (6) CSR (10 per cent) (MARC, 2015).

While globally financial ratings of the IFSI are floated by renowned agencies, such results are only partially useful for participants in the industry. It is good to know the financial strength and ability to meet obligations by an IFI; however, stakeholders have another concern too; whether such an institution is being managed according to Sharī'ah norms. While the practical efforts of IIRA and MARC to provide independent opinion on the Sharī'ah-compliance mechanism of IFIs are welcome, they are at a nascent stage. However, scope-limitation hinders the achievement of this objective. The coverage of these agencies is of limited scope in the absence of a model (a bank with desired behavior) to follow. For example, in the selection of financing modes, the debate regarding Sharī'ah-compliance and Sharī'ah-based alternatives offers an important insight into the desired behavior of an Islamic banking institution. A bank with an “A” grade that lacks in the incorporation of a

reasonable percentage of Sharī'ah-based modes of financing cannot be considered a model institution from the Sharī'ah perspective. Moreover, to the best of the author's knowledge, the methodologies of IIRA and MARC are either based on subjective evaluation and/or certain important factors are ignored or less emphasized. These include, among others, equitable distribution of wealth (risk-return sharing, access to finance), opinion of customers/stakeholders and organizational design. Furthermore, the weighting (suggested points) for execution of a particular task in the overall Sharī'ah-compliance process is not clear. For example:

- What is the desired combination of participatory and debt-based financing?
- What weight assigned is for establishing standard Sharī'ah supervision, for full disclosure, new products developed and market reputation?

An important question is whether there exists a model – in light of Sharī'ah guidance and objectives of the IFS – for the Islamic banking industry to follow? What is expected from a model Islamic bank in the areas of Sharī'ah governance, transparency, portfolio structure, treatment of stakeholders and CSR? The author believes that such a model is required in this area that clearly defines the tasks of the overall Sharī'ah-compliance mechanism and allocates a weight to each one. Such a model would present the desired behavior from an Islamic bank, and ratings would be assigned according to the extent of an institution's adherence to it. With the passage of time, it is hoped – as one learns through experience – the IFSI will be able to compete *par excellence* in all aspects, including Sharī'ah-compliance ratings, with the global financial system.

Studies on the development of a Sharī'ah-compliance rating mechanism are limited. [Obaidullah \(2005\)](#) has made a good effort in this respect, identifying six important factors to be considered in Islamic value ratings: elimination of *ribā*, participatory modes, equality in employment, concern for human rights, supporting social enterprises and supporting the unprivileged. Three factors – participatory modes, elimination of *ribā*, and just employment policies – directly relate to internal operations of the industry, while others involve external parties looking for finances from Islamic banks.

The study of [Ashraf and Lahsasna \(2017\)](#) is very close to the objectives of this research. They have suggested quantitative scores by dividing the whole process into five factors – regulatory support, Sharī'ah supervision, business structure, products-depth and capital adequacy. They have suggested a negative score, too, for failing in meeting capital adequacy and for adverse opinion in the Sharī'ah-compliance report. However, the following are some of the issues that can be highlighted in the work by [Ashraf and Lahsasna \(2017\)](#):

- Certain areas are missing from their scoring mechanism (e.g. human resource policies, access to finance by the underprivileged, etc., as documented in a survey by [Obaidullah, 2005](#)).
- Certain weight allocations are debatable (e.g. from the Sharī'ah perspective, two important factors notably participatory modes and Sharī'ah supervision have been allocated weights of 7 and 13 per cent, respectively (arguably too low), while a combined weightage of 13 per cent is given to legal identity and age of the bank (arguably too high). The contribution of certain factors in Sharī'ah-compliance ratings looks overstretched (e.g. assigned weight for regulatory support for Islamic finance products is 13 per cent). It is an established fact that none of the banks can work in a country where regulatory approval of contracts is non-existent; however, legal status might be different ([El-Gamal, 2005](#))[2]. Furthermore, regulatory recognition of Islamic finance contracts is beyond the direct control of the

management of an Islamic bank; hence, punishment for failure on this front looks inappropriate. Likewise, the role of the profit equalization reserve (PER) in Sharī'ah compliance is questionable (the assigned weight is 7 per cent).

This study is an effort to present a comprehensive mechanism – taking into account the objectives of the IFS and developments so far on the subject – for quantitative ratings of Islamic banking institutions. A quantitative rating mechanism is recommended for the following important reasons:

- Quantification breaks the broader goal into specific and measurable small objectives, leading to ease in measuring the level of attainment.
- Quantification is an objective evaluation, significantly eliminating or reducing, the subjectivity of opinion by the evaluator.
- Quantitative evaluation provides a mechanism for independent verification by anyone with required skills.
- Quantification is a widely accepted and practiced tool of openness and transparency.

Considerations

To establish Sharī'ah quality ratings, a quantitative score is required. Scores have been allocated taking into account different aspects of the business. The following important considerations are kept in view while assigning points to an activity:

- Whether an activity has already been built into the system or further efforts are required to bring it into the system. Additionally, what amount of efforts and resources is required to perform an activity with or without financial gains? (e.g. accounting disclosures and customer surveys require varying amounts of effort and resources).
- How conducive is the environment in performing an activity? Islamic banks work in an environment dominated by the conventional financial system, backed by global political and legal support. Islamic bankers perform their activities in a difficult environment. Some of the activities of Islamic banks are performed with relative ease while others do not fit well in the prevailing institutional settings and business norms. Consequently, more efforts, resources and focus are required for such activities (e.g. financing through *murābahah* is much easier than financing through *mushārakah* and *muḍārabah*).
- What are the consequences of failure in the performance of an activity – whether it is a direct Sharī'ah violation or leads to a Sharī'ah violation? There are certain activities which if not performed will not result in a direct Sharī'ah violation (e.g. failure to provide *qard ḥasan* [benevolent loan]). Similarly, there are practices like *hibah* (gift) to match returns on conventional deposits which are not explicit Sharī'ah violations but come close. On the other hand, failure in checking/performing certain activities entails direct Sharī'ah violation (e.g. generation of *harām* [prohibited] income through *ribā*, *gharar*, *maysir* and *qimār*).
- How vital is an activity in the overall Sharī'ah-compliance objective? There are certain activities that are directly responsible for ensuring Sharī'ah compliance (e.g. structure and effectiveness of the Sharī'ah board and performance of Sharī'ah audit in line with global practices).

- What is the application of Sharī'ah-based and Sharī'ah-compliant methods/activities? Sharī'ah-based methods of executing operations include the modes that are preferred or liked from the Sharī'ah perspective (e.g. the participatory modes of financing). Sharī'ah-compliant modes such as debt-based modes are only permitted methods but not preferred.
- What is the nature of the activity? Is it of a compulsory or voluntary nature, based on the system design? (e.g. taking deposits on profit-and-loss sharing is compulsory, and extending finances under profit-and-loss sharing is voluntary). A higher score is allocated to voluntary activities compared to those compulsory by design.

A number of considerations are applied in assigning weight to each financing product in the investment and financing portfolio: existing practice, the desired combination and the conduciveness of prevailing market circumstances. Participants in the IFS have certain concerns about the desirability/undesirability of certain practices. These concerns carry due weight in the assignment of the score.

Classification and score allocation

The customary activities of the bank need to be considered in measuring the level of Sharī'ah compliance of an Islamic bank. The grade assigned should also consider the desired behavior from a self-declared Islamic organization. The important question to be asked is: What are the underlying objectives of the IFS? Ratings should help in determining progress in the achievement of goals.

Chapra (2008) postulates that Islam promotes justice; as such, a just financial system is required to satisfy at least two conditions – sharing of risk and rewards, and equitable access to finance – in addition to stability. Access to finance means it is also available for the poor. This would provide employment opportunities and help to eliminate poverty and reduce inequalities of income and wealth. A well-documented principle of the IFS is *al-kharāj bi al-ḍamān* (benefit goes with liability). Cash lending for return (risk-free return) is prohibited because it is *ribā*. The lender is not liable for the cash while it is on loan; hence, he has no right to benefit from it while the borrower is liable for it. Cash lending without return is a charitable loan, which is praiseworthy. Debts are not totally eliminated within the IFS. Chapra (2008) documents that focus on equity financing does not mean elimination of debt financing; however, certain restrictions are imposed. No direct lending-and-borrowing on interest is allowed; rather, there is a focus on asset-based financing. A moderate amount of risk is involved in asset-based financing (used for debt financing). Hence, debt financing is not risk-free. Moreover, transactions are based on real assets, not fictitious assets. The supplier of assets possesses the ownership of the underlying assets and bears ownership risk. As a result of restrictions on debt-financing, speculation is eliminated and credit expansion corresponds to a rise in the real economy, leading to financial stability. Finally, Sharī'ah-compliance, in letter and spirit, in the governance of IFIs is expected.

To summarize, the objectives of Islamic finance include equitable distribution of wealth, stability in the financial system and adherence to Sharī'ah norms. Equitable distribution of wealth is achieved through risk-reward sharing and availability of finance to the less-privileged. Financial stability is linked to matching credit with the rise in real economy. Sharī'ah compliance covers broader areas including discouraging *ribā*, *gharar* and *maysir*; promoting socially responsible investments; and ensuring Sharī'ah-compliance in operations. These important objectives of Islamic finance need to be considered in

ratings of self-declared IFIs, and grades may be awarded based on progress towards the achievement of these objectives.

In this study, the overall Sharī'ah-compliance system has been divided into multiple performance measures. Although factor selection is based on the judgment of the author, due contributions in the literature are acknowledged: [Obaidullah \(2005\)](#), [Chapra \(2008\)](#), [Merchant \(2013\)](#), [MARC \(2015\)](#) and [Ashraf and Lahsasna \(2017\)](#). This study has grouped banking operations into four major categories for Sharī'ah-compliance rankings:

- (1) *Portfolio construction (34 per cent)*: Deposits, financing and investments (participatory modes and asset-based financing).
- (2) *Access to finance (18 per cent)*: Share in financing of underprivileged segments including low-income groups and rural economy, screening of customers in the light of Sharī'ah and established CSR principles.
- (3) *Reputation (12 per cent)*: Disclosures and opinions of stakeholders.
- (4) *Sharī'ah governance (36 per cent)*: Sharī'ah board, internal control and Sharī'ah audit, charitable operations, human resources, product development and organization.

The above makes up the Portfolio, Access, Reputation and Sharī'ah governance (PARS) rating system, where PARS refers to parity/balance. After grouping each factor into a related category, points are assigned to each group (combination of points of factors), with the total number of points equal to 100 ([Table I](#)). Allocation of points demands due care. One way to allocate points would be by a mechanism developed on historical data. However, data on factors which contribute to Sharī'ah violations or compliance by the Islamic finance industry are required but missing. Another method is to survey the experts in the area to document the inputs and conclude on averages. Score allocations, in this study, have important inspirations from the following sources:

Broad grouping	Points (%)	Sub-sections explanation
Portfolio construction	34	Deposits (Points = 08): Sharī'ah compliance of deposit management; use of <i>hibah</i> ; issuance of <i>qard ḥasan</i> Financing and investments (Points = 26): Sharī'ah compliance in financial products; selling modes including debt-based financial products; participatory financing modes and investments in marketable securities
Access to finance	18	Serving less-privileged segments (individuals and rural areas) (Points = 10) Sector screenings based on Sharī'ah and CSR principles (Points = 08)
Reputation	12	Customer satisfaction (Points = 07): <i>Par excellence</i> customer service delivery Disclosures (accounting and others); accounting system (Points = 05)
Sharī'ah governance	36	Internal control and Sharī'ah audit (Points = 12): Internal control system, standard operating procedures and information system; and audit independence (external audit) Sharī'ah board (Points = 07): Composition of Sharī'ah board, qualification of board members and independence of board; effectiveness of board Human resources (Points = 05): Qualification, remuneration, career path, just and merit-based promotions Product development (Points = 03) Charitable operations (Points = 06) Organizational design (Points = 03)

Table I.
PARS ratings
distribution of points

$$SCR_t = P_t + A_t + R_t + S_t \tag{1}$$

where:

SCR_t = Shari'ah-compliance rating; P_t = Portfolio consisting of deposits and financing and investments; A_t = Access to finance; R_t = Reputation; and S_t = Shari'ah governance.

- (1) Survey results (Obaidullah, 2005). In that survey, categorization of respondents (195) includes economists and researchers (38 per cent), bankers and finance professionals (32 per cent), religious scholars (20 per cent) and others (10 per cent).
- (2) Study on Shari'ah risk rating by Ashraf and Lahsasna (2017).
- (3) IFIs Governance Rating Methodology by MARC (2015).
- (4) Input from anonymous reviewers.
- (5) Considerations, documented in the previous section.
- (6) Selected literature on principles of Islamic finance (Iqbal *et al.*, 1998; Usmani, 1999; Mawdudi, 2000; Ayub, 2007, 2016; Chapra, 2008; Visser, 2012).

Such an exercise (score allocations) is the mere beginning for the consideration by the community of Islamic finance – scholars, practitioners, customers, regulators, academics and the general public. Improvements and modifications in the suggested scores, as well as additions/deletions of components, are expected over time. The best forums to debate the issue are Shari'ah boards, regulators and standard-setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

Portfolio construction

Portfolio covers both sides of the balance sheet of an Islamic bank – deposits and financing and investments (Table II). Financing and investments are further categorised as sale-based, *shirkah*-based (profit-and-loss sharing), mortgages, rent-based and marketable securities operation.

Factors	Points	Weight	Description
<i>Panel A: Collections</i>			
Deposits management (Loan accounts and Investment accounts)	08	24%	Includes 01 point for current deposits, 03 points for investment deposits' management system, 02 points for <i>qard hasan</i> , and 02 points for discouraging <i>hibah</i> practices
<i>Panel B: Investments</i>			
Non-participatory modes Selling (<i>murabahah, salam, istiṣnā'</i>)	10	29%	Marks should be reduced if the share of debt-based modes increases above 50% in financing and investments. Also, more marks are recommended for <i>salam, istiṣnā'</i> and <i>ijarah</i> on account of riskiness
Leasing (<i>ijarah</i>) Participatory modes (<i>musharakah</i> and <i>muḍārabah</i>)	16	47%	16 points within the portfolio are suggested for the most preferred sources of financing and investments. Further, such points may be distributed equally among <i>musharakah</i> and <i>muḍārabah</i> , mortgages and marketable securities
Mortgages			
Marketable securities			
Total	34	100	Overall, a score of 34 points is allocated for the main activities of an Islamic bank due to importance in achieving the objective of Shari'ah compliance

Table II.
Rating points for portfolio

$$P_t = D_t + F_t \quad (2)$$

$$D_t = CD_t + QH_t + ID_t \quad (2.1)$$

$$F_t = PM_t + NPM_t \quad (2.2)$$

where:

P_t = portfolio; D_t = deposits; F_t = financing and investments; CD_t = current deposits; QH_t = *qard ḥasan*; ID_t = investment deposits; PM_t = participatory modes; and NPM_t = non-participatory modes.

Deposits. Deposits under the Islamic banking system are collected either as current accounts or investment accounts on the basis of *muḍārabah*. A current account is a contract of loan between the depositor (lender) and the Islamic bank (borrower). Accepting current deposits under *amānah* (trust) is not recommended because the bank cannot use the funds collected for commercial benefits. Islamic banks get a huge amount of money in current accounts and use that money to generate revenue but do not share it with the depositors. It is suggested that a portion of that amount should be reserved for *qard ḥasan* (charity loans) for the needy and poor. Small amounts of loans should be provided to the less-privileged small entrepreneurs engaged in cottage industries, students and employees of the government or private sector with low salaries – to buy household items. Additionally, such loans should be made available for certain emergencies including accidents, deaths or marriage ceremonies of the poor masses. To promote the concept of *qard ḥasan* among Islamic banks, the study recommends two (2) points in Sharī'ah-compliance ranking of an Islamic bank. Suggested points for current deposits are thus three (3) – distributed as one (1) for accepting current deposits as loans and two (2) for *qard ḥasan*.

In the case of investment deposits, there are certain issues which need to be addressed:

- First is the profit-sharing ratio with depositors. What should be the profit-sharing ratio between the two parties in a *muḍārabah* partnership? Sharī'ah has left this decision to the partners; however, given the competition among Islamic banks, not much difference is expected in the profit-sharing ratio among Islamic financial depository institutions. Also, the regulator is expected to have an eye on operations to avoid cartels that favor the banking industry. Still, an analysis of profit sharing should be conducted in awarding points on this front. A lesser share for depositors is a form of exploitation due to weaker bargaining power.
- Moreover, in certain cases, *hibah* (gift) is practiced. After profit distribution, a comparison with market return on deposits is made and any deficiency is met from the share of the *mudārib* (Islamic bank). Although there is no Sharī'ah restriction on a bank occasionally gifting profit to customers in the absence of any pre-set condition, it is not in line with the economic substance of the IFS and it is problematic as a regular practice, based on the Islamic legal maxim:

المعروفُ عرفاً كالمشروط شرطاً

What is expected by custom is tantamount to what is stipulated in a contract.

To discourage this practice, this paper recommends more points for a bank with zero *hibah* to depositors. There should also be a proportionate reduction in score for increase in the

hibah amount in percentage terms, as well as number of times exercised during the year (monthly or quarterly distribution of profit).

The score suggested for investment deposits is thus five (5) – three (3) for accepting deposits under risk-and-reward sharing and two (2) for discouraging *hibah* practices. While assigning scores on investment deposits, due attention should be paid to the fairness and disclosure of the profit-sharing ratio as well as expenses charged to the customers.

Financing and investments. Every bank collects deposits and makes investments in multiple channels, earns revenue and shares a portion with money suppliers. Islamic banks do the same but in a different manner. Islamic banks have multiple suggested options to create earning portfolios including trade-based and rent-based contracts, mortgages, participatory modes of financing and investments in marketable securities including *sukūk* and equities. All of these modes are *ḥalāl* (permissible) forms of doing business as long as the specific requirements of each mode are fulfilled – clearly defined by the Sharī'ah boards of the respective banks. Despite the fact that they are all *ḥalāl* in legal form, in economic substance, they are not the same. Some of the modes are clearly more in line with the spirit of the IFS and preferred over others.

For example, in selling modes, *salam* and *istiṣnā'* financing are preferable over *murābahah* financing on account of the risk–reward relationship as well as service to agriculture/rural community. Likewise, investment in equities is preferred over *sukūk*; and *musharakah/muḍarabah* is the most preferred mode of financing under the IFS. The underlying reason for preference is the riskiness of different modes. Risk (but not *gharar*) is preferred over the risk-free investments to earn a profit. A well-established norm of Islamic business is *al-kharāj bi al-ḍamān* (benefit goes with liability). This study has taken into account this principle while assigning rating points to each mode of revenue generating for an Islamic bank.

A total of 26 points are suggested for the make-up of the financing and investments portfolio of an Islamic bank. This is on account of its importance in achieving the Sharī'ah-compliance objective. They are distributed as under Table II. More points are allocated to participatory (16) and less to non-participatory (10) modes of financing. Partnership modes are not very much practiced on account of the difficulties in implementing them; however, a bank using more equity-based financing should be rated higher based upon the preference for it under the IFS. The importance of participatory modes of financing in the overall IFS is documented in a survey conducted by Obaidullah (2005). What is desired combination of participatory and non-participatory modes in investment and financing portfolio of an IFI? Ideally, share of participatory modes should be higher; however, difficulty in the practice of equity modes has been well documented. This study suggests equal weight in portfolio make-up for debt-based (50 per cent) and participatory products (50 per cent) while acknowledging that the weight of the latter should ideally be greater. Additionally, portfolio weights are suggested – based on Islamic finance objectives, market practices, as well as, financial and operational viability – as a guide for allocating points. In the case of non-participatory modes, the following aspects need consideration:

- Given Islamic bankers' preference (based on operational ease) for *murābahah*, caution is suggested, that its share not exceed 25 per cent.
- If the share of *salam* and *istiṣnā'* is more, then more points may be awarded for the previously mentioned reasons.
- Rental income is generated under *ijārah*, which is different from both selling and profit-and-loss sharing. Although risk in *ijārah* is more than *murābahah*, *ijārah* also generates debts. It is more appropriate to categorize it as debt-based financing than equity.

In the case of partnership modes, especially *mushārah* and *muḍārah*, empirical evidence suggests a very discouraging picture due to various reasons including: riskiness, lack of transparency in accounting records of the investee, lack of trust and tax considerations (Hanif and Iqbal, 2010). Although these are the most preferred modes of financing under Islamic norms because of actual profit- and loss-sharing, the IFSI could not use them on a wider scale. The study has suggested 16 points which may be divided equally among *mushārah*, *muḍārah*, diminishing *mushārah* and marketable securities. The only caution under this mode is suggested that as opposed to trading modes, here points shall be deducted for the lesser or non-application. Only a bank with 50 per cent or more investments under partnership modes will get 100 per cent points (i.e. 16). Less points shall be awarded for a corresponding reduction of investments under partnership modes of financing. House financing is provided by Islamic banks globally. Some banks use diminishing *mushārah* model (DMM) for mortgages. DMM (a participatory mode) is preferred over *murābahah* for Shari’ah considerations; hence, banks with DMM should get a higher score. In case a *murābahah* model is used, it should be accounted for in non-participatory modes. True DMM is riskier than *murābahah*; hence, more points are suggested. Investment in marketable securities is the primary tool of liquidity management for an Islamic bank. If the share of equity securities is more, a higher score may be assigned based on the risk-bearing feature. Less points may be assigned for more investment in *shukūk* on account of less riskiness.

A caveat is suggested while assigning scores to financing and investments: one should take into account a cap of 50 per cent for both participatory and debt-based modes of financing. Certain controversial products – approved in some jurisdictions – should be accommodated in ranking in those jurisdictions by grouping as participatory or debt-based.

Access to finance

Access to finance is subdivided into two sections: serving less-privileged segments and sector screenings (Table III). It is expected that a just financial system will provide equitable access to finance, especially by less-privileged and unserved/underserved segments of the society. This is an important aspect of Islamic banking as far as the customer base is concerned. It is important to know whether all financing facilities are available to big corporations and urban centers, or a portion has been granted to individuals and for financing the rural economy. Islam promotes equality in opportunities; hence, Islamic banks are expected to consider underserved and less-privileged people and sectors, too, in the distribution of capital. Ten points are suggested for this aspect and shall be awarded to a bank with a reasonable amount (close to one-third) of disbursements to low-income individuals and the rural economy.

Factors	Points	Weight (%)	Explanation
Service to underserved	10	56	Points should be allocated based on financing provided to low-income individuals and rural economy
Customer screening	08	44	Allocation of finances is based on customer screening in the light of Shari’ah and established CSR principles
Total	18	100	Overall, a total score of 18 points is allocated for access to finance due to importance of achieving equitable distribution of wealth under the IFS

Table III.
Access to finance

$$A_t = SU_t + SS_t \tag{3}$$

where:

A_t = access to financing; SU_t = service to underserved segments; and SS_t = customer/sector screening.

Moreover, sector screening is expected from an IFI. Extending finances to business with Sharī'ah non-compliant activities and/or not caring for human rights and the environment, for example, is not an appropriate practice for ethical entities. In selection of projects and customers, adherence to Sharī'ah and established CSR principles is expected from Islamic banks. Eight (8) points are reserved for this aspect. [Obaidullah \(2005\)](#) lists multiple important factors in this regard, including: upholding human rights, promotion of social enterprises, environmental protection, fair trading practices, labor rights and responsible marketing – that may be considered in sector screenings. [Saged et al. \(2017, p. 131\)](#) state that caring for and preserving the environment are among the purposes of Islamic law on account of the welfare of mankind.

Reputation

Scoring under reputation is divided into two sub-sections: customer satisfaction and disclosures ([Table IV](#)). Although the IFSI has an advantage over conventional banking as far as customer attraction is concerned, better customer service is required for success in the long run. Surveys have documented religious linkages as one of the reasons for using Islamic financial services by customers ([Bley and Kuehn, 2004](#); [Haque et al., 2009](#); [Hanif et al., 2012](#)). This research allocates seven (7) points to this aspect, and scores should be allocated based on the analysis of surveys of stakeholders only, particularly customers. An important consideration in such a survey would be: What is a Sharī'ah-compliance rating of a banking firm in the eyes of stakeholders? Such a survey ideally should be conducted through an online facility available within every branch; however, in the beginning, the objective can be achieved through the random selection of customers by the rating agency.

Accounting and non-accounting disclosures are very important and serve as a valuable tool in the transparency of operations. Disclosures include the directors' report, financial statements, auditors' report, report on corporate governance practices and the Sharī'ah board report. In addition, disclosures are required for the amount of *ḥarām* income generated and the mechanism to distribute it. Details of the profit calculation mechanism need to be disclosed, including weights assigned to each category, the share of the *muḍārib*, expenses chargeable under each service/contract to customers, use of *hibah* and profit equalization reserve, etc. Disclosures contribute to market perception and transparency. This study recommends a score of five (5) points to this important aspect in the overall Sharī'ah-compliance process.

Sections	Points	Weight (%)	Explanation
Disclosures	05	40	Availability of reports to the public, including accounting and Sharī'ah board. Transparency about profit-sharing mechanism, charges for services and others
Customer satisfaction	07	60	A survey with carefully designed questions covering areas of provision of services, keeping promises, dealing equally, and overall satisfaction with conduct of the Islamic bank
Total	12	100	Overall, a total score of 12 points is allocated for reputation of an Islamic bank among stakeholders

Table IV.
Reputation

$$R_t = DC_t + CS_t \tag{4}$$

where:

R_t = reputation of an Islamic bank; DC_t = disclosures; and CS_t = customer satisfaction.

Sharī'ah governance

The final and vital aspect of the overall Sharī'ah-compliance mechanism adopted by an Islamic bank is the Sharī'ah governance system, which is further subdivided into multiple sections: Sharī'ah board, internal control and Sharī'ah audit, charitable operations, human resources, product development and organizational form. Table V presents weights for each of the factors under consideration.

Sharī'ah board. The Sharī'ah board is the highest approval authority of business systems and products used by an Islamic bank in its operations. In addition, the Sharī'ah board is a policy-formulating body for smooth operations and achievement of the Sharī'ah-compliance objective within the organization. Given the required skills of business/banking, as well as Sharī'ah expertise, board members should ideally be well qualified in both streams of knowledge, conventional and Islamic. However, the number of such professionals/experts is very low compared to global demand. On account of this constraint, a mixture of qualified business/finance professionals and Sharī'ah experts is recommended with Sharī'ah experts comprising at least a simple majority and having decision-making authority. This study has suggested seven (7) points (19 per cent within the section) to the Sharī'ah board in overall Sharī'ah-compliance ratings, which is further subdivided into three sections. Fifty per cent of the score is allocated to having a sufficient number of Sharī'ah experts with a repute in Sharī'ah expertise; and 25 per cent each for members from business/banking/finance. Another 25 per cent is allocated to the independence of the Sharī'ah board, with zero or minimal conflict of interest. The expertise of members, including formal qualification and experience, is key in the assignment of the score on this front.

Sections	Weight		Explanation
	Points	(%)	
Sharī'ah board	07	19	Sharī'ah board score should be allocated based on three criteria including composition, qualifications and independence
Internal control & Sharī'ah audit	12	33	Marks should be allocated based on staff sufficiency, qualification, procedures and controls, and external Sharī'ah audit
Charitable operations	06	17	Marks should be allocated based on <i>zakāh</i> collection from customers and owners of the bank; sources of <i>haram</i> income generation; distribution mechanism for charity funds
Human resources	05	14	Human resources development includes wage structure, qualification, training, career path and merit system
Products development	03	8.5	Includes new products developed as well modifications made to existing products of the conventional industry in the light of Sharī'ah norms
Organizational design	03	8.5	Whether an independent Islamic bank or a business segment under a conventional banking system
Total	36	100	Overall, 36% score is allocated for Sharī'ah governance due to its importance and vital role in achievement of the Sharī'ah-compliance objective

Table V.
Sharī'ah governance

$$S_t = SB_t + SA_t + CO_t + HR_t + PD_t + OG_t \quad (5)$$

where:

S_t = Sharī'ah governance; SB_t = Sharī'ah board; SA_t = Sharī'ah audit; CO_t = charitable operations; HR_t = human resources; PD_t = product development; OG_t = organizational design.

Sharī'ah audit. The internal control system, including Sharī'ah audit, is a vital factor in achieving the Sharī'ah-compliance objective. A total of 12 points are allocated to it. Overall 12 per cent weight (33 per cent within the section) assignment to Sharī'ah audit is justified on account of the substantial reliance on this system for achieving the objective of Sharī'ah compliance. Due attention is required while assigning the Sharī'ah audit score to the following important aspects:

- Sufficiency of resources including human resources. It would be determined based on the number of branches/transactions/operational force, as well as geographical coverage by an Islamic bank.
- The second aspect relates to the qualification of the Sharī'ah audit staff including Sharī'ah auditor and officers. Sharī'ah certification is a must for Sharī'ah auditors; additional qualification – in Sharī'ah as well as in business – is preferred due to increased and superior skill-development in executing the required job. Another important aspect is the independence of the Sharī'ah auditor, measured through reporting authority (CEO or board).
- The third suggested area of scoring points is the ensuring of foolproof arrangements for the Sharī'ah audit system including software development, standard operating procedures and internal Sharī'ah-compliance control system.
- The fourth area of Sharī'ah audit is external Sharī'ah audit. External Sharī'ah audit has not yet developed sufficiently; however, an external audit has always been preferred in organizations to get an independent opinion about operations, in line with pre-set objectives and system in place. DeLorenzo (2000) justifies independent Sharī'ah audit/supervision on account of gaining and maintaining the trust of Muslim investors and consumers.

Charitable operations. This is an important function expected from a modern Islamic bank. Generation of charitable funds – including *zakāh* collection, income from *ḥarām* operations on account of interaction with conventional industry and late payment charges – exists by design in modern Islamic banking. The suggested weight for charitable operations is 17 per cent (6 points) within the category of Sharī'ah governance. It should be assigned by taking into account the following considerations:

- The ultimate objective of Sharī'ah compliance is to ensure that the income of stakeholders is *ḥalāl*. In the presence of a dynamic and well-regulated system, the probability of generating *ḥarām* income is significantly reduced. However, if there is still a *ḥarām* element, and then Islamic banks should get punished for this in their Sharī'ah-compliance ranking. The tolerable limit of *ḥarām* income generation for an Islamic bank has not yet been decided at the policy level; however, AAOIFI (2015, Sharī'ah Standard 21) has suggested the highest limit of *ḥarām* income to be 5 per cent of total investee income under capital markets' operation. The score should be reduced corresponding to an increase in *ḥarām* income (from zero), except for late payment charges because Islamic banks have zero or very minimal control of this factor.

- The second area selected for scoring under charitable operations is *zakāh* collection from account holders by an Islamic bank as well as *zakāh* contribution from its owners' wealth.
- The third area of scoring under charitable operations is the distribution mechanism. An Islamic bank having a fool-proof distribution system, with application in letter and spirit, should be rewarded accordingly.

Human resources. Human resources are vital for the success or failure of any venture, and IFSI has no exception in that regard. The human resources proxy is also used in the financial ratings of banks (e.g. CAMELS rating). This study has allocated five (5) points (14 per cent within the section of Shari'ah governance) to this important aspect of goal achievement. It is further suggested that three areas should be taken into account in score allocation: remuneration, quality (covering formal qualifications, training, and development) and career path.

- *Remuneration:* From the Shari'ah point of view, just and timely wages must be paid to the workforce. Exploitation based on weaker bargaining position of the workforce is against the teachings of Shari'ah, and Islamic banks must avoid it.
- *Quality or skill of human resources available to an Islamic bank:* It includes formal professional qualifications as well as the amount spent on training and development of the workforce by an Islamic bank. It also includes Shari'ah-law understanding through formal/informal learning.
- *Career path and promotions of the workforce:* While assigning the score, a review of the prevailing promotion system, based on merit and best market practices, should be conducted. Merit-based and stable career path generates security sentiments among employees and increases loyalty to the organization, which is vital for success.

One way to assess policies of an organization relating to human resource management is to check the staff turnover ratio. If it is high, that is an indicator of dissatisfaction by the workforce, and the score should be reduced for such an organization.

Product development. One of the important activities that can help in competing with the conventional industry, and in the growth of Islamic banking, is product development, taking into account Shari'ah considerations as well as business viability. Product development includes the creation of tools/contracts for deposit collection, financing and investments and capital market operations. New products, as well as modified forms of conventional products in the light of Shari'ah regulations, are eligible for scoring – although new products are preferred. Marketable products are vital for successful operations of Islamic banking. This research assigns three (3) points (8.5 per cent weight within the section of Shari'ah governance) to product development activity in the overall Shari'ah-compliance system, which may be distributed 60:40 between new products and modified products from the conventional operations.

Organizational design. An Islamic bank might be a full-fledged Islamic bank or an independent segment of a conventional bank, working as per the procedure laid down by the regulator. Ideally, an Islamic bank should not be a business segment of a conventional bank. However, in practice, it may be difficult to sustain as an independent institution in financial terms. Hence, some banks provide parallel services to both types of customers including conventional and Islamic. In addition, given the nascent stage of the IFSI, some risk-averse owners of conventional banks do start Islamic banking in parallel to conventional banking

to check market response. Success of the experiment may lead to the conversion of Islamic banking operations into a full-fledged Islamic bank. The proposed rating system does not consider both types of arrangements – full-fledged Islamic bank vs. a segment/division within conventional banking – equal. Hence, this study recommends a score of zero (0) for an organization which is not a full-fledged Islamic bank and a ranking score of three (3) for an independent Islamic bank. Although operations of an Islamic banking segment are performed in agreement with Sharī'ah principles, it is ideally preferred to execute operations of Islamic banking separately from conventional banking.

Finally, following [Ashraf and Lahsasna \(2017\)](#), if the Sharī'ah board report carries adverse opinion, then negative 100 marks are recommended. That judgment would be based on the intensity of the adverse opinion. Recommendation of the very high negative score is justified because dissatisfaction of Sharī'ah board clearly signifies Sharī'ah non-compliance.

Ratings

Once scores are computed in each category, the next process is allocating the proper ranking in the area of Sharī'ah-compliance. There are multiple ranking mechanisms. In academia, grades start from A+ and finish at F, forming 12 stages. In the financial sector, ratings range from 10 to 21 stages (Aaa to C, 21; [Moody's Investors Service, 2017](#)); (AAA to D, 10; [S&P, 2016](#)) and (AAA to D, 11; [Fitch, 2017](#)).

This research suggests a total of six (6) stages to start with ([Table VI](#)). The lowest stage is an “F” grade. If a self-declared institution cannot score even 50 points, it should be held under notice for a reasonable period. In case of failure to improve suggested weaknesses, it should be declared Sharī'ah non-compliant. The highest grade is allocated to elite IFIs, scoring more than 90 points. Platinum status with five stars is suggested for such an organization. Four stars are awarded to a firm with score >80 <90 with a suggested status of gold. Silver status with three stars is suggested for a firm with a score >70 <80. Average status with two stars is suggested for an institution with a score >60 <70. Lowest score with a single star is suggested for a firm with >50 <60. These rankings are not based on the concept of either Sharī'ah compliance or non-compliance; rather, they are based on the concept of more or less Sharī'ah-compliance, taking into account constraints as well as professional practices.

Applications

Application of the rating mechanism needs due care, especially in an era when multiple voices are raised about divergences between the theory and practice of the Islamic banking industry. It is fundamentally the duty of Sharī'ah auditors and Sharī'ah boards to ensure the practice of Islamic financing according to the letter and spirit of the Sharī'ah. Criticisms

Score	Scores	Explanation
≤50	F grade	An Islamic bank with score less than 50 should not be considered Sharī'ah compliant and should be held on notice
51-60	*	Single star for a score up to 60, pass but “Below average”
61-70	**	Two stars for a score above 60, “Average status”
71-80	***	Three stars for a score more than 70 “Silver status”
81-90	****	Four stars for a score more than 80 “Gold status”
90-100	*****	Five stars for a score more than 90 “Platinum status”

Table VI.
Sharī'ah compliance ratings

and dissatisfaction by experts in the field of Islamic finance point out the partial failure in the achievement of goal. Shari'ah rankings carry the potential to generate pressure on management and Shari'ah supervisors to address weaknesses. Nevertheless, organizations involved in rankings need due care and prudence in the process, with a special focus on the following concerns:

- (1) In case of deposit management, if current deposits are accepted as *amānah* and then used for the benefit of bank owners, it is deemed a questionable practice, as compared to the use of the loan contract. Likewise, under profit- and loss-sharing deposits, excessive use of *hibah* dilutes the spirit of the participatory form of banking.
- (2) In the case of the profit-and-loss sharing mode of financing, the practice of “incentive” for managers reduces the level of compliance with the essence of the IFS. Once the target profit of the financiers is achieved (usually interbank offered rate – IBOR plus), excess return is either awarded wholly or a significant portion to the manager as an “incentive” for managing (JAFZ, 2007, p. 14). To meet the cash demands of customers, a running *mushārah* agreement is introduced by banks in certain jurisdictions. Profit is distributed as per equity stake up to an agreed profit ceiling, i.e., until the required rate of return for the bank (IBOR plus) is achieved. Once the bank achieves the target profit, a different profit-sharing ratio is applied in which an insignificant (e.g. 2 per cent) portion is awarded to the bank (Siddiqui, 2016). In a critical analysis of running *mushārah* as practiced in Pakistan, Ayub (2016) concludes that the prevailing practice is less desirable than the fixed-return modes of financing (*murābahah*, *salam*, and *ijārah*) for multiple reasons, including the following:
 - It is against the principle of *al-kharāj bi al-qamān*. The banker (manager of deposits) agrees to limit the right of profit sharing; however, the loss is to be shared as per equity stake (limitless).
 - Although *hibah* is allowed, if it becomes a norm through a formal understanding of the parties to pay the bank a predefined rate linked with IBOR, irrespective of huge actual profit, then it is not much different from *ribā*.

(These practices reduce the level of compliance with the essence (risk-reward sharing) of the IFS)

- (3) In case of mortgages, due care is needed in scrutinizing the practice, with a special focus on the following concerns:
 - In case of rent-charging, due attention should be given to a choice between market rentals and IBOR-linked pricing.
 - Whether equity units are traded at market value or par. Market rentals and trade of equity units at market prices are more in line with the essence of the IFS.
- (4) In case of asset-based financing, an examination of the due process and steps, as recommended in the theory of Islamic finance, needs to be completed. Certain issues, including ownership, risk bearing and market element in pricing, need special focus to determine the divergences/compliances.

(5) Sharī'ah supervision is an important aspect of overall Sharī'ah-compliance quality. Independence and effectiveness of the Sharī'ah board and its members need to be judged by taking into account multiple factors:

- Remuneration of members. Are they paid or not? If paid, is it by the employer or the regulator?
- Decision criterion. Are Sharī'ah board decisions made on the basis of unanimity or majority? What is the intensity of dissenting notes?
- Reporting authority. Is it the CEO, or the board, or shareholders?
- Sharī'ah board report. This is an important document and is very helpful in the understanding of state of affairs. Qualifications raised in the Sharī'ah board report need to be taken into account while assigning a score.

These ratings can be determined by any person – with due qualification and access to the required information – for an Islamic bank. It could be argued that professional rating agencies with required expertise are the preferred choice to determine the Sharī'ah ratings of the IFSI. However, the author considers regulators (central banks) the most appropriate choice for Sharī'ah ratings of the industry, due to the following reasons:

- The regulator has unrestricted access to records; also, the management of Islamic banks listens to regulators.
- More public trust in regulators is expected than of any private agency.
- The regulator can ensure removal of weaknesses (if any) identified in the rating process.

Conclusion

This research is conducted to develop a Sharī'ah-compliance rating model for the IFSI with a special focus on Islamic banking. The IFS objectives are taken into account in the allocation of scores. The study has included numerous performance indicators, grouped into four categories including Portfolio, Access to finance, Reputation and Sharī'ah governance (PARS).

Scores are assigned to each performance indicator based on certain considerations, including the amount of resources and time required in performing an activity, suitability of prevailing business conditions, the degree of compulsion/discretion in performing a task and linkage with the essence of the IFS. Finally, a score of 50 per cent is considered the minimum to remain in the Sharī'ah-compliant list of institutions. For scores above 50, five ranking categories are suggested – below average, average, silver, gold and platinum.

This is a comprehensive study in the area of quantitative Sharī'ah-compliance ratings of the IFSI, and the suggested methodology is a contribution to the literature of Islamic finance. This study is useful for building market confidence, for Sharī'ah boards, regulators, management of firms and standard-setting bodies. Sharī'ah rating helps in determining the status of compliance by an organization entrusted with funds by customers having aspirations to participate in *halāl* business. IFIs are exposed to Sharī'ah non-compliance risk, a unique risk for the IFSI, and an analysis of Sharī'ah-compliance is helpful for participants. This paper recommends the application of Sharī'ah-compliance ratings at the regulator level, including central banks and Sharī'ah boards of firms engaged in the provision of Islamic financial services.

The future research agenda includes the application of this ranking system to evaluate the results and make further improvements. The model can also be extended beyond Islamic banking to other areas such as asset management companies and *takāful* (Islamic insurance) operations, with certain modifications.

Notes

1. Malaysian-based rating agencies (MARC and RAM) are exceptions. They have incorporated the uniqueness of the Islamic banking business model in their rating methodologies (RAM, 2010; MARC, 2015).
2. For further reading, legal cases relating to Islamic finance decided by Western courts, including Dana Gas *Shukūk*, are recommended.

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