

[Exposure Draft (AGEB 2/2022) v10.0 of the]
AAOIFI Governance Standard (GS) ____

**Shari’ah Compliance and Fiduciary Ratings of Sukuk and
Other Islamic Finance Instruments**

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AAOIFI Governance Standard (GS) ____ “Shari’ah Compliance and Fiduciary Ratings for Sukuk and Other Islamic Finance Instruments” is set out in paragraphs 1-60.

Where the context so requires, the use of the masculine gender shall include the feminine gender and the singular shall include the plural and vice versa and the word “person” shall include any institution, corporation, firm, partnership, body corporate or other forms of association. The table of contents and headings do not form part of the text of the standard and are for the purpose of convenience and ease of understanding, and may, at times, help in the interpretation of text only.

Preface

- PR1 In order to develop a market for Islamic finance instruments, particularly, publicly offered instruments, it is essential to establish stakeholders' confidence in such instruments. Although the same notion applies to the conventional finance instruments, the expectations from their respective stakeholders may differ. While the stakeholders' confidence in the conventional finance instruments primarily rests on the credit worthiness of the instrument's originator, stakeholders of Islamic finance instruments look towards Shari'ah compliance and the safeguard of the underlying asset(s) and the ability of the same to generate the expected returns. These expectations fundamentally change the approach that should be applied towards the independent rating of these instruments, which is essential for establishing the confidence of the stakeholders.
- PR2 This standard is a continuation of AAOIFI GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions" and intends to promote the Shari'ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments. It sets out the minimum requirements and defines the approach and methodology that may be applied by a rating agency with regard to the issuance of Shari'ah compliance and fiduciary rating for such instruments.

Introduction

Overview

- IN1 This standard sets out principles to be applied by rating agencies for Shari'ah compliance and fiduciary rating of Sukuk and other Islamic finance instruments. It provides principal guidance on the responsibility, acceptance, process, reporting and quality assurance for such services. Rating agencies are free to develop their own detailed methodologies for such ratings including the rating scales, as long as they are aligned with the requirements of this standard.
- IN2 The elements of Shari'ah compliance and fiduciary ratings include Shari'ah compliance (i.e., compliance with Shari'ah principles and rules), Shari'ah governance, related corporate governance, transparency and disclosure, ethics and values, as well as, fiduciary performance.
- IN3 The standard encourages originators to perform such ratings regularly, at suitable intervals, for all Sukuk and other publicly offered Islamic finance instruments.

Rationale for issuing this standard

- IN4 A Sukuk or any other Shari'ah compliant financial instrument is expected to deliver the return or repayment expectations, follow Shari'ah principles and rules in its structure – ensuring that funds are channeled from source to user, used for permissible purposes and returned to source all in a Shari'ah compliant manner – and ensure continued oversight and requisite transparency. The stakeholders, including investors, customers, suppliers, employees, regulators and the society at large, have the right to know the extent of delivery against this promise of Shari'ah compliance.
- IN5 In addition, the structures of different Islamic finance instruments may have returns generated from the performance of their underlying asset(s). This means that they carry risks different from most conventional transactions, which are essentially based on debt and are subject to only credit risk. Accordingly, merely applying the conventional credit rating methodologies and approaches to these Sukuk and other Islamic finance instruments may not be suitable.
- IN6 This standard is intended to promote and provide standardised practices for Shari'ah compliance and fiduciary rating for Sukuk and other Islamic finance instruments, which shall, in turn, improve the stakeholders' confidence in such instruments.

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AAOIFI Governance Standard (GS) ____
Shari’ah Compliance and Fiduciary Ratings of Sukuk and Other Islamic Finance Instruments

Objectives of the standard

1. The objectives of this standard are as follows:
 - a. introduce and set out principle-based guidance on Shari’ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments;
 - b. strengthen stakeholders’ confidence in the Islamic finance industry and the Islamic capital markets; and
 - c. improve transparency and demonstrate the compliance of Sukuk and other Islamic finance instruments with the standards, regulations, and best practices related to Shari’ah principles and rules, Shari’ah governance, adherence to values and fiduciary responsibilities.

Scope of the standard

2. This standard applies to Shari’ah compliance and fiduciary rating engagements conducted by independent rating agencies to provide various stakeholders an independent, comparable, assessment-based rating (or scoring) on state of Sukuk and other Islamic finance instrument’s Shari’ah compliance and adherence to fiduciary responsibilities by the originator and other organs of governance (including, where applicable, the trustee and the service agent(s)).
3. For the purpose of this standard, the assessment shall be performed primarily at the Sukuk’s and other Islamic finance instruments’ level. However, considering the nature of the instrument, an assessment of the relevant functions of the originator / service provider / trustee may also become necessary in line with the requirements of this standard.
4. The instruments subject to this standard may include, inter-alia, the following:
 - a. Sukuk – including those issued by Islamic financial institutions (IFIs), corporate entities or governments [Explanation: instruments meeting the definition of Sukuk, by whatever name called, shall be considered as Sukuk for the purpose of this standard];
 - b. investment management instruments – including restricted investment accounts (RIA), which are not registered as separate legal entities;
 - c. unrestricted investment accounts (URIA) or a class of URIA or a similar instrument – which are offered as Shari’ah compliant instruments by an entity other than an IFI, or by an IFI that is not rated in line with the GS 10 “Shari’ah Compliance and Fiduciary

Ratings for Islamic Financial Institutions”, or an IFI that is rated but considered as having less than the targeted rating; and

- d. any other Islamic finance instruments (or products) offered publicly by IFIs or other institutions as a liability, quasi-equity or asset product [For example, a Shari’ah compliant housing finance product in a country where IFIs do not exist].

Responsibility

- 5. The standard is applicable to rating agencies for the purpose of conducting Shari’ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments.
- 6. It is highly recommended that all Sukuk and other publicly offered Islamic finance instruments – excluding those offered by such IFIs which are rated in line with the requirements of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions” – be subject to a Shari’ah compliance and fiduciary rating in line with the requirements of this standard. Such ratings should preferably be updated annually, and announced publicly.

Definitions

- 7. Any term or expression, unless defined in this standard, shall have the same meaning as assigned to it under the respective Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Governance Standards (GSs) or Standards on Auditing (SOAs). The following specific terms have the meanings attributed below:
 - a. Islamic financial institutions (IFIs) – are financial institutions that operate in line with Shari’ah principles and rules performing banking, insurance / Takaful, capital markets and similar activities, and include the standalone branches, divisions and windows of conventional financial institutions that offer products and services in line with Shari’ah principles and rules;
 - b. instrument – is as defined in paragraph 4;
 - c. originator – for the purpose of this standard, is an IFI or other institution (including a corporate entity or government) that originates or issues a Sukuk in line with Shari’ah principles and rules, directly, or through the use of a Special Purpose Vehicle (SPV) or similar mechanism, and, hence is the recipient (or the beneficiary) of the Sukuk assets (if applicable) or the proceeds thereof;
 - d. rating agency – for the purpose of this standard, is a company or a firm that assigns Shari’ah compliance and fiduciary ratings (see paragraphs 8 and 9) in line with the requirements of this standard;
 - e. rating scale – is the range of potential outcomes from which one would be assigned to an instrument as the final summarised output (in the form of an alpha-numeric or any other symbol, or less commonly as a numeric score), and which would form part

of a hierarchical representation reflecting the relative rank of the instrument (vis-à-vis the benchmarked parameters under the scope of Shari’ah compliance and fiduciary ratings);

- f. rating engagement – for the purpose of this standard, is an engagement accepted by a rating agency to determine and express Shari’ah compliance and fiduciary rating in respect of an instrument;
- g. Shari’ah compliance and fiduciary rating – is the rating engagement in line with the requirements of paragraph 11;
- h. Shari’ah principles and rules – comprise the Shari’ah principles and rules defined by the following hierarchy, as appropriate:
 - i. the Shari’ah standards issued by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI);
 - ii. the regulations issued by the respective jurisdiction’s regulator insofar as these entail the regulatory Shari’ah requirements;
 - iii. the rulings of the Central Shari’ah Board for the respective jurisdiction (if one exists);
 - iv. the requirements of the applicable Financial Accounting Standards (FASs) as issued by AAOIFI insofar as these entail Shari’ah related requirements; and
 - v. the approvals and rulings given by the Shari’ah supervisory board of the IFI.

Key compliance requirements applicable to rating agencies¹

Eligibility to conduct ratings under this standard

- 8. A rating agency eligible to conduct a rating engagement under this standard shall be either:
 - a. a credit rating agency duly licensed (or recognised) to function as such by the respective regulators, having developed the capacity and the methodology in line with the requirements of this standard; or
 - b. a Shari’ah compliance and fiduciary rating agency, duly licensed (or recognised) to function as such by the respective regulators, having developed the capacity and the methodology in line with the requirements of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions” and of this standard (with due involvement of experts having suitable experience in credit rating and similar services).

¹See GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions”, paragraphs 7-17.

9. A rating agency shall not be considered eligible for performance of a rating engagement under this standard unless it:
- a. meets the ethical requirements in line with paragraph 10;
 - b. meets the quality control requirements as provided in paragraphs 11-13 of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions”;
 - c. follows the requirements of paragraphs 14-17 of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions” with regard to the acceptance of a rating engagement; and
 - d. meets the fit and proper criteria as defined by the relevant regulator for this purpose principally in line with the sample criteria provided in the Appendix B of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions”.

Ethical requirements

10. The rating agency shall comply with the requirements of the relevant AAOIFI code of ethics², as well as, the requirements of other relevant codes of ethics insofar as the same are consistent with the requirements of the relevant AAOIFI code of ethics.

Assessment scope and benchmarked parameters

Assessment scope for a rating engagement

11. Shari’ah compliance and fiduciary rating reflects a combined assessment of an instrument on two aspects:
- a. relative state of Shari’ah compliance and governance, duly reflected on a rating (or scoring) scale, with standards, regulations and best practices (collectively called benchmarked parameters) with regard to:
 - i. compliance with Shari’ah principles and rules;
 - ii. Shari’ah governance framework;
 - iii. corporate governance practices related to Shari’ah governance;
 - iv. transparency and disclosure; and
 - v. ethics and values.
 - b. relative state of fiduciary performance and capacity including:
 - i. asset quality and returns; and

² AAOIFI Code of Ethics for Islamic Finance Professionals.

- ii. credit worthiness of the originator.

Assessment scope for a rating engagement: types of instruments

- 12. The scope of ratings, in line with the requirements of this standard, includes all Shari'ah compliant financial instruments.
- 13. For the purpose of determining the suitable scope and rating scale for a specific type of Sukuk or other Islamic finance instruments, the instruments shall be classified into the following types:
 - a. equity or quasi-equity type (without guarantee) instruments;
 - b. quasi-equity type (with guarantee) instruments;
 - c. liability type instruments; and
 - d. asset type instruments.

Equity or quasi-equity type (without guarantee) instruments

- 14. A Sukuk or other Islamic finance instrument may be considered as an equity type instrument where the structure is participatory in nature i.e., whereby:
 - a. the instrument represents a residual interest in the underlying asset(s);
 - b. the instrument is perpetual and / or convertible in nature;
 - c. the originator of such Sukuk / instrument has an unconditional right to avoid delivering cash or any other asset to the Sukuk / instrument holder; and
 - d. the instrument shall be subordinate to all the liability and quasi-equity instruments of the entity excluding only the share capital and / or any other similar instrument.
- 15. Quasi-equity type instruments are those instruments which have characteristics of both equity and liability. Primarily, these instruments entail sharing of profits (and losses, as applicable) and having a claim on net underlying asset(s). However, they are classified differently from the equity type instruments as they have a put option in the hand of the holder i.e., they are redeemable on a due date or on demand, hence they also have liability characteristics. Any quasi-equity type instrument that does not entail a guarantee of capital (through any form of guarantee or purchase undertaking) shall be kept in this category, along with equity type instruments.
- 16. The risk and return characteristics of such instruments are representative of the performance of the underlying asset(s) (which may, depending on the nature of the instrument, include all assets / business of the originator). Returns on such instruments may vary from time to time. No guarantees or purchase undertakings are in place to guarantee the capital (and / or return thereon).

17. Examples of such instruments include:
- a. different types of share capital, other than common share capital, including e.g., Shari'ah compliant preference shares;
 - b. tier 1 Sukuk which are normally based on participatory modes i.e., Musharaka, Mudaraba or Al-Wakala Bi Al-Istithmar and are convertible or perpetual in nature;
 - c. Sukuk and restricted investment accounts that are eligible for off-balance sheet accounting in line with AAOIFI FASs, based on participatory modes i.e., Musharaka, Mudaraba or Al-Wakala Bi Al-Istithmar;
 - d. Sukuk and other similar instruments based on Ijarah Muntahia Bittamleek, including its different types (such as Ijarah Muntahia Bittamleek through gradual transfer of ownership) whereby the transfer of asset after the end of the lease term or through sale of units during the lease term takes place at fair value; and
 - e. Sukuk and other similar instruments based on participatory modes i.e., Musharaka, Mudaraba or Al-Wakala Bi Al-Istithmar (when commingled with Mudaraba), duly accounted for as quasi-equity in line with relevant AAOIFI FASs, and not having a guarantee or purchase undertaking for redemption or maturity.

Quasi-equity type (with guarantee) instruments

18. These instruments include quasi-equity type Sukuk or any other instruments where a guarantee or purchase undertaking provides a guaranteed amount of redemption or maturity. More specifically, in the case of a potential default, the recourse is first to the originator, instead of a direct recourse to the underlying asset(s) (and hence, the nature of underlying asset(s) in case of default is more of a security).
19. In such cases, it is presumed that the risks and rewards related to the underlying asset(s) are partially absorbed by the originator, and hence, these instruments include substantial characteristics of a liability, particularly in case of default.
20. Examples of such instruments include:
- a. Sukuk and other similar instruments based on participatory modes i.e., Musharaka, Mudaraba or Al-Wakala Bi Al-Istithmar (when commingled with Mudaraba), duly accounted for as quasi-equity in line with relevant AAOIFI FASs, having a guarantee or purchase undertaking for redemption or maturity;
 - b. Sukuk and other similar instruments based on Ijarah Muntahia Bittamleek, (including its different types such as Ijarah Muntahia Bittamleek through gradual transfer of ownership), whereby the transfer of asset after the end of the lease term or through sale of units during the lease term takes place at a pre-agreed price or through a gift;
 - c. hybrid Sukuk and other instruments, if they do not meet the criteria specified in either paragraph 14 or paragraph 21; and

- d. URIs and other similar accounts (where redemption and maturities, periodically or on demand, take place on an ongoing basis).

Liability type instruments

- 21. Liability type instruments refers to Sukuk or other instruments which are based on transactions which result in the creation of a monetary or non-monetary liability for the originator such as Murabaha, commodity Murabaha / Tawarruq, Salam and Istisna. These instruments include any hybrid Sukuk whereby, subject to the fulfilment of Shari'ah principles and rules including the tangibility ratio, a combination of liability products is used with a participatory product. Any such instrument shall be classified as liability type instrument if:
 - a. the ratio of its liability component (at par value i.e., the sale price of the transaction including the cost and profit) mostly, or at times, during the continuity of the instrument, is more than 50% of the total underlying asset(s) (duly considering the tangibility ratio in line with the Shari'ah principles and rules³); and / or
 - b. the return from its liability component provides more than 66.67% of the return of the overall instrument.
- 22. Examples of such instruments include:
 - a. Murabaha, commodity Murabaha / Tawarruq, Salam, Istisna or other deferred payment sale-based Sukuk; and
 - b. Hybrid Sukuk, which meet the criteria specified in paragraph 21.

Asset type instruments

- 23. Asset type instruments refers to an asset-side product such as a financing and investment product offered to customers through any acceptable mode of Islamic finance, in line with the Shari'ah principles and rules, offered by:
 - a. IFIs which are not rated in line with the requirements of GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions", or IFIs which have a rating below the desired rating and hence wishes for one or more products to be rated separately in line with the requirements of this standard; and
 - b. other entities / institutions which publicly offer Islamic finance products such as those based on deferred payment sales or Ijarah, either linked with their business model or offered in a market where they are not licensed as Shari'ah compliant products.

³ In order to remain negotiable / tradeable at values other than the par value of the instrument, a hybrid instrument shall fulfil the tangibility requirements of relevant Shari'ah principles and rules, even if the instrument itself may still be Shari'ah compliant.

Establishing benchmarked parameters

24. The following aspects are to be assessed for all the instruments in the above four types, with some aspects relevant to each type:
- a. compliance with Shari'ah principles and rules;
 - b. Shari'ah governance framework;
 - c. corporate governance practices related to Shari'ah governance;
 - d. transparency and disclosure;
 - e. ethics and values; and
 - f. fiduciary performance and capacity.
25. The relative importance of the aspects as enumerated in paragraph 24 may differ from one type of instrument to another. In certain instruments, one or more aspect, except for aspect (a) (i.e., compliance with Shari'ah principles and rules), may become less relevant or not applicable.
26. A rating agency shall develop the benchmarked parameters for conducting ratings in respect of Sukuk and other Islamic finance instruments in line with the principles provided in paragraphs 28-46 of this standard.
27. It is recommended as a preferred practice that two different scores or ratings are developed by the rating agency in respect of (i) Shari'ah compliance and governance (comprising items (a)-(e) of paragraph 24), and (ii) fiduciary responsibilities and capacity (comprising item (f) of paragraph 24). (Also see paragraph 48)

Compliance with Shari'ah principles and rules

28. The benchmarked parameters with regard to the Shari'ah principles and rules shall be defined by the following hierarchy, as appropriate:
- a. the Shari'ah standards issued by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI);
 - b. the regulations issued by the respective jurisdiction's regulator in so far as these entail the regulatory Shari'ah requirements;
 - c. the rulings of the Central Shari'ah Board for the respective jurisdiction (if one exists);
 - d. the requirements of the applicable Financial Accounting Standards (FASs) as issued by AAOIFI in so far as these entail Shari'ah related requirements; and
 - e. approvals and rulings given by the Shari'ah Supervisory Board of the originator or one appointed solely for a review of the instrument to be issued.

29. For the purpose of determining compliance with Shari'ah principles and rules, a rating agency shall assess the state of compliance of the subject instrument or product, with regards its underlying structure, as per the above hierarchy. The sources and uses of funds underlying an instrument, the mechanism by way of which funds are collected and repatriated, or returns accumulated for investors, and the compliance of such mechanism with the Shari'ah principles and rules, constitute the basic elements of subject ratings.

Shari'ah governance framework

30. The benchmarked parameters with regard to the Shari'ah governance framework shall be defined by the following hierarchy, as appropriate:
- a. any Shari'ah governance standard issued jointly by AAOIFI and the Islamic Financial Services Board (IFSB);
 - b. the governance standards issued by AAOIFI (particularly GS 12 "Sukuk Governance");
 - c. the Shari'ah governance standard(s) issued by the IFSB; and
 - d. the Shari'ah governance regulations issued by the respective jurisdiction's regulator.
31. The key considerations, depending on the type of instrument, for determining the relative significance and scope in respect of the Shari'ah governance framework are as follows:
- a. the Shari'ah governance framework shall be considered in specific relation to the framework applicable to the instrument being rated, or at the originator level, with due emphasis on the subject instrument;
 - b. the Shari'ah governance framework of the originator will be particularly relevant (and may be assigned more weightage) for equity or quasi-equity (without guarantee) type instruments, as the risk and reward characteristics are primarily dependent on the governance of the originator;
 - c. in the case where assets have been carved out and a trustee and / or service provider has been appointed, the Shari'ah governance of these parties will be relevant to the extent required to fulfil obligations vested under the governing structure of the instrument;
 - d. in the case of a liability type instrument, the weightage for Shari'ah governance may be less as compared to other types of instruments considering that the return on the instrument is directly attributed to a transaction, and not to ongoing operations;
 - e. the Shari'ah governance of the originator may be weighted higher for asset type instruments issued by financial institutions given the dependence of the instrument's performance on originator level conduct; and
 - f. the capacity of the trustee to uphold the provisions of Shari'ah principles and rules as applicable to the instrument and have ready access to relevant resources for

guidance in delivering a trustee's obligations to stakeholders in an instrument, shall also be considered. In this connection, there will be an extension of assessment requirements to the trustee of the subject instrument.

Corporate governance practices related to Shari'ah governance

32. The benchmarked parameters with regard to corporate governance practices related to Shari'ah governance shall be defined by the following hierarchy, as appropriate:
 - a. the corporate governance standard(s) issued by the IFSB;
 - b. the governance standards issued by AAOIFI; and
 - c. the corporate governance regulations issued by the respective jurisdiction's regulator.
33. Corporate governance practices are essentially institutional practices which are relevant to instrument ratings where risk return characteristics are linked to the originator either for equity type instruments, or where the instrument holders have recourse to the originator via a partial or full recourse guarantee, or where the instrument being evaluated is an asset side type instrument.
34. Where assets have been fully carved out with no recourse to the originator, corporate governance practices of a service provider (if appointed) are relevant. Similarly, corporate governance practices instituted at trustee level are relevant, to ensure continuity of trusteeship and credibility of the trustee, as long as it dispenses its obligation relevant to the rated instrument.
35. Corporate governance framework, unlike Shari'ah governance practices, refers to corporate practices only on an overall entity level. Accordingly, the same, generally, may only be assessed at originator and trustee / service provider level (as and when relevant) and may generally not be assessed at instrument level.
36. Considerations provided in paragraph 31 with regard to the Shari'ah governance practices of different types of instruments may also be relevant in cases of corporate governance practices.

Transparency and disclosure

37. The benchmarked parameters for transparency and disclosure, particularly with regard to various stakeholders and including those related to the instrument, shall be defined by the following hierarchy, as appropriate:
 - a. the requirements of the applicable AAOIFI FASs and those pertaining to the financial instruments (particularly, FAS 34 "Financial Reporting for the Sukuk-holders");
 - b. the standard(s) related to transparency and disclosure issued by the IFSB;

- c. template documents issued by the International Islamic Financial Market (IIFM), where applicable, for the respective instrument structures; and
- d. the regulations related to transparency and disclosure issued by the respective jurisdiction's regulator.

Ethics and values

- 38. The benchmarked parameters with regard to ethics and values, particularly those related to stakeholder (and investor) protection, shall be defined by the following hierarchy, as appropriate:
 - a. the relevant code of ethics issued by AAOIFI⁴ and the code of conduct (or ethics) standard(s) issued by the IFSB; and
 - b. the regulations related to ethics or code of conduct issued by the respective jurisdiction's regulator.
- 39. In a manner similar to the Shari'ah governance framework and corporate governance practices (see paragraphs 31 and 34-35), ethics and values of the originator, the trustee and / or the service agent, respectively, shall be considered according to the nature of the instrument and the respective responsibilities of the organs of governance.

Fiduciary performance and capacity

- 40. It is preferred, in line with the requirements of paragraph 27, that the fiduciary performance and capacity may be evaluated and rated separately. Considering the nature of the instrument, this aspect of instrument rating may have higher or lower significance. It shall be the primary aspect for liability type instruments and have a significantly higher aspect for quasi-equity (with guarantee) type instruments.
- 41. The benchmarked parameters (including quantitative parameters) with regard to the performance of the instrument against expectations and forecasts, (including the capacity to protect the value of initial investment), shall be developed by taking into consideration, inter-alia, the following:
 - a. the quality of the assets underlying the instrument;
 - b. the asset management quality of the originator and / or the service agent (where applicable);
 - c. the performance track-record of the originator in cases where the risk and return characteristics of the instrument depend partially or entirely on the performance of the originator; and

⁴ AAOIFI Code of Ethics for Islamic Finance Professionals.

- d. practices of governance and management with regard to the fair treatment of investors in terms of allocating returns.
- 42. Fiduciary responsibilities, performance and capacity shall include two main elements, and it is recommended that the rating agency should assess (and where possible, publish) the rating or score separately, including:
 - a. asset management quality (including return on investment aspects); and
 - b. credit worthiness of the originator (where applicable).
- 43. Whereas the aspects as defined in paragraphs 41 and 42 are applicable for all types of instruments, the same shall be more relevant for equity and quasi-equity type instruments (particularly those without guarantee).
- 44. In the case of instruments classified as liability or quasi-equity (with guarantee) types, an evaluation of the repayment and returns distributed should be addressed through methodologies similar to those employed for credit ratings (excluding the external factors impacting the credit rating of an institution).

Tiered and jurisdiction-specific rating considerations

- 45. Ratings may be provided on a global or a jurisdiction-specific basis, which in turn may separately reflect an international benchmark and a jurisdiction-level benchmark. The latter would facilitate stakeholders who are jurisdiction bound in their investment and transaction choices, while the former would cater to international stakeholders.
- 46. In a jurisdiction-specific rating engagement, the benchmarked parameters, depending upon the respective jurisdiction's regulations, may change the above hierarchy of resources or may disregard one or more of the resources, as provided in paragraphs 28-44. In all such situations, a rating agency shall:
 - a. document and publicly announce the amended hierarchy applied for the purpose of jurisdiction-specific ratings; and
 - b. not claim that such jurisdiction-specific rating as being in line with AAOIFI's Shari'ah and governance standards in general.

Relative weight of benchmarked parameters

- 47. A rating agency shall define, on a consistent basis, the relevant weight for each of the components of benchmarked parameters (see paragraphs 28-44) and shall publicise the same.

48. The following table provides a suggested distribution of weight to benchmarked parameters.⁵

Components of benchmarked parameters	Suggested weightage (%) under the proposed standard for instruments									
	Institutions' suggested weightage (%) (for reference purpose only ⁶)		Sukuk or other IF instruments classified as							
			Equity / quasi-equity <u>without</u> purchase undertaking / guarantee		Quasi-equity <u>with</u> purchase undertaking / guarantee		Liability ⁷		Asset	
	From	To	From	To	From	To	From	To	From	To
1) <u>Shari'ah compliance and governance</u>										
a) Compliance with Shari'ah principles and rules	30	35	30	35	30	35	30	35	30	35
b) Shari'ah governance framework	15	20	10	15	10	15	5	10	10	15
- Originator			3	5						
- Instrument			4	5						
- Service provider / trustee			3	5						
c) Corporate governance practices related to Shari'ah compliance and implementation	10	15	10	15	10	15	5	10	10	15
- Originator			5	8						
- Service provider / trustee			5	7						
d) Transparency and disclosure	10	15	10	15	10	15	5	10	10	15
e) Ethics and values	10	15	5	10	5	10	5	10	5	10
- Originator			3	5						
- Service provider / trustee			2	5						
2) <u>Fiduciary performance and capacity</u>⁸										
a) Asset quality / returns			25	30	15	20	N/A	N/A	N/A	N/A
b) Credit worthiness of the originator			N/A	N/A	15	20	35	45	N/A	N/A

Limitations of scope and suitability of benchmarked parameters

Assessing limitations of scope

49. The rating agency, at all stages of a rating engagement, shall assess the existence of any significant limitation of scope that may impact the performance or quality of the rating

⁵ Although the weight of different categories is independent of each other, a failure in a significant category (for example, compliance with Shari'ah principles and rules) shall be considered an overall failure.

⁶ As per GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions"

⁷ A hybrid instrument shall be classified as a liability type instrument if a substantial portion of its returns is originating through the liability component of the instrument (see paragraph 21).

⁸ Where (2) is conducted on a separate rating scale, the related weights may be redistributed across the pillars (from 'a' to 'e').

engagement. In the case of such limitation, which after due efforts still remains present, the rating agency shall consider withdrawing itself from the rating engagement.

Assessing the suitability of the benchmarked parameters

50. The rating agency shall assess the suitability of the benchmarked parameters with regard to the respective instrument and shall document the detailed requirements thereof. With respect to any missing parameters related to compliance with Shari'ah principles and rules, the rating agency shall coordinate with the Shari'ah supervisor(s) to develop the benchmarked parameters.
51. Where the rating agency is unable to conclude as to the suitability of the benchmarked parameters, it shall withdraw itself from the rating engagement.
52. The rating agency shall also identify the Shari'ah supervisor(s) of the originator, the service provider and the trustee, with whom it may need to interact, communicate, request Fatwas, rulings and specific opinions, including on observations. A Shari'ah Supervisory Board, or equivalent, or its nominee, shall be the person(s) suitable for this purpose, unless the structure or regulations have mandated other Shari'ah supervisor(s) in its place, including regulators, Central Shari'ah Board or their respective nominees.

Rating scale

53. A rating agency shall determine and publicise a rating scale (see paragraph 54) based on the determination of benchmarked parameters and relative weight of the components of the same. A rating scale is suggested to have a span of 5-10 stepped grades, and entail an explanation of the expectations of state of affairs with regard to Shari'ah compliance and adherence to fiduciary responsibilities associated with such grade, respectively.
54. The following rating scale is suggested (as a combined scale) for Sukuk and other similar Islamic finance instruments (particularly for the equity and quasi-equity (without guarantee) Sukuk and other instruments).

Ratings⁹	Score ranges (%)¹⁰	Suggested conclusion statement	Summarised indicators (to be explained properly by the rating agency)
	90+	<ul style="list-style-type: none"> Excellent level of compliance 	<ul style="list-style-type: none"> Underlying structure of the instrument is preferred in terms of Shari'ah principles and is free of any controversial elements. To the extent relevant to the instrument, an excellent governance environment is maintained. Fiduciary performance is expected to be excellent.

⁹ A rating agency may have a symbolic, alpha-numeric or any other suitable rating system.

¹⁰ Weighted average for different components of the benchmarked parameters. The rating agency may decide to publish and disclose individual level scores as well as for all the components of rating.

Ratings⁹	Score ranges (%)¹⁰	Suggested conclusion statement	Summarised indicators (to be explained properly by the rating agency)
	80-89	<ul style="list-style-type: none"> • Very good level of compliance 	<ul style="list-style-type: none"> • Underlying structure of the instrument is preferred in terms of Shari'ah principles and is free of any controversial elements. • To the extent relevant to the instrument, a strong governance environment is maintained. • Fiduciary performance is expected to be strong.
	70-79	<ul style="list-style-type: none"> • Good level of compliance 	<ul style="list-style-type: none"> • Underlying structure of the instrument is approved by relevant authorities and free of basic elements of Shari'ah non-compliance. • To the extent relevant to the instrument, the governance framework is considered good. • Fiduciary performance is likely to be well aligned with the expectations set forth in the issuing document.
	60-69	<ul style="list-style-type: none"> • Highly satisfactory level of compliance 	<ul style="list-style-type: none"> • Underlying structure is less preferred but approved by relevant authorities and may include some controversial elements. • Overall governance environment is sound. • Satisfactory level of fiduciary performance.
	50-59	<ul style="list-style-type: none"> • Reasonable level of compliance 	<ul style="list-style-type: none"> • Underlying structure may not be universally considered compliant but is approved by the relevant Shari'ah authorities. • Certain material non-compliant elements are noted. • Overall governance environment is largely satisfactory, leaving some gaps against best practices. • Fiduciary performance may be weaker than the expectations mentioned in the issuing document.
	<50	<ul style="list-style-type: none"> • Unsatisfactory level of compliance 	<ul style="list-style-type: none"> • Underlying structure is considered controversial by several international jurists or there is noteworthy presence of basic elements of Shari'ah non-compliance. • Significant weaknesses observed in the governance framework. • Fiduciary performance is expected to be weak.

55. For instruments which are liability type or quasi-equity (with guarantee) type characteristics, the element of fiduciary performance should be reduced or eliminated across the scale with performance aspects to be captured in credit ratings as per the rating methodologies and rating scales of the rating agencies. Similarly, for asset side type instruments, the fiduciary element may be eliminated given its irrelevance.
56. The distinct, though interconnected, nature of the instrument's performance against expectations and forecasts vis-à-vis the quality of management services relevant to an instrument, may best be addressed by separately assessing these two elements from a) asset quality / returns and b) credit worthiness of the originator on distinct scales.

Principal procedures

57. The principal procedures and general methodology followed by a rating agency in respect of an engagement for Shari'ah compliance and fiduciary rating for Sukuk and other Islamic finance instruments shall be principally in line with the requirements of paragraphs 37-54 of GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions", as suitably amended in line with the requirements of this standard and / or scope of service.

Documentation, archiving and confidentiality

58. A rating agency shall follow the documentation, archiving and confidentiality requirements as contained in paragraphs 37-54 of GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions", in respect of an engagement for Shari'ah compliance and fiduciary rating for Sukuk and other Islamic finance instruments, as suitably amended in line with the requirements of this standard and / or scope of service.

Reporting

59. The report in respect of an engagement for Shari'ah compliance and fiduciary rating for Sukuk and other Islamic finance instruments shall be developed, issued and published in line with the requirements of paragraphs 61 and 62 of GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions", as suitably amended in line with the requirements of this standard.

Effective date

60. This standard is effective for Shari'ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments issued on or after 01 July 2023.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Governance and Ethics Board's meeting No. _____ held on _____H, corresponding to _____ and was duly approved.

Members of the Board

1. Mr. Mohammad Farrukh Raza (chairman)
2. Dr. Walid Hegazy (deputy chairman)
3. Dr. Abdulbari Mashal
4. Mr. Abdullah AlMoqbel
5. Mr. Abozer Magzoub
6. Dr. Ahmet AlBayrak
7. Dr. Ali Sartawi
8. Mr. Ebrahim Sidat
9. Ms. Ibtihal Al-Shamali
10. Dr. Mohammad Kabir Hassan
11. Mr. Moosa Khoory
12. Mr. Muzammil Kasbati
13. Mr. Sohaib Umar
14. Mr. Wael Merza
15. Dr. Zahid ur Rehman Khokher

Reservation

The standard was approved unanimously.

Working group and team

1. Mr. Abdullah AlMoqbel (chairman)
2. Dr. AbdulBari Mashal
3. Mr. Abdulkader Thomas
4. Mufti Abdullah Masum
5. Mr. Abul Quasem Md. Saifullah'

6. Mr. Ahmad Feizal Sulaiman Khan
7. Dr. Ascarya Ascarya
8. Mr. Ijlal Ahmed Alvi
9. Mr. Kamran Sherwani
10. Mr. Mazin Khalil
11. Dr. Mohammad Kabir Hassan
12. Mr. Mukhlesur Rahman
13. Mr. Salman Ahmed
14. Ms. Shabnam Mokhtar

Executive team from the Islamic International Rating Agency (IIRA)

1. Ms. Sabeen Saleem
2. Mr. Faheem Ahmad
3. Ms. Farah Parveen Khan

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Ms. Zahra Jassim AlSairafi (AAOIFI)
3. Ms. Alyaa Adel (AAOIFI)

Appendix D: Basis of conclusions

The need for the standard

- BC1 The members of the AAOIFI Governance and Ethics Board (AGEB / the board) discussed in detail as to whether there is a need for a standard on Sukuk and other Islamic finance instruments, taking into consideration the issuance of GS 10 “Shari’ah Compliance and Fiduciary Ratings for Islamic Financial Institutions”. The members further discussed whether it is appropriate to issue a standard on Shari’ah compliance and fiduciary ratings for instruments immediately or whether it should wait for certain market developments before the issuance.
- BC2 It was also considered that certain matters relevant from the Shari’ah perspective are explicitly not being considered while assigning conventional credit ratings to Islamic finance instruments, and that asset-backed Sukuk, which are preferable from a Shari’ah perspective, are excluded from credit ratings by most credit rating agencies.
- BC3 The members also discussed certain scenarios highlighting the importance of such rating exercises. For example, a situation where an IFI does not have a Shari’ah compliance and fiduciary rating, but would like to get one of its instruments rated because the competitor’s instruments are rated. The second situation is when an IFI’s rating is lower than the target rating, however, it seeks a better rating on its instruments.
- BC4 After due deliberations, AGEB agreed that there is a need for Shari’ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments to support the market developments. It was agreed that Shari’ah compliance and fiduciary rating of Sukuk and other Islamic finance instruments will encourage the issuance of a wider range of Shari’ah compliant instruments and thus provide investors comparability of available investment options, from a Shari’ah compliance perspective. This will eventually enhance the stakeholders’ confidence on this subject. The board concluded that a standard, duly applicable to the rating agencies, is needed to encourage and guide them, in order to enhance their rating methodologies by including Shari’ah compliance and fiduciary rating for Sukuk and other Islamic finance instruments.

Market and regulatory acceptance of the standard

- BC5 The members deliberated on whether the subject standard will find relevance in markets given the lack of regulatory push behind the adoption of such standards. Additionally, there is no significant market demand of such a rating exercise for Sukuk and other Islamic finance instruments, although the experts and researchers have highlighted need for such exercise.
- BC6 Certain members were of the view that AAOIFI as a standard setting organisation is obliged to facilitate the regulators to consider the implementation of this standard, taking into account the evolutionary nature of such concepts. They also considered the concept of peer pressure and market discipline as the natural way of introducing and implementing such improvements in the market.

- BC7 It was further acknowledged that while the regulatory requirement for such ratings will serve to enhance the implementation of the standard, ultimately the push would be by the investors, as they have the right to know the status of Shari'ah compliance and fiduciary capacity of an instrument being pronounced as Shari'ah compliant. The members also discussed the significant role of rating agencies in fulfilling the investors' right to know the level of compliance of issued instruments.
- BC8 After due deliberation, the board agreed that Shari'ah compliance and fiduciary ratings provide necessary support to the stakeholders to make their informed decisions and eventually enhance their overall confidence in the market.

Scope of the Standard: inclusion of Sukuk and other Islamic finance instruments

- BC9 The board discussed the scope of the standard at length – for it to only include Sukuk or to also cover other Islamic finance instruments. The members discussed the range of instruments that may be considered within the scope of the standard. They questioned whether the scope should also include normal investment accounts offered by the IFIs as among the instruments to be rated under this standard. The board also considered the appropriateness of including the asset side (e.g., financing and investment) instruments / products in the scope of the standard.
- BC10 The members further agreed that the need for such rating may arise for any type of instrument, although the primary need is for Sukuk, given that it is the major Islamic finance instrument publicly available. They also agreed that a separate standard on other Islamic finance instruments is not needed and a single standard may provide guidance in respect of all such instruments, including those on asset side. Accordingly, the board decided that all types of Islamic finance instruments should be brought into the scope of this standard.

Eligible rating agencies

- BC11 The members discussed as to which rating agencies are suitable and hence, shall be eligible to conduct the ratings of Sukuk and other Islamic instruments according to this standard. It was discussed that presently the necessary capacity may not be available with the traditional rating agencies, or any other advisory, assurance or consultancy organisations. The members discussed the advantages and disadvantages of including or excluding the traditional credit rating agencies, or allowing other types of organisations to provide such service.
- BC12 The members agreed that credit ratings and Shari'ah compliance and fiduciary ratings differ in their approach and skill sets required to conduct such ratings. However, in order to support wider adoption of this standard, they decided to not restrict a credit rating agency in any way to adopt the standard, regardless of whether or not it engages in Shari'ah compliance and fiduciary ratings of IFIs, covered under the earlier issued GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions".
- BC13 After due deliberations, the members agreed to include credit rating agencies, in addition to specialised Shari'ah compliance and fiduciary rating agencies, as eligible agencies to conduct

Shari'ah compliance and fiduciary rating for instruments subject to developing necessary capacity and methodology in line with the requirements of this standard and fulfilling the relevant quality assurance and ethical requirements.

Classification of instruments by type

- BC14 The members discussed in detail the relevance of benchmarked parameters to different types of Sukuk and other Islamic finance instruments. After due deliberations, the board concluded that a single set of parameters and a single approach towards assigning weights to different parameters may not work for all such instruments. Accordingly, the board decided that it is important to divide all such instruments into four broad categories and to provide guidance, as appropriate, for each such category in order to properly assess the scope of the rating service and rating scale for each specific type of Sukuk or other Islamic finance instruments.

The relevance of benchmarked parameters for each instrument's classification in comparison to the institution's rating

- BC15 The members deliberated on the key benchmarked parameters and weights assigned to each benchmarked parameter which vary according to the type of instrument being rated. The respective parameters and weights suggested for institutions' rating by GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions" were also considered and compared with regard to their suitability for different types of the institutions.
- BC16 The members were of the view that Shari'ah compliance and fiduciary ratings combine two aspects of assessing an instrument. First, relative state of Shari'ah compliance and governance. Second, relative state of fiduciary performance and capacity. It was discussed that while for institutions, these may be considered on a combined basis, different types of instruments have certain aspects which need to be addressed specifically, and at times separately for the two key aspects.
- BC17 After due deliberations, the board agreed on the key benchmarked parameters and their suggested weights. The members also concluded that within the scope of assessment of each benchmarked parameter, the standard shall provide guidance on the extent of coverage extended to service providers that facilitate the issuance of an instrument, including, but not limited to the originator, in terms of compliance with Shari'ah principles in their respective capacity.

Discretion in laying down an appropriate rating scale and market specific issues

- BC18 The members discussed the level of detail and prescription that should be covered in this standard regarding the rating scale. Particular emphasis was on the question as to whether determining the rating scale shall be addressed in this standard or left to the rating agencies. There were concerns of certain members with regard to the different market characteristics as well, e.g., the regulatory requirements and adoption of AAOIFI Shari'ah standards. Certain members were of the view that prescription of the rating scale to the rating agencies in the standard would not provide necessary discretion to the rating agencies enabling them to

design a rating scale commensurate with their methodologies and the market specific situations.

- BC19 After due deliberations, the members agreed that the rating denominations shall be left to the rating agency undertaking such rating service. However, it was considered necessary to suggest a rating scale for Sukuk and other similar instruments within this standard, only for illustration purposes. It was further decided to allow jurisdiction-specific and tiered ratings, to allow for the necessary flexibility.

Appendix E: Brief history of the preparation of the standard

- H1 The secretariat proposed developing a standard on Shari’ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments in the 14th meeting of AGEB held on 29-30 Rajab 1441H, corresponding to 24-25 March 2020 via video conferencing. The members agreed that there is a need in the market and approved the initiation of the project and the formation of a working group.
- H2 Following the board's approval, three working group meetings via video conferencing were held to discuss the preliminary study of the standard on 19 Muharram 1442H, corresponding to 7 September 2020, 14 Jumada II 1442H, corresponding to 27 January 2021 and 20 Rajab 1442H, corresponding to 4 March 2021. The members discussed the preliminary study and agreed on conceptual issues. The working group approved the preliminary study.
- H3 Following the approval of the preliminary study, the development process of the exposure draft started. The working group held two meetings to discuss the exposure draft. The meetings were held via video conferencing on 17 Jumada II 1443H, corresponding to 20 January 2022 and 15 Rajab 1443H, corresponding to 16 February 2022.
- H4 AGEB held its 24th meeting on 29-30 Rajab 1443H, corresponding to 2-3 March 2022 via video conference and approved the issuance of the exposure draft. The board directed the secretariat to make the necessary changes in light of the comments of the AGEB members and the discussions during the meeting. After due process, the exposure draft was issued on 17 Jumada I 1444H corresponding to 11 December 2022.