



RATING METHODOLOGY CORPORATE GOVERNANCE

The Islamic International Rating Agency's (IIRA) Corporate Governance Rating is an independent opinion on an organization's structure and practices for managing the business. It reflects an entity's governance practices with respect to the relationships among shareholders, the board of directors, management and other stakeholders. It evaluates the extent to which they conform to regulations and global best practice. Sound corporate governance provides proper incentives for the board and management to pursue objectives that are in the interest of the institution and all shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently. Effective corporate governance is measured on the basis of a variety of characteristics. The most important of these are:

- Transparency and adequate disclosure;
- History, Board performance, demonstrated trustworthiness;
- Management: Who is the actual governor (CEO or executive team);
- Effectiveness of the top management team and process;
- Shareholders
- For financial institutions, do they know their customers, AML focus.

The current preoccupation with corporate governance can be attributed to the aftermath of the East Asian Crisis of 1997 and the American corporate fraud incidents which saw the collapse of Enron and WorldCom. The ensuing scandals collapsed other companies like Arthur Andersen, Global Crossing and Tyco.

Corporate Governance is an integral element of all investment and credit analysis. The financial health of the entity is dependent to a large extent on the governance practices of the entity. A number of studies published in recent years have exhibited a strong link between effective corporate governance procedures and standards and a healthy earnings stream.

IIRA'S APPROACH

IIRA's corporate governance methodology endeavors to synthesize the key elements of Corporate Governance on a global basis and not to impose the standards of any particular country or jurisdiction. The aim here is to ensure sufficient flexibility to accommodate different governance structures in the evaluation process without compromising the assessment of the entity's governance standards on the touchstones of fairness, transparency, accountability and responsibility.

IIRA's corporate governance methodology takes into consideration the broader aspects of governance as well as the effectiveness of the organization in thwarting moral hazard (basically dishonesty and malfeasance) by adhering to international corporate governance best practice. The assessment highlights the gap between the organization's existing status and the requirements of global best practice. The methodology considers local country law when specifically working on a project to issue a compliance rating that is applicable for regulatory and commercial purposes. IIRA will use following guidelines to incorporate local legal requirements into its methodology:

- If there is a conflict between international best practice and local government regulatory requirements, local law will prevail;
- If local law and international laws differ in the extent of strictness, then stricter of the two laws will prevail;
- If international best practice is silent on an area which is addressed by local law then local law will prevail.

IIRA's CGR entails in-depth study of the corporate governance practices of an entity and comparison with global 'best practice'. Rating agencies are uniquely placed to carry out this function because managerial assessment is the most important qualitative aspect examined during the credit rating process. These agencies are also in close contact with the regulatory frameworks. In addition, they have a comprehensive understanding of the various kinds of risks to which the stakeholders are exposed.

TRANSPARENCY AND DISCLOSURE

IIRA looks for clear ownership information specifying actual owners rather than nominees and precise identification of controlling shareholders. Are decisions publicized? To what extent are voting powers made clear. Proxy arrangements should be fully disclosed. Comprehensive audit reports with full footnotes prepared according to International Accounting Standards or US GAAP should be published regularly.

IIRA assesses transparency not just in a single facet or framework; rather it is assessed across the board throughout the organization. IIRA assesses the clarity with which an organization defines roles and responsibilities of board and management to its shareholders, and with what level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all

investors have access to clear, factual information. The IIRA team of analysts assesses the following open issues with respect to transparency and disclosure:

- Oversight of the preparation of the entity's financial statements
- Quality of the financial statements
- Timeliness in performance presentation
- Accessibility of publicly released information (including entity by-laws, statues and/or articles and other information) to the stakeholders of the company
- Internal controls and the independence of the entity's auditors
- Review of the compensation arrangements for the chief executive officer and other senior executives
- The way in which individuals are nominated for positions on the board
- The resources made available to directors in carrying out their duties
- Oversight and management of risk
- Entity's openness regarding non-financial performance.
- Timeliness of the information available on the company website and the frequency with which it is updated
- Dividend policy

History, Board performance, demonstrated trustworthiness

IIRA will review the issuer's history to ensure all obligations have been met according to the agreed terms. The expectation is that the record will demonstrate trustworthiness without ambiguity or exceptions. Is it clear that all subsidiaries under control of the issuer have also conducted their affairs properly? Board performance is a critical element in the CGR rating process. The review considers the following:

Board Structure and Processes

IIRA studies the board composition and questions whether the members of the board have the relevant education and experience to operate independently, and actively. IIRA looks at the board's responsibilities to ensure that it provides a strong base of independent directors, evaluates the entity's strategy regularly, and guides management performance. If a member has substantial involvement in other occupations which requires a lot of time and attention then he will not be in a position to give appropriate level of attention to the company affairs and will tend to rely only on the information provided by the management.

Independence is defined as the ability of the board to take an independent line from the management to ensure that the shareholders' interests are protected. Independence of the board from the management will be possible if the following criteria are satisfied:

- Chairman of the Board and CEO are different persons;
- Majority of the directors are non-executive members and are elected through an established voting process which enjoys the trust and confidence of ordinary shareholders;
- All directors are submitted for re-election at regular intervals to allow effective rotation and a capable combination of directors who are competitive in achieving entity's objectives;
- Elections are not staggered as the complete board is reconstituted at the election date;
- There are no conflicts of interest between board members and shareholders.

Board Committees IIRA analyzes the various committees on HR, compliance, risk management and audit and their responsibilities to determine whether they promote a sound internal control environment. IIRA checks if the committees are comprised of directors who are independent. Moreover, IIRA questions whether they possess the required skills specific to the committee that they are in which can help promote unbiased and critical oversight of the entity's practices. The assessment process entails taking into account following factors/events:

- Minutes of meetings with agendas;
- Number of times committee meetings are held in a year;
- Number of times the meetings are held with the management participation;
- Number of times the board seeks advice of an independent expert other than management;
- Self evaluation process employed by the board;
- Strategic plans for the future.

Ownership Interest The most crucial factor that ensures board active involvement is their ownership stake in the company. It serves well if eligibility criteria are outlined specifying the minimum shareholding for anyone contesting board elections.

Basis of Compensation IIRA examines the compensation of board members to check whether they are fairly remunerated and motivated to ensure the success of the entity. At the same time, the compensation should not be extravagant, which could result in the directors perpetuating themselves without contributing to the entity's development. To make sure that the directors maintain their active involvement in affairs of the company, ideally their compensation should be linked to performance of the company and its ability to implement the strategic goals and objectives.

Conflict of Interest IIRA carefully examines the extent of involvement of the board members with the company affairs and take note of conflicts of interest that can hamper the director's ability to carry out their duties with independence. For example, if the board or any member of the board has established a beneficial relationship with the company (such as supply contract to the company by another company in which the director has position of influence) then this will lead to conflicts of interest. The director's fate is indirectly tied with management consent and approval.

Other Considerations IIRA searches for a clear division of responsibilities between running the board and running the business. It looks at the frequency and outcome of internal meetings in light of board decisions to see if the organization is working cohesively. IIRA also examines the level of delegation of powers by the board to the executive management. This analysis helps ascertain whether the executive management has sufficient independence to handle day-to-day operations, take proactive actions, avail business opportunities and counter any adverse developments to protect the entity. IIRA also sees if the presence and composition of any executive management committee is separate from the board committees to ensure the appropriate distribution of powers.

Authority vested in the Board

IIRA evaluates the effectiveness of the board by checking the execution expediency of the decisions taken during the board meetings. Board reputation is analyzed with the help of assessing the support or opposition from employees to the decisions taken by them. IIRA also test if implementation is consistent in letter and spirit or if it's a cosmetic measure. IIRA also evaluates the legal framework under which the implementation is to be carried out and if there is recourse available to the shareholders or employees to stop such actions and the probability of it being exercised.

Management: Who is the actual governor (CEO or executive team)

There are various facets to assessing quality of management. These include analysis of the profile such as skills, experience, qualification, track record and analysis of results and achievements that are registered on a historical basis. However, under the corporate governance framework, IIRA is more focused on assessing the effectiveness of incentives and the feedback mechanism within the organization. This system should be designed to align management and shareholder's interest and ensures that the management performs in the best

interest of the shareholders. The following factors are assessed to determine the effectiveness of such a system:

- Decision making style;
- Role conflicts and ambiguities;
- Performance Management System;
- Selection Criteria for Senior Managers;
- Disclosure and transparency;
- Internal controls.

Decision Making Style

IIRA assesses the decision making effectiveness by evaluating the decision making style and mechanism in the company. Style may be democratic, semi democratic or autocratic. In a democratic environment a collegial style is followed where information flows to employees and decisions are made through a process of consultation. Conversely, in an autocratic environment the CEO typically takes all the decisions without consultation. The mechanism refers to the levels of delegation in the decision making. In a decentralized setting, decision making is done at the grass roots level by unit managers who are accountable for their performance and the outcome of their decisions, whereas in a centralized environment the decisions are only taken at the top.

Role Conflicts and Ambiguities

Role conflicts and ambiguities are factors that constrain the ability of the organization to pursue common objectives. It arises when the responsibilities and chain of command are not clearly spelled out and documented.

Performance Management

The performance management system starts with defining goals and objective at the strategic and tactical level for the employees. Goal setting should be followed by an appraisal system and recognition and reward mechanism.

Goal and Objectives Employees will perform well only when they are given specified targets and goals to be achieved. We assess if the goals are measurable, quantifiable and realistic to determine their effectiveness. Absence of goals and objectives indicates a lapse on the part of management which can result in waste of time and resources of the company and unproductive workforce.

Performance Appraisal IIRA ask questions to assess the effectiveness of the performance appraisal system. An appraisal that is part of an interactive process between employee and manager is considered effective.

Variable Pay\ Performance Bonuses: To be effective Variable pay, also known as incentive pay, should be based on measurable performance parameters. We also look to the consequences of persistent below-average performance to determine the extent of implicit incentive to perform well.

Compensation Structure of Senior Management Compensation structure of the senior management and CEO also influences the level of involvement of the management and is a very important consideration. IIRA analyzes the percentage contribution of senior executive's compensation relative to total compensation and relative to total revenues. Transparency regarding senior management performance evaluation is also very important and carries significant weight in the overall framework.

IIRA assesses other human resource management policies by looking at communication channels between employer and employees, objectives and work assignments, employee turnover, hiring process, disciplinary actions and training procedures. IIRA evaluates the adaptation and disclosure to code of business conduct and ethics. IIRA also analyzes the mode adopted to convey the code of ethics and governance practices to internal employees.

Selection Criteria for Senior Managers and CEO

IIRA closely monitor the procedures adopted for the selection of chief executive officer, chief financial officer, corporate secretary and departmental heads. IIRA also analyzes the importance given to qualification, integrity, technical competence, leadership skills and experience to handle operations.

Internal Control and Audit

IIRA evaluates the strengths and weaknesses in a number of key departments such as internal audit, finance, risk management and compliance. IIRA analyzes quality of staff, checks qualifications, experience, capabilities and competence to handle job responsibilities.

IIRA examines if the entity has selected qualified and independent external auditors by looking at the procedure for auditor's selection based on background, qualifications and reputation. IIRA checks whether they are given any other assignments which would give them the financial benefits that may run contrary to their independence. IIRA also scrutinizes the reasons behind changes of auditors. IIRA questions whether the entity is utilizing an independent and objective audit process by taking actions on the issues raised by external auditors.

IIRA assesses the outcomes of auditors' meetings and studies the deliberations with respect to audit, risk management and control systems. The actions based

on such deliberations are also evaluated. In addition, IIRA monitors the overall level of financial discipline of the entity to ensure continued operations. IIRA also determines whether the auditors provide accurate accounting statements in line with the entity's financial position and fundamental risks to protect the integrity of financial reporting. IIRA establishes whether or not the entity demonstrates that its operations are measured, monitored and controlled by appropriate, effective and prudent risk management systems.

Organization Structure

IIRA attempts to make sure that the organizational structure clearly defines a set of responsibilities for the key executives to work together and independently to achieve the entity's objectives.

SHAREHOLDERS

Key issues in looking at the ownership include the role and behavior of strategic or blocking shareholders, and the rights of and protections for minority shareholders.

Ownership Structure

The analysis of the ownership entails assessment of quality of shareholders. The presence of several influential shareholders with lack of coherence in their objectives and strategic direction will be detrimental to the organization. If the state is the majority owner then the role that it plays in the governance and active management of the institution is also to be considered.

IIRA analyzes the breakdown of shareholdings to identify majority holders, indirect ownership, and executive equity ownership. Such an analysis is required to screen out the issues of concentration and large block-holders (who may exert influence that is detrimental to the interests of other stakeholders). This scrutiny also ensures that the minority shareholders are protected against loss of value or dilution of their interest due to acts of majority block-holders and take note of two or more than two groups having a sizable stake but differences in opinion regarding the strategic positioning of the organization.

The ownership rights are evaluated by analyzing the arrangements of transfer registration, shareholding structure, shareholder agreement, dividend payout history, and information on share repurchases and swaps.

History and Reputation of the Owners

IIRA also analyzes, to the extent possible, credit history and trustworthiness of the majority shareholders or groups having sizable ownership stake. It gathers information on number of years the company is in operation, the default history

of the company's majority shareholders. Company's own default history for all known credits and default history of subsidiaries in which the entity has substantial involvement.

Shareholder satisfaction with the management

IIRA explores relations between shareholders and management. It screens the annual general meeting's minutes and assesses the quality of shareholder participations. IIRA sees if the shareholders are furnished with sufficient and timely information to allow effective shareholder participation and deliberations in the meetings. Moreover, IIRA assesses the quality of management's participations in the meetings and their actions and responses to shareholder observations and queries.

STAKEHOLDERS' RELATIONS

IIRA focuses on an entity's social responsibilities and customer relations because they increase stakeholders' confidence in the entity and lead to profit maximization. It is the obligation of management to take actions which enhance the welfare and interests of the society as well as the entity. This is related to an entity's ethical, economic, legal, and discretionary responsibilities.

While a growing business needs to constantly capture new customers, the priority of a business should be to maintain existing customer relations. IIRA ascertains if the entity is investing in customer relations management to maintain customer goodwill. IIRA also studies the entity's relationship with immediate competitors. The entity's efforts to maintain a healthy competitive environment are given consideration during the rating process.

EXTERNAL CORPORATE GOVERNANCE CONTROLS

External corporate governance encompasses the controls external stakeholders exercise over the organization. Examples include:

Debt covenants, which are obligation or restrictions on the management to take certain actions in association with debt management. Covenants can be affirmative or negative. Affirmative covenants are obligation to take certain action such as obligation to allocate 40% of net income to debt retirement or use the debt raised specifically for the declared objective. Negative covenants are restrictions to take certain actions on the management such as restriction on management's ability to exceed the debt by a certain margin.

Government regulations play an important role in constraining management against taking steps that are against the interest of shareholders

Media pressure is also an external check and it's most effective in countries where media is independent and strong. The bigger the company operations the more closely it will be followed by the media. Sometimes investigative reporters go to the extent of tapping the telephone conversation and with such precedence managers are more careful in their day to day dealings.

Takeover threats and resulting threat of job loss acts to restrain management from taking actions detrimental to shareholders' benefits.

Competition is another factor that serves to make sure that the management is employing best of its abilities for the benefit of the company. With increasing competition the question of survival becomes dependant upon the ability to perform at optimum utilization of resources. The management performance improves with increase in competition since it's never in their interest to rock the boat otherwise they will lose their job.

ADDITIONAL CONSIDERATIONS FOR FINANCIAL INSTITUTIONS

IIRA evaluates the Know-Your-Customer and Anti-Money Laundering (KYC) policies of the bank. A written policy that outlines the information to be obtained before establishing business relationship with a customer is necessary to avoid money laundering. Formal client acceptance should be conditioned on the approval of two senior officers who testify that the policy requirements are satisfied. KYC compliance does not stop at the commencement of the transaction. Financial institution must have the requisite infrastructure to monitor on a regular basis the consistency of the client transaction with his business. Responsibility for implementation of KYC policy must rest with a designated compliance officer who would have a position of authority and knowledge about the legal laws and regulatory requirements of the countries where the company has its business.

CORPORATE GOVERNANCE RATING SCALE AND DEFINITIONS

IIRA uses a scale of CGR-1 to 10 to rate corporate governance with CGR-10 being the highest possible rating and CGR-1 being the lowest possible rating.

CORPORATE GOVERNANCE RATING SCALE AND DEFINITIONS

CGR-10: Strongest corporate governance processes and practices overall with very few weaknesses in any of the major areas of governance analysis.

CGR-9: Very strong corporate governance processes and practices overall with few weaknesses in any of the major areas of governance analysis.

CGR-8: Strong corporate governance processes and practices overall with some weaknesses in certain of the major areas of governance analysis.

CGR-7: Moderately strong corporate governance processes and practices overall with weaknesses in certain of the major areas of governance analysis.

CGR-6: Satisfactory corporate governance processes and practices overall with some weaknesses in several of the major areas of governance analysis.

CGR-5: Adequate corporate governance processes and practices overall with weaknesses in several of the major areas of governance analysis.

CGR-4: Moderately weak corporate governance processes and practices overall with weaknesses in a number of the major areas of governance analysis.

CGR-3: Weak corporate governance processes and practices overall with significant weaknesses in a number of the major areas of governance analysis.

CGR-2: Very weak corporate governance processes and practices overall with significant weaknesses in most of the major areas of analysis.

CGR-1: Weakest level of corporate governance processes and practices overall with significant weaknesses in most of the major areas of analysis.