

Chapter 33

Corporate governance in Islamic finance

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Introduction

Islamic finance is a nascent industry, with a small share of the global market – about 1%. However, Islamic finance is benefiting from a number of favourable structural and cyclical drivers: strong growth in the GCC and emerging market economies (EMEs) of Asia; positive demographics of young and rapidly growing populations; and a shift of preferences of savers/investors towards Islamic finance in Muslim countries reflecting, in part, a self-reaffirmation or awakening of cultural and religious identity.

The economic renaissance of the GCC and EMEs has been accompanied by a surge in Islamic finance, which has grown by about 15% to 20% in each of the past four years with some forecasts estimating the potential size of Islamic finance at \$4tn, over four times its current size, over the next decade. Since the inception of modern Islamic banking, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975, to more than 300 institutions operating in more than 75 countries. Product and service innovation through the development of *Shariah* compliant mortgages, leasing, securitisation, *sukuk* and *takaful* have also contributed to growth in Islamic finance. The other major factor is that *Shariah* products have yielded higher returns compared to conventional assets in countries pegged to the US dollar.

Islamic finance has transcended borders and regions but many challenges lie ahead before it can make that crucial leap from being an interesting but niche market to being an integral part of the global financial markets. These challenges include: a lack of product standardisation resulting in higher costs and lengthier time faced by financial institutions offering *Shariah* compliant products; ensuring convergence of legal and regulatory frameworks; risk/liquidity management due to prohibition from investing in hedging instruments and the lack of instruments with short term maturities; a need for innovation both in terms of retail products and services, but also for liquidity management; development and implementation of a corporate governance framework for *Shariah* compliant finance; a shortage of professionals and expert talent; and a lack of reliable statistical data.²

However, standard setting agencies are actively trying to address these very fundamental issues facing the industry. AAOIFI has been actively seeking to reconcile international accounting standards with the specific Islamic accounting standards, and provides useful

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guidance on *Shariah* standards. The IFSB provides very valuable standards setting out the regulatory framework and capital issues which are relevant to Islamic finance, again drawing upon the international standards. The efforts of the IFSB, the IDB and AAOIFI facilitate the move towards greater alignment, standardisation and harmonisation in Islamic finance. This chapter focuses on a neglected but important area: corporate governance in Islamic finance.

Corporate governance

The definition of corporate governance has evolved and broadened over the past decade as a result of experience with corporate ‘malgovernance’ and policy reactions, as in the case of the Sarbanes Oxley Act of 2002.³ Corporate governance aims at providing institutions with a body of rules and principles, with a view to ensuring that good practices guide overall management of an institution. It has now come to mean the whole process of managing a company and the incentive structure to address principal-agent issues and ensure that executive management serves the long-term best interests of the shareholders and sustainable value of the company in conformity with the laws and ethics of the country. All of the complex factors that are involved in balancing the power between the chief executive officer (CEO), the board, and the shareholders are now considered to be a part of the corporate governance framework, including auditing, balance sheet and off-balance disclosure, and transparency.

The OECD principles of corporate governance, first endorsed by OECD ministers in 1999, and subsequently revised in 2004, have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. The Financial Stability Forum (FSF)⁴ has designated these principles as one of the 12 key standards for sound financial systems.

Exhibit 33.1

OECD principles of corporate governance

I	Ensuring the basis for an effective corporate governance framework
II	The rights of shareholders and key ownership functions
III	The equitable treatment of shareholders
IV	The role of stakeholders in corporate governance
V	Disclosure and transparency
VI	The responsibilities of the board

Source: Author's own

The OECD principles of corporate governance are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. Over the years, several institutions have developed their own set of codes and principles like the Institute of International Finance's policies of corporate governance and transparency in emerging markets,⁵ which established a code based on criteria that are considered important to international investors.

Both the OECD principles (see Exhibit 33.1) and the IIF code broadly assess five elements of corporate governance: (1) minority shareholder protection; (2) responsibilities of the board of directors; (3) accounting and auditing; (4) transparency of ownership and control; and (5) the regulatory environment. The OECD has issued a revised set of principles of corporate governance aiming to provide a framework for sound corporate governance.

Hence, corporate governance refers to the method by which a corporation is directed, administered and controlled. It includes the laws and customs affecting that direction, as well as the goals for which it is governed. Corporate governance mechanisms, incentives and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. Corporate governance is also viewed as a process of monitoring performance by applying appropriate counter-measures and dealing with transparency, integrity and accountability. It organises the way corporations are accountable to shareholders and the public, and also the monitoring of the executive management of organisations in running their businesses.

Islamic banking

Islamic banking refers to a system of banking or banking activity which is consistent with Islamic law (*Shariah*) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called '*riba*' in Islamic discourse. Instead, profit-and-loss sharing arrangements (PLS) or purchase and resale of goods and services form the basis of contracts. In PLS modes, the rate of return on financial assets is not known or fixed prior to undertaking the transaction. Islamic law also generally prohibits trading in financial risk (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses that are considered *haram* (such as businesses that sell alcohol or pork, or businesses that produce un-Islamic media).⁶

In countries where Islamic banking is operating, its coverage and extent vary significantly from situations where the whole financial sector is entirely Islamic (Iran) to others where conventional and Islamic systems co-exist (Indonesia, Malaysia, Pakistan, and the United Arab Emirates), to countries where there are one or two Islamic banks, or countries where 'Islamic windows' exist within conventional banks. The current trend seems to be toward separation between Islamic and conventional banks.

In recent years, many new Islamic financial products have been developed and are increasingly used in financial market activities, including equity and bond (*sukuk* and certificate of investment) trading and investment, *takaful* and *re-takaful*, Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products including Islamic trust services (*waqf*).⁷

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Corporate governance framework of Islamic banks and financial institutions

Corporate governance is not new to Islamic finance. Indeed, Islamic finance embeds the basic tenets of good corporate governance, stressing the three main areas of accountability, transparency and trustworthiness.⁸

Corporate governance in Islamic finance necessitates Islamic financial institutions abiding by a set of rules called the Islamic law or *Shariah*. The *Shariah* governs the bank's operations and transactions in accordance with Islamic principles derived from the *Quran* and *Hadith*.

Having established a broad understanding of the notion of corporate governance, let us now fit this into an Islamic banking paradigm. Exhibit 33.2 above suggests the build-up of a corporate governance framework for IFIs. To ensure that a national or sector specific corporate governance framework is consistent with international best practice, the framework should incorporate the OECD principles and the BIS guidelines.

The guidelines issued by the BIS, 'Enhancing corporate governance for banking organisations,' builds on a paper originally published by the committee in 1999, as well as the OECD principles for corporate governance. The intent is to help ensure the adoption and

Exhibit 33.2

Regulatory and corporate governance (CG) framework for IFIs

Regulatory and corporate governance (CG) framework of banks

I National CG framework

- Banking sector specific laws/codes/guidelines
- Stock exchanges listing rules and regulations
- Listed companies regulatory authorities laws, rules and regulations

II Islamic finance and *Shariah* specific codes and standards

- IFSB guiding principles on corporate governance for institutions offering Islamic financial services 2006¹
- Accounting and auditing organisation for Islamic financial institutions (AAOIFI) accounting, auditing and governance standards (for Islamic financial institutions)²
- Islamic Financial Services Board (IFSB) published standards including guidance on key elements in the supervisory review process of institutions offering Islamic financial services (excluding Islamic insurance [*takaful*] institutions and Islamic mutual funds)

III International standards and codes

- The OECD principles of corporate governance³
- Guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations 2006⁴

¹<http://www.ifsb.org/index.php?ch=4&pg=140>

²www.aaofii.com

³http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html

⁴<http://www.bis.org/publ/bcbs122.htm>

Source: Author's own

Exhibit 33.3

Guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations, 2006

Principle 1	Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank
Principle 2	The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation
Principle 3	The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation
Principle 4	The board should ensure that there is appropriate oversight by senior management consistent with board policy
Principle 5	The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions
Principle 6	The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment
Principle 7	The bank should be governed in a transparent manner
Principle 8	The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency ('know-your-structure')

Source: Author's own

implementation of sound corporate governance practices by banking organisations worldwide, whether conventional or *Shariah* compliant. As Exhibit 33.3 shows, the guidelines focus on: (1) the roles of boards of directors and the important role of independent directors, and senior management; (2) effective management of conflicts of interest; (3) the roles of internal and external auditors, as well as internal control functions; (4) governing in a transparent manner, especially where a bank operates in jurisdictions, or through structures, that may impede transparency; and (5) the role of bank supervisors in promoting and assessing sound corporate governance practices.

IFSB principles and AAOIFI governance standards

Islamic banking offers a different paradigm from conventional banking, and from the viewpoint of corporate governance, it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements form the basis of Islamic financing. These financial arrangements imply different stakeholder relationships, and by

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corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. In addition, the Islamic bank is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community.

In December 2006, the Islamic Financial Services Board (IFSB) published the 'Guiding principles on corporate governance for institutions offering only Islamic financial services (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds)' and has since set-up a working group to address implementation issues.

The IFSB document sets out seven guiding principles (the guiding principles) of prudential requirements in the area of corporate governance for institutions offering only Islamic financial services (IIFS) (excluding (1) Islamic insurance (*takaful*) institutions; and (2) Islamic mutual funds). The guiding principles are divided into four parts:

- 1 general governance approach of IIFS;
- 2 rights of investment account holders (IAH);
- 3 compliance with Islamic *Shariah* rules and principles; and
- 4 transparency of financial reporting in respect of investment accounts.

The guiding principles are designed to help IIFS establish and implement effective corporate governance practices. The guiding principles are applicable to commercial banks, investment banks, finance houses and other fund-mobilising institutions that offer only financial services and products complying with Islamic *Shariah* rules and principles, as determined by the respective supervisory authorities.⁹

A number of corporate governance issues are of equal concern to all institutions offering financial services, whether IIFS or others. The IFSB acknowledges that many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices, which have been widely accepted as the international standards, and would be relevant and useful for IIFS. On this premise, the guiding principles do not intend to reinvent the wheel by proposing a wholly new corporate governance framework. Instead, the guiding principles aim to complement the existing internationally recognised standards of good corporate governance by particularly addressing the specificities of IIFS (see Exhibit 33.4). Indeed, the IFSB's guiding principles complement those of the OECD and the BIS. As shown in Exhibit 33.2 above, the CG framework for IIFS stands on top of and builds on the international codes and standards and forms the basis for national codes, guidelines and regulations to be issued by bank supervisors and central banks.

The IFSB in its guiding principles places the focus on IAHs and protecting their rights.

Conceptually, under the principle of *modaraba*, IAHs as *rabb al-mal* bear the risk of losing their capital invested by the IIFS as *mudarib*. Effectively, this means the IAH's investment risk is similar to that of the shareholders of IIFS who bear the risk of losing their capital as investors in the IIFS.

However, the IIFS as *mudarib* owes a fiduciary duty to the IAH under the *modaraba* contract, which is parallel with their duty to their shareholders. In this context, the IIFS as *mudarib* refer to both their management and their shareholders, not the management alone.

Exhibit 33.4

The seven guiding principles of IFSB

Principle 1.1	IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders. Ensuring the basis for an effective corporate governance framework
Principle 1.2 ¹	IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards which are in compliance with <i>Shariah</i> rules and principles and are applicable to the Islamic financial services industry as recognised by the supervisory authorities of the country
Principle 2.1	IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised
Principle 2.2	IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns
Principle 3.1	IIFS shall have in place an appropriate mechanism for obtaining rulings from <i>Shariah</i> scholars, applying <i>fatwa</i> and monitoring <i>Shariah</i> compliance in all aspects of their products, operations and activities
Principle 3.2	IIFS shall comply with the <i>Shariah</i> rules and principles as expressed in the rulings of the IIFS's <i>Shariah</i> scholars. The IIFS shall make these rulings available to the public
Principle 4	IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage

¹Note the special focus in the IFSB principles no 1.2, 2.1, 2.2 and 4 on IAH

Source: Author's own

Therefore, for the purpose of the guiding principles, discussions on the fiduciary duties of IIFS to the IAH shall always be understood as the fiduciary duties of both the management and shareholders of IIFS as *mudarib* towards the IAH as *rabb al-mal*.

In this respect, whether the investment mandate is restricted¹⁰ or unrestricted,¹¹ under a *modaraba* contract, the IIFS have a fiduciary duty to the IAH to uphold their interests no less than those of the IIFS's own shareholders. In other words, although as investors in the IIFS's assets the shareholders would rank *pari passu* with the IAH, the IIFS's as a party in the *mudarib* side of the *modaraba* contract also owe a fiduciary duty to the IAH and would have to ensure the protection of the IAH's interests.

Hence, it is appropriate that IIFS put IAHs on an equal footing with the IIFS's own shareholders by duly acknowledging the IAH's right to access all relevant information in

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relation to their investment accounts. This would assist the IAH in making an informed decision on their selection or choice of the investment accounts in which to place their funds with the IIFS. In a situation where the local legal framework is not yet capable of facilitating the exercise of these rights by the IAH, the supervisory authorities should play a role in protecting the interests of the IAH vis-à-vis the shareholders of IIFS with regard to their rights, provided that they are in compliance with *Shariah* rules and principles.

The IAH's right to monitor the performance of their investment should not be misconstrued as a right to intervene in the management of the investments by the IIFS. It shall be noted that shareholders of IIFS who are entitled to vote in general meetings, to pass resolutions on the appointment of directors and auditors, and to access the documents of the IIFS are also not considered as intervening in the management of the IIFS. Therefore, it is only appropriate that IIFS disclose to the IAH their policies and practices in respect of the investment accounts which they offer.

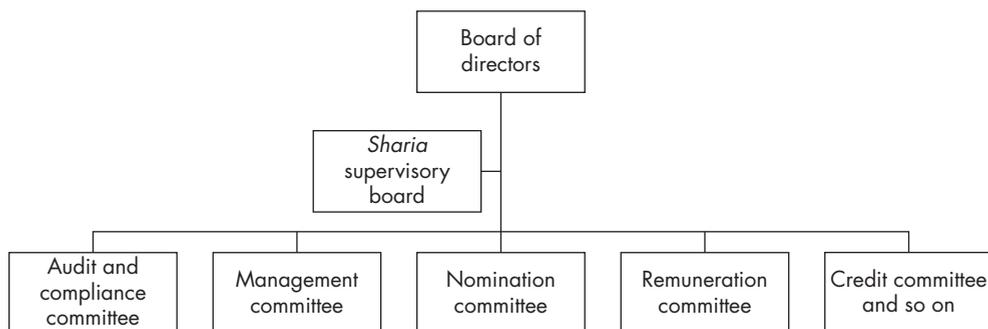
The AAOIFI has also issued 35 standards on accounting, auditing, governance, ethical and a *Shariah* governance pronouncement. The AAOIFI explains the role of the audit and governance committee as being responsible for overall monitoring of business covering internal control, compliance with *Shariah* laws and principles and adherence to code of ethics. In 2008, AAOIFI revised the accounting, auditing and governance standards (for Islamic financial institutions) to take account of changes in international accounting and auditing standards and their impact for IIFs.

Internal and external *Shariah* compliance for IFIs

To ensure *Shariah* compliance, Islamic banks employ an individual *Shariah* adviser and/or board. Central to such a framework is the *Shariah* supervisory board (SSB) and the internal controls which support it. In some countries the SSB is established at central banks while

Exhibit 33.5

Sample organisational chart of an Islamic bank



Source: Author's own

in others *Shariah* advisers are established at commercial banks. In the latter case, their independence from bank management is an issue. On occasions a number of banks might use the advice of the same *Shariah* adviser (SA), which could raise an issue of conflict of interest. Establishing guidelines for, and coordinating the advice of an SA, appear to be an issue of concern that has drawn the attention of regulators. Similarly, cross-country coordination among SSB's interventions/guidance is also an issue that has led the authorities in a number of countries to call for harmonisation.

In principle, the role of the SSB covers five main areas: ensuring compliance with overall Islamic banking fundamentals, certifying permissible financial instruments through *fatwas*, verifying that transactions comply with issued *fatwas*, calculating and paying *zakat*, disposing of non-*Shariah* compliant earnings, and advising on the distribution of income or expenses among shareholders and investment account holders. The SSB issues a report to certify that all financial transactions (including investments) comply with the above-mentioned principles. This report is often an integral part of the annual report of the Islamic financial institution. In practice an SSB's tasks may vary according to provisions stipulated in the articles of association of the financial institution or those stipulated by national regulators.¹²

The SSB can also issue recommendations on how the institution could best fulfil its social role as well as promote Islamic finance. In addition to internal corporate arrangements, national regulators and international standard setters have developed guidelines for SSBs. These often refer to the SSBs' general duty to ensure *Shariah* compliance of transactions and, less frequently, indicate areas of competence, composition and decision-making.

There are external arrangements in place as well; such arrangements, including mechanisms of market discipline, can provide complementary channels inducing compliance with rulings and their harmonisation. Indeed these are similar to the Basel II pillars, where the second and third pillars focus, respectively, on supervisory/regulatory review and market discipline.

Exhibit 33.6 illustrates the different roles and competencies of the internal *Shariah* review unit as compared with the external *Shariah* review and audit.

Good corporate governance practice should also specify the role, structure and composition of SSBs. Exhibit 33.7 shows the legal basis and nature of regulations on internal SSBs in selected countries as promulgated by the respective regulatory bodies.

Many countries with important Islamic finance sectors have also sought to organise the role of external *Shariah* review and in some cases established a central *Shariah* board or council (Indonesia, Kuwait, Malaysia, Sudan, Pakistan and UAE). Having a central SSB or *Shariah* council can help in the standardisation of *Shariah* opinions across the jurisdiction and also helps reduce costs. However, it may also stifle innovation and impose a regulatory burden on the growth of the industry.

Exhibit 33.8 shows the external *Shariah* corporate governance institutions by country.

Corporate governance in *takaful* and *re-takaful* industry¹³

This underdevelopment and low penetration rates of the insurance industry, both conventional and *Shariah* compliant, in the MENA region and countries with an important Islamic

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Exhibit 33.6

Comparison between internal and external *Shariah* arrangements

	Internal <i>Shariah</i> review unit	External <i>Shariah</i> review and audit
Focus	Provides exhaustive internal review, and trains employees on <i>Shariah</i> related matters. It responds to managerial concerns over upholding <i>Shariah</i> conformance of all transactions.	Primarily provides an independent certification as to the reasonableness of financial information provided to shareholders and stakeholders. It responds to regulators' and stakeholders' desire for an independent appraisal of <i>Shariah</i> compliance.
Activities	Assess compliance of <i>all</i> transactions with the <i>fatwas</i> issued by the SSB. To this effect, it creates systems of control and assessment.	Assess the information provided by the managers and present statements according to relevant <i>Shariah</i> accounting standards. It uses <i>samples</i> of transactions to evaluate truthfulness of compliance and expresses an opinion on financial statements.
Management	Reports to management administratively. Builds relationships throughout the organisation to ensure concerns are identified and resolved in a timely manner.	Primarily reports to the board/audit committee on financials and internal control.
Board of directors/committee	Reports directly to the audit committee. Provides opinions on the organisation's business risks, financial statements, system of internal control, and level of compliance with laws, regulations, and policies.	Attests to the audit committee the accuracy of the financial reports and attests on management's assessment on internal controls over financial reporting. Provides updates on pending accounting pronouncements and their potential impact on the organisation.
Independence	Should demonstrate organisational independence and objectivity in work approach, but is managerially dependent on the organisation.	It is organisationally and managerially independent of the organisation.
Results	Identifies problems, make recommendations, and helps facilitate resolutions.	Meets statutory requirements and provides necessary adjustments to meet financial accuracy.
Risk	Identifies and qualifies key business risks to estimate probability of occurrence and impact on business. Makes appropriate recommendations as a result of the risk assessment.	Identifies key transactions and exposures for financial statements.
Fraud	Includes fraud detection steps in audit programmes. Investigates the allegations of fraud. Reviews fraud prevention controls and detection processes put in place by management and makes recommendations for improvement.	Includes fraud detection steps in audit plan. Gathers information necessary to identify risks of material misstatement due to fraud, by inquiring of management and others within the entity about the risks of fraud. Considers the results of the analytical procedures performed in planning the audit and fraud risk factors.
Recommendations	Communicates to management in the audit reports recommendations for corrective action.	Communicates recommendations for corrective action to the board audit committee.

Source: Wafik Grais and Matteo Pellegrini (2006), 'Corporate Governance and *Shari'a* Compliance in Institutions Offering Islamic Financial Services,' World Bank Policy Research Working Paper 4054, November, 2006

finance industry is attributable to a number of factors, including poor corporate governance, barriers to entry, restricted market access and protection of local insurers. The near absence of competition, restrictions on entry of foreign insurers and the dominance of government-owned insurers and regulatory control of insurance pricing and products has led to expensive insurance and an absence of new products and innovation.

Exhibit 33.7

Legal basis and nature of regulations on internal SSBs in selected countries as at November 2006

Country	Legal base for SSB	SSB competences as spelled out by existing laws	SSB composition	SSB decision making	SSB appointment and dismissal rules	Fit and proper criteria for SSB members
Bahrain	BMA Rulebook Volume 2 – Islamic Banks – the BMA (2005) and all AAOIFI standards	General duty to verify <i>Shariah</i> compliance and issue an annual report. Binding advice. The shareholders shall decide how SSB will discharge this duty	At least three members (according to AAOIFI)	Unspecified (to be decided by shareholders)	Appointed by shareholders. Dismissal is proposed by board and approved by shareholders (according to AAOIFI standards)	Conflict of interest and competence clauses (according to AAOIFI governance standards)
DIFC*	Law regulating Islamic financial business, DIFC Law No. 13 of 2004 and the Islamic Financial Business Module of the DFSA Rulebook	Oversees and advises on <i>Shariah</i> compliance. Specific duties to be established and documented by the BIFS	No less than three members	Unspecified	Appointed and dismissed by the bank's governing body	They must be competent (based on previous experience and qualifications) and are not directors or controllers of the BIFS
Indonesia	Act No. 7 of 1992 as amended by Act 10 of 1998, Regulation 4/1/PBI/2002	General obligation to verify <i>Shariah</i> compliance (duties as stipulated by National <i>Shariah</i> Board and established in bank's articles of association)	Unspecified	Unspecified	Any appointment or replacement of SSB members must be reported to Bank Indonesia and approved by the National <i>Shariah</i> Board	Documentary evidence on SSB members' previous experience to be submitted to Bank Indonesia's Board of Governors
Jordan	Art. 58 of Law 28 of 2000 as amended by temporary Law No. 46 of 2003	Ex ante audit (fatwas), ex-post audit, opinions on <i>Shariah</i> matters referred to it	No less than three members	By unanimous or majority vote. Its votes are valid only if a majority of members is present	Appointed by the general assembly of shareholders. Discharged only through a reasoned decision taken by two-thirds of the board of directors and endorsed by the general assembly. Changes have to be notified to the central bank	Unspecified
Kuwait	Art 93 of Law No. 32 of 1968	General obligation to verify <i>Shariah</i> compliance of banking operations	No less than three members	By unanimity. In case of conflict the matter is referred to the <i>fatwa</i> board	Unspecified	Unspecified

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Lebanon	Law No. 575 on 'Establishing Islamic banks in Lebanon'	Certification of <i>Shariah</i> compliance and proposals for properly achieving bank's objectives pursuant to the <i>Shariah</i>	Three members	Unspecified	Appointment for a renewable three year period	Unspecified (experts' background must be in Islamic law, doctrine and banking and financial operations)
Malaysia	Islamic Banking Act of 1983 and Central Bank of Malaysia Act 1958 (revised 1994) and Guidelines on the Governance of <i>Shariah</i> Committees (2004)	Binding advice on <i>Shariah</i> compliance of banking operations for Islamic banks. The central <i>Shariah</i> advisory council is the ultimate arbiter	Unspecified	Unspecified	Unspecified	There are several incompatibility clauses
Pakistan	IBD Circular No. 02 of 2004	General obligation to verify <i>Shariah</i> compliance of banking operations. The SSB must submit an annual report to shareholders	Only one advisor required. A board may be set up at the bank's discretion	Unspecified	Appointment must be approved by State Bank of Pakistan	They are compulsory and relate to minimum qualification and experience, track record, solvency, financial integrity, honesty and reputation and conflicts of interests
Philippines	Republic Act No. 6848 and Manual of Regulations for Banks – implementing Rules and Regulations of Republic Act No. 6848	It offers advice and undertakes reviews on matters relating to <i>Shariah</i> compliance	At least three but no more than five members	Unspecified	Unspecified	SSB members must be Islamic scholars and jurists of comparative law
Thailand	Islamic Bank of Thailand Act B.E 2545	It has 'the authority and duty to give advice and recommendations to the board of directors concerning Islamic principles related to the operation of the bank'	Not more than four members	At least half of the SSB members form a quorum and decisions are taken by majority vote	SSB members have a two year tenure and may be reappointed. They are appointed and removed by the board of directors	Financial integrity, competence, honesty and conflicts of interests

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UAE	Federal Law No. 6 of 1985	General obligation to verify <i>Shariah</i> compliance of banking operations. Detailed competences to be established by the bank	No less than three	To be decided in the articles of association of the bank	SSB members must be approved by the higher <i>Shariah</i> authority	Unspecified
* Dubai International Financial Centre						

Source: Official country websites and central bank annual reports, see also Annex III of W. Grais and M. Pellegrini (2006), 'Corporate Governance and *Shari'a* Compliance In Institutions Offering Islamic Financial Services,' World Bank Policy Research Working Paper 4054, November 2006

The guidelines laid down by the OECD and the International Association of Insurance Supervisors (IAIS)¹⁴ for corporate governance in the insurance sector serve as an industry benchmark for standard setting. These guidelines emphasise the importance of sound risk management and decision-making processes. They also include setting out the role and responsibilities of directors and ensuring that the rights of policyholders and shareholders are protected. Transparency, disclosure and regular reviews are also key requirements to facilitate good decision-making as well as protecting stakeholder rights.

The IAIS has also developed insurance core principles and methodology stating the essential principles that need to be in place for a supervisory system to be effective. In particular, ICP 9¹⁵ deals with corporate governance and emphasises that the corporate governance framework should recognise and protect rights of all interested parties. The board is the focal point of the corporate governance systems and is ultimately accountable and responsible for the performance and conduct of the insurer. The delegation of authority to board committees, *Shariah* committees or executive management does not in any way mitigate or dissipate the discharge by the board of directors of its duties and responsibilities.

In August 2006, the IFSB and IAIS published the informative, 'Issues in regulation and supervision of *takaful*,' which touched on corporate governance, noting that international corporate governance principles extend to the *Shariah* board/committee. The latter should be an integral part of the internal governance structure of the insurer and ensure compliance with the *Shariah*.

Consideration also needs to be given to the relationship between the *Shariah* committee and other governance structures of the company to ensure that responsibilities are clearly and appropriately allocated.

The corporate governance framework should ensure the independence, confidentiality and competence of *Shariah* scholars, as well as the consistency of *Shariah* scholars' *fatwas* (rulings).

There are additional specific challenges faced by the *takaful* industry in terms of corporate governance. Governance issues to be addressed include the protection of minority shareholders, improved disclosure of risks, commingling of resources, balancing UIA holders' risks and rights, and the rules for the utilisation of reserve funds. More generally, regulators need to impose mandatory, uniform financial reporting standards and disclosure requirements.

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Exhibit 33.8

External *Shariah* CG institutions by country as at November 2006

Country	Separate Islamic banking and <i>takaful</i> department at CB or at bank supervisor	Centralised SSB or high <i>Shariah</i> authority or <i>fatwa</i> board	Islamic rating agency	Separate Islamic capital market department within securities regulator
Bahrain	Yes, Islamic financial institutions supervision directorate	No, but the international Islamic financial market is to promote the harmonisation and convergence of <i>Shariah</i> interpretations in developing Islamic banking products and practices which are universally acceptable	No, but international Islamic rating agency operates in Bahrain	No
Indonesia	Yes, the directorate of <i>Shariah</i> Banking	Yes, the National <i>Shariah</i> Board is authorised to issue <i>fatwas</i> concerning products, services and operations of BIFS. It also recommends advisors to <i>Shariah</i> BIFS	No	*
Jordan	No	No	No	No
Kuwait	No	The <i>fatwa</i> board in the Ministry of Awqaf and Islamic Affairs is the final authority on <i>Shariah</i> disputes. Its advice is binding when it arbitrates on disputes between members of the same SSB	No	No
Malaysia	Yes, regulation department – Islamic banking and <i>takaful</i>	Yes. The <i>Shariah</i> council advises central bank on <i>Shariah</i> matters and is the ultimate arbiter in <i>Shariah</i> interpretation disputes. The directives issued by BNM in consultation with the <i>Shariah</i> council have binding authority over banks with Islamic windows	Yes, Malaysian rating corporation – Islamic capital market department	Yes, Malaysian SEC – Islamic capital market department. The SEC also has its own <i>Shariah</i> advisory board
Sudan	Not applicable, the whole financial regulatory system is Islamic	Yes, the <i>Shariah</i> high supervisory board is responsible for <i>fatwas</i> , contract specimen, arbitration, consultations relating to Islamic legal aspects, training, research, lectures and seminars	No	Not applicable, the whole financial regulatory system is Islamic

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Pakistan	Yes, Islamic banking department	Yes, the <i>Shariah</i> board of the state bank is to advise the central banks on matters of <i>Shariah</i> . It also produces specimens of permissible Islamic financial contracts to ensure compliance with minimum <i>Shariah</i> standards	No	No, but several departments share Islamic finance portfolio
UAE	No	Yes, the higher <i>Shariah</i> authority, attached to the Ministry of Justice and Islamic Affairs, is the final arbiter on <i>Shariah</i> matters. It is also responsible of <i>Shariah</i> supervision	No	No

* Indonesia's House of Representatives has passed an Islamic bank law in 2008 that may result in changes to the current regulatory structure. See: http://www.thaindian.com/newsportal/business/indonesian-parliament-passes-islamic-banking-bill-into-law_10061212.html.

Source: Official country websites and central bank annual reports and Wafik Grais and Matteo Pellegrini (2006) 'Corporate Governance and *Shari'a* Compliance in Institutions Offering Islamic Financial Services', World Bank Policy Research Working Paper 4054, November, 2006

Common corporate governance practices in banks and other institutions

The foregoing describes the corporate governance (CG) structure specifically for IFIs. There are many similarities in the requirements of a CG framework of conventional banks and other companies and that of *Shariah* compliant institutions and which are touched upon in the following paragraphs.

Commitment to good corporate governance

An organisation should have a comprehensive board charter¹⁶ detailing the duties and responsibilities of the board of directors. It should have a corporate governance manual detailing the organisational structure, roles and responsibilities of key executives.¹⁷ The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.

Structure and functioning of the board¹⁸

Ideally the board should consist of one third independent directors¹⁹ with a majority of non-executive directors.²⁰ The board may delegate some of its functions and constitute²¹ special committees, for the purpose of undertaking specific operations on its behalf. The functions of these committees are approved by the board and clearly spelled out in the committee

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charters duly approved by the board. Examples of such committees are the audit committee, corporate governance committee, remuneration and nominations committee and executive committees and so on. In any event, and even where the board delegates one of its functions or authority, the board cannot delegate any of its responsibilities and the board remains liable for all of its functions so delegated.

Board meetings should be regularly held as required to effectively discharge the board duties. The board meets when convened by its chairman or upon the written request of board members. The notice of convening the board meeting is usually communicated to each board member at least one week before the meeting date together with the meeting's agenda.

All board deliberations are recorded in the board minutes by the board secretary.²² It is best to specify that the board meets at least a minimum times a year in person to pass board resolutions. The board may take decisions by resolutions approved by circulation in case of urgent matters where it is not possible for the board to meet in person due to practical difficulties.

The board secretary should preferably be a member of a recognised body of professional accountants, member of recognised body of corporate/chartered secretary, a lawyer or a graduate from a recognised university or equivalent.

Control environment and processes

The board of directors should establish an audit committee²³ comprising of non-executive members the majority of whom are preferred to be independent.

In addition to the audit committee, banks have an internal audit function as well, headed by an internal auditor.

The internal auditor prepares and submits to the audit committee, board of directors or to any other reporting authority, an internal audit report which shall include a review and assessment of the internal control system.

Every company should have an independent external auditor as well. most jurisdictions have an external audit rotation policy in place whereby the company is required by law to rotate the external audit firm or partner in charge of audit services every three to five years.

Disclosure and transparency

Depending upon the various country laws, a company's financial reports must comply with International Financial Reporting Standards (IFRS), International Accounting Standards (IAS), generally accepted accounting practices (GAAP) or other local accounting laws.

The company's audited financial reports should be circulated to all shareholders.

Some jurisdictions have a policy of including a corporate governance report as a part of its annual report. The said report is signed by the chairman and includes the board's assessment of its compliance with corporate governance principles. Some jurisdictions require the external auditor to certify the corporate governance report as well.

The Company should have a policy on addressing 'conflict of interest'. The policy should reflect the procedure to be followed by board members who are conflicted in any

way on the matter under discussion/deliberation by the Board. The policy should clearly state that the directors must abstain from voting on any board resolution in which they or any of their associates have a material interest and that they shall not be counted in the quorum present at the board meeting for that item. The minutes of the meeting should record the same as well.

Insider trading and abusive self-dealing should be prohibited.²⁴

Treatment of minority shareholders and other stakeholders

Companies and in particular public and listed companies should have an investor relations officer who is responsible to deal with investor related queries.

Companies should also have a 'whistle blower protection policy' in place. This will help stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices to the board without their rights being compromised for doing so.

Most jurisdictions have a requirement for companies to obtain the approval of shareholders for major transactions or transactions which change the nature of the business. A standard exception applies to transactions of a bank which are undertaken in the normal course of business.

It is preferred to provide the shareholders with the right of cumulative voting. Cumulative voting helps strengthen the ability of a minority shareholder to elect a director. It is a type of voting process that allows shareholders to cast all of their votes for a single nominee for the board of directors when the company has multiple openings on its board. In contrast, in 'regular' or 'statutory' voting, shareholders may not give more than one vote a share to any single nominee.

Conclusions

Increasingly, good corporate governance practices are integral to creating and sustaining the long term value of firms, whether or not *Shariah* compliant. Empirical evidence suggests that more than 84% of the global institutional investors are willing to pay a premium for the shares of a well governed company over one considered poorly governed but with a comparable financial record.²⁵ Similarly, a study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19% over a two-year period.²⁶

Transparency and disclosure is a key element of corporate governance. Good CG practices not only impacts a company's performance in terms of its equity only, but better corporate governance standards make banks and rating agencies lead to improved credit ratings thereby reducing the cost of borrowing of well governed companies. It also improves an institution's market perception and rating and positively affects its market value.

The international corporate governance frameworks mentioned in this chapter including the OECD and BIS principles set out the broad corporate governance framework for Islamic banks. IFSB and AAOIFI standards have developed corporate governance standards and principles specifically for *Shariah* compliant institutions that complement on and extend

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good corporate governance principles to IIFS. All these standards complement the national and organisation specific CG practice prevalent in *Shariah* compliant institutions and which help them to integrate with the mainstream financial services industry.

Today, good corporate governance is considered vital as it promotes morality, honesty, integrity, trust, openness, performance orientation, responsibility and accountability, as well as mutual respect and commitment to the organisation from all parties in an organisation. Corporate governance does not apply only to directors and executives, but to all players in the organisation. Indeed the values underlying good corporate governance are fully consistent with and embedded in the principles of Islamic finance.

Strong corporate and bank governance are essential ingredients for the development of a vibrant and sound Islamic finance industry. The time is ripe for action on two broad fronts: (1) the mainstreaming of Islamic financial services and products; and (2) the creation of an international Islamic financial market. The egalitarian nature of Islamic finance and its risk-sharing characteristics are ideal for incorporation in access to finance programmes in Africa, MENA, and Asia and elsewhere. Islamic finance is a viable and credible complement to conventional financing. Governments, central banks, regulators must take concerted action with banking and financial industry to create the enabling environment, including corporate governance frameworks in order to build an integrated Islamic capital market and mainstream *Shariah* compliant products and services to improve access to finance as well as develop a sound, well-functioning Islamic financial system and achieve banking and financial deepening.

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- ¹ The author would like to thank Jahanara Ahmad, for efficient research assistance and Wafik Grais, Mohammed El-Qorchi, Sohail Jaffer, Hari Bhambra, and Dana Kablawi for constructive comments.
- ² See the discussion in Nasser Saidi, 'Leading Islamic Finance across Borders', speech at Leaders in Islamic Finance conference, Istanbul, May, 2008.
- ³ This is available in www.soxlaw.com.
- ⁴ www.fsforum.org.
- ⁵ <http://www.iif.com/emr/corpgov/code/>. For the OECD principles and discussion thereof: http://www.oecd.org/document/56/0,2340,en_2649_34813_31530865_1_1_1_1,00.html.
- ⁶ IMF working paper 'Islamic banks and financial stability', January 2008 and 'The Muslim banking world faces the challenge of expanding internationally while remaining true to Islamic principles', Nasser M. Suleiman. See also, El-Hawary, D., Grais, W. and Iqbal, Z., 'Regulating Islamic financial institutions: the nature of the regulated', Policy Research Working Paper 3227 (Washington, World Bank, March 2004).
- ⁷ See IMF Finance and Development Quarterly magazine, December 2005.
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- ⁹ IFSB is producing a CG code for *takaful* and for collective investment schemes that would parallel the CG guidelines for collective investment vehicles issued by the International Organisation of Securities Commissions (IOSCO) www.iosco.org.
- ¹⁰ Restricted investment account means that the Islamic bank can invest the depositors' funds in specified investments only. As those funds are invested according to clients' directives and are not at the discretion of the banks, they cannot be part of a bank's source of funds. In this context, AAOIFI recommends that restricted investment accounts be included as off-balance sheet items.
- ¹¹ Unrestricted investment account means that the Islamic bank has the discretion of investing the depositors' funds in any investment. <http://www.palgrave-journals.com/jbr/journal/v9/n1/full/2350059a.html>.
- ¹² See also Wafik Grais and Matteo Pellegrini, 'Corporate governance in institutions offering', (2006). 'Islamic financial services issues and options', World Bank Policy Research Working Paper 4052, November.
- ¹³ Dr. Nasser Saidi, Middle East Insurance Review, March 2008. See also: http://www.hawkamah.org/bridging_the_gap/networks/regional_task_forces/.
- ¹⁴ www.iaisweb.org.
- ¹⁵ http://www.iaisweb.org/_temp/IAIS_expands_core_principles_for_insurance.pdf.
- ¹⁶ See also guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations 2006.
- ¹⁷ Principle 3 of guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations 2006.
- ¹⁸ SCA CG regulations for joint stock companies and criteria for institutional discipline, 2007.
- ¹⁹ Independent director is 'A director whose position as board member constitutes his/her only connection to the company and whose judgment as director is objective and independent of any direct or indirect personal relationship with the company other than acting as a director.'
- ²⁰ Non-executive director is 'a director who is not performing executive management duties for the company and is not full-time dedicated to the company and who does not receive monthly or yearly remuneration from the company other than the said director's remuneration as director.'
- ²¹ Guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations, 2006.
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