

Corporate Governance For Shariah Compliant Banks and Financial Institutions

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Presentation Purpose And Content

Purpose: To explain the concept of corporate governance for Shariah compliant financial institutions

Outline:

1. Islamic Banking vs Conventional Banking
2. Principles of Islamic Banking
3. Governance structures in Islamic Bank
4. Importance of CG for Islamic Financial Institutions
5. Governance Challenges for Islamic Financial Institutions
6. IFSB Guidelines
7. Rating and Islamic Indices
8. Selected Country Models

Takeaways

By the end of this workshop, you should be able to:

- Understand the inherent corporate governance principles in Shari'ah;
- Identify governance challenges for Islamic Financial Institutions
- Understand Shari'ah compliant corporate governance framework

Islamic Banking Vs Conventional Banking

- Islamic banking represents a radical departure from conventional banking
- A conventional bank is basically a borrower and lender of funds
- An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment.
- These financial arrangements imply quite different stockholder relationships, and as a consequence governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment.

Islamic Banking vs Conventional Banking ...contd

- 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.
- For this purpose, Islamic banks employ an individual Sharia Advisor and/or Board

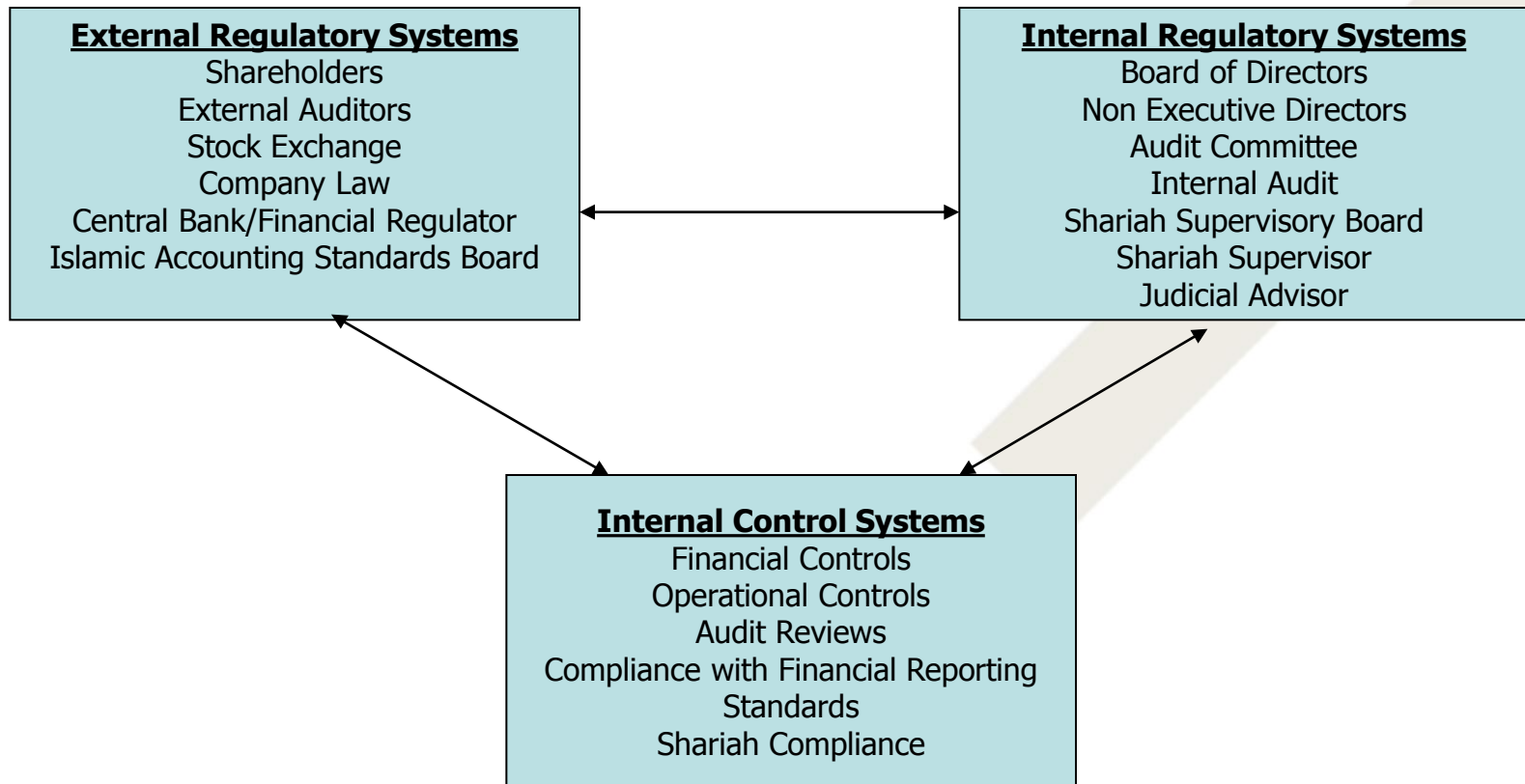
Principles Of Islamic Banking

- An Islamic bank is based on the Islamic *faith* and must stay within the limits of Islamic Law or the *shariah* in all of its actions and deeds.
- Four principles govern investment behaviour in Shariah compliant Banks:
 - a) the absence of interest-based (*riba*) transactions;
 - b) the avoidance of economic activities involving speculation (*ghirar*);
 - c) the introduction of an Islamic tax, *zakat*;
 - d) the discouragement of the production of goods and services which contradict the value pattern of Islamic (*haram*)

Governance structure in Islamic Banks

- The Governance Structure in Islamic Banks is depicted in the Chart below which sketches the conceptual framework of corporate governance for Islamic bank.
- Central to such a framework is :
 - The *Shariah Supervisory Board (SSB)* and
 - The *internal controls* which support it.

Corporate Governance Structure In An Islamic Bank



IIFS' Internal CG Structures and Processes

- Each IIFS has a ***Shariah Supervisory Board "SSB"***;
- Their tasks vary according to provisions stipulated in the charters of the institution or by national regulators;
- SSBs' prerogatives:
 - 1- certification of permissible financial instruments through *fatwas*;
 - 2- verification of transactions' compliance with issues *fatwas*;
 - 3- disposal of non *Shariah* compliant earnings;
 - 4- Advice on distribution of income or expenses among bank's shareholders and investment account holders.

IIFS' Internal CG structures and processes (contd)

- In addition to SSBs, **most IIFS particularly those complying with AAOIFI standards, have established *Shariah Review Units***;
- These units are independent of other departments or are part of the audit and control department;
- The array of their tasks include:
 - 1- ascertain that financial transactions implemented by management comply with SSB rulings;
 - 2- Exclusive competence on ex-post facto monitoring;

IIFS' External CG Structures and Processes

- Beyond SSBs, IIFS have Centralized SSBs; and
- The presence of providers of financial information services external to the firms.
- Centralized SSB's are significantly different across countries;
- Centralized SSBs' are usually concerned with:
 - 1- Standardization of Shariah interpretation;
 - 2- Ex-post monitoring (monitoring of Shariah compliance);
 - 3- Issues relating to upholding Shariah compliance, offer arbitration and recourse to settle disputes;

CG Importance to IIFS

1. **Stakeholders'** value is central purpose for IIFS;
2. Confidence feature in respect to IIFS is conformity with stakeholders religious beliefs;
3. Corporate Governance arrangements internal & external to the corporate entity include structures and procedures that provide sufficient comfort the business is conducted in accordance with stated objectives, in particular compliance with Shariah;
4. For both ICFS & IIFS sound CG practices create an enabling environment, which rewards banking efficiency, mitigates financial risk and increases systemic stability.

Shareholders' Vs Stakeholders CG in IIFS

1. **Stakeholders** value is central to the IIFS;
2. IIFS mission statement focuses on :
 - A- Compliance with Shariah principles;
 - Conduct of financial systems in accordance with the prohibition of Riba & Gharar;
 - furthering Islam's social objectives;
 - Promotion of an integrated Islamic financial system based on Shariah;
 - B- Provision of excellent services;
 - Service to the community as a whole including non Muslim community;
 - promoting the interest of related parties, including shareholders, depositors & employees;
 - developing professional & ethical qualities of management and staff;

Mission statements IFIs

- Bank Islam Malaysia Berhad

“The corporate mission of the bank is to seek to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process”-.

- Jordan Islamic Bank

“Commitment to providing banking services based on compliance with the rules and principles of the glorious Islamic Shariah in all our activities to serve our community as a whole. Commitment to equally serve the interests of all related parties including shareholders, depositors, and employees”.

Shareholders' Vs Stakeholders CG in ICFS

- The cornerstone of CG arrangements for conventional business is the protection of **shareholders** rights;
- Conventional CG however, does not overlook stakeholders other than shareholders;
- OECD definition of CG incorporated the approach and codified it "*CG is a set of relationships between a company's management, its board, its shareholders and other stakeholders*";

Challenges for IIFS Governance

Internal & External CG Arrangements

SSBs

- Independence
- Confidentiality
- Competence
- Consistency
- disclosure

Centralized
SSBs

- Independence
- competence

External
providers

- Private mechanisms are Limited
- Financial Media not concerned
- External Auditors less concerned with assessments of Shariah compliance.
- Market solutions are non existent

These challenges and issues exist for all IIFS

Challenges To The Provision Of Financial Information on IIFS

- IFRS adopted by a number of countries to enable IIFS to produce credible financial statements are wholly unsuitable for IIFS. They generate financial statements that may incorrectly reflect the IIFS' performance
- While AAOIFI's standards, developed specifically to IIFS, would enable the accounting system to deal adequately with IIFS specificities, they may however make cross-sector comparisons difficult

Islamic Financial Services Board Guidelines

- The IFSB has developed seven guiding principles collectively referred to as **the Guiding Principles**, of prudential requirements in the area of corporate governance for institutions offering only Islamic financial services (**IIFS**).
- The Guiding Principles are divided into four parts:
 - (i) general governance approach of IIFS;
 - (ii) rights of investment account holders (**IAH**);
 - (iii) compliance with Islamic *Shari'ah* rules and principles; and
 - (iv) transparency of financial reporting in respect of investment accounts.
- The Guiding Principles are designed to facilitate IIFS in identifying areas where appropriate governance structures and processes are required, and to recommend best practices in addressing these issues.

Recommendations On Enhancing IIFS CG Arrangements

- Internal Issues to be addressed:
 - Protection of minority shareholders;
 - Increased disclosure;
 - Commingling of resources;
 - Balancing UIA holders risks & rights;
 - Utilization of reserve funds;
- External Issues to be addressed:
 - Recognizing the specificity of IIFS within the broader institutional infrastructure would contribute to greater transparency;
 - Developing regulatory frameworks acceptable to IIFS;
 - Private self-regulatory initiatives providing channels to market discipline;

Hawkamah's Approach To CG In IIFs

- To address Internal Issues:

- 1- Undertake an assessment of IIFs focusing on Protection of minority shareholders; Increased disclosure; Com- mingling of resources; Balancing UIA holders risks & rights and Utilization of reserve funds;
- 2- develop an improvement of CG plan where all the above issues are addressed respectively.

- To address External Issues:

- Set up an IIFS Hawkamah Advisory group in the MENA region which works on highlighting the specificity of IIFS within the broader institutional infrastructure;
- Developing regulatory frameworks acceptable to IIFS & IIFS corporate governance guidelines based on the Islamic Finance Board guidelines.
- Develop private self-regulatory initiatives providing channels to market discipline;

What Can Hawkamah Do For Shariah Compliant Institutions?

Partnership to improve CG in Shariah compliant institutions and markets

On the firm Level:

- Undertake an assessment of CG
- Conduct an Asset Managers CG Training program.
- A Board Development Training program.
- Board Secretary Training Program.

On the institutional level:

- Set up a Task Force devoted to the development and finetuning of shariah compliant corporate governance.
- Development of corporate governance guidelines & criteria for loans and investments
- Develop a corporate governance rating system for Shariah Compliant Banks and Financial Institutions
- Workshops, Seminars and Conferences.
- International IIFS Taskforces.

Rating And Islamic Indices

- Islamic Rating Agency of Bahrain (IIRA), is the first Islamic International Rating Agency which provides sovereign ratings, Credit Ratings, Shariah Quality Ratings and Corporate Governance Ratings.
- Dow Jones Islamic Index is the first of its kind. It has an independent Shariah Supervisory Board counsels Dow Jones Indexes on matters related to the compliance of index-eligible companies

Models Of Shariah Governance From Selected Countries

MALAYSIA Model

PAKISTAN Model

KUWAIT Model

BAHRAIN Model

U.A.E. Model

QATAR Model

Malaysian Model

- ❑ The establishment of **Shariah Advisory Council** at Bank Negara Malaysia by virtue of **section 16B** of the **Central Bank of Malaysia Act 1958 (CBA)**

- ❑ The SAC is **the final authority** in matters relating to—
 - ❑ Islamic banking business,
 - ❑ takaful business,
 - ❑ Islamic financial business,
 - ❑ Islamic development financial business, or
 - ❑ any other business which is based on Shariah principles and is supervised and regulated by Bank Negara Malaysia

Malaysian Model (...contd)

- ❑ The SAC of BNM will be referred to by the court or arbitrator in disputes involving Shariah issues in Islamic banking & finance and takaful
- ❑ In the case of the arbitrator, the SAC's resolution "shall be binding" on the arbitrator (obligatory)
- ❑ In the case of the court, the SAC's resolution "shall be taken into consideration" on the court (advisory)

Malaysian Model (...contd)

- ❑ BNM also issued “**Guidelines of the Governance of Shariah Committees for Islamic Financial Institutions (BNM/GPS1)**” which provides that –
- ❑ A Shariah body which is to be known as a “**Shariah Committee**” is to be established by each and every Islamic banks, Islamic windows & takaful operators
- ❑ Relationship – all these **Shariah Committees** play a **complementary role** to the SAC of BNM

Malaysian Model (...contd)

- ❑ **Restrictions** imposed –
- ❑ Members of SAC of BNM are **not allowed to serve** in the Shariah Committee of any financial institutions (by virtue of s. **16B (6) of the CBA 1958**)
- ❑ **One Shariah advisor** can only serve as a member of Shariah Committee in **one financial institution in the same industry** (Islamic banking and takaful are considered as different industries)

Pakistan Model

- ❑ The establishment of **Shariah Board** at the State Bank of Pakistan (SBP)
- ❑ **Shariah Board** is the **sole authority** in matters pertaining to Islamic finance
- ❑ **Requirement** for the establishment of **Shariah advisor** for the Islamic financial institution

Pakistan Model (...contd)

- ❑ Any member of Shariah Board at the SBP is allowed to serve as Shariah advisor of a financial institution (different from Malaysian situation)
- ❑ Restriction imposed – a Shariah advisor is allowed to serve only one financial institution
- ❑ No division of industries as in the Malaysian situation has been made

Kuwait Model

- ❑ Kuwait is practicing **self regulation** of Islamic financial institutions
- ❑ There is **no Shariah Advisory Council** at the Central Bank of Kuwait
- ❑ **Section 10, Chapter 3, Central Bank of Kuwait Law 32/1968** provides that every Islamic financial institution shall have its own **Shariah Supervisory Board**

Kuwait Model (...contd)

- ❑ In the case of **conflict of opinions** among members of the Shariah Supervisory Boards concerning a Shariah ruling, the **Board of Directors** of the designated Islamic FI may **transfer** the matter to the “Fatwa Board” in the **Ministry of Awqaf and Islamic Affairs** (this is not compulsory)
- ❑ **The Fatwa Board** in the Ministry of Awqaf and Islamic Affairs shall be the **final authority** on the matter
- ❑ This Fatwa Board is an **external body** to the Central Bank of Kuwait

Kuwait Model (...contd)

- ❑ **No restriction** is mentioned/found in the law
- ❑ **From the existing practice**, it can be said that there is **no restriction** for the members of the Fatwa Board **to serve** in any Islamic financial institution
- ❑ Similarly, **there is also no limitation** to serve as a member of Shariah Supervisory Board of more than one Islamic financial institution

Bahrain Model

- ❑ Establishment of **National Shariah Board** of the Central Bank of Bahrain – to serve and to verify the Shariah compliance of **its own products only**
- ❑ All other Islamic financial institutions shall establish “**Shariah Supervisory Committee**” and comply with the AAOIFI's **Governance Standards for Islamic Financial Institutions No. 1 and No. 2**
- ❑ **No restriction** for the member of National Shariah Board to serve any financial institution, also **no limitation** to serve only one institution

U.A.E Model

- ❑ Establishment of “Higher Shariah Authority” to supervise Islamic banks, financial institutions and investment companies (Art. 5, Federal Law No. 6 of 1985)
- ❑ This Authority shall be accorded the final authority in Shariah matters in Islamic banking and finance
- ❑ Formation of Shariah Supervision Authority at the financial institution level (Art. 6 of the same Law)
- ❑ Nothing is mentioned about any restriction

Qatar Model

- ❑ Practicing **self regulation** of Islamic banks
- ❑ **No Shariah Advisory Board** at Central Bank of Qatar. But has “**Supreme Shariah Council**” attached to Awqaf Ministry – any issue can be **directed to the Council** for clarification
- ❑ Central Bank of Qatar **appoints Shariah scholars** to solve any problem encountered on **case-to-case basis**
- ❑ **No restriction** on Shariah advisors to be a member of Shariah Board in more than one Islamic FI

Summary of the Models

COUNTRY	SHARIAH AUTHORITY		FINAL AUTHORITY	RESTRICTION
	Central Bank	IFI		
Malaysia	SAC	SC	SAC	1) Members of SAC cannot serve IFI 2) One SA can only serve one IFI in same category (Banking & Takaful)
Pakistan	SB	SA	SB	1) Members of SB can serve IFI 2) One SA can only serve one IFI (no category mentioned)
Kuwait	n/a	SSB	SSB*	No restriction is mentioned
UAE	HSA	SSA	HSA	No restriction is mentioned
Bahrain	NSB	SSC	NSB	No restriction is mentioned
Qatar	N/A	SSB		No restriction is mentioned

*In case of dispute: Fatwa Board in the Ministry of *Awqaf* and Islamic Affairs

Thank You

