
Chapter 7. Corporate Governance for Islamic Financial Institutions

For Islamic financial institutions, the adoption of best practices for corporate governance is crucial for competing effectively on the world stage and to preserve the institutions' reputations. Sound corporate governance—for Islamic and conventional enterprises—is an imperative for long-term success. By fostering a culture based on ethics and accountability, strong governance policies and practices serve to enhance corporate value and support stakeholder interests.

Good corporate governance is needed to address the opaqueness inherent in the management of financial institutions. Particularly for an outsider (potential and existing customers and investors), assessing investment performance, the performance or profitability of the institution itself, the risks taken, and the presence of outright ethical or legal violations is hard. Therefore, regulatory bodies play an important role as watchdogs for both conventional and Islamic banks. Because of their profit-and-loss-sharing model and newness on the scene, however, Islamic banks pose special corporate governance challenges, especially with regard to the rights of investment account holders and in the setting up of a *Shari'a* supervisory board to ensure compliance with *Shari'a* principles.

Corporate Governance

The term “corporate governance” refers to the way an organization is directed, administered, or controlled. It includes the set of policies and practices that affect managers' decision making and contribute to the way a company is perceived by current and potential stakeholders. Good corporate governance procedures ensure that the management team is held properly accountable and promote personal integrity, strong internal controls, and appropriate risk management practices at the institution.

Corporate governance generally has two components: self-governance and statutory regulation. Self-governance relates to areas that are difficult to legislate, such as leadership transition, independence of the board of directors, appraisal of directors' performance, and directors' relationships with managers (Nordin 2002). Statutory regulation encompasses the rules and regulations of governing authorities that companies must comply with. Regulatory statutes typically cover the duties, obligations, rights, and liabilities of directors, controlling shareholders, and company officers. They also generally apply to the timeliness and quality of corporate disclosures, as well as accounting standards and practices.

Corporate Governance in Islam

The Islamic concept of corporate governance emphasizes the traits that Allah (God) expects in people: accountability, transparency, and trustworthiness (Mustapha and Salleh 2002). Thus, according to Islam, a company's managers and staff, by virtue of their individual responsibility to religious principles, are accountable to the shareholders, customers, regulatory bodies, and society at large. In Islam, self-governance is encouraged by the principle of *tawhid*, which promotes the need to submit fully to God. *Tawhid* focuses on the unique relationship between people and Allah and seeks to prevent people from behaving in a harmful way toward all living creatures. Acting responsibly toward others and being responsible for oneself is an *amanah* (literally, trust), or act of the free will given by God. Neglecting personal and social responsibilities is a form of *khianat* (betrayal) in the eyes of God. Muslims are also called to be dedicated to their work. Work and dedication to work are a form of *ibadah* (worship) and are viewed as an *amal salih* (virtuous act). Acting with integrity is required of a practicing Muslim under the principle of *khilafah* (trusteeship). All of these aspects of Islam support the goal of strong corporate governance.

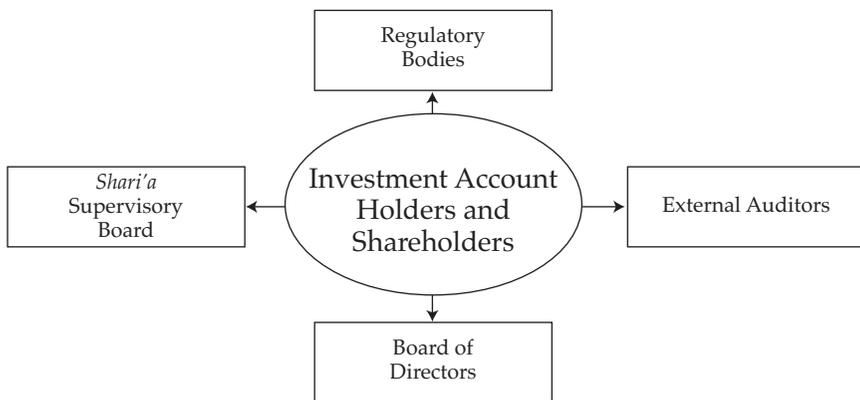
Shari'a governs Islamic financial institutions just as it governs individuals and their actions. The aim of *Shari'a* for financial institutions is to support Islamic financial practices that do not exploit or do injustice to the institution's shareholders and customers. Three basic elements of the Islamic faith provide the foundation for corporate governance in Islamic banking (Haron and Shanmugam 1997): (1) *aqidah*, which concerns all forms of faith and belief in Allah, (2) *Shari'a*, the law, which concerns practical actions taken by Muslims in manifesting their faith and beliefs, and (3) *akhlak*, which covers all aspects of a Muslim's behavior, attitude, and work ethic (see Chapter 2 for more information about these concepts). Islam inculcates into the faithful the principles necessary for strong corporate governance by providing spiritual backing to these tenets, which enforces their adoption among believers.

In fact, some Islamic scholars have argued that strict adherence to Islamic religious principles is sufficient to counter the problems of conflicts of interest in incentive that are inherent in financial institutions, such as an institution's *ex post* determination of the client's share of profits and an institution's unilateral decision-making ability in investing client funds. The argument is that the Islamic moral code will prevent Muslims from behaving in ways that are ethically unsound and that Islamic religious ideology acts as its own incentive mechanism to reduce the inefficiency that arises from asymmetric information and moral hazard (Suleiman 2005). Prudent managers of financial institutions, however, do not depend on the individual's relationship with his or her God to ensure compliance with legal and ethical obligations; additional measures should be taken.

Corporate Governance Framework in Islamic Financial Institutions

An Islamic corporate governance framework has been developed by regulatory bodies and/or central banks in various countries to facilitate good governance practices and end poor governance practices at Islamic financial institutions. The important components of the framework are illustrated in Figure 7.1. The framework provides standards and guidelines that are in accordance with *Shari'a*; addresses the intermediary and multifaceted roles of Islamic financial institutions; seeks to ensure accountability, transparency, and an adequate division of power among stakeholders; and seeks to avoid conflicts of interest.

Figure 7.1. Responsible Parties for Implementation of Corporate Governance



Islamic banks operate on the principle of profit-and-loss sharing. Thus, the funds contributed by investment account holders are more than mere deposits; they are, in part, equity investments. Investment account holders lack some of the rights that a shareholder enjoys, however, even though, like shareholders, they are a type of equityholder with residual claims to their share of the bank's assets (Archer, Abdel Karim, and Al-Deehani 1998).

Hence, an Islamic corporate governance framework should encompass the interests of all stakeholders, including the fair treatment of minority shareholders and investment account holders at Islamic banks, as is encouraged in the Islamic faith under the concept of *taqwa* (righteousness). The governance framework should also encourage transparency and disclosure regarding decision making in all areas of an institution's professional competence, which is of paramount importance to investment account holders because their funds are normally pooled together with those of shareholders. The framework prescribes disclosure rules, firewalls to protect against conflicts of interest, and sanctions for breaches.

The governance structures of Islamic financial institutions are distinguished from conventional governance structures by the addition of a *Shari'a* advisory body. Usually, each Islamic financial institution has its own in-house religious advisers who compose the *Shari'a* supervisory or advisory board and whose responsibility is to ensure that the institution's business practices and products conform to Islamic law. The existence of the advisory board mitigates the institution's exposure to fiduciary and reputational risks related to Islamic standards of compliance, which, in turn, boosts the confidence of Muslim shareholders and the *ummah* (Muslim community) in the institution.

Islamic corporate governance practices may require the composition of the *Shari'a* advisory body to be disclosed and all *fatwa* (religious opinions) issued by the advisory body to be published. Such public disclosures strengthen stakeholders' confidence in the credibility of the institution's assessment of its *Shari'a* compliance. The roles of various parties in the corporate governance framework as practiced in Malaysia are illustrated in **Exhibit 7.1**.

To provide sufficient oversight and to protect the interests of the investment account holders, the Malaysia-based Islamic Financial Services Board (IFSB), which issues standards and guiding principles for the Islamic financial industry, has advocated the creation of a special corporate governance committee at each institution. The IFSB has stated that the committee should be established by an institution's board of directors and that it should comprise three members: a nonexecutive director selected on the basis of experience and ability, an audit committee member, and a *Shari'a* scholar, who may be a member of the company's *Shari'a* supervisory board.

Exhibit 7.1. Illustration of Roles of Elements in a Corporate Governance Framework

Body	Tasks	Reports
SC and BNM SAC	Promulgate national <i>Shari'a</i> rulings, opinions, and policies	<i>Shari'a</i> rulings and basis; approved products and services
SC and BNM supervisory review	Conduct supervision of IFI <i>Shari'a</i> opinions and policies	Specific guidelines and reports on <i>Shari'a</i> compliance
<i>Shari'a</i> supervisory boards and <i>Shari'a</i> committees	Formulate and review financial institution's <i>Shari'a</i> opinions and policies	Comprehensive <i>Shari'a</i> supervisory report
External auditors	Undertake financial audit to express true and fair opinion	External audit report
Boards of directors; audit and governance committees	Structure internal control processes and activities of an institution to be <i>Shari'a</i> compliant	Statement of corporate governance

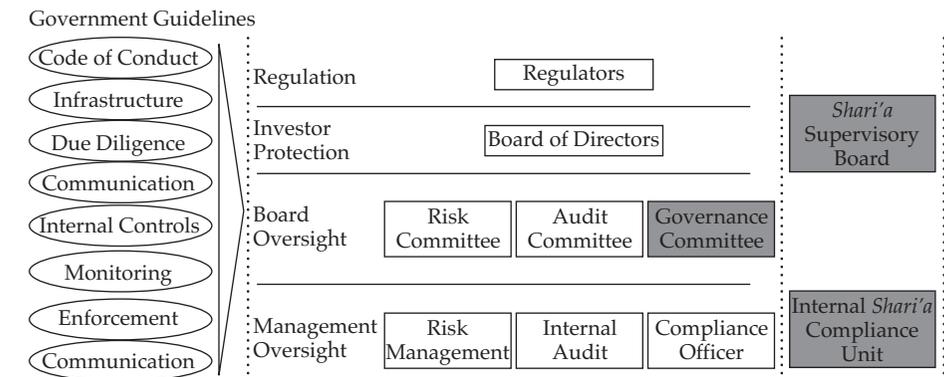
Note: SC = Securities Commission Malaysia; BNM SAC = Bank Negara Malaysia *Shari'a* Advisory Council; IFI = Islamic Financial Institution.

Source: Alhabshi 2007.

To summarize, because investment account holders and shareholders of the same institution are exposed to similar risks—through the principle of *mudharabah* (risk sharing)—but investment account holders do not always receive proportionate rewards for those risks, special care must be taken to protect the interests of investment account holders (see Chapter 3 for more information on the mechanics of Islamic investment accounts).

Figure 7.2 depicts the recommended governance structure for a typical Islamic financial institution.

Figure 7.2. Governance Structure for an Islamic Financial Institution



Source: Stanley (2008).

Islamic Corporate Governance Models in Various Countries

In this section, we compare the corporate governance models for Islamic financial institutions in Malaysia, Pakistan, Kuwait, Bahrain, the United Arab Emirates, and Qatar.

Malaysia. Bank Negara Malaysia (BNM), the Malaysian central bank, monitors and supervises Islamic financial institutions in Malaysia (also refer to Exhibit 7.1). Financial institutions are governed by the Islamic Banking Act 1983, which stipulates that a financial institution must have an internal *Shari'a* supervisory board consisting of three to seven Muslim religious scholars. BNM has also issued “Guidelines on the Governance of *Shari'a* Committees for Islamic Financial Institutions.”

BNM established the national *Shari'a* Advisory Council (SAC) under Section 16B of the Central Bank of Malaysia Act 1958. The work of the council and the *Shari'a* committees of individual financial institutions are complementary, as shown in Exhibit 7.2. The SAC arbitrates disputes and is the final authority on all matters

Exhibit 7.2. Malaysia Model: *Shari'a* Advisory Council and *Shari'a* Committees at Islamic Financial Institution

<i>Shari'a</i> Advisory Council	<i>Shari'a</i> Committee at Islamic Financial Institution
<ul style="list-style-type: none"> • Independent central <i>Shari'a</i> council commands public confidence. • <i>Shari'a</i> council promotes harmonization and uniformity of <i>Shari'a</i> interpretations. • Council is the highest authority on <i>Shari'a</i> matters and a reference point for court decisions. 	<ul style="list-style-type: none"> • <i>Shari'a</i> committee provides checks and balances to ensure <i>Shari'a</i> compliance. • Committee advises Islamic financial institution on <i>Shari'a</i> matters. • Committee endorses <i>Shari'a</i> compliance manuals and product documentations. • Committee assists in internal audit of Islamic financial institution as to <i>Shari'a</i> compliance.

Source: Ibrahim (2007).

pertaining to Islamic finance in Malaysia, including *takaful* (Islamic insurance). (Remember that Islamic banking and *takaful* are considered separate industries.) Its resolutions are binding, and when a *Shari'a*-related dispute is under the jurisdiction of the Malaysian legal system, the SAC advises the court.

Members of the national *Shari'a* Advisory Council cannot serve on the *Shari'a* committee of a financial institution, and each *Shari'a* scholar can serve as a *Shari'a* committee member of only one financial institution in a particular industry.

Pakistan. Pakistan has adopted an unusual three-tier *Shari'a*-compliance structure to ensure “deep and extensive” supervision of *Shari'a* compliance. The structure consists of the following components: (1) internal *Shari'a* advisers for Islamic banks, (2) a national *Shari'a*-compliance inspection unit, and (3) a national *Shari'a* advisory board established by the State Bank of Pakistan, the central bank (Akhtar 2006).

The *Shari'a* board established by Pakistan’s central bank is the final authority on all matters pertaining to Islamic finance in the country. A member of the national *Shari'a* advisory board is allowed to serve concurrently as a *Shari'a* adviser of a financial institution, unlike the rules promulgated in Malaysia. But similar to the Malaysian system, a *Shari'a* adviser can serve only one financial institution at a time (Hasan, Zulkifli, 2007).

Kuwait. The Central Bank of Kuwait regulates Islamic banking institutions domiciled in the country under the Central Bank of Kuwait Law of 1968. Kuwaiti banks are required to have an independent *Shari'a* advisory board when applying for registration under Article 93 of the 1968 law. Each bank’s advisory board is required to have at least three members, all of whom are appointed by the Central Bank of Kuwait. A financial institution must thoroughly disclose in its memorandum of agreement and articles of association presented to the Central Bank of Kuwait details governing the creation, jurisdiction, and procedures of its advisory board.

Conflicts of opinion among members of an institution's *Shari'a* advisory board concerning a *Shari'a* ruling may be referred by the board of directors of the institution to the Fatwa Board in the Ministry of Awqaf and Islamic Affairs, which is the final arbiter. A bank's advisory board is required to submit to its board of directors an annual report listing its opinions on the bank's operations with regard to *Shari'a* compliance. This report then becomes part of the bank's annual report. A bank's *Shari'a* advisory board reports directly to the Ministry of Awqaf and Islamic Affairs, not to the Central Bank of Kuwait. Islamic scholars may serve concurrently on the *Shari'a* advisory committees of more than one financial institution.

Bahrain. In Bahrain, financial institutions are required to establish their own *Shari'a* supervisory committees and comply with the Bahrain-based Accounting and Auditing Organization of Islamic Financial Institutions' "Governance Standards for Islamic Financial Institutions No. 1 and No. 2." The Central Bank of Bahrain has established a national *Shari'a* board, but the jurisdiction of this board is limited to verification of *Shari'a* compliance in the central bank's activities.²³

United Arab Emirates. The Higher Shari'ah Authority supervises Islamic financial institutions in the United Arab Emirates (UAE) to ensure that transactions are compatible with the principles of *Shari'a*. It is the final authority on all matters relating to Islamic finance. The Higher Shari'ah Authority was established under Article 5 of Federal Law No. 6 (1985).²⁴ The 1985 law requires that each financial institution domiciled in the UAE form a *Shari'a* supervisory board with a minimum of three members whose appointments must meet the approval of the Higher Shari'ah Authority.²⁵

Qatar. Islamic banks in Qatar have their own *Shari'a* advisory boards. *Shari'a* advisory board members are not restricted from serving on the board of more than one financial institution (Hasan, Aznan bin, 2007). The Qatar Central Bank does not have a national *Shari'a* advisory board; it appoints *Shari'a* scholars to issue rulings on a case-by-case basis. The Supreme Shari'a Council at the Awqaf Ministry may arbitrate disputes.

International Islamic Standard-Setting Bodies

A number of multilateral institutions issue standards and best practice guidelines not necessarily related to *Shari'a* compliance for the rapidly growing but fragmented Islamic financial industry. These standards and guidelines are not legally binding, but they may become mandatory if approved by national regulatory authorities.

²³For more on Bahrain Islamic Bank, see Islamic Finance News Portal posts: <http://islamicfinanceupdates.wordpress.com/tag/bahrain-islamic-bank>.

²⁴See <http://centralbank.ae/pdf/LawNo6-1985-IslaminBanks.pdf>.

²⁵For more on these policies, see the Central Bank of the UAE at www.centralbank.ae.

Compliance with such standards helps an institution achieve a good reputation globally and win customer confidence. The international standard-setting bodies also help governments and supervisory agencies gain a better understanding of the marketplace and may play a key role in promoting financial stability across the markets.

The goals of the international Islamic standard-setting organizations are as follows:

- to promote good corporate governance, enhance transparency, and strengthen market discipline;
- to support research and development in areas that are critical for financial stability; and
- to provide a platform for regulators and interested stakeholders to discuss and share expertise and experiences.

Exhibit 7.3 outlines the governing purpose and mission of the major international Islamic standard-setting bodies.

Challenges to Effective Islamic Corporate Governance

Developing a strong framework for governance, supervision, and regulation of Islamic banks is a challenge for the Islamic financial industry today. In this section, we discuss several topics that are necessary for achieving best practices in Islamic corporate governance as highlighted by Nafis and Shanmugam (2007) and Akhtar (2006).

An Internationally Recognized Regulatory System. Significant fragmentation exists among the countries with Islamic financial institutions as to the scope of corporate governance and regulation of these institutions. The ability of Islamic banks and financial institutions to grow and compete globally requires the establishment of an internationally accepted regulatory body. Some countries have adopted the view that Islamic banks should be subject to a supervisory and regulatory regime that is separate from that of conventional banks. Other countries, however, see no problem with having Islamic banks and conventional banks regulated under the same regime, although they recognize the distinctiveness of Islamic banking. The UAE, Qatar, and Malaysia are among the countries that have adopted a single regulatory system.

A Level Playing Field. In many non-Muslim countries, Islamic and conventional institutions are not on a level playing field because of the different nature of financial contracts that Islamic institutions use and the required legal documentation, regulatory requirements, and *Shari'a*-enforcement rules. At present, most Islamic banks, whether in Muslim or non-Muslim countries, operate under a dual banking system; the exceptions are Iran and Sudan, which allow only Islamic banks. Until a single international regulatory framework for Islamic banking is adopted, continued growth of Islamic banking and financing—especially in countries with dual banking systems—requires the creation and maintenance of a level playing field for Islamic and conventional financial institutions.

Exhibit 7.3. Primary International Islamic Standard-Setting Organizations

AAOIFI	The Accounting and Auditing Organization for Islamic Financial Institutions prepares and issues accounting, auditing, and corporate governance standards, as well as ethics and <i>Shari'a</i> standards, for Islamic financial institutions. It has also planned a Certified Islamic Public Accountant program for accountancy education. www.aaofi.com
IFSB	The Islamic Financial Services Board serves as an international standard-setting body for regulatory and supervisory agencies. It has pronounced on corporate governance, risk management, capital adequacy, supervisory review processes, transparency, market discipline, recognition of ratings on <i>Shari'a</i> -compliant financial instruments, and the development of money markets. It also arranges summits, conferences, and workshops on issues relating to Islamic banking. www.ifsb.org
MASB	The Malaysian Accounting Standards Board's primary role is to develop accounting and financial reporting standards. Its financial reporting standards are developed in harmony with the international accounting standards organization and the AAOIFI. The standards are developed specifically to meet the needs of Islamic financial practices as well as the needs of the regulatory and economic structure in Malaysia. www.masb.org.my
GCIBFI	The General Council for Islamic Banks and Financial Institutions is an international autonomous not-for-profit corporate body that represents Islamic banks and financial institutions globally. Its key aims are as follows: <ul style="list-style-type: none"> • disseminating information on <i>Shari'a</i> concepts and the rules and provisions related to them in order to help develop the Islamic financial industry, • enhancing cooperation among its members, • providing information related to Islamic financial institutions, and • promoting the interests of its members and helping them overcome common difficulties and challenges.
IIFM	The International Islamic Financial Market is one of the core infrastructure institutions of the Islamic financial industry. The not-for-profit organization was founded jointly by the central banks and monetary authorities of Bahrain, Brunei, Indonesia, Malaysia, and Sudan and the Islamic Development Bank (Jeddah, Saudi Arabia). Its primary function is to enhance cooperation among Islamic countries and their financial institutions, specifically in promoting trading in the secondary market for <i>Shari'a</i> -compliant financial instruments. www.iifm.net
IIRA	The Islamic International Rating Agency started operations in July 2005 with the aim of assisting the development of regional financial markets. It assesses the risk profiles of market participants and financial instruments to help inform investor decision making. www.iirating.com
LMC	The Liquidity Management Centre seeks to develop an active secondary market for short-term <i>Shari'a</i> -compliant treasury products. It helps Islamic financial institutions effectively manage their asset/liability mismatch and improve the quality of their portfolios.
BIS	The Bank for International Settlements of Basel, Switzerland, fosters international monetary and financial cooperation and serves as a bank for central banks. This international body has issued guidelines to mitigate supervisory issues and improve the quality of banking supervision worldwide. Like conventional banks, Islamic financial banks have to comply with Basel and Basel II guidelines. www.bis.org
IMF	The International Monetary Fund was established to promote international monetary cooperation, financial stability, and arrangements for reforming the international financial system. Among its goals are to foster economic growth and support high levels of employment. It also provides temporary financial assistance to countries to help ease balance of payment problems. www.imf.org

Risk Management. *Shari'a* compliance procedures and risk management in Islamic financial institutions are currently hampered by discrepancies in interpretation by the *Shari'a* supervisory boards of the individual financial institutions and by the lack of a single Islamic financial regulatory body.

As we have noted, the Islamic financial model is built around the concept of risk sharing between the provider and user of funds. Thus, investment risk must be managed. Although profit-and-loss sharing may shift risks to investment account holders and bank depositors, it may also expose the Islamic banks themselves to risks normally borne by equity investors. Also, with the blurring of the distinction between depositor and equityholder in the profit-and-loss-sharing model, the bank may have an increased exposure to risk because this model has no concept of a borrower being in default (with an exception of negligence or mismanagement), so the bank may or may not have ways to recover collateral, as is possible in conventional banking.

Disclosure and Transparency. Information disclosure is crucial in an Islamic financial environment because of the absence of protection for investment account holders and bank depositors. Aside from helping Islamic bank stakeholders make reasonably informed business and investment decisions and enabling depositors and creditors to monitor a bank's performance, adequate disclosure also helps oversight bodies exercise effective supervision of banks and other financial institutions.

Additional disclosure is needed in the areas of bank administrative policies, investment strategies, and financial performance. Customers should be informed on a consistent and timely basis about the bank's methods of profit calculation, its asset allocation decisions, and the mechanics of return smoothing (if any) in their investment accounts.

Islamic financial institutions should also be transparent in their adoption and application of *Shari'a* principles and rules issued by religious scholars and in disclosing information about the structure of products and the products' strengths and weaknesses. This issue has been debated with increasing vigor within the Muslim community.

Responsibility and Accountability of *Shari'a* Supervisory Body. The demarcation needed in a conventional bank between the board of directors and the managers has an analogy in Islamic finance—namely, the demarcation needed between the role and functions of the *Shari'a* advisory committee or special *Shari'a* board and the management of the Islamic bank. Because of the faith-based nature of the business, the *Shari'a* adviser will obviously review most aspects of the businesses, but the involvement should focus on approval of the basic structure of products and other special activities, not the day-to-day operations of the business. The *Shari'a* adviser, however, has to be more involved than an outside board member or adviser in a conventional bank.

Shortage of *Shari'a* Scholars. Not enough *Shari'a* scholars with financial expertise exist to engage in the kind of careful oversight that Islamic banking requires. Thus, the pool of overseers trained in both *Shari'a* and finance must be increased (Khir, Gupta, and Shanmugam 2007).

The shortage of sufficiently qualified *Shari'a* scholars means that in countries where it is allowed, scholars often serve concurrently on the *Shari'a* supervisory boards of a number of firms. This practice raises concerns about a board's ability to exercise effective oversight of a firm's products and services by rigorously challenging them when necessary. Also at issue is the inevitable conflict of interest when a firm's *Shari'a* advisory board is responsible for both the annual *Shari'a* audit and the approval of products for *Shari'a* compliance. Some regulatory bodies have worked to address these concerns in a move toward better governance policies, but many have not.

Summary

Adopting strong corporate governance practices is vital to the success of conventional and Islamic banks and financial institutions. If the Islamic financial industry is to continue to grow and garner additional market share in the competitive global financial industry, widespread adoption of corporate governance best practice is imperative. The Islamic finance model, built on the Islamic religious principle of risk and profit sharing on an *ex post* basis, will benefit from increased transparency and improved disclosure of operations. The moral teachings of Islam, such as accountability, trustworthiness, and transparency, apply to its followers in all aspects of their lives, including their professional pursuits, and in the context of institutional responsibility, not individual responsibility alone. Nevertheless, an Islamic bank or financial institution must also adopt internationally acceptable corporate governance practices, operate with the oversight of the relevant national and supra-national regulatory bodies, and obey applicable regulations and laws.