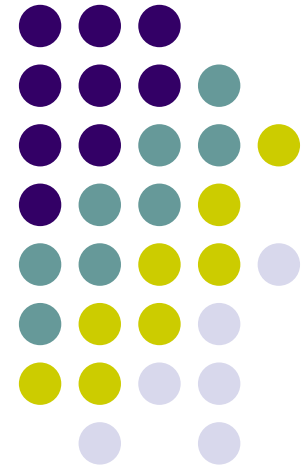


IFSB STANDARDS – A DIRECT COMPARISON TO BASEL II

An Insight into the Guiding Principles on Corporate Governance for Institutions offering Islamic Financial Services (“IFS”)



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PRESENTATION OUTLINE



6 November 2007

- Understanding the motivating factors
- Defining ‘corporate governance’ (**CG**) and ‘stakeholders’ in the context of institutions offering Islamic financial services (**IIFS**)
- CG issues specific to IIFS
- An insight of the IFSB Guiding Principles of CG for IIFS (**IFSB3**)

UNDERSTANDING THE MOTIVATING FACTORS



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Separation of ownership & control

- Agency problems occur when the principal (investors) lacks the necessary power or information to monitor and control the agent (managers) and when the incentive of the principal and agent is not aligned.
- When contracts are incomplete and managers possess more expertise than investors, managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behaviour.
- The challenge for good CG is in ensuring how the providers of capital can influence the managers to meet such wider obligations as may in the circumstances be pertinent.

UNDERSTANDING THE MOTIVATING FACTORS (2)



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Information asymmetries

- In the case of financial institutions there are particular issues - the ability of 'outsiders' to monitor and in particular evaluate the performance and conduct of the managers may well be difficult.
- This opaqueness makes it easier and more likely for managers and large investors to manipulate board of directors and exploit the private benefits of control.
- In such circumstances suspicions of insider dealing and abuse may be detrimental not only the institution in question and those responsible for management, but the market as a whole.

UNDERSTANDING THE MOTIVATING FACTORS (3)

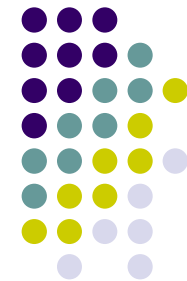


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Balancing stakeholders' protection

- The conventional approach - Anglo-American model vs. Franco-German model.
- In the context of IIFS, their duties and responsibilities as *Muqārib* are set out not only in contracts and residual contracts but ultimately accountability to God.
- IIFS must carefully manage potential conflicts of interest between its various stakeholders, particularly between its shareholders and the investment account holders (IAH), bearing in mind the parameters set by the *Sharī'ah*.
- Concerns of anti-money laundering, fraud and misconduct.

UNDERSTANDING THE MOTIVATING FACTORS (4)



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Transparency and Market Discipline

- Transparency in providing timely and adequate information to IIFS investors, for example in the calculation of *Muqārib* share and profit allocation, is not only important for protecting the interest of investors but to enforce market discipline on IIFS.
- Furthermore, it would contribute in bringing about systemic stability.
- It is necessary therefore, to enhance transparency and comparability of IIFS through suitable disclosures.



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DEFINING 'CORPORATE GOVERNANCE'

A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which:

- the objectives of the company are set; and
- the means of attaining those objectives and monitoring performance are determined.

In the context of **IIFS**, good CG should encompass:

- a set of organisational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders;
- provision of proper incentives for the organs of governance such as the Board of Directors, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and
- compliance with Islamic *Shari`ah* rules and principles.

DEFINING 'STAKEHOLDERS'



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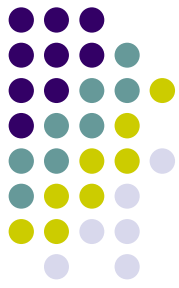
BCBS paper:

- 'Stakeholders' include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders [of banks].

From **Islamic** financial services perspective:

- 'Community' should particularly connote the Muslim Ummah.
- 'Customers' does not refer to conventional depositors and borrowers but to Investment Account Holders (**IAH**) and Current Account Holders.

ISLAMIC VIEWPOINTS ON IMPORTANCE OF GOOD GOVERNANCE



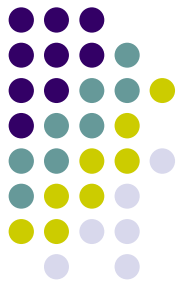
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- The concept of vicegerency - Accountability to God as well as to others. Ethics of IIFS are set out not only in contracts and residual contracts but ultimately accountability to God.
- Amongst the code of ethics set out in the Qur'an:
 - ❖ Honest fulfilment of all contracts (*Al-Māidah:1*)
 - ❖ Prohibition against betraying any trust (*Al-Anfāl:27*)
 - ❖ Prohibition against deriving income from cheating, dishonesty or fraud (*Āli Imrān :29*)
 - ❖ Prohibition against bribery to earn unfair advantage (*Al-Baqarah :188*)
 - ❖ Prohibition against concealing evidence (*Al-Baqarah :283*), for e.g. to manipulate prices

SPECIFICITIES OF IIFS

In addition to general banking matters, organs of governance of IIFS also need to attend to:

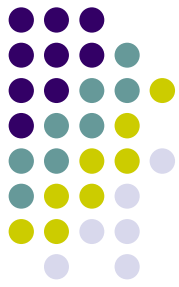
- *Sharī`ah* compliance
- Ethics & social responsibility (in line with the concept of vicegerency)
- Interests of IAH, especially unrestricted
- Potential conflicts of interest between shareholders and unrestricted IAH especially where the funds are commingled - issues of asset allocation and risk appetite
- Transparency in financial reporting, e.g. calculation of *Muqārib* share (especially where funds are commingled) and profit distribution



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CG ISSUES IN IIFS

- Protection of Investment Account Holders (“IAH”)
 - ❖ Like investors in Collective Investment Schemes (CIS), IAH are exposed to potential conflict of interest with the management of an IIFS, which may look after the interest of shareholders at the expense of IAH.
 - ❖ As in the case of securities regulators, this requires more emphasis on fiduciary responsibility or establishment of detailed regulations designed to monitor potential conflicts of interest.
 - ❖ Furthermore, adequate disclosure of relevant information about the IIFS’ investment objectives and policies, operational guidelines that govern the relationship between the IIFS and IAH, etc. should be made available.
 - ❖ Albeit IAH may have no representation in the organs of governance such as the Board of Directors or *Sharī`ah* Supervisory Board, they have every right to expect accountability and transparency on investment made on their behalf.



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CG ISSUES IN IIFS (2)

- *Sharī`ah* Supervisory Board (“SSB”)
 - ❖ SSB is a specific organ of governance. It should be concerned with **monitoring** *Sharī`ah* compliance and not just issuing edicts (*fatāwa*).
 - ❖ Since SSB members may lack monitoring skills, auditors and audit committee should act in concert to assist the SSB.
- Transparency in financial reporting
 - ❖ The current financial reporting practices of IIFS do not provide adequate information to their IAH regarding the revenues and expenses accruing to their particular investment fund.
 - ❖ IAH is rightfully entitled to transparency, e.g. calculation of *Muqārib* share and profit allocation.



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CURRENT STATUS OF CG AWARENESS AMONGST IIFS



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IFSB Survey (2004) highlights:

- Strong awareness amongst IIFS on the importance of good governance.
- Majority IIFS offer only unrestricted IA, and even for those offering restricted IA they do not address the IAH's risk appetite.
- “Smoothing of returns” has not been proven as a widespread practice, however it is appropriate that the practice be accepted with caution in order to avoid it being used to mislead the IAH on the performance of the IA.
- SSB have become almost a compulsory feature of Islamic finance. However their cost and efficiency continue to be a major concern.

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SCOPE OF IFSB3 ...(1)

Filling in the Gaps

CG aspects already covered	OECD	BCBS	IOSCO	FRC/FSA
<u>Companies</u>				
Directors/The Board	√	√		√
Remuneration/Compensation	√	√		√
Accountability and Audit	√	√		√
Relations with Shareholders	√	√		√
<u>Shareholders</u>				
Rights and Key functions	√			√
Equitable Treatment	√			√
<u>Other Stakeholders</u>				
Employees/Manager	√	√		
Regulator/Supervisor	√	√	√	
Disclosure and Transparency	√		√	√

The issue of **IIFS' accountability and transparency to its customers, particularly IAH** , as well as **Shari`ah compliance**, have not been covered or contemplated in any of the above documents.



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SCOPE OF IFSB3 ...(2)



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IFSB3 aims to cover these aspects:

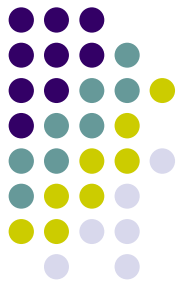
- Information environment and transparency:
 - ❖ specifying and enforcing appropriate disclosure requirements
 - ❖ fostering auditors independence and enforce the relevant and applicable auditing standards
 - ❖ the focus is very specifically on protection of the IAH's interests – not to overlap with general transparent reporting which would be covered by the Transparency and Market Discipline Standard
- Organs of governance:
 - ❖ safeguarding **interests of IAH**, especially the unrestricted
 - ❖ adequate **monitoring of *Sharī`ah* compliance**

General Governance Approach in IIFS ... (1)

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 their accountabilities to various stakeholders.

- **Main recommendations**

- ❖ The adoption of OECD and BCBS recommendations through comprehensive governance policy framework.
- ❖ Establishment of a 'Governance Committee' to implement the governance policy framework.



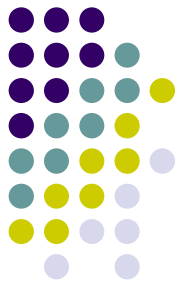
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General Governance Approach in IIFS (2)

Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Sharī`ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.

- **Main recommendation**

- ❖ Establishment of an 'Audit Committee' to ensure good implementation of internationally recognized accounting standards.

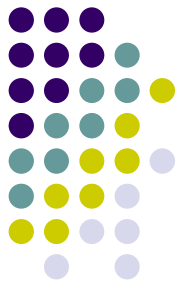


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Rights of IAH

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.

- **Main recommendation**
 - ❖ Establishment of an internal guideline that sets out adequate protection of the IAH investments, including the disclosure of relevant and material information to the IAH such as on profit allocation and investment policies.

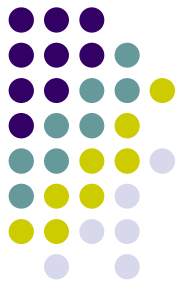


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Rights of IAH (2)

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.

- **Main recommendations**
 - ❖ Distinguishing between “profits earned” and “actual dividends payout” through appropriate disclosure.
 - ❖ The Governance Committee to oversee the utilization of any reserves for these purposes.

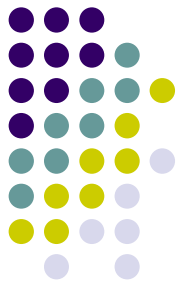


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Compliance with *Sharī`ah* Rules and Principles

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings from *Sharī`ah* scholars, applying *fatāwā* and monitoring *Sharī`ah* compliance in all aspects of their products, operations and activities.

- **Main recommendations**
 - ❖ Emphasis on *ex-post* and *ex-ante* roles of *Sharī`ah* scholars – beyond just issuing edicts.
 - ❖ Ensuring appropriate qualifications and accountability of *Sharī`ah* scholars.

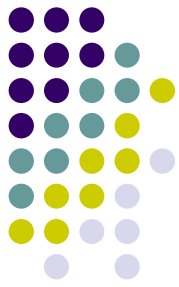


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Compliance with *Sharī`ah* Rules and Principles (2)

Principle 3.2: IIFS shall comply with the *Sharī`ah* rules and principles as expressed in the rulings of the IIFS's *Sharī`ah* scholars. The IIFS shall make these rulings available to the public.

- **Main recommendations**
 - ❖ Encouraging transparency in the process of issuing, applying or abandoning of *fatāwa* through appropriate disclosure and publications.
 - ❖ Check on the activity of *fatāwa*-shopping.



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Transparency of Financial Reporting i.r.o. IAH

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.

- **Main recommendation**
 - ❖ Making adequate and timely public announcement in annual report, website and in mainstream media organs in respect of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that the IIFS manage.



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OUTCOMES EXPECTED FROM IFSB3



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SPECIFICALLY,

- Adoption of OECD and BCBS recommendations will improve IIFS' Board of Directors' and Management's awareness of the importance of good governance, at par with international best practices
- Due recognition of IAH's rights and risks as residual claimants will lead to appropriate protection of IAH
- More professional approach for *Sharī`ah* compliance will mitigate compliance and reputational risks of IIFS
- Increased transparency in financial and non-financial reporting by IIFS will inculcate better risk management structure and discipline culture amongst IIFS

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THANK YOU FOR LISTENING



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