

Innovation Series
GLOBAL CORPORATE TRUST

Improving Corporate Governance in Islamic Finance

Sukuk-type transactions often fall short in meeting generally accepted international financial governance standards, a limitation that may hinder further expansion.



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THE PHENOMENAL GROWTH OF ISLAMIC FINANCE HAS FAR OUTPACED THE ABILITY OF REGULATORS TO ESTABLISH OR AGREE UPON BEST PRACTICES FOR ITS GOVERNANCE. WITH ISLAMIC FINANCE SET TO EXPAND INTO STRUCTURED BONDS AND CAPITAL MARKET INSTRUMENTS, WHAT CORPORATE GOVERNANCE STANDARDS CAN REGULATORS, ISSUERS, AND UNDERWRITERS ADOPT TO ENSURE THAT SUKUK AND OTHER INVESTMENTS REMAIN ATTRACTIVE TO INTERNATIONAL INVESTORS?

Islamic finance is growing worldwide, both among the world's estimated 1.5 billion Muslims (*Islamic Finance Information Service* [IFIS]) seeking Shariah-compliant investments and international investors drawn to their relatively high-yield, low-risk dividends. Growth has centered on issuance of Sukuk certificates. Ijara or asset-based Sukuk is one of the most common forms of securitization, typically sponsored by Islamic sovereign and quasi-sovereign issuers.

In August 2007, IFIS reported that the global Sukuk market hit an all-time high, with market value totaling US\$24.5 billion in the first half of 2007, or 75% growth over the prior year (*Sukuk Market Report First Half 2007*). Sovereign Sukuk issues grew by 521% to US\$4.4billion. Total Sukuk issues in 2007 are expected to reach \$50 billion, according to IFIS, and may soon reach between US\$160 billion (*S&P Direct Rating Services*) and \$200 billion (*ABANA Review Spring/Summer 2007*) by 2010.

This phenomenal growth of Islamic financing over the past five years has outpaced the development of standardized regulation. Different regions continue to apply their own standards, as do different Shariah boards. What is Shariah compliant to one board may not be approved by a different board. In addition, Islamic jurisdiction is not bound by precedent.

Good governance is consistent with Islamic principles, such as preventing gharar (risk, uncertainty, and hazard) and avoiding business transactions that cause injustice to any of the parties.

The lack of clear standards has led to some corporate governance deficiencies readily apparent when comparing Sukuk transactions to generally accepted international financial standards. In more developed markets, poorly structured transactions led to deficiencies in transparency, accountability, arms-length transactions, and other standard investor safeguards. Over time, such deficiencies took their toll, resulting in fraud, external and internal audit failure, imprudent lending, excessive risk taking, and neglect of minority shareholders' interests (Enron, Worldcom, Global Crossing, Mycal, etc.).

Good governance also is consistent with Islamic principles, such as preventing gharar (risk, uncertainty, and hazard) and avoiding business transactions that cause injustice in any form to any of the parties.

Good Governance: Good for Business

Good corporate governance is more than a noble idea. It encourages capital formation, creates incentives to engage in value-maximizing behavior, lowers the cost of capital, and fosters strong markets. At its heart are structures and processes that require individuals participating in corporate enterprise to exercise professional discretion in a way that demonstrates integrity, judgment, and transparency. These principles are central to Shariah and Islamic finance.

The adoption of best practice standards is a matter to be addressed by regulators or rule-makers. However, market participants with a vested interest in the development of sustainable local capital markets can also play a role in elevating corporate governance standards by setting market expectations for what is acceptable corporate behavior.

Structural Principles at the Heart of Good Governance

The cornerstone of corporate governance principles is the protection of the rights of residual claimants who have entrusted their financial capital to the control of a third party to obtain a return on their investment. Residual claimants may include stockholders, bondholders, and creditors, depending on the organizational form chosen for the particular business activity.

An important interest common to any residual claimant is how best to secure their economic rights of ownership when the “control rights” over the use of a particular financial asset have been delegated to an agent or trustee – usually a group of managers (board of directors) but could equally be a trustee or a professional investment manager. Such agents or trustees may be delegated with a range of powers and subject to certain duties. Normally the delegation of authority occurs pursuant to certain contractual terms. However, the overarching responsibility of any agent is to ensure that particular assets over which they have control are adequately maintained and not unnecessarily risked or left unprotected.

Where there is separation of ownership from control, governance principles are designed to mitigate the costs and risks that arise when the welfare of investors is contingent upon the actions of their agents or trustees, which is commonly known as the “agency problem.”

- 1. Avoiding conflicts of interest.** Conflicts arise where the interests of an agent conflict or may conflict with the interests of residual claimants. The classic situation is where the agent is confronted with a situation where there is the potential to derive a benefit contrary to the interests of the residual claimant. The conflict should at best be avoided or, at worst, managed by identifying the conflicting interests and reconciling them.

The first step in avoiding conflicts of interest is to establish a systemic way to disclose conflicts so that all affected parties are aware that there is a conflict. The limitation on certain behaviors provides protection for residual claimants from agent behavior that may not be in the best interests of the residual claimants.

Central to avoidance of conflicts of interest is that agent behavior be seen as ethical. As the repository of decision rights over the property rights of residual claimants, agents or trustees must demonstrate trust, honesty, and fairness. Organizational agreements and contractual arrangements should ensure agents or trustees are obliged to act with fairness to residual claimants without compromising normative standards of impartiality.

2. Avoiding conflicts of duty. Conflicts of duty occur when an agent owes a legal duty to two groups at the same time. This situation can arise from a matrix of contractual relationships, which impose obligations to make decisions that affect the rights (as opposed to interests) of two different parties. This requires the execution of the duty by the agent or trustee to be prioritized, since it is impossible to exercise conflicting duties for the maximum benefit of both parties. At a minimum, the agent or trustee would be required to disclose in advance the existence of any conflict and how these conflicting duties would be prioritized. The better approach is to avoid the conflict entirely by assigning agents or trustees to represent each party independently.



3. Avoiding related-party transactions. Related-party transactions are a subset of the “conflict” situations, and involve the ability to transfer value or confer a benefit on the related party to the detriment of a residual claimant. Parties may be related because of common ownership between the parties or the ability to control (de jure or de facto) or influence decisions of the other party. At the heart of inquiry concerning related parties is whether the existence of the relationship is fair to residual claimants. Related parties should disclose the nature of the relationship, any material terms which govern the relationship, as well as any benefits that the related parties may derive. Benefits can include giving preferential treatment to the related party in a conflict situation.

Adoption of transparent and ongoing disclosure to residual claimants is the key to improving corporate governance. Since disclosure regulates the behavioral choices agents or trustees make and assists in fixing accountability on agents or trustees performing actions on behalf of residual claimants, an agent should disclose any information that might have a bearing on the agent’s ability to carry out its agency activities effectively and free from conflict. It requires agents or trustees to report regularly (and in some cases immediately) to residual claimants information that affects their property rights and to communicate performance information to enable residual claimants to evaluate the (non)performance of their agents or trustees in the discharge of their functions.

Good corporate governance is more than a noble idea. It encourages capital formation, creates incentives to engage in value-maximizing behavior, lowers the cost of capital, and fosters strong markets.



Governance in the Context of the Sukuk Structure

A typical example of a Sukuk structure is where an entity sells certain assets (such as land, buildings, or machinery) to a Special Purpose Vehicle (SPV) for a fixed price. To raise the required funds to acquire the asset, Sukuk certificates are issued to investors. The Sukukholders thereby acquire a beneficial interest in the SPV's assets. The SPV also is appointed as Trustee for the Sukukholders (pursuant to a Declaration of Trust), holding the assets in trust for Sukukholders and obtaining an opinion (fatwa) as to the Shariah-compliant nature of the issuance. This structure raises a number of governance issues.

1. **The SPV**- The issuer's complete discretion over the configuration of the investment pool, the commingling of funds within the pool, and the ability to expend the funds without oversight or controls exposes Sukukholders to risk well beyond the accepted Islamic practice of equitable sharing of risks and gains.
2. **The custodian** - responsible for the safekeeping of the asset representing the Sukukholders' ownership interest. A custodian is ordinarily appointed by the beneficial owner of the assets or their agent and owes duties accordingly. In some Sukuk transactions the custodian has been a wholly owned subsidiary of the issuer.
3. **The Shariah Supervisory Board** - part of the internal governance structure of the Islamic financial institution and appointed by shareholders of the institution but whose remuneration is proposed by management and approved by the board. Structures and processes to ensure their independence should be paramount.



Governance for Arrangers/Lead Managers

In a Sukuk arrangement, the arranger or lead manager often acts as the Sukukholders' agent, the entity entrusted with meeting the SPV's obligations in cases of default. This dual-agency role creates conflicts that cannot simply be resolved by resigning a trusteeship or investment banking (IB) relationship within the standard 90-day period of issuer default. The dual-agency role is flawed from the start and should be avoided. Consider just three of the following built-in conflicts:

- 1. Fees.** The arranger typically receives a percentage of the overall transaction as compensation, whereas the Sukukholders' agent may be paid a much smaller fee over several years. The Sukukholder agent role therefore is offered as part of a bundled IB service.
- 2. Former and Future Arrangements.** An IB typically has a deep relationship with an issuer, one that extends well beyond the current offering and that may involve global arrangements.
- 3. Weak Chinese Walls.** Chinese walls are used to manage conflict of duties within integrated securities firms. Captive corporate trust (CT) departments have a natural symbiotic relationship with their firm's IB departments, as they are largely dependent on the IB side for revenue. That makes the captive CT department vulnerable to potential IB pressure.

Weak Governance: A Brake on Further Expansion?

With the Islamic market poised to expand into repos, structured finance, and non-sovereign offerings, improvement of corporate governance standards becomes ever more critical to the expansion of Sukuk and other financial structures. Sukuk offerings, for example, have generally been well rated by the major rating services. But these ratings come with important qualifiers that may limit further market expansion.

Moody's noted the following in its 2006 report, *Understanding Moody's Approach to Unsecured Corporate Sukuk*. "While many Sukuk may appear initially to have assets at their core, a detailed analysis of their terms and structure may show that the key securitisation elements are not in place and the credit risk is really that of the sponsor or originator. In such cases, Moody's rating is governed more by the borrower or originator, and its conventional corporate finance analysis applies. It should be noted that the legal framework in certain countries remains untested and uncertain, with sometimes little or no guidelines with regard to bankruptcy practices."

The cornerstone of corporate governance is the protection of the rights of residual claimants who have entrusted their financial capital to the control of a third party to obtain a return on their investment.

Basel 1999 and Islamic Finance Reform

In 1999, the Basel principles set forth corporate governance standards for the banking sector. Since that time, a corporate governance movement has been slowly taking shape in the Gulf region. Numerous conferences have been held on the subject, but actual implementation of reform has generally been slow.

One promising trend has been the growing acceptance of oversight boards, such as the Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Financial Service Board. These boards have no formal power, but have become increasingly influential over enforcement of accounting standards.

Governance is also beginning to improve on a country-by-country basis. Among the most promising change was the August 2006 enactment of a new Bahrain trust law. It details the obligations of trustees and trust administration services. Abdul Rahman Al Baker, Bahrain's central banker, recently told the *International Financial Law Review* ("Trust in Bahrain," August 2007) that the new law would have a substantial beneficial impact on Sukuk and other securitizations.

"It will really help the development of Islamic instruments such as Sukuk, as well as asset-backed securities and bonds," he said. "It will enable them to be structured through trusts and have an actual trustee to manage them – rather than just using a custodian as most do at the moment. While the concept of waqf is similar in some ways to a western trust under common law, the latter is far more efficient for the management of structured bonds and capital market instruments. Trusts will be a big area of growth for capital market instruments."

An independent trustee, custodian, or newly empowered Sukukholder representative could play a critical role in future Islamic finance transactions and how well they perform.

Corporate Governance and the Independent Trustee/Sukukholder Agent

The international capital markets value good corporate governance. The past decade or so has witnessed concerted international efforts to raise the standards of governance across all markets. Emerging and sophisticated capital markets alike have sought to ensure the growth, integrity, and long-term viability of their markets by insisting that issuers of public securities adopt and adhere to proper corporate governance practices.

The importance of good corporate governance to the Islamic market is similarly a prerequisite to its successful development. Good corporate governance therefore is central to helping Islamic finance reach its next level of development and in fulfilling the promise of providing millions of Muslim investors with investments in accord with the true spirit of Islam.

An independent trustee, custodian, or newly empowered Sukukholder representative could play a critical role in future Islamic finance transactions and how well they perform. History has shown that investors are best served when an independent entity manages cash and makes payments, controls the calculations done by the seller/servicer, and tracks and reports deal representation breaches and compliance with covenants.

In today's demanding and complex Islamic finance market, issuers must select an independent trustee who can assure both international and local investors that every aspect of a Sukuk or other transaction is being handled according to international best practice standards and in accordance with Shariah. Such a choice may ultimately affect the issue's rating and potential performance in developing secondary markets.



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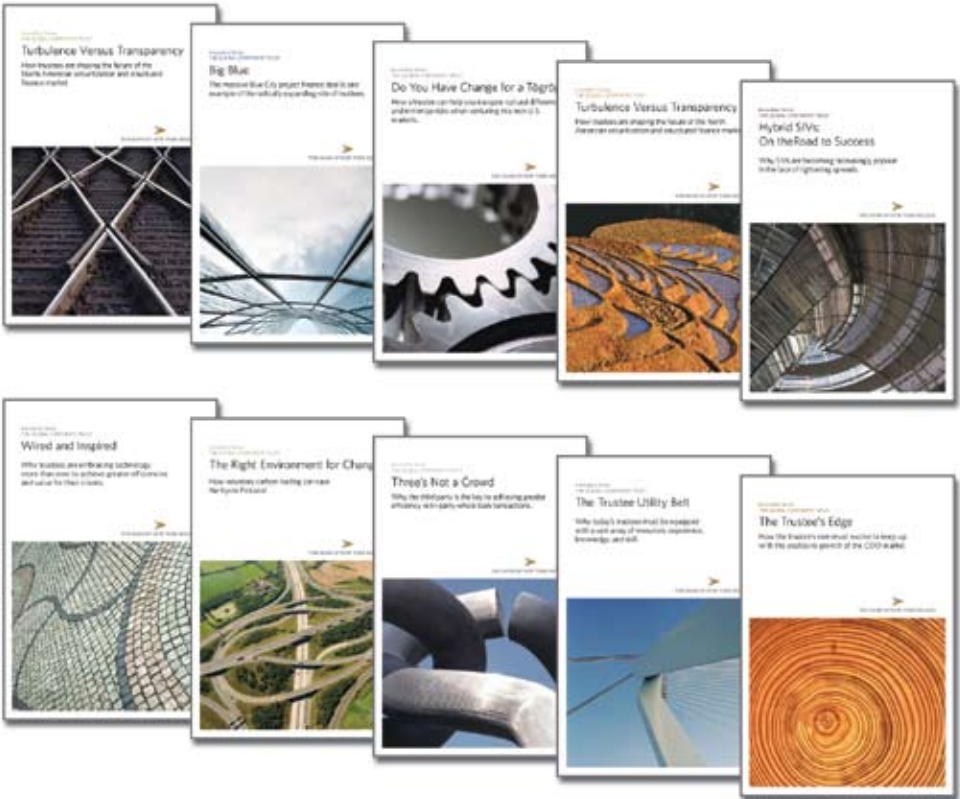
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Who's Helping You?



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Improved corporate governance is central to helping Islamic finance reach its next level of development. In this edition of the Global Corporate Trust Innovation Series, you'll learn about how an independent trustee, custodian, or newly empowered Sukukholder representative could play a critical role in overcoming current governance shortcomings.

Who's Helping You?



By Hani Kablawi



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