Shariah Compliant Corporate Governance[1]

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1. The Corporate Governance (CG) for Islamic Financial Institutions (IFIs) is assuming growing significance with the steep growth in Islamic Finance system both regionally and now globally. This industry has become a major source of wealth creation and financing of investment projects world wide and cumulative worth of its transactions are reaching a trillion dollar. IFIs provide a viable option to savers and investors who are inclined to deal with exclusively Islamic financial system given their religious and ideological stance.

2. To the extent that an IFI is principally a company structure it ought to align, adopt and abide by the generic global corporate governance principles and models including the OECD principles of Corporate Governance, originally issued in 1999[2] and other elaborate guidelines that have emerged internationally as well regionally. Islamic finance, however is a specialized industry which is based on Quran and Sunnah. It offers a distinct view on eligible financial transactions and implicitly brings to forefront a rich and superior architecture and texture to the field of corporate governance. The driving force of corporate governance for IFIs on one hand is the concept of justice, moral obligation, accountability, and equality that are fundamental to Islamic ideology and on the other hand, is the nature of permissible transactions which tend to have different risks associated with it than conventional banking business.

3. Long before the age of complex legal documentation and financial revolution, Islam prescribed the concept of writing contracts in financial transactions, and insisted that no party of any contract or exchange should be exploited. This legacy provides IFIs the foundation of good corporate governance which can be well blended and integrated and would reinforce modern principles and models of corporate governance.

4. The uniqueness of corporate governance for IFIs stems from two principle elements: (i) faith-based approach that mandates conduct of the business in accordance with Shariah principles; and (ii) profit-motive that recognizes business and investment transactions and maximization of shareholder's wealth etc. At times these elements could be perceived to be in conflict with each other and as such corporate governance framework for IFIs has to treat these tensions effectively, while providing an enabling framework that allows ample opportunities of growth and strength of the system.

5. At present Shariah Compliance standards vary across jurisdictions (see Attachment) since in absence of a well conceptualized framework, countries evolved their own framework drawing from their own needs and experiences. At the same time, IFIs encouraged product innovation which moves away from fixed-interest (riba) loan transaction to promoting a contractual arrangement for profit-sharing in businesses. The inherent risks exposures (legal, credit, market etc) in financial instruments is very different from risks associated with loans. An appropriate corporate governance framework would need to recognize these elements and identify risks and challenges associated with the different Islamic contractual arrangements and instruments. IFIs reputation is highly dependent on the

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[2] OECD Principles of Corporate Governance 2004; Include (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, and (vi) The Responsibilities of the Board.

perception of customers with respect to Shariah Compliance and issues surrounding investor's protection given the traditional reliance on the deposit products etc.

6. Key challenges that Islamic banks face need to be tackled effectively. These challenges are inter-linked and mutually reinforcing and range from:

7. *Reputational Risk arising out of any uncertainty on Shariah compliance*. Success of an Islamic financial system is based on stakeholders believe that the system is Shariah Compliant. This single factor intensifies the role of good corporate governance to ensure that the faith of stakeholders is not compromised and the system sustains and grows smoothly. The reputational risk factor i.e. loss of faith has to be managed right from the inception of an IFI and the Shariah Advisor/Board are assigned to perform their duties.

8. *Commitment of Dedicated, Qualified Directors who Understand and can assess Shariah Compliance* would facilitate effective oversight and protect the industry from overall reputation risks. Qualifications/experience of Shariah advisors is the key to judge and support the development of Shariah compliant financial services. In absence of this, there is a risk that for short term profits/gains the shareholders/BOD may become willing to compromise on the Shariah principles. The presence of Shariah literate directors would discourage precedence of profit motive over Shariah Compliance. From the regulatory point of view, the licensing stage is of particular importance whereby the licensing authority should demand a clear demonstration of sponsors' commitment to Islamic banking.

9. *Demarcation of responsibility and accountability between Board, Management and Shariah Advisor.* Akin to the demarcation issue in a conventional bank between Board of Directors and the Management; is the demarcation essential between the role and functions of Shariah Advisor or a special Shariah Board (as the case may be) as distinct from the Management/BOD. Due to faith-based nature of the business, it is evident that the Shariah Advisor will review most aspect of the businesses but the involvement could vary and focused on approval of basic structure of products and other special activities rather than interfering in day-to-day operations of businesses. Notwithstanding, Shariah Advisor has to be more mainstream than an advisor in a conventional bank. To perform their functions effectively, there is need to enhance the pool and capacities of Shariah scholars in financial business as currently the most experienced Shariah scholars are represented on Shariah Boards of different institutions. State Bank of Pakistan has taken a lead in this direction by requiring that the banks appoint one Shariah Scholar for a single bank only, according to the Fit and Proper Criteria, as a result of which, all the 18 licensed Islamic banking institutions have appointed their own Shariah advisors and new institutions are appointing Shariah advisors. This policy also ensures full time availability of these advisors to guide and monitor the banks on daily basis.

10. *Investment policy to comply with Shariah criteria*. An IFI can not invest, whether through financing or share purchase, in the companies which are engaged in *non-halal* businesses. This adds a new dimension to corporate governance which the Board and the management of the IFIs have to fulfill. The investment policy, which has to be consistent with Shariah, is a part of the encompassing corporate strategy to be approved by Board.

11. *Investors' Protection* Under the principle of Mudaraba, Investment account Holder (IAH) as Rabb-ul-Mal bears the risk of capital invested by the IFI as *Mudarib*. This equates the IAHs' investment risk with the shareholders of IFI who bears the risk of losing their capital as investors in the IFI. Given the IAH would be more risk averse than owners of IFIs, the supervisory authorities should play a role in protecting the interests of the IAH vis-à-vis the shareholders of IFIs with regard to their rights and safeguarding against commingling of funds and/or conflict of interest of shareholders.' Way for central banks offering Deposit Insurance schemes would be to devise Shariah

compliant-Deposit insurance schemes for depositors of IFIs to provide a safety net, while ensuring stability in the financial system.

12. On the financing side, if the funds are invested on *Musharaka or Mudaraba* basis, the safety of the funds invested would depend on the governance of the borrowing enterprise. The IFIs should be expected to conduct active monitoring of enterprises they invest in under *Musharaka or Mudaraba*. IFIs relationship with such enterprises ought to be of long-term nature with active involvement in governance in contrast to a short-term, transactional relationship. Among others, some expertise about business of such enterprises would be prerequisite for IFIs for them to assess appropriately business risk and to effectively monitor their operations.

13. *Disclosure and Transparency*. Transparency and disclosure of a structure of product and its strengths and weaknesses are critical and IFIs should be mandated to this discipline. IFIs should further conform to the highest international standards and practices for financial and non-financial reporting and disclosure. Moreover, IFIs should be transparent in the adoption and application of *Shariah* rules and principles issued by its *Shariah* scholars. These should be made publicly available through appropriate channels. In line with the IAHs' rights of monitoring the performance of their investments, they should be entitled to be informed of the methods of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of their investment accounts.

14. Corporate governance framework should ensure, in order to provide relevant information for investors' decisions, that the disclosure is timely and accurate on all material matters, is in accordance with high quality standards of accounting and disclosure and the audit and review of these disclosures by independent, competent and qualified auditors is carried out. The external auditors of Islamic financial institutions also need to develop expertise to conduct Shariah Compliance Audit and report on their findings to the Shareholders and general public.

15. *Harmonization of Shariah Rulings*. One of the issues faced by Islamic financial industry is lack of standardization of Shariah rulings within the same jurisdictions and among various regions. The diversity provided by different schools of thoughts on same issues at times creates confusion in the minds of general public, but if properly harmonized across the globe, can become a great strength for the Islamic financial services industry thereby providing different options suitable to the varying needs of customers. AAOIFI[3] has taken a lead by preparing Shariah standards approved by 14 renowned Shariah scholars across the world. Some countries have recognized these standards in their regulatory framework, and adoption of these standards in other countries will pave the way not only for Shariah compliance but also product innovation. In addition, the central banks/regulatory agencies monitoring the performance of Islamic financial institutions also need to establish their own Shariah Board for guiding them in formulation of policies and rules as well as for resolution of conflicting Shariah opinions.

16. *Vigilance and Oversight of the Supervisor*. As in any conventional bank, the role of the supervisor is critical in ensuring smooth functioning of the institutions. The key element of Shariah supervision is existence of a mechanism that ensures that the Islamic financial system continues to remain viable and growing without compromising the principles of Shariah. This leads me to share with you the experience of Pakistan in the area of Islamic banking.

[3] Accounting and Auditing Organization for Islamic Financial Institutions, headquartered in Bahrain. Its Shariah Board consists of 14 Shariah scholars across the world.

17. Managing corporate governance in Pakistan's IFIs is critical given the surge in their assets from Rs6.9 billion in CY02 to Rs100 billion by end October, 2006, growing at an average annual rate of above 300 percent. Growth in assets was well supported by a sharp increase in deposit base; which increased from Rs5.0 billion in CY02 to Rs70.0 billion (annualized growth rate of over 85%) by the end October, 2006. This rapid growth allowed IFIs to increase their share in the overall banking industry to around 2.6 percent.[4]

18. Positioning itself effectively the State Bank of Pakistan has established a dedicated Islamic Banking Department (IBD) that operates in close coordination with Policy and Regulatory Department and Inspection and Supervision departments to facilitate IFIs development. The IBD coordinates with rest of the SBP and banking industry to provide valuable regulatory guidance related to overall Shariah Compliance and specific issues/ challenges being faced by the Islamic banks in Pakistan.

19. Pakistan has adopted a three tiered, somewhat unique, Shariah Compliance Mechanism and process_to ensure a deeper and extensive Shariah compliance supervision on an on-going basis. The Shariah supervision mechanism consists of three basic elements. Shariah Advisors for banks undertaking Islamic Banking, a Shariah Compliance Inspection and a centralized Shariah Board for the country at SBP.

20. The first is appointment of Shariah Advisors at each bank undertaking Islamic Banking operations. The fit and proper criteria of the Shariah Advisor are determined by SBP. This criterion is, apart from the usual aspects of integrity and honesty, based on a person's qualifications both in terms of education and experience in understanding the Islamic financial transactions. Another importance aspect is the person's qualifications and experience in issuing Fatwas relating to financial transactions. The fit and proper criterion determined by SBP allows for inclusion of all school of thoughts and also includes scholars that have experience and qualification of international level. These Shariah scholars are chosen by the banks, approved by SBP and appointed by the banks to over see their Islamic banking operations. Therefore they serve as SBP's eyes and ears at the operational level of Islamic Banking operations in the country.

21. The second element is a Shariah Compliance Inspection. The inspection manual, which is very comprehensive, was compiled by Ernst & Young out of Bahrain in collaboration with their affiliate in Pakistan. The Shariah Compliance Inspection is needed to ensure that specific terms of Islamic contracts, fatwa on the transaction, as well as the sequence of execution of the agreement are conducted according to Shariah principles. We are in the initial stages of rolling out Islamic accounting based on AAOIFI standards and the Inspection is geared towards auditing the transactions according to these standards. Next year in addition to the normal SBP inspection, all banks conducting Islamic banking will also have to undergo the Shariah Compliance Inspection.

22. The third element of our Shariah compliance Supervision is the all important Shariah Board. We have instituted a Shariah Board[5] at SBP. One of the unique features of the Shariah Board is the

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[4] Table is attached as annexure

[5] Our Shariah Board has five members. The chairman is a Shariah scholar of outstanding repute, Dr. Mahmood Ghazi. We have one more Shariah scholar as a member. It is Dr. Imran Usmani, son of the most respectable Maulana Taqi Usmani. We have a lawyer member on our Board, very well versed in laws pertaining to Islamic financial transactions. We have the country's most eminent Chartered Accountant as the fourth member of the Board. This gentleman also leads the committee of Institute of Chartered Accountants of Pakistan that is adapting the AAOFI accounting standards in the country. The fifth member of the Board is SBP's Director of Islamic Banking Department, who represents the interests of both the Islamic commercial banks and the State Bank of Pakistan on the Board.

composition of its membership; because the board includes not only Shariah Scholars, but also a chartered accountant, lawyer, and central banker. We believe that Shariah is the pivot around which Islamic banking revolves but in addition there are other disciplines that are critical to the success of executing the Shariah standards. As such we believe that all such critical disciplines must be represented within the Shariah Board so that the rulings emerging out of the Shariah Board are not only 100% Shariah compliant but these are also compatible with the legal and financial infrastructure available to the Islamic banks. The Board is responsible to give ruling on any conflicts arising out of the Shariah Compliance Inspection. It is responsible to provide guidelines to SBP for Shariah aspects of regulations. It helps in product development and provides support for approving any new products developed by the commercial banks. This Board has been functional for almost three years now. The feedback from the industry and SBP experience with the Shariah Board has been excellent. In fact the Shariah Board has played a key role in ensuring an issueless promotion of Islamic banking in the country.

23. All three elements are interactive, and together form the comprehensive Shariah Compliance Supervision mechanism. Each element has been performing its role very effectively. We have been able to make sure that the whole is far greater than the sum of the parts. As such we are very confident that our Shariah Compliance Supervision is second to none and the mechanism we have put in place has worked very well and will continue to do so. This can serve as a model for any other Central Bank that may want to institute Shariah Compliant supervision in its jurisdiction.

24. To facilitate the growth of Islamic banking across borders, I would like to emphasize the need for increasing international cooperation between supervisors in different areas including Corporate Governance. We need more dialogue between supervisors across regions for mutual learning and evolution of international best practices.

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ANNEXURE

Growth of Islamic Banking in Pakistan

Description	***Dec.-03***	***Dec.-04***	***Dec.-05***	***Jun-06***	***Oct-06***
Total Assets (Rs. in Bn)	13	44	72	87	100
%age of Banking Industry	0.5%	1.4%	2.1%	2.3%	**2.6%**
Deposits (Rs. in Bn)	8	30	50	60	70
%age of Banking Industry	0.4%	1.2%	1.9%	2.1%	2.5%
Financing. & Invest. (Rs. in Bn)	10	30	48	58	61
%age of Banking Industry	0.5%	1.3%	1.8%	2.0%	2.1%
Full Fledge Islamic Banks	1	2	2	4	**4**
Conventional Banks with Islamic Banking Branches	3	7	9	11	**11**
Total No. of Branches	17	48	70	100	**114**

Note: Two more full-fledge Islamic banks have been granted licenses, which have not started operations as yet.
In addition, two more conventional banks have plans to open Islamic Banking Branches this year.

Shariah Compliance Framework –Country wise

Country	Islamic Banking Law	Shariah Committee		Fit & Proper Criteria for Shariah Advisor/ Committee	Shariah Compliance Inspection	Shariah Standards	Accounting Standard
		At Central Bank	at bank Level				
Malaysia	Islamic Banking Law 1983	Shariah Advisory Council	Shariah Committee	Approval by BNM	Governance through Shariah Committee	All Products approved by SAC, Role of Shariah Committee defined by BNM	Accounting Standards developed by MASB
Bahrain	Regulations for Islamic Banks	Shariah Supervisory Committee	Shariah Supervisory Board	N.A	Internal and External Shariah Audit as per AAOIFI standards	AAOIFI	AAOIFI
Indonesia	Laws for Islamic Banking Introduced in 1992 & Amended in 1999	National Shariah Board	Shariah Supervisory Board	NSB approves appointment of SSB members	Internal and External Shariah Audit	Fatwa on products issued by NSB	AAOIFI
Iran	Usury free Banking Act 1983	Council of Guardian	N.A	N.A	No	Guidelines provided by Council of Guardians	Not Known
Brunei	Islamic Banking Act Cap.168	Shariah financial supervisory Board (SFSB)	Shariah Advisory Board	SFSB approves appointment of Shariah Advisory Board members	No	SFSB Approves Islamic products introduced by Financial Institutions	Not Known
Pakistan	Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 & 2003	Shariah Board	Shariah Advisor	Fit & Proper Criteria by SBP	Manual developed in 2004, now being implemented	Essentials for Islamic modes	AAOIFI standards are being adapted by a committee of ICAP