

Corporate Governance in Institutions Offering Islamic Financial Services

Issues and Options

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Abstract

This paper reviews Institutions Offering Islamic Financial Services (IIFS) corporate governance (CG) challenges and suggests options to address them. It first points out the importance of CG for IIFS, where it would require a distinct treatment from convention CG and highlights three cases of distress of IIFS. It then dwells on prevailing CG arrangements addressing IIFS' needs to ensure the consistency of their operations with Islamic finance principles and the protection of the financial interests of a stakeholders' category, namely depositors holding unrestricted investment accounts. It raises the issues of independence, confidentiality, competence, consistency and disclosure that may bear on pronouncements of consistency with Islamic finance principles. It also discusses the agency problem of depositors holding unrestricted investment accounts. The paper argues for a governance framework that combines internal and external arrangements and relies significantly on transparency and disclosure of market relevant information.

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List of Abbreviations

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS:	Basel Committee on Banking Supervision
BCCI:	Bank of Credit and Commerce International
CAH:	Current Account Holders
CB:	Central Bank
CFI:	Cooperative Financial Institutions
CFS:	Conventional Financial Services
CG:	Corporate Governance
CIBAFI:	General Council of Islamic Banks and Financial Institutions
FDIC:	Federal Deposit Insurance Corporation
FAS:	Financial Accounting Standards
FSA:	Financial Services Authority
ICFS:	Institutions offering Conventional Financial Services
IFH:	Ihlas Finance House
IIFS:	Institutions offering Islamic Financial Services
IFRS:	International Financial Reporting and Accounting Standards
IFSB:	Islamic Financial Services Board
IIFM:	International Islamic Financial Market
IIRA:	International Islamic Rating Agency
IRR:	Investment Risk Reserve
IOSCO:	The International Organization of Securities Commissions
LMC:	Liquidity Management Center
OECD:	Organization for Economic Cooperation and Development
PER:	Profit Equalization Reserve
PLS:	Profit and Loss Sharing
PQBC:	Publicly Quoted Corporation Bank
RIA:	Restricted Investment Account
SME:	Small and Medium Enterprise
SSB:	<i>Shariah</i> Supervisory Board
UIA:	Unrestricted Investment Account

Introduction¹

Good governance is crucial to the ability of a business to protect the interests of its stakeholders. These interests may extend beyond the purely financial to the stakeholders' ethical, religious, or other values. In the case of an institution offering Islamic financial services, stakeholders expect its operations to be carried out in compliance with the principles of *Shariah* (Islamic Law). A corporate structure that enables such an institution to implement good governance through *Shariah*-compliant operations is therefore essential.²

Islamic finance helped sustain economic growth throughout the Muslim world during the Middle Ages. After a long period of lull, the last three decades witnessed its revival, notably after the first oil price shock of 1973-74. Beyond the surge in liquidity, its reemergence was prompted by the introduction of innovative Islamic financial products and a demand by Muslim populations for financial services compatible with their religious beliefs. More recently, the industry has received a new impetus that can be ascribed to a number of factors: the uneven performance of Western financial markets, a perception of increased risk for Gulf Cooperation Council capital in traditional financial markets, a renewed surge in oil prices, an expressed demand from Muslim communities in Western countries, and the development of managerial skills necessary for providing Islamic financial services.³ The global Islamic financial services industry now includes 284 institutions offering Islamic financial services (IIFS) operating in 38 countries, both Muslim and non-Muslim.⁴

¹ The authors would like to thank Arun Adarkar, Stijn Claessens, Dahlia El-Hawary, Zamir Iqbal, Luigi Passamonti, Leila Triki, and participants to meetings of the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Services for helpful comments on the issues discussed. All remaining errors are the authors'.

² Annex I provides a glossary of Arabic terms.

³ According to the General Council of Islamic Banks and Financial Institutions (CIBAFI), total assets have roughly doubled in the period 1998-2001, soaring from \$134 to \$261 Billion. Source: <http://www.islamicfi.com> (last visited April 04, 2005).

⁴ IIFS refers to a firm offering Islamic financial services, and includes finance houses, that offer retail commercial and investment services. This paper does not deal with *Takaful* (insurance) companies.

Initially, IIFS developed without being clear about the legislative and regulatory framework that applied to them.⁵ However, their conceptual foundations and operational practices have specific features that pose challenges to regulators and call for solutions beyond the simple extension of existing legislation and regulation applying to institutions offering conventional financial services (ICFS). Consequently, a number of countries have established laws and regulations for IIFS, and international bodies have been created to adapt conventional standards and harmonize practices.⁶

This paper reviews IIFS' corporate governance (CG) challenges and suggests options to address them. Four main concerns motivate this attention to the CG of IIFS: (i) CG is important for economic development; (ii) the assets of IIFS are significant and growing, (iii) sound CG may be more critical for financial than other organizations, and (iv) the CG vulnerabilities of IIFS may not have received adequate attention in conventional CG frameworks.⁷

The activities of IIFS impact the welfare of more than 20% of the world's population, mostly in developing countries.⁸ In certain financial systems, IIFS may channel more than 20% of financial flows. Moreover, IIFS provide access to financial services to social groups that would otherwise hesitate to use them. For both ICFS and IIFS, sound CG creates an enabling environment, which rewards banking efficiency, mitigates financial risks, and increases systemic stability.

Islamic capital markets, mutual funds and insurance services are also developing, but are not covered here. These figures were reported in a press release by CIBAFI dated May 8, 2005, ("CIBAFI Raises the Glance toward IIFS Growth with a Unique Statistic-Based 10-Year Strategic Plan").

⁵ For example, in some cases the general prudential regime was extended to IIFS without recognizing any specific feature. In other cases, IIFS registered as non-bank commercial businesses. For an introduction to the principles and instruments of Islamic finance as well as regulatory arrangements applying to IIFS, refer for instance to El-Hawary, Grais, and Iqbal (2004).

⁶ These include the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market (IIFM) and the Liquidity Management Center (LMC). Rather than seeking to replace existing regulation, these bodies propose solutions whenever conventional regulation fails to address the distinctiveness of the Islamic financial industry.

⁷ CG is here understood as a set of systems and processes for ensuring proper accountability, probity and transparency in the conduct of an organization's business as well as in the relationships between different stakeholders. The definition of CG will be expanded in Section III.

⁸ According to www.adherents.com, Muslims represent 22% of the world population (as of April 04, 2005).

In a review of the impact of corporate governance on economic development, Claessens (2003) identifies four areas in which empirical evidence points to the positive effects of good CG on the performance of firms. First, it facilitates access to external finance. Lenders and other investors are more likely to extend financing to a business if they are comfortable with its CG arrangements, including the clarity and enforceability of creditor rights. Second, good CG tends to lower the cost of capital, by conveying a sense of reduced risk that translates into shareholders' readiness to accept lower returns. Third, good CG is proven to lead to better operational performance. Finally, it reduces the risks of contagion from financial distress. In addition to reducing the internal risk through raising investors' risk perception and willingness to invest, it increases the robustness and resilience of firms to external shocks.

The second motivation, namely, the importance of CG arrangements for financial institutions, arises out of the fiduciary nature of their activities and the likely asymmetry in access to information.⁹ In essence, a financial institution is a fiduciary trustee, which is entrusted with the assets of investors. It is therefore obliged to act in their best interests when holding, investing, or otherwise handling their property¹⁰. This is crucial in banking institutions, where the scope for informational asymmetries is likely to be greater than in other firms. It is difficult for an outsider to control or evaluate bank managers, given the latter's ability to influence boards, alter the risk composition of assets, or hide information on loan quality.¹¹ The opacity of the banking system inevitably reduces the effectiveness of a competitive environment by itself to ensure good CG, as takeovers can rarely take place when insiders have an informational advantage.¹²

⁹ Dewatripont and Tirole (1993) argue on the contrary that financial firms present no specific externality that differentiates them from other firms and that would justify the need for stricter regulation of financial institutions.

¹⁰ In some countries, the fiduciary nature of banking is enshrined in law. For instance, the General banking Law of the Philippines states that the "fiduciary nature of banking requires high standards of integrity and performance" (Republic Act No. 8791). Also refer to Macey and O'Hara (2003) for an explanation of why fiduciary duties of directors should be extended to stakeholders other than shareholders in the case of financial firms.

¹¹ Caprio and Levine (2002), Morgan (2002).

¹² In general, the disciplining power of competition is hindered in banking by limited product market competition as banks construct long-term relationships with customers. Even if product markets were fully

Nevertheless, some Islamic scholars argue that IIFS should be immune to these flaws. They contend that IIFS have better CG because the moral code of Islam induces stakeholders to behave ethically.¹³ Nevertheless, the commitment of concerned stakeholders to Islamic religious principles cannot be taken for granted. The Nobel Laureate Albert O. Hirschman contended that “under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior”.¹⁴ Islamic financial institutions are no exception. Indeed, IIFS are no less prone to suffer from breaches of fiduciary responsibilities or the consequences of asymmetric information. The history of Islamic finance shows that cases of CG failures have features in common with conventional banking scandals, such as collusion of the board with management, external and internal audit failure, neglect of minority shareholders’ interests, imprudent lending, and excessive risk taking by management.¹⁵

The third motivation of this paper is that the practices of IIFS raise specific CG challenges. While a number of problems are common to all financial institutions, and can be mitigated by existing regulations, two broad sets of CG issues are specific to IIFS.¹⁶ The first arises from the need to reassure stakeholders that the institution’s activities fully comply with the precepts of Islamic jurisprudence.¹⁷ Ultimately, the core mission of an Islamic financial institution is to meet its stakeholders’ desire to conduct their financial business according to *Shariah* principles.¹⁸ There must, therefore, be CG mechanisms to assure them that the necessary safeguards are in place. The same stakeholders also need to be assured that the firm will nonetheless actively promote their financial interests, and

competitive, capital markets would still ill-function due to waves of irrational optimism and pessimism that result in shareholders looking at immediate revenues rather than the long-term ability of firms to pay dividends. For more see Levine (2004) and Prowse (1998).

¹³ Sarker (1999).

¹⁴ Hirschman (1970).

¹⁵ For some examples of IIFS CG failures, refer to section II.

¹⁶ We refer to OECD Principles of CG and BCBS Standards for Enhancing CG for Banking Organizations. This presents the additional advantage of favoring the integration of IIFSs into global markets. This position is also supported by international standard setters like the IFSB and AAOIFI.

¹⁷ Islamic jurisprudence is also known as *Fiqh*. It covers all aspects of life: religious, political, social and economic. It is mainly based on interpretations of the *Quran* and *Sunna* (sayings and deeds of the prophet).

¹⁸ For a glossary of terms, please refer to Annex I

prove to be an efficient, stable, and trustworthy provider of financial services. In practice, depositors and borrowers need to feel confident that the types of liabilities and assets that IIFS deal with are competitive and offer a risk-return trade-off acceptable to their clients. This combination of requirements of *Shariah* compliance and business performance raises specific challenges and agency problems, and underlines the need for distinctive CG structures.¹⁹

The following section begins with a review of three cases of IIFS distress. They illustrate issues specific to IIFS, such as failure to comply with the *Shariah*, capture of the institution by special interests, and weak public policy. Section II considers IIFS' emphasis on stakeholders' value and the relevance to such institutions of CG arrangements based on shareholder value. Section III identifies shortcomings in prevailing CG arrangements in protecting stakeholders' ethical interests in IIFS and offers suggestions to address vulnerabilities. Section IV reviews stakeholders' financial interests and arrangements to protect them. Section V presents the conclusions of the paper.

I. Three Cases of Distress

Three cases illustrate possible CG weaknesses in IIFS.²⁰ The first relates to the failure to ensure compliance with stakeholders' religious beliefs. The other two cases show how poor CG structures, both internal and external, can affect investors' finances, particularly those of the relatively unprotected unrestricted investment account (UIA) holders, as well as the stability and sustainability of the Islamic financial industry.

A central feature of the CG of an Islamic financial institution is ensuring *Shariah* compliance. To reassure stakeholders, the institution generally sets up a *Shariah*

¹⁹ This paper focuses on those financial issues specific to IIFS, such as the existence of investment accounts, profit-smoothing instruments and poor ring-fencing of funds provided by different stakeholders.

²⁰ Other notable examples, not mentioned in this chapter, include the Kuwait Finance House engulfment in the Souk al Manakh crash (1986-87); the liquidation of the International Islamic Bank of Denmark due to excessive financing exposure to a single client (1986); and the failure of the Islamic Money Management Companies in Egypt (1988-89).

supervisory board (SSB) or retains the services of *Shariah* advisors that certify the *Shariah* compliance of the financial transactions. However, the ability of the SSB or the *Shariah* advisors to fulfill the mandate may be constrained by the volume of activity, their access to monitoring systems, the complexity of financial transactions, or the extent of their independence.²¹ These factors may have been at play during the collapse of the Bank of Credit and Commerce International (BCCI), which involved several IIFS. Five IIFS deposited significant resources with the BCCI, a leading CFS business, with the understanding that they would be invested in commodity contracts, in compliance with *Shariah* principles.²² However, following the failure, Price Waterhouse, BCCI's auditor, reported that "there is no evidence to suggest that the bank actually entered into any commodity contracts".²³ The discovery was important, given the level of exposure of the concerned IIFS in the BCCI. Reportedly, one of the IIFS involved had 25% of its assets placed with the BCCI.²⁴ The size of exposure suggests a weak due diligence process in the verification of *Shariah* compliance. More generally, the case illustrates the limits a SSB may face in discharging its mission.

The 2001 collapse of Ihlas Finance House (IFH) of Turkey illustrates the consequences of capture by special interests in an environment of weak internal and external checks. The largest of the Turkish IIFS, with over 40% of the sector deposits, IFH was liquidated by the Turkish Banking Regulation and Supervision Agency because it had illegally appropriated almost \$1billion, virtually the entire value of the deposit base, through connected lending to shareholders, concealed by the rapid growth of deposits. Concentrated ownership and control had permitted an incentive system biased in favor of shareholders. When the bank was liquidated, the misappropriation of funds was so large that the bank was unable to pay back its 200,000 depositors.²⁵

²¹ Section IV expands on the challenges of *Shariah* CG.

²² The IIFS in question were the Faisal Islamic Bank of Egypt, the Dubai Islamic Bank, the Khartoum-based Tadamon Islamic Bank, the Qatar Islamic Bank and Kuwait Finance House, as reported by *The Asian Wall Street Journal*: "BCCI Creditors Granted More Time" (April 9, 1992).

²³ As reported in the *Washington Post*: "Exposing BCCI Faults: Audit, Testimony Show Disregard for Rules" (August 12, 1991).

²⁴ *Financial Times*: "BCCI Shutdown. Response Muted from Islamic Institutions" (August 8, 1991)

²⁵ Starr and Yilmaz (2004).

IFH, like other Turkish Special Finance Houses, was not covered by deposit insurance.²⁶ The failure created panic among UIA holders that threatened to bring down other IIFS in the country. In spite of the reported sound fundamentals of the sector, and assurances by Turkish regulators as well as the Association of Special Finance Houses on the good health of the system, runs eroded 63% of total deposits in IIFS within the first quarter of 2001.²⁷ Compounding the IFH failure was the inability of IIFS to manage liquidity in the absence of *Shariah*-compliant secondary markets. Overall, the failure of IFH revealed the contagion risks to the financial stability and reputation of other IIFS because of poor CG.

The 2003 failure of the Patni Cooperative Credit Society of Surat in India provides an example of how weakness in the external institutional environment can affect the governance of IIFS. External CG, includes the legal, regulatory and conflict resolution framework. As an example, the Reserve Bank of India Act, by requiring that deposit-taking institutions maintain interest-bearing accounts with the central bank, effectively prevents the functioning of IIFS as deposit taking businesses.²⁸ Most IIFS have chosen the organization form of a cooperative and, as such, face two sets of conditions that magnify the challenges of their operations. Firstly, they can operate only in the state in which they are licensed, as prescribed by the Cooperative Societies Act.²⁹ Secondly, they have to observe conventional prudential standards on capital adequacy, income recognition, and asset classification and provisioning, all of which extend to financial cooperatives. The cumulative effect of these conditions complicates the intrinsic challenge of liquidity management for IIFS, given their exclusion from conventional money markets. They also limit the potential scale of the firms' activities and affect their

²⁶ IIFS investment deposits cannot in principle be insured because this would insulate UIA holders from credit and market risks, thus violating the risk-sharing nature of investments, prescribed by *Fiqh* jurists.

²⁷ Starr and Yilmaz (2004).

²⁸ To acquire bank status, Indian IIFS would be required to maintain a deposit account with the central bank, on which they would earn interest. A strict interpretation of this rule forces them to opt for the status of non-banking financing company to preserve their Islamic (interest-free) nature. For more, refer to Khan (2001). Regulations applying to IIFS in India are currently under review.

²⁹ Bagsiraj (2002), and Kahn (2001).

competitive position.³⁰ The management of the Patni Cooperative may therefore have been induced to take excessive risks, resulting in an unsustainable level of non-performing loans.³¹

II. Shareholders' versus Stakeholders' Value: Corporate Governance in Islamic and Conventional Financial Institutions

Widely publicized mismanagement scandals have focused attention on the relevance of CG for the protection of the rights of shareholders' as well as of other stakeholders.³² Misconduct in financial businesses not only creates widespread investment losses, but also shakes investors' confidence, and raises doubts about the stability of the international financial system. Equally important, they damage the value of all other stakeholders, such as creditors, suppliers, consumers, employees, and pensioners, and of communities at large. They affect the livelihoods of the victims of the businesses' financial distress.³³ The consequences of weak CG in a financial institution are, therefore, not only financial, but also entail heavy costs in social and human terms. In contrast, sound CG facilitates access to external finance, improves the firms' operational performance, enhances systemic financial stability, and contributes to the welfare of the community.

Over time, growing concerns about the impact of business performance on groups other than shareholders have led to measures to protect stakeholders being superposed on what continues to be essentially a shareholder value based framework. Conventional CG does not yet offer an analytical framework to internalize stakeholders' protection within the objectives of the firm. It adopts a pragmatic approach that offers rules that may not

³⁰ Ramesha (2003). There is also a different school of thought that maintains that prudential standards conceived for shareholding financial companies can be applied to financial cooperatives with no negative impact on the performance of the latter.

³¹ For more refer to Bagsiraj (2002). As of the final drafting of this paper, no decision has yet been taken on the liquidation by Patni bank by the Reserve Bank of India.

³² At the end of 2004, the insurance industry was the target of accusations by Eliot Spitzer, New York's Attorney General, for price-fixing, bid-rigging and undisclosed payments. See *The Economist* "Reprehensible - The Insurance Industry" (October 23, 2004).

³³ These would be stakeholders with a contractual relationship with the firm. The notion of stakeholder could be extended to parties who do not have a contractual relationship with the firm and who would be affected by the externalities of its decisions. For example, communities downstream of a new dam project may be affected by biodiversity damage to their environment.

necessarily be consistent with the incentives driving whoever controls the business. The conceptual difficulty of conventional CG in fully integrating the interests of non-shareholding stakeholders diminishes its ability to design incentives that can be adapted to IIFS. Indeed, the latter have always assigned a much higher priority than CFS firms to non-financial interests as well as given more weight to the interests of non-shareholding stakeholders.

The cornerstone of CG arrangements for conventional businesses is the protection of shareholders' rights. From this perspective, the question is how to secure the rights of ownership once the investors' financial resources have been relinquished. The answer to this question may lie in the configuration of incentives for managers, control retention by owners, and the reliability of the legal system.³⁴ Shleifer and Vishny (1996) argue that "corporate governance deals with the agency problem: the separation of management and finance". They then point out that "the fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment". While the reference to finance and financiers may also include creditors, the primary focus of their review is on shareholders' protection. Indeed the distinction of management and finance is targeted at the separation of ownership and control. Thus, the major feature of shareholders' value based CG is the design of incentives that lead managers to pursue the maximization of shareholders' value.

Conventional CG does not overlook stakeholders other than shareholders. Shleifer and Vishny (1997) acknowledge the impact of corporate decisions on multiple stakeholders. Such awareness is generally either based on agnostic empirical observations or social responsibility considerations. For example, Tirole (1999) holds that "managerial decisions do impact investors, but they also exert externalities on a number of natural stakeholders who have an innate relationship with the firm". He follows up by asking "why (one) should ignore the natural stakeholders and favor the investors, who are

³⁴ The choice of the distribution and use of owners' control may be affected by the extent to which ownership is atomistic or concentrated. However, while the protection of minority shareholders' rights compounds the difficulties stemming from the agency problem, the conceptual framework remains the same.

“stakeholders by design”, by giving them full control rights and by aligning managerial compensation with their interests”.

Trying to internalize, through incentives, stakeholders’ value in the decision-making process of corporations is a daunting challenge. Tirole (1999) examines whether the managerial incentives and control structure in a shareholder value framework can be adapted to include other stakeholders’ interests. Managerial incentives are difficult to design if the firm’s objective shifts from the maximization of shareholders’ value to that of the “aggregate welfare of the stakeholders”. The latter has no clear widely accepted measure or market value. Accordingly, it does not provide a foundation for linking incentives with performance. Falling back on a profit-based compensation system is likely to lead to biased decisions, as managers would pursue profitability at the expense of other objectives. Sharing control among stakeholders with heterogeneous interests in a joint venture would seriously impede its efficacy.³⁵ Similarly, relying on enlarging management’s fiduciary duty to various stakeholders may leave it with too much power to pursue its own objectives.³⁶ Thus, trying to design managerial incentives to accommodate stakeholders’ interests is more complex than might at first appear.

Public policy overcomes the limitations of available analytical frameworks to deal with stakeholders’ value by adopting pragmatic approaches. The outcome is arrangements that generally strengthen transparency and limit blatant misconduct. Standards have emerged and principles have been codified, with significant contributions notably by the OECD and the BCBS. The OECD defines CG as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate Governance *also provides the structure through which the objectives of the company are set*, and the means of attaining those objectives and monitoring performance are determined”.³⁷ This definition provides important attributes of CG and emphasizes transparency. However, it does not directly deal with the intrinsic issue of the business

³⁵ Hansmann (1996) quoted in Tirole (1999). However some may consider this a much lesser evil than the outcome of decisions emanating from undivided control by shareholders.

³⁶ “Management can almost always rationalize any action by invoking its impact on the welfare of some stakeholder”. See Tirole (1999).

³⁷ OECD (2004)

objectives that should guide the distribution of rights and responsibilities within the corporation. Indeed, the objectives of a corporation's founders', whether these be the increase of shareholders' value or the pursuit of stakeholders' interest, can be expected to affect such a distribution and shape the institutional structure and systems. In particular, the distribution of rights and responsibilities among shareholders and other stakeholders would be driven by the interests of whoever establishes the corporation and subsequently controls it.

Stakeholders' value is central to the IIFS, and is generally incorporated in mission statements (Annex II).³⁸ A selection of mission statements suggests that IIFS focus on two broad sets of objectives: (a) compliance with *Shariah* principles, and (b) provision of excellent services. *Shariah* compliance appears to fall into three categories. The first one and most widely understood includes the conduct of financial business in accordance with the prohibition of *Riba'* and *Gharar*.³⁹ The second appears to cover the furthering of Islam's social objectives, in particular the promotion of social benevolence.⁴⁰ In this regard, the Central Bank of Jordan states in its Banking Law that one of the objectives of Islamic banking is the provision of "services aimed at reviving social solidarity organized on the basis of mutual benefit".⁴¹ The third aspect of *Shariah* compliance is the development and promotion of an integrated Islamic financial system, or the "eventual institution of an elaborate and comprehensive banking system based on the rules of Islamic *Shariah*".⁴² Subsumed under the set of *Shariah* objectives of providing excellent services are: (a) service to the community as a whole, referring primarily but not exclusively to the Muslim community (*Ummah*); (b) promoting the interests of related

³⁸ Annex II compares the mission statements of 22 leading IIFS and ICFS.

³⁹ Compliance with *Shariah* principles appears explicitly in almost all IIFS mission statements. The explicit reference to *Riba'* or *Gharar* is less frequent. *Riba'* is mentioned in the mission statement of Dubai Islamic Bank. Islamic Bank of Thailand mentions "not being tied with interest".

⁴⁰ The social nature of Islamic finance emerges most clearly in the practices of *Zakat* and *Qard Hassan*. *Zakat* is a tax on wealth while *Qard Hassan* are zero-return beneficence loans to be made to the needy. See for example the goals of ABC Islamic Bank (E.C.) and Dubai Islamic Bank. Badr-Forte Bank of Russia mentions "social justice and harmony". Meezan Bank limited of Pakistan refers to the "implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind".

⁴¹ Article 50a of the Banking Law of Jordan, Law No. 28 of 2000, as amended by Temporary Law No.46 of 2003. Available at www.cbj.gov.jo/

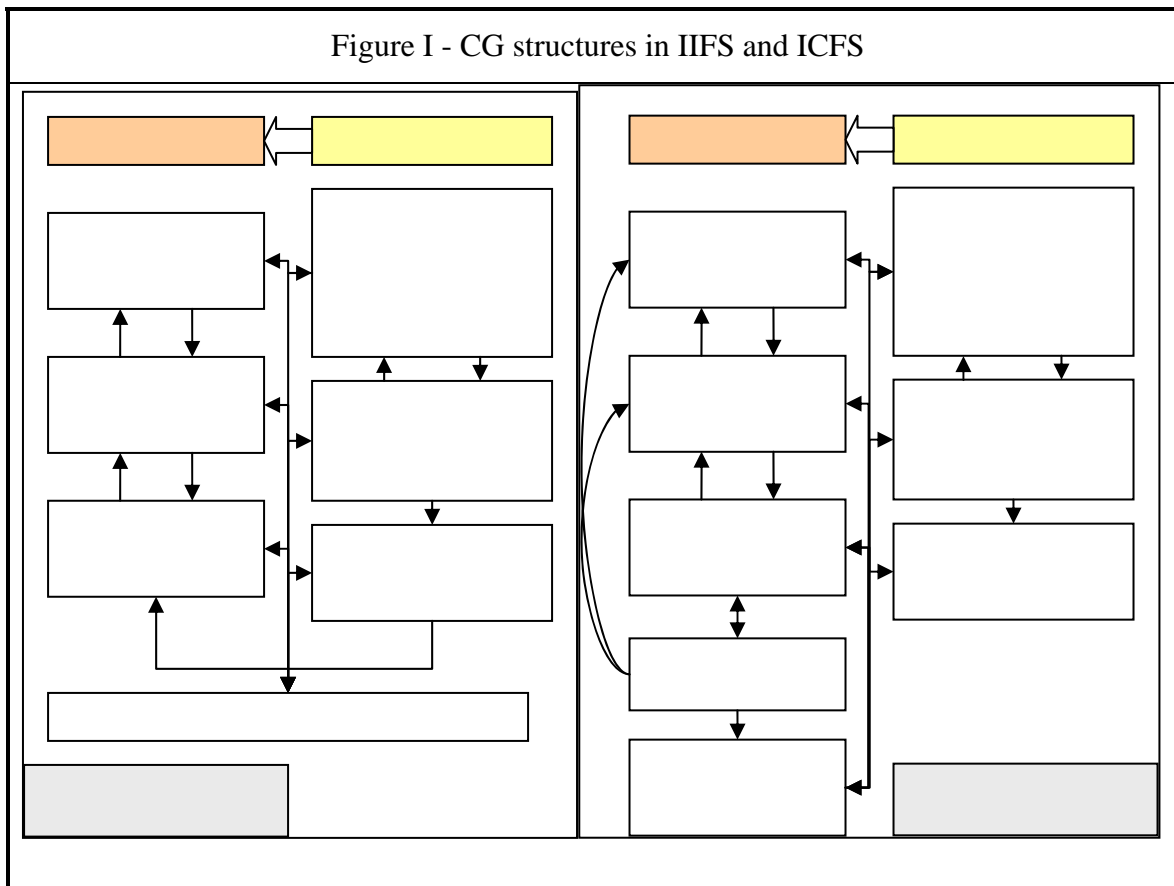
⁴² See the mission statements of Badr-Forte Bank of Russia, Al Baraka Islamic Bank (Bahrain), and Faisal Islamic Bank of Egypt.

parties, including shareholders, depositors, and employees; and (c) the developing the professional and ethical qualities of management and staff.⁴³

IIFS' CG arrangements are mostly modeled along those of the conventional shareholder corporation, in spite of the explicit mandate to promote social welfare and pursue stakeholders' value. This configuration leads to a distribution of rights and responsibilities that essentially leaves control with shareholders. The most notable variation in CG structure is the presence of a *Shariah* board of scholars and a *Shariah* review unit that ensure compliance with the Islamic law. *Shariah* compliance decisions affect all IIFS stakeholders. In addition, internal stakeholders such as investment account holders, and external governance structures such as accounting would perhaps be distinctive features of an Islamic financial institution Nevertheless, IIFS' CG practices and structures are mainly fashioned along those of a CFS firm. (Figure I).⁴⁴

⁴³ This is referred to as “maximizing our clients and shareholders value” (Al Baraka Islamic Bank), “achieve optimum and not maximum profits, for the mutual benefit of customers and the bank” (Dubai Islamic Bank), “constantly strive to protect (its) shareholders' interest” (Bank Islam Malaysia Berhad), or “optimizing the stakeholders' value” (Meezan Bank limited Pakistan).

⁴⁴ IIFS operate mostly in jurisdictions where legal protection could be strengthened. The prohibition of *Riba* and *Gharar* translates into risk-sharing arrangements that may leave stakeholders in uncertainty as to the security of their assets. Furthermore undivided control with shareholders can create biased decision-making, see Tirole (1999)



Since IIFS' configurations mostly identify shareholders as the residual claimants of the institutions, the internalization of stakeholder value may in the short-term require solutions that do not necessarily reflect the incentives enshrined in the firm's governance system and processes. However, the identification of IIFS' mission as the promotion of the welfare of all stakeholders should lead to the gradual adaptation of ownership structures to permit the alignment of governance arrangements with the incentives of all stakeholders.⁴⁵

⁴⁵ Table I provides a simplified contrast of the issues in shareholder and stakeholder centered perspectives of CG and expands on positive and normative illustrations of CG in IIFS.

Table I - Shareholder versus Stakeholder Centered CG Issues			
<i>Model</i>	<i>Control</i>	<i>Fiduciary Duty</i>	<i>Firm's Objective</i>
Shareholders Centered	With shareholders	To shareholders	Maximize shareholders' wealth
Stakeholders Centered	Stakeholders have right to participate in decisions	To all stakeholders	Promote the interests of all stakeholders
IIFS Current Practice	With shareholders	-To all stakeholders -To board of <i>Shariah</i> scholars	- Compliance with Islamic <i>Shariah</i> - Excellence of service to all stakeholders
IIFS Options	Stakeholders have right to participate in decisions	-To all stakeholders -To board of <i>Shariah</i> scholars	- Compliance with Islamic <i>Shariah</i> - Excellence of service to all stakeholders

Source: Derived from Boatright, J. R. (2002) and extended to include IIFS.

III. Shariah Compliance and Stakeholders' Ethical Interests

The Governor of the Bahrain Monetary Agency conveyed the sense of IIFS' roots in stating that "Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles".⁴⁶ This pledge to conduct activities in accordance with *Shariah* principles entails that IIFS would: (i) not engage in interest-based debt transactions, (ii) not conduct a purely financial transaction disconnected from real economic activity⁴⁷, (iii) not participate in a transaction where there is exploitation of any party, and (iv) not participate in activities regarded as harmful to society. Failure of individual institutions to ensure compliance would entail a reputational risk for the Islamic finance industry.⁴⁸ To mitigate such risk, IIFS have created CG structures and processes that reassure

⁴⁶ As reported by *Middle-East-Online.com* on February 17, 2004. <http://www.middle-east-online.com/english/bahrain/?id=8922=8922&format=0> (last visited April 11, 2005)

⁴⁷ This concept is sometimes referred to as "materiality".

⁴⁸ In a survey of depositors' preferences, Chapra and Ahmed (2002) show that 81.7% of surveyed depositors in Bahrain would withdraw funds from their Islamic bank and chose an alternative Islamic bank, should failure to comply with to *Shariah* emerge. In the case of Bangladesh, the percentage is 46.6. In Sudan, it raises to 94.6.

stakeholders on the *Shariah* compliance of all transactions. A widely adopted approach is to have independent bodies certify such compliance.

Each Islamic financial institution has in-house religious advisers, collectively known as *Shariah* Supervisory Board (SSB), as part of the internal governance structure of the institution.⁴⁹ In some countries, authorities have created oversight arrangements, such as *Shariah* boards or Islamic banking departments within supervisory agencies. These usually operate in conjunction with private independent market agents familiar with Islamic finance.

SSBs' tasks may vary according to provisions stipulated in the articles of association of the institution or by national regulators. Corporate charters would entrust SSBs with ex-ante monitoring and the calculation of *Zakat*. International and national regulators often publish guidelines for SSBs, which refer to their general duty to ensure *Shariah* compliance of transactions and, less frequently, provide guidelines on competences, composition and decision-making (Table II).⁵⁰

In principle, SSBs' prerogatives lie in five main areas: certification of permissible financial instruments through *fatwas* (ex-ante *Shariah* audit), verification of transactions' compliance with issued *fatwas* (ex-post *Shariah* audit), the calculation and payment of *Zakat*, disposal of non-*Shariah* compliant earnings, and advice on the distribution of income or expenses among the bank's shareholders and investment account holders.⁵¹ Each SSB issues a report to certify the *Shariah* compliance of all financial transactions. This report is usually an integral part of the institution's annual report.

⁴⁹ They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with *Shariah* is guaranteed and monitored by the central bank.

⁵⁰ We here mention only those countries where authorities have implemented laws, acts or issued circulars and regulations on internal *Shariah* Supervisory Boards. Annex III details the legal bases and the provisions of these regulations.

⁵¹ A *Fatwa* is a religious edict or proclamation. It is a legal opinion issued by a qualified Muslim scholar on matters of religious belief and practice. For more, see Briston and El-Ashker (1986) and Abdel Karim (1990). For an explanation of *Zakat* refer to footnote 40.

Table II - Regulations on Internal <i>Shariah</i> Advisory**					
<u>Country</u>	<u>SSB terms of reference</u>	<u>SSB composition</u>	<u>SSB decision-making</u>	<u>SSB appointment & dismissal</u>	<u>SSB Fit and Proper Criteria</u>
<i>Bahrain</i>	✓	✓	unspecified	✓	✓
<i>DIFC*</i>	✓	✓	unspecified	✓	✓
<i>Indonesia</i>	✓	unspecified	unspecified	✓	✓
<i>Jordan</i>	✓	✓	✓	✓	unspecified
<i>Kuwait</i>	✓	✓	✓	unspecified	unspecified
<i>Lebanon</i>	✓	✓	unspecified	✓	unspecified
<i>Malaysia</i>	✓	unspecified	unspecified	unspecified	✓
<i>Pakistan</i>	✓	✓	unspecified	✓	✓
<i>Philippines</i>	✓	✓	unspecified	unspecified	✓
<i>Thailand</i>	✓	✓	unspecified	✓	✓
<i>U.A.E.</i>	✓	✓	unspecified	✓	unspecified
* Dubai International Financial Centre					
** Annex III details the legal bases and the provisions of these regulations					
Source: Official country websites and central bank Annual Reports					

In addition to *Shariah* boards, most IIFS, particularly those complying with AAOIFI standards, have established another internal *Shariah* review structure, namely, *Shariah* Review units.⁵² These units are independent of other departments or are an integral part of the Internal Audit and Control Department. The array of tasks that they perform is parallel to that of audit departments: reviewers generally use all necessary powers to ascertain that all financial transactions implemented by management comply with SSB rulings.⁵³ In some instances *Shariah* review units have exclusive competence

⁵² In AAOIFI member countries and banks adhering to the organization, internal *Shariah* review is prescribed by Governance standard 3. In Pakistan, it is regulated by Annexure-III to IBD Circular No. 02 of 2004.

⁵³ In this respect, the role of the internal review unit is limited to a complementary ex-post monitoring. This makes its task secondary, if more focused and defined, to that of the SSBs, which are the ultimate arbiters in matters of *Shariah* compliance.

on ex-post facto monitoring.⁵⁴ These units and SSBs face similar challenges, relating, in particular, to independence, and competence.

Beyond internal arrangements, the broader *Shariah* governance framework may include features put in place by regulators, as well as the provision of financial information services to persons outside the institution. Among regulatory arrangements, centralized SSBs are the most noteworthy in relation to *Shariah* governance. While there are significant differences across countries, centralized SSBs are usually concerned with ex-ante monitoring, mostly understood as standardization of *Shariah* interpretation, and ex-post monitoring of *Shariah* compliance. They are also concerned with issues relating to upholding *Shariah* compliance, and offer arbitration and recourse to settle *Shariah* disputes between members of the same SSB.⁵⁵

Table III - External <i>Shariah</i> CG institutions by country*		
Country	Centralized SSB or High <i>Shariah</i> Authority or Fatwa Board	Islamic Rating Agency
<i>Jordan</i>	No	No
<i>Malaysia</i>	✓	✓
<i>Sudan</i>	✓	No
<i>Bahrain</i>	No †	No †
<i>Kuwait</i>	✓	No
<i>Pakistan</i>	✓	No
<i>UAE</i>	✓	No
<i>Indonesia</i>	✓	No

* Annex IV details the names and powers of these departments/authorities.
† Bahrain is the seat of the IIFM and the IIRA that respectively set standards for Islamic jurisprudence and rate Islamic instruments on an international scale.
Source: Official country websites and central bank Annual Reports.

⁵⁴ This is the case of large IIFS where the SSBs may not be able to assess large volumes of transactions. Therefore, separate *Shariah* control departments have been established. This seems to be the case in al Rajhi Banking and Investment Corporation and Dubai Islamic Bank.

⁵⁵ Annex IV presents names and powers of these organizations. It focuses in particular of the powers of central SSBs.

Private mechanisms for the external monitoring of *Shariah* compliance are limited. In particular, private rating agencies have not yet developed the necessary skills or found enough incentives to monitor IIFS' *Shariah* compliance. "Islamic rating" has so far been the exclusive domain of government-sponsored organizations such as the IIRA and the Malaysian Rating Corporation. Likewise, other external actors with an interest in Islamic finance, such as financial media and external auditors, are still generally less concerned with assessments of *Shariah* compliance.⁵⁶

The functioning of SSBs raises five main CG issues: independence, confidentiality, competence, consistency and disclosure. The first issue concerns the *independence* of the SSB from management. Generally, members of an SSB are appointed by the shareholders of the institution, represented by the board of directors to which they report. As such, they are employed by the institution, and their remuneration is proposed by the management and approved by the board. The SSB members' dual relationship with the financial institution, as providers of remunerated services and as assessors of the nature of operations, could create a conflict of interest.

The issue of *confidentiality* arises from the practice of *Shariah* scholars often sitting on the SSBs of several IIFS, thereby gaining access to proprietary information of possibly competing institutions.

The third issue is *competence*. In performing their function, *Shariah* scholars are expected to be familiar with Islamic law and to have financial expertise. In practice, very few scholars are well-versed in both disciplines.

The fourth issue is the *consistency* of judgment across IIFS, over time or across jurisdictions, within the same institution. Such consistency would help to promote the customer's confidence in the industry and the enforceability of contracts. Conflicting

⁵⁶ A notable exception is the multiplication of Stock Market Islamic Indices whose major contribution is the identification of *halal* investments. *Halal* conveys goodness and by extension has taken the meaning of "permissible".

opinions on the admissibility of specific financial instruments or transactions would hurt business confidence and market efficiency.⁵⁷

Finally, *disclosure* of all information relating to *Shariah* advisory functions would strengthen the credibility that the offered services are essentially distinct from conventional ones and, furthermore, promote market discipline.

A SSB within an IIFS has the advantage of being close to the market. A competent and independent SSB, empowered to approve new *Shariah* conforming instruments, would facilitate innovation within the firm. In issuing its fatwas, the SSB could be guided by standardized contracts and practices that could be harmonized by an international standard-setting self-regulatory professionals' association. Such an approach could ensure consistency of interpretation and enhance the enforceability of contracts before civil courts. Review of transactions would mainly be entrusted to internal review units, which in collaboration with external auditors, would be responsible for issuing an annual opinion on the *Shariah* compliance of the transactions. This process would be sustained by reputable agents, like rating agencies, stock markets, financial media, and researchers that would channel signals to market players. Such a framework would also enhance public understanding of the requirements of *Shariah*, and lead to a more effective participatory role by the stakeholders in the activities of the institution.

IV. Stakeholders' Financial Interests

Given that the core mission of a financial institution is to enable its stakeholders to pursue their financial interests, the CG arrangements for IIFS cannot underestimate the importance of having a framework that credibly protects these interests while not breaching their values. We focus attention here on three main categories of stakeholders, namely, shareholders, depositors, and borrowers.

⁵⁷ A typical example is the financing of leisure activities, which is regarded as *haram* only by some Fiqh scholars. Moreover, Islamic jurisprudence is based on different schools of thought that may vary from country to country (the *Shiah* branch and the Sunni branch, which in turn includes the *Madhahib*, *Shafie*, *Hanafi*, *Hanbali* and *Maliki* traditions).

The prevailing organizational structure of IIFS is that of a shareholding company. Their CG arrangements, therefore, appear similar to those of businesses offering conventional financial services, with the conventional focus on agency problems between shareholders and management (Figure I).⁵⁸ However, they may not have effectively incorporated incentives to protect other stakeholders' financial interests, in particular those of unrestricted investment account (UIA) holders.

Generally, IIFS offer three broad categories of deposit accounts: current, unrestricted investment, and restricted investment.⁵⁹ Each category raises some CG issues, but those of unrestricted investment account (UIA) holders may be the most challenging. Essentially, it is the asymmetry between the extent of these depositors' participation in bearing investment risks and of their ability to influence the operations of the institution.

UIA holders are often the most important category of IIFS depositors. They enter into a *mudaraba* contract with the financial institution to manage their funds.⁶⁰ The institution places these funds in investment pools, and profits on investments, if any, are distributed at maturity according to the profit and loss sharing (PLS) ratio specified in the contract. The UIA holders, and not the IIFS, bear the risk of a poor performance of the investment pool, except for misconduct on the part of the financial institution.⁶¹ Thus, UIA holders are stakeholders akin to shareholders. They are principals entrusting their resources to an agent, the financial institution's management – with the significant difference that, in their case, the agent is appointed by another principal, namely, the shareholder.

⁵⁸ Concentrated ownership in private IIFS, or state ownership in others point to the need to pay attention to the protection of small shareholders and that of state assets respectively.

⁵⁹ Most IIFS also offer savings accounts. However, they usually fall in either the category of term investments or in that of current accounts. We therefore only distinguish between investment deposits and current account deposits.

⁶⁰ The case of *Wakalah* UIAs, which are based on an agency relationship with the IIFS earning a flat fee, rather than a share of profits, is not considered here.

⁶¹ This risk-sharing feature has led some to argue that UIA are not liabilities for the IIFS and accordingly they should not be required to meet the same capital requirements as ICFS. In particular, the credit and market risk would fall on depositors, while the bank would only be subject to operational risk.

The IIFS practice of commingling shareholders' and depositors' resources in investment pools can raise the possibility of conflict of interest. The management's discretion in the configuration of the pools and in the investments made from them, can result in differential treatment of various stakeholders. Moreover, the practice may reduce the transparency of IIFS' compliance with their clients' investment objectives. Accordingly, regulatory authorities may need to prescribe disclosure rules, and possibly firewalls and sanctions for breaches. This is of paramount importance to UIA holders, whose funds are normally common-pooled with those of shareholders.

IIFS generally create reserve funds to smooth the returns to UIA holders or protect their principal in case of adverse developments in the performance of the investment portfolio.⁶² IIFS consider these funds important to deal with competitive pressure from ICFS and other IIFS. While in principle, returns to UIA holders are supposed to vary according to IIFS performance, poor returns may induce UIA holders to transfer their funds to a better performing institution. To mitigate such a risk, IIFS set up profit equalization reserves and use them in periods of poor performance to complement the returns that would be due to UIA holders. The reserves are fed by retaining earnings to UIA holders in periods of high returns on investment. Similar arrangements help the IIFS protect the principal of UIA holders. A special risk investment reserve is used for compensating a loss of principal resulting from poor investment results. The use of profit equalization and risk investment funds raises issues pertaining to the governance of these funds and the protection of UIA holders' rights. In particular, the practice of profit equalization may convey an inaccurate view on the actual performance of the financial institution, compounding the asymmetry of information available to UIA holders and management.

Widely available and affordable financial information can enhance the effectiveness of official and private monitoring of financial businesses' performance. It promotes transparency and supports market discipline, two important ingredients of

⁶² These reserves are generally known as Profit Equalization Reserves (PER) and Investment Risk Reserves (IRR). We follow AAOIFI's definition in Financial Accounting Standard (FAS) 11.

sound CG to protect stakeholders' financial interests. Financial information may be particularly important for IIFS because of the private equity nature of UIAs and the assumption that UIA holders have more at stake than conventional depositors. UIA holders could therefore be expected to have a heightened interest in directly monitoring the institution's performance. However, this requires an institutional infrastructure that facilitates the production of accurate financial information, the availability of agents that can interpret and disseminate it, as well as arrangements to protect its integrity. On all these counts, the Islamic financial industry may be facing challenges. The existing limited infrastructure reduces the role that information flows can play in promoting competition and market activities that would induce managers to adopt sound CG practices.

Of particular relevance to the *financial information infrastructure* is a chart of accounts for businesses to organize and produce credible financial statements. To enable IIFS to achieve this, the accounting profession has developed standards, at both the national and international levels. An increasing number of countries have adopted the International Financial Reporting and Accounting Standards (IFRS) in the wake of an apparent consensus to promote international convergence. However, these standards are designed for conventional businesses, including ICFS. As for IIFS' case, their practice of setting up reserve funds to smooth profit distribution and protect the UIA holders' principal, and the commitment to distribute *Zakat*, are among the features that make the IFRS not wholly suitable for IIFS. This led to the establishment in the early nineties of AAOIFI, which developed standards specific to IIFS.⁶³ While there has been some progress through using AAOIFI's standards, the accounting pillar of the financial information infrastructure for IIFS continues to present challenges. Wherever IFRS are the only rule, they may not generate financial statements correctly reflecting the IIFS' performance, and may instead give a false sense of reliability. Where AAOIFI standards

⁶³ AAOIFI's standards are mandatory for the following markets: Bahrain, Jordan, Sudan, Qatar, and Dubai International Financial Center. Syria is considering their adoption. The standards are used as guidelines in Saudi Arabia, Kuwait, Malaysia, Lebanon, and Indonesia. Most Islamic banks' *Shariah* supervisory committees use AAOIFI standards as guidelines.

prevail, they would enable the accounting system to deal adequately with IIFS specificities. However, they may make cross-sector comparisons difficult.

Table IV - Country Approaches to Accounting and Auditing Standards for IIFS		
Country	AAOIFI standards (adopted adopted/recommended/ adapted) or national IIFS specific standards	Non-IIFS specific standards
<i>Bahrain</i>	✓	
<i>DIFC</i>	✓	
<i>Egypt</i>		✓
<i>Indonesia</i>	✓	
<i>Jordan</i>	✓	
<i>Lebanon</i>	✓	
<i>Malaysia</i>	✓	
<i>Philippines</i>		✓
<i>Qatar</i>	✓	
<i>Saudi Arabia</i>	✓*	
<i>Sudan</i>	✓	
<i>Syria</i>	✓	
<i>Thailand</i>		✓
<i>Turkey</i>		✓
<i>USA</i>		✓
<i>UK</i>		✓
* The Saudi Arabian Monetary Agency recommended IIFS to seek guidance from AAOIFI FAS in compiling their statements, but requires IFRS.		
Source: Official country websites and central bank Annual Reports.		

The *provision of financial information* on IIFS continues to be limited. Investors and analysts may not be entirely familiar with the nature of IIFS and with AAOIFI standards, but the action of market forces has already brought about substantial progress. For instance, leading international rating agencies now monitor and rate IIFS and are acquainted with AAOIFI prescriptions.⁶⁴ They have also tailored their rating mechanisms to the risk profile of Islamic banks.⁶⁵ However, the absence of a consensus on

⁶⁴ These are Fitchratings, Capital Intelligence and Moody's Investors Service. Capital Intelligence was the pioneer in rating and analyzing IIFS. It now covers 21 IIFS across 8 countries.

⁶⁵ Capital Intelligence uses the same categories to rate IIFS and ICFS, falling namely in 6 areas: regulation and supervision, operating environment, franchise strength, management quality, financial fundamentals, and external support. However, given the nature of IIFS, the analytical focus is adjusted. For instance, liquidity risk management may be more important in rating IIFS than in rating ICFS given the lack of *Shariah*-compliant secondary markets.

internationally accepted and standardized accountancy practices for IIFSs reduces the ability to make comparisons across markets, and may reduce consistency in ratings.⁶⁶

Overcoming these financial information challenges should promote a *competitive environment* for IIFSs, and thereby enhance the contribution that competition can bring to sound IIFS CG.⁶⁷

There are three alternative approaches to empowering and protecting UIA holders. Rights that normally belong to equity-holders could be extended to UIA holders. Or, moving in the opposite direction, UIA holders could be granted full debt-holding status and the protection it carries. Alternatively, the *sui generis* status of UIA holders could be maintained, provided that specific governance structures for the protection of UIA holders' interests are in place.

The first option would be the extension of shareholders' rights and duties to UIA holders. Given their equity-like investment, it may be argued that UIA holders should be on an equal footing with shareholders and thus be granted the right to have a voice by electing board representatives. This measure would increase their ability to air their demands and concerns with management. It would also satisfy these depositors' demand for greater involvement in the strategic management of the IIFS.⁶⁸

If extending shareholders' rights to UIA holders is deemed impractical, depositors' protection may be an alternative option. However, the moral hazard argument against deposit insurance schemes would need to be addressed. Furthermore, the PLS nature of investment accounts prevents the application of deposit insurance in its present form, and a *Shariah*-compliant version would need to be developed.

⁶⁶ For example, as we can see on table IV, AAOIFI's standards are not broadly endorsed by regulatory agencies.

⁶⁷ Grosfeld and Tressel (2001) provide evidence that competition has an important complementary effect where good CG mechanisms are already in place.

⁶⁸ In a survey of IIFS consumers' preferences, Chapra and Ahmed (2002) record an interest by depositors to be involved in the strategic management of the bank.

The third option would be to create new governance structures that cater to the specific needs of UIA holders. One possibility is to elect a special representative or body that would act as an intermediary and, if necessary, expose wrongdoings. Such a policy would provide the key rationale for the creation of a permanent institutional channel to facilitate information flows from and to UIA holders. However, the creation of a new agent would bring with it additional agency problems and the risk of multiplying rather than diffusing the asymmetries of information to which UIA holders are subject.

Concerns on potential conflicts of interest should lead regulators to emphasize a transparent conduct of business. In this regard, smoothing of returns to UIA holders as currently practiced appears to be a significant obstacle to transparency. The practice of smoothing of returns introduces a veil of opacity between depositors and the firm, whereas, in all circumstances, an IIFS should be fully transparent in the use of funds. AAOIFI FAS 11 provides clear principles and guidelines on this issue. In particular, it requires IIFSs to disclose the shares of the actual profits and of the funds from the profit equalization reserve in the returns they receive.⁶⁹ In addition, each IIFS needs to adopt clear provisions regulating contributions to these funds and their disclosure in financial statements and annual reports.⁷⁰

Overall, internal and external CG structures can complement each other in strengthening stakeholders' protection. Internally, the protection of minority shareholders and provisions for increased disclosure need attention, but can be addressed by the application of existing rules. The commingling of resources, balancing UIA holders' risks and rights, and the utilization of reserve funds need concrete actions to enhance the soundness of the internal CG frameworks of IIFS.

⁶⁹ Some IIFS have already established the practice of distinguishing between profit distribution and the amount of reserve distributed.

⁷⁰ Decisions pertaining to PER and IIR should ideally be left to the business. However, concerns over maintaining the UIA holder principal and the systemic consequences that losses may provoke have led some regulators to intervene. For instance, the Banking Law of Jordan as amended in 2003 establishes a minimum deduction of 10% on earnings to be invested in an investment risk fund in order to cover losses in mutual investment accounts. Such minimum deduction may be increased by the CB (Art. 55).

Externally, recognizing the specificity of IIFS within the broader institutional infrastructure, would contribute to greater transparency. Whichever regulatory approach is chosen, it can be guided by two rules of thumb. First, regulators need to be flexible and to work with IIFS in order to become acquainted with the needs of the industry and be able to develop acceptable regulatory frameworks. Secondly, private self-regulatory initiatives can provide channels to market discipline and may be as important in Islamic finance as in a conventional financial system. In jurisdictions where regulations result in constraints on Islamic finance, IIFS need to evaluate which licensing status is best suited to their need for protecting stakeholders' interests. Regulatory authorities and market participants ought to become well versed in the nature and implication of the rules adopted, and thus help to promote market discipline without placing an undue burden on the IIFS. The existence of an infrastructure, such as IIFS-adapted accounting and auditing standards, that would permit the production of timely and reliable financial information, would complement the role of public authorities and reputational agents.

V. Conclusions

Poor CG can carry heavy financial costs for IIFS' stakeholders, as it would for other corporations. In addition, poor governance in IIFS would undermine their credibility as financial businesses offering services in compliance with *Shariah*. Given the fledgling nature of the sector and its ethical foundations, the effects of a CG failure could be particularly damaging. While international standards applicable to conventional financial businesses can offer useful inspiration for IIFS CG, their simple extension to IIFS would not be effective in providing safeguards for IIFS stakeholders. The ongoing efforts of national and international bodies to address these issues focus on the existing shareholding corporate structure of IIFS. They generally do not address the issue of the nature of the corporate structure that would be best adapted to the founding principles of Islamic finance, the services it would offer, and the competition it would face. It would seem, however, that no single model of corporate governance is likely to prevail, as the effectiveness of any framework would depend on the socio-economic context and the specific needs of each jurisdiction.

Confidence in the consistency of business practices with *Shariah* can emanate from a SSB as is currently the case. The financial competence of SSB members and their independence would need strengthening. The availability of *Shariah* compatible guiding principles whose interpretation has broad international acceptability can be helpful. An international self-regulatory *Shariah* financial scholars' association may help to reconcile the requirements for innovations with the need for broad standards. Business confidence would be strengthened through credible expectations of enforceability of contracts. Ex-post verification of *Shariah* compliance could be handled by internal review units, and certified by external auditors and reputational agents.

Protecting the interests of UIA holders has developed into one of the main challenges of IIFS CG. Their status of quasi-shareholders, bearing investment risks but not having a voice, has led to a number of arrangements. They include profit equalization reserves, investment risk reserves, special board committees, or special supervisory attention.

Shortcomings in current practices may require a combination of solutions. In particular, the protection of stakeholders' financial priorities calls for attention to the protection mechanisms for "weak voice" stakeholders, including minority shareholders, the position of UIA holders, transparent use of reserves, disclosure of policies and structures, and the soundness of regulatory and broader institutional controls. Strengthened arrangements that would lead to the emergence of reputational agents that can exert market discipline would be most helpful. The synergies between regulation, arrangements at the corporate level and the actions of market reputational agents could help enhance CG soundness.

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Annex I: Glossary of Arabic Terms

<i>Amana</i> (Demand deposits)	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value and earn no return.
<i>Fatwa</i>	Legal opinion issued by a qualified scholar on matters of religious belief and practice.
<i>Fiqh</i> (Islamic jurisprudence)	It refers to Islamic jurisprudence that covers all aspects of life: religious, political, social and economic. <i>Fiqh</i> is mainly based on interpretations of the <i>Qur'an</i> and <i>Sunna</i> (sayings and deeds of the prophet).
<i>Fiqh al-Muamalat</i>	Islamic Commercial Jurisprudence.
<i>Gharar</i>	Literally, : uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, such as fish in water or a bird in the air.
<i>Halal</i>	That which is permissible according to <i>Shariah</i> Law.
<i>Haram</i>	Unlawful according to the <i>Shariah</i> . It indicates transactions which are not permissible under Islamic law.
<i>Hibah</i>	Literally gift. A gift awarded voluntarily in return for a loan.
<i>Ju'ala</i> (Service charge)	A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
<i>Kifala</i>	It is a pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
<i>Mudaraba</i> (Trustee finance contract)	<i>Rabb -al- mal</i> (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers his labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by <i>rabb-al-mal</i> . The liability of the entrepreneur is limited only to his time and effort.
<i>Murabaha</i> (Mark-up financing)	The seller informs the buyer of his cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
<i>Musharaka</i> (Equity participation)	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
<i>Qard Hassan</i> (Beneficence loans)	These are zero-return loans that the <i>Qur'an</i> encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
<i>Quran</i>	Islamic scriptures believed by Muslims to be God's revelation to the Prophet.
<i>Riba'</i>	Literally, an excess or increase. Technically, an increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party.
<i>Shariah</i> (Islamic Law)	The Islamic Law extracted from the <i>Qur'an</i> and <i>Sunna</i> (sayings and deeds of the Prophet).
<i>Sunna</i>	Deeds of the Prophet.
<i>Takaful</i>	Arabic name for insurance based on <i>Shariah</i> rules. An Islamic Insurance is a collective protection scheme. It literally means solidarity. <i>Takaful</i> reflects solidarity and is akin to mutual insurance.
<i>Umma</i>	Community of the faithful within Islam
<i>Wadiyah</i>	A safe custody contract between the depositor (customer) and the custodian (bank).
<i>Wikala</i>	An Agency contract which may include in its terms a fee for the agent. Same contract can also be used to give a power of attorney to someone to represent another's interests.
<i>Zakat</i>	Religious tax to be deducted from wealth to be paid to the needy.
Compiled from El-Hawary, Grais, and Iqbal (2004) and the glossary of the IIFM website (www.iifm.net).	

Annex II: Mission statements of IIFS and ICFS

<u>IIFS</u>	Mission statements, objectives or vision	<u>ICFS</u>	Mission statements, objectives or vision
<i>Jordan Islamic Bank, Jordan</i>	(The bank's goals are) commitment to providing banking services based on compliance with the rules and principles of the glorious Islamic <i>Shariah</i> in all our activities to serve our community as a whole, and commitment to equally serve the interests of all related parties including shareholders, depositors, and employees. (website)	<i>Mizuho Financial Group, Japan</i>	(Our) (...) basic principles of the consolidation are: 1) offer a wide range of the highest quality financial services to our customers 2) maximize shareholders' value and, as the leader of Japan's financial services industry, earn the trust of society at large, 3) offer attractive and rewarding job opportunities for employees (...)
<i>Bank Islam Malaysia Berhad</i>	<p>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</p> <p>(The Bank's) Corporate Objective is to provide its customers with Islamic Banking facilities and services of the highest possible quality; to attain viability and sufficient level of profitability to sustain growth; to develop and foster a competent and innovative management imbued with high standards of integrity and Islamic banking professionalism; to develop a motivated workforce inculcated with appropriate work ethics fully committed to the Bank and to offer efficient and courteous service to customers; to constantly strive to protect its shareholders' interest; to be always conscious of its responsibilities and duties as an Islamic corporate citizen.</p>	<i>Norges Bank, Norway</i>	<p>The company's primary objective must be to maximize shareholders' long-term returns. There must be a clearly defined business strategy that is anchored in the board of directors. The company must present accurate, adequate and timely information concerning its financial position and other relevant information.</p> <p>The company's board of directors shall protect the interests of all shareholders and shall be accountable for the decisions made by the board. The board of directors shall supervise the day-to-day management and company activities, and shall ensure a proper organization of these activities, including adequate internal control systems.</p>
<i>Kuwait Finance House, Kuwait</i>	In accordance with the Islamic principles, KFH ensures that while working with the public professionally, the company guarantees an honorable relationship with its client base and the Muslim community as a whole	<i>Coastal Federal Bank, USA</i>	Our basic corporate objective (is) maximizing the value of our shareholders' investment
<i>Faisal Islamic Bank of Egypt</i>	The ultimate goal being to eventually institute an elaborate and comprehensive banking system based on the rules of Islamic Shari'ah which meets the needs of all those concerned... shareholders-clients-employees.	<i>Deutsche Bank, Germany</i>	Mission: We compete to be the leading global provider of financial solutions for demanding clients creating exceptional value for our shareholders and people.

Bank Muamalat Berhad, Malaysia	To build the bank into a modern, dynamic and strong Islamic Bank that would play a role in providing a viable alternative to the conventional system, that will contribute to the development of Modern Malaysia.	<i>Commonwealth Bank, Australia</i>	The key financial objective of the Bank is to have Total Shareholder Return in the top quartile of our Australian listed peers over each rolling five year period.
Badr-Forte bank, Russia	To contribute to the globalization of Islamic Banking as the principal institution within the Russian Federation implementing Islamic financial and economic concepts, which offer a unique solution for social justice and harmony in our contemporary society	<i>BBVA Group, Spain</i>	The seven corporate principles are as follows: Focus on the customer as the centre of business; creation of shareholder value through business activity; teamwork as the engine in the creation of value; a management style that generates enthusiasm; ethical behavior and personal integrity as a way of understanding and conducting business; innovation as the engine of progress; and corporate social responsibility as an intrinsic part of development.
AlBaraka Islamic Bank, (Bahrain and Pakistan)	We strive to be a premier regional Islamic bank, dedicated to the economic and social development of our target markets, maximizing our clients and shareholders value, and focusing on the human resource development in an environment of creativity and innovation. Albaraka is committed to develop and promote an integrated Islamic Financial System. Compliance with the rules and principles of Islamic Shariah is the core of the banking and financial activities of the Bank. To this end, the Bank has successfully sought the advice and expertise of Islamic scholars acclaimed for their knowledge and piety from all over the Islamic world to guide its path and monitor its performance (website)	<i>BNP Paribas, France</i>	BNP Paribas founds its corporate project on three commitments: 1) toward its customers, BNP Paribas undertakes to give first priority to their satisfaction and to constantly improving the quality of their welcome and of the services offered, 2) toward its shareholders, BNP Paribas undertakes to put value creation at the very heart of its options, 3) toward its employees, BNP Paribas undertakes to ensure a dynamic and stimulating management of careers and remuneration by developing employee share-ownership and promoting social dialogue. The respect of these commitments is guaranteed by the team spirit of all the bank's employees and their adherence to a code of ethics founded on transparency, professionalism and quality
Dubai Islamic Bank, UAE	(The) Objectives of the Bank (are): 1) Providing banking services of the highest standards according to Islamic <i>Shariah</i> without dealing in <i>riba</i> (interest on money) and by using the state-of-the-art technology in computer, telecommunication and information system 2) Investing funds prudently to achieve optimum and not maximum profits, for the mutual benefit of customers and the bank. 3) Coordination, cooperation and integration with other financial bodies that apply Islamic <i>Shariah</i> in their dealings, in order to support creating a base and regulations for an Islamic financial system. 3) Development of the Islamic society in all fields of the economy by investing in industries, agriculture, commerce, and real estate in order provide job opportunities.	<i>Jyske Bank A/S, Denmark</i>	(...) The Jyske Bank Group is managed and operated as a business. At the same time, we attach great importance to treating the three groups of stakeholders – shareholders, customers and employees – with equal respect. (...) Our objective is to provide our shareholders with a satisfactory long-term return on their investment. Thus, the aim is for Jyske Bank every year to be one of the top-performing Danish banks based on the level of our earnings. Jyske Bank is thus an excellent choice for shareholders who want to make a long-term investment and who do not attach great importance to decisions which generate only short-term price increases.

	4) Promotion of social benevolence through its Islamic methods, particularly through Zakat. 5) Contributing to the welfare of society in line with the five main tenets of Islam, namely protection of life, purity of mind, property, honour and social justice. 6) Promoting the savings habit and encouraging people to invest wisely within the parameters of Islamic <i>Shariah</i> through investment and finance instruments to suit individual requirements. 7) Making available the necessary capital for entrepreneurs for the establishment of economic projects and creation of alternative instruments for finance according to Islamic <i>Shariah</i> .		
Islamic Bank of Thailand, Thailand	(The bank's goals are): to maintain the role of a bank that is not tied up with interest; to strengthen the business; to carry out social and organizational stability; to provide an excellent service; and to well direct and supervise the community development	<i>RHB Group, Malaysia</i>	Mission: To become the most admired Malaysian financial services company by providing excellent customer services, enhancing shareholder value, providing challenging career and learning opportunities for employees, demonstrating responsibility for society.
ABC Islamic Bank (E.C.)	Our mission is to uphold our carefully formulated <i>Islamic principles</i> in the quest for <i>mutual prosperity for our clients and the Bank</i> . In pursuit of our mission, we commit the Bank to the purest forms of Islamic banking products and services from a Shari'a perspective. We remain demonstrably <i>independent from the conventional sector</i> and recognize the <i>importance of Islam's social objectives</i> in conducting business. We are committed to delivering a <i>level of service</i> that matches, or exceeds, the market practice internationally. To do so, we seek to employ the best available human resources and the technology to apply the <i>highest professional, moral and ethical standards</i> .	<i>HSBC Canada, Canada</i>	HSBC in Canada is committed to being Canada's leading international financial services organization, a leader in chosen markets, and recognized by its clients as proactive, responsive, competitive and secure. To achieve a superior long term return for our shareholder we will efficiently deliver a differentiated client experience which reflects our commitment to excellence in sales, service and products, and which is delivered by highly motivated and well qualified employees, working as a team. Through managing for value, HSBC in Canada is committed to making a world of difference to its clients, employees, communities and shareholders
Meezan Bank Limited, Pakistan	Establish Islamic banking as banking of first choice to facilitate the implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind. To be a premier Islamic bank, offering a one-stop shop for innovative value added products and services to our customers within the bounds of <i>Shariah</i> , while optimizing the stakeholders' value through an organizational culture based on learning, fairness, respect for individual enterprise and performance.(website)	<i>Barclays Group, UK</i>	Barclays aims to be one of the most admired financial services organizations in the world; in the eyes of our shareholders, our customers, our colleagues and the communities in which we work. The best measure of our long term performance is the total return we give to our shareholders - the increase in the price of our shares, assuming that any dividends are used to buy more shares, known as 'Total Shareholder Return'.

Source: Extracts of corporate mission and goals obtained from websites or annual reports.

Annex III: Legal Basis and Nature of Regulations on Internal SSBs in Selected Countries						
Country	Legal base for SSB	SSB competences as spelled out by existing laws	SSB composition	SSB decision making	SSB Appointment and Dismissal rules	Fit and proper criteria for SSB members
Bahrain	<i>BMA Rulebook - Volume 2- Islamic Banks - The BMA (2005) and all AAOIFI standards</i>	General duty to verify <i>Shariah</i> compliance and issue an annual report. Binding advice The shareholders shall decide how SSB will discharge this duty.	At least three members (according to AAOIFI)	Unspecified (to be decided by shareholders)	Appointed by Shareholders. Dismissal is proposed by Board and approved by shareholders (according to AAOIFI standards)	Conflict of interest and competence clauses (According to AAOIFI governance standards).
DIFC*	<i>Law regulating Islamic financial business, DIFC Law No. 13 of 2004 and the Islamic Financial Business Module of the DFSA Rulebook</i>	Oversees and advises on <i>Shariah</i> compliance. Specific duties to be established and documented by the BIFS.	No less than three members.	Unspecified.	Appointed and dismissed by the bank's governing body	They must be competent (based on previous experience and qualifications) and are not directors or controllers of the BIFS
Indonesia	<i>Act No. 7 of 1992 as amended by Act 10 of 1998, Regulation 4/1/PBI/2002.</i>	General obligation to verify <i>Shariah</i> compliance (duties as stipulated by National <i>Shariah</i> Board and established by in bank's articles of association).	Unspecified.	Unspecified.	Any appointment or replacement of SSB members must be reported to Bank Indonesia and approved by the National <i>Shariah</i> Board.	Documentary evidence on SSB members' previous experience to be submitted to Bank Indonesia's Board of Governors.
Jordan	<i>Art. 58 of Law 28 of 2000 as amended by temporary Law No.46 of 2003.</i>	Ex ante audit (<i>fatwas</i>), ex-post audit, opinions on <i>Shariah</i> matters referred to it.	No less than three members.	By unanimous or majority vote. Its votes are valid only if a majority of members is present.	Appointed by the general assembly of shareholders. Discharged only through a reasoned decision taken by 2/3 of the board of directors and endorsed by the general assembly. Changes have to be notified to the Central Bank.	Unspecified.
Kuwait	<i>Art 93 of Law No. 32 of 1968.</i>	General obligation to verify <i>Shariah</i> compliance of banking	No less than three	By unanimity. In case of conflict the	Unspecified	Unspecified

		operations.	members.	matter is referred to the Fatwa Board.		
Lebanon	<i>Law No. 575 on "Establishing Islamic Banks in Lebanon".</i>	Certification of <i>Shariah</i> compliance and proposals for properly achieving bank's objectives pursuant to the <i>Shariah</i> .	Three members.	Unspecified.	Appointment for a renewable three- year period.	Unspecified (experts' background must be in Islamic law, doctrine and banking and financial operations).
Malaysia	<i>Islamic Banking Act of 1983 and Central Bank of Malaysia Act 1958 (Revised 1994) and Guidelines on the Governance of Shariah Committees (2004)</i>	Binding advice <i>Shariah</i> on compliance of banking operations for Islamic Banks. The Central <i>Shariah</i> Advisory Council is the ultimate arbiter.	Unspecified.	Unspecified.	Unspecified.	There are several incompatibility clauses.
Pakistan	<i>IBD Circular No. 02 of 2004.</i>	General obligation to verify <i>Shariah</i> compliance of banking operations. The SSB must submit an annual report to shareholders.	Only one advisor required. A board may be set up at the bank's discretion.	Unspecified.	Appointment must be approved by State Bank of Pakistan.	They are compulsory and relate to minimum qualification and experience, track record, solvency, financial integrity, honesty and reputation and conflicts of interests.
Philippines	<i>Republic Act No. 6848 and Manual of Regulations for Banks-Implementing Rules and Regulations of Republic Act No. 6848</i>	It offers advice and undertakes reviews on matters relating to <i>Shariah</i> compliance.	At least three but no more than five members.	Unspecified.	Unspecified.	SSB members must be Islamic scholars and jurists of comparative law.
Thailand	<i>Islamic Bank of Thailand Act B.E 2545.</i>	It has "the authority and duty to give advice and recommendations to the Board of Directors concerning Islamic principles related to the operation of the bank".	Not more than 4 members	At least half of the SSB members form a quorum and decisions are taken by majority vote.	SSB members have a two-year tenure and may be reappointed. They are appointed and removed by the board of directors.	Financial integrity, competence, honesty and conflicts of interests.
UAE	<i>Federal Law No. 6 of 1985</i>	General obligation to verify <i>Shariah</i> compliance of banking operations. Detailed competences	No less than three	To be decided in the articles of association of the	SSB members must be approved by the Higher <i>Shariah</i> Authority	Unspecified

		to be established by the bank.		bank		
* Dubai International Financial Centre						
Source: Official country websites and central bank Annual Reports						

Annex IV: External <i>Shariah</i> CG institutions by country				
Country	<i>Separate Islamic Banking & Takaful Department at CB</i>	<i>Centralized SSB or High Shariah Authority or Fatwa Board</i>	<i>Islamic Rating Agency</i>	<i>Separate Islamic Capital Market Department within Securities regulator</i>
<i>Bahrain</i>	Yes, Islamic Financial Institutions Supervision Directorate	No, but the International Islamic Financial Market is to promote the harmonization and convergence of <i>Shariah</i> interpretations in developing Islamic banking products and practices which are universally acceptable	No, but International Islamic Rating Agency operates in Bahrain	No
<i>Indonesia</i>	Yes, the Directorate of <i>Shariah</i> Banking	Yes, the <i>National Shariah Board</i> is authorized to issue <i>fatwas</i> concerning products, services and operations of BIFS. It also recommends <i>Shariah</i> advisors to BIFS	No	
<i>Jordan</i>	No	No	No	No
<i>Kuwait</i>	No	The <i>Fatwa Board</i> in the Ministry of <i>Awqaf</i> and Islamic Affairs is the final authority on <i>Shariah</i> disputes. Its advice is binding when it arbitrates on disputes between members of the same SSB	No	No
<i>Malaysia</i>	Yes, Regulation Department –Islamic Banking and <i>Takaful</i>	Yes. The <i>Shariah Council</i> advises central bank on <i>Shariah</i> matters and is the ultimate arbiter in <i>Shariah</i> interpretation disputes. The directives issued by BNM in consultation with the <i>Shariah Council</i> have binding authority over Banks with Islamic windows.	Yes, Malaysian Rating Corporation -Islamic Capital Market Department	Yes, Malaysian SEC- Islamic Capital Market Department. The SEC also has its own <i>Shariah</i> Advisory Board
<i>Sudan</i>	N/A, the whole financial regulatory system is Islamic	Yes, the <i>Shariah High Supervisory Board</i> is responsible for fatwas, contract specimen, arbitrage, consultations relating to Islamic legal aspects, training, research, lectures, and seminars	No	N/A, the whole financial regulatory system is Islamic
<i>Pakistan</i>	Yes, Islamic Banking Department	Yes, the <i>Shariah Board</i> of the State Bank is to advise the central banks on matters of <i>Shariah</i> . It also produces specimen of permissible Islamic Financial contract to ensure compliance with minimum <i>Shariah</i> standards	No	No, but several departments share Islamic finance portfolio
<i>UAE</i>	No	Yes, the <i>Higher Shariah Authority</i> , attached to the Ministry of Justice and Islamic Affairs, is the final arbiter on <i>Shariah</i> matters. It is also responsible of <i>Shariah</i> supervision	No	No

