

ISLAMIC BANKING AND FINANCIAL INSTITUTIONS: WHAT KIND OF GOVERNANCE?

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Corporate governance, well defined and applied, provides a structure which, at least in theory, operates in the interest of those involved in ensuring that the institution follows requested ethical standards, legal regulations and good governance. The IFBIs ethical standards governance is mainly structured from the different teachings and principles of the Chari'a (Islamic law). Hence, any IFBIs must operate in accordance to the principles of the Islamic law.

In 1991, the governors of the central banks and monetary authorities of the Organization of the Islamic Conference (OIC) member countries considered the necessity of establishing of the Islamic financial system regulations. Indeed, regulatory efforts, monitoring and control have increased with the creation of various monitoring and control bodies of Islamic finance, beside the endogenous elements of control and governance in Islamic financial and banking institutions (IFBIs).

Thus, this article aims to analyze the following problematic: **"How Islamic banking and financial institutions are governed?"** In order to better comprehend the phenomena we set to study the following hypothesis:

1. The nature of IFBIs corporate governance, which is based on Chari'a, requires a specific model of governance, and needs to be completely different from the conventional one;
2. Despite the Shari'a-compliant functioning of IFBIs, they can be governed in the same way as their conventional counterparts.

In order to carry out our study, we used a descriptive approach, based on a conceptual and an empirical literature review related to the topic. This approach allowed us to describe and to explain how IFBIs are governed and what are the main elements contributing to it. The research study is structured in three main points. Firstly, an overview of governance model in Islamic banking and financial institutions (IBFIs) is presented. Secondly, the endogenous elements of governance in IBFIs (namely, the role of Chari'a board and human resources governance) are studied. Finally, the exogenous elements of IBFIs governance presented through various governing bodies (namely, Central Banks and international Islamic governance institutions) are reviewed and analyzed.

1. Islamic banking and financial institutions: governance model overview
1.1. Understanding of IFBIs governance

In the literature review, several definitions have been given to corporate governance. Cadbury (1992)¹ defines corporate governance as “the system by which companies are directed and controlled”. A widely used definition holds that “corporate governance deals with the ways in which suppliers of finance to corporate assure themselves of getting a return on their investment”². One of the most complete definitions stipulates that corporate governance refers to “relations between a company’s senior management, its board of directors, its shareholders and other stakeholders, such as employees and their representatives. It also determines the structure used to define a company’s objectives, as well as the means of achieving them and of monitoring the results obtained”³.

Corporate governance, well defined and applied, provides a structure which, at least in theory, operates for the benefit of all concerned, ensuring that the institution adheres to accepted ethical standards and best practices, as well as formal laws⁴. Ethical standards of governance in IBFIs are represented by the different teachings and principles of the Shari’a (Islamic law). Thus, according to Mohsen Elkhudairy (1999) “administrative work in Islam has its principles based on Islamic law that establish restrictions, limitations and drive that members of the Administrative Board, leaders and employees should undertake in their relationship with each other, but also with the surrounding community”⁵. Therefore, IBFIs carrying out Islamic financial business shall ensure that the aims and operations of its business are in compliance with Shari’a principles at all times. An end-to-end Shari’a compliant control mechanism should be established in all aspects of its business operations in order to ensure that all activities are Shari’a compliant⁶.

The governance structure of IBFIs is distinguished from conventional governance structures by the involvement of a Shariah advisory body called “*Shariah board*”⁷. However, IBFIs are doubly governed: ie a so-called governance “administrative”, which is common with conventional banking and financial institutions (accounting, audit, control, management...)

¹ Cadbury.A; *Report of the committee on the financial aspects of corporate governance*; London; December 1992; p 14.

² Hopt.K.J; “*Better governance of financial institutions*”; Law Working Paper N° 207/2013; European Corporate Governance Institute; Belgium; April 2013; p 4.

³ European Commission; “*Corporate governance in financial institutions and remuneration policies*”; Green Paper; Brussels; June 2010; p3.

⁴ <http://searchfinancialsecurity.techtarget.com/definition/corporate-governance> (viewed on 10/03/2015)

⁵ Khudhairi Mohsen Ahmed, “*Management in Islam*”, Proceedings of the Symposium No. 21, Research and Training Institute, Islamic Development Bank, 'Jeddah, Saudi Arabia, 1999, p. 145. (Translated from Arabic)

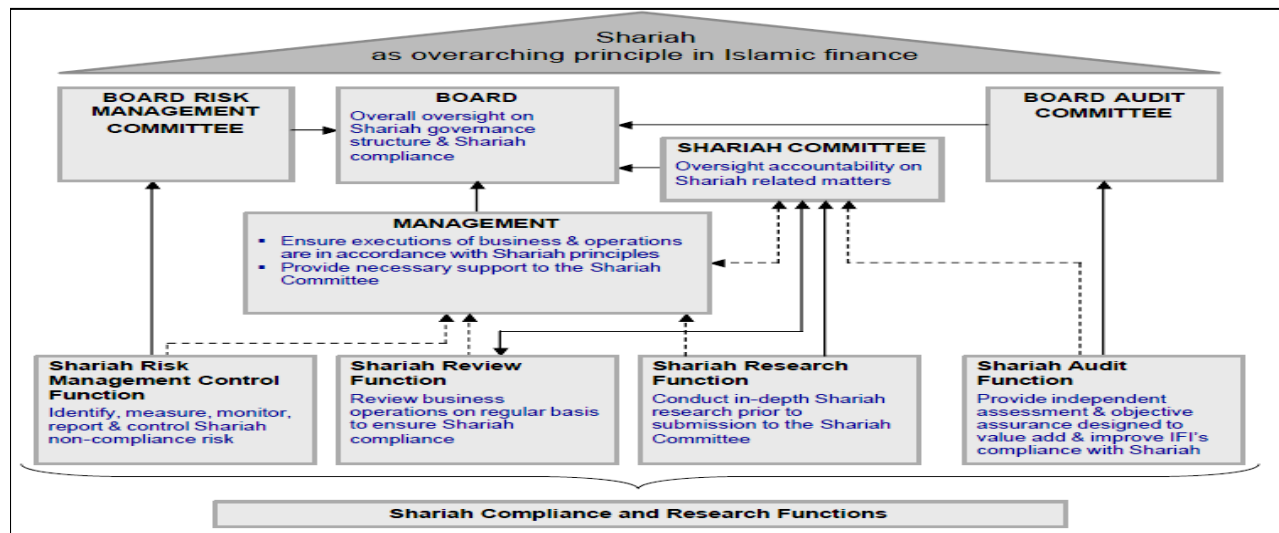
⁶ Bank Negara Malaysia; “*Shariah governance framework for Islamic financial institutions*”; Islamic banking and takaful department; BNM/RH/GL_012_3; Malaysia; 2010; p 5.

⁷ Shanmugam. B & Zahari A. R ; “*A primer on Islamic finance*”; The Research Foundation of CFA Institute; Virginia; December 2009; p 83.

and specific governance to this type of institutions, called "Sharia-compliant", represented by the Shariah board¹.

Figure 1 presents an illustration of a model structure of roles, functions and reporting relationship of key organisms in the IFBIs Shariah governance framework.

Figure 1: Shariah governance framework model for IFBIs



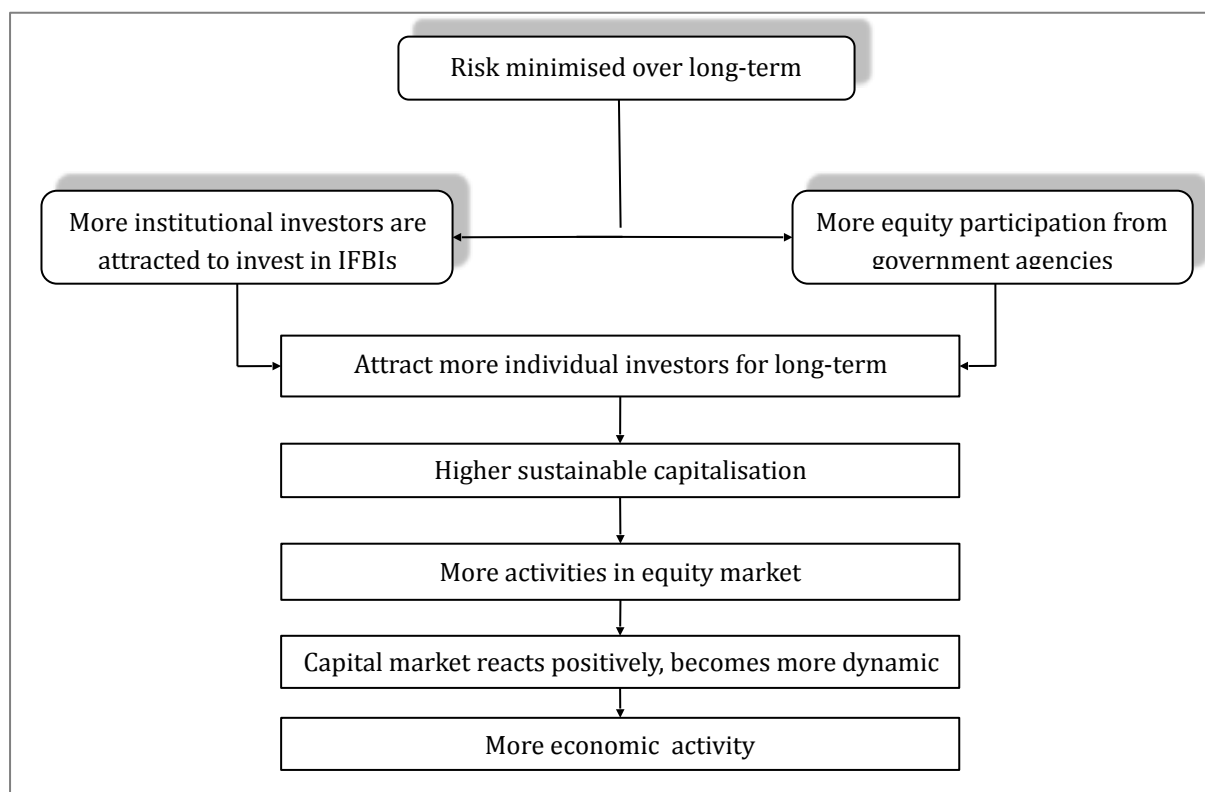
Source: Bank Negara Malaysia; “*Shariah governance framework for Islamic financial institutions*”; Islamic banking and takaful department; BNM/RH/GL_012_3; Malaysia; 2010; p 8

The existence of good corporate governance in any IFBI presents several benefits. Benefits to the *corporation* by increasing firm value, lowering cost of capital, enhancing capital efficiency and protection of shareholders’ rights.... In addition, benefits to the overall *society* (such as, more open transparent society, corruption prevention, rule of law: fair and orderly, promoting ethical wealth creation...). And finally, benefits to *the economy* by revitalizing market economy, enhancing sustainable economic growth, providing positive development capital markets and increasing competitiveness through fair compliance....² The figure 2, summaries benefits of good corporate governance of IFBIs.

Figure 2: Benefits of good corporate governance of IFBIs

¹ Yahia Abdul-Rahman; “*The art of islamic banking: Tools and techniques for community based banking*”; Hoboken edition; New Jersey (USA); 2010; p115.

² Dato’Shahran Laili Haji.A.M; “*Corporate governance in Islamic perspectives*”; 5th International Islamic Finance Conference: “Thirty five years on Islamic finance”; 3&4 September 2007; Kuala Lumpur; Malaysia; p42.



Source: Dato'Shahran Laili Haji.A.M; *"Corporate governance in Islamic perspectives"*; 5th International Islamic Finance Conference: "Thirty five years on Islamic finance"; 3&4 September 2007; Kuala Lumpur; Malaysia; p 43

1.2.The guiding principles of IFBIs governance

The Islamic Financial Services Board "IFSB" (one of the most important international organization on Islamic corporate governance, refers to in table 2) shares the opinion of the OECD and BCBS (Basel Committee) that there is no 'single model' of corporate governance that can work in every country; each country, or even each organization, should develop its own model that can cater for its specific needs and objectives. According to some specific needs and objectives, IFSB has developed seven principles based on the recommendations by eminent scholars, and which can be structured as follows¹:

1.2.1. General Governance Approach:

In this case, IFBIs should:

- Establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IFBIs' accountabilities to various stakeholders;
- Ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards that are in compliance with Shariah rules and principles and are applicable to the Islamic

¹ Islamic Financial Services Board; *"Guiding principles on corporate governance for institutions offering only Islamic financial services"*; Malaysia; December 2006; p 2-14.

financial services industry as recognized by the supervisory authorities of the country.

1.2.2. Rights of Investment Account Holders (IAHs):

- IFBIs shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised;
- IFBIs shall adopt a sound investment strategy which ought to be appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.

1.2.3. Compliance with Shariah Rules and Principles:

- IFBIs shall put in place an appropriate mechanism for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance in all aspects of their products, operations and activities;
- IFBIs shall comply with the Shariah rules and principles as expressed in the rulings of the IFBI's Shariah scholars. The IFBIs shall publish and make these rulings available to the public.

1.2.4. Financial Reporting Transparency in accordance to Investment Accounts

The IFBIs have the obligation to make adequate, audited and timely disclosure of accounting and financial reports to the Investment Account Holders (IAH). In addition, they are required to publish consolidated accounts and any other relevant information on the managed investment accounts portfolio.

2. The endogenous elements of governance in IBFIs

2.1. The Shariah board

The Shariah board is responsible for overseeing the application of different aspects of the Islamic law in the IFBI. It certifies every product, finance model and service provided by the institution. It also insures that all the transactions are in strict compliance with the principles of Shariah. The Shariah board is comprised of scholars and experts in research and development of religions rulings by applying Shariah to financial and banking products and operations¹. Shariah boards play a key role in advising institutions on their compliance with Shariah rules and principles; and they ought to respect the following guiding rules²:

¹ Yahia Abdul-Rahman; op.cit; p 114-115

² Elasrag Hussein; "Corporate governance in Islamic finance: Basic concepts and issues"; LAP Lambert Academic Publishing; Germany; 2014; p 78-79.

- *General approach*: various Shariah governance structures have been adopted in different jurisdictions, and the systems adopted should be proportionate to the size, complexity and the nature of the business. Shariah boards should have a clear mandate and be equipped with operative procedures and reporting lines to provide effective Shariah governance;
- *Competence*: the selection of scholars and other individuals whose role is to provide Shariah advice should be made on the basis of good character, honesty and necessary qualification to understand the technical requirements of the business;
- *Independence*: each member of a Shariah board should be capable of exercising independent judgment;
- *Confidentiality*: members of the Shariah board should inevitably be exposed to withhold commercially sensitive inside information once discharged from their duties. It should ensure that adequate confidentiality clauses are duly included in each member's service contract;
- *Consistency*: Shariah boards decisions should be consistent and, as far as possible, follow the pronouncements of the central Shariah authority in the relevant jurisdiction, where applicable. In case where no such authority exists, it is recommended that the Shariah board uses best judgments and efforts to conform to any previous rulings and to publish its decisions so that they may be openly and transparently assessed.

2.2. Governance of Human Resources

The specificity of IFBIs requires well trained and qualified human resources (HR) on Islamic finance and its jurisprudence. The good governance of human resources would enable a better functioning of these institutions as well as a better contribution to their emergence and development. Story (1989) defines HR governance as "a set of interrelated policies with an ideological and philosophical basis"¹. This ideological approach of HR governance can be observed in IFBIs through its specificity based on Shariah.

The HR issues have received considerable attention in Islam: Islamic law is a crucial law that preaches fairness and justice in all activities of life among human kind, without discrimination and regardless of the status and/or position between the counterparties to the agreements or contracts.

According to Al-Faruqi (1980), "there is no partiality in Islam in the treatment of an employee with an employer, nor an employer with an employee, because Islam follows the

¹Armstrong Michael; «A handbook of Human Resource Management Practice »; Kogan Page edition; London & Philadelphia; 2006; p 3

path of justice and equity and, therefore, it requires all mankind to live in dignity in order to ensure peace and stability”¹.

Several studies and researches have stressed on the importance and needs of HR training in IFBIs, noting that such training should cover administrative and technical aspects of these institutions. It should also, focus on the ethical and religious aspects. These studies have presented the main training components necessary for the good governance of IFBIs. We can highlight the main training components as follows²:

- *The Shariah-compliant aspect of IFBIs*: all employees must have a pre-requisite on the regulations regarding the functioning of all activities (financial, administrative, accounting,...) which should be compatible with Islamic law;
- *The Shariah board*: the primary role of this Committee in any IFBIs requires rigorous and permanent training of its members to ensure total control of both the Islamic banking and financial system (with a deep knowledge of the conventional system), and the Islamic financial law;
- *IFBIs' instruments and services*: these institutions offer instruments and services specific to their nature (based on Shariah), however, employees must have total control of their use, and also have the ability to market them;
- *The Islamic financial innovation in IFBIs*: it's among the most important HR training areas, since their contribution would help develop Islamic finance and banking industry to meet the needs and requirements of their customers, and face the competition from conventional finance;
- *The administrative management of IFBIs*: these institutions should focus more on the development programmes of HR management, ensure an ethical and equitable governance based on Shariah;
- *International regulations*: the IFBIs are also referred to the implementation of international standards (in accordance with Shariah), such as Basel standards; which requires HR training and development on these regulations.

3. The exogenous elements of IBFIs governance

3.1. The central bank role

Central bank is among the main actors of Islamic monetary and interbank market. Its main role is to supervise Islamic banks' activities. It is also involved in the development of rules

¹ Nik Mutasim Nik Ab.Rahman and Sharmin Shahid; «Islamic HRM Practices and Employee Commitment? A Test Among Employees of Islamic Banks in Bangladesh»; Asia-Pacific Business Research Conference: «Research for progress»; Kuala Lumpur-Malaysia; 21-22 February 2011; p 6-7.

²Beltagy Mohamed, "human resource development in the Islamic financial institutions," the Second Conference of the Islamic financial services 27-28, Tripoli – Libya, April 2010, p 12-14. (Translated from Arabic).

and principles relating to banking and finance functions, and in establishing business processing order and customer. Cooperation between IFBIs and the central bank is important to promote growth and development of these institutions, but also to help them compete with their conventional counterparts. IFBIs must be subjected to similar treatment, in terms of respecting the fulfillment of the obligations in setting up reserve funds, voting and creating new branches and obtaining licenses¹.

The nature of the relationship between IFBIs and the central bank differs from one country to another; depending on the legal framework governing the status of these institutions in each country, as it is illustrated in table 1. Some states have adopted specific legislation for this type of institutions, while others apply the same legislation developed for conventional system. However, we can distinguish three aspects of relation between IFBIs and the central bank, namely²:

- *As a lender of last resort*: the central bank may intervene to prevent crises, to protect depositors and prevent damage to the economy that may be caused by the collapse of banks, to provide liquidity to Islamic banks in need of capital, on the basis of mudaraba and/or mucharaka;
- *As a clearing house*: the central bank offers to Islamic banks regulatory checks and other payment methods, and provides services related to letters of credit and letters of guarantee for a commission;
- *As a monetary policy supervisor*: the central bank must approve regularly models and forms of data required by Islamic banks. Some central banks have also set a lower level of liquidity ratio in Islamic banks compared to other banks, according to the specific nature of their relationship.

Table 1: Nature of the relationship between central bank and IFBIs

Example of countries	Governance
Iran, Pakistan et Soudan	Regulation and governance system adopted by the central bank are Shariah-compliant in the entire banking and financial sector of the country.
Malaysia, Turkey, AUE, philippines, etc	The central bank of the country establishes a specific regulation and governance system to IFBIs in addition to those of conventional institutions.
Algeria, Tunisia, France, Germany, etc	The central bank of the country establishes common regulation governance to IFBIs as well as to conventional institutions.

¹ Bouyahiaoui Nasser et Ouendi Lynda; « *La gouvernance des institutions bancaires et financières islamiques : Quel rôle pour la banque centrale ?* » 8^{ème} colloque international sur Le rôle de la gouvernance dans l'activation de la performance des institutions et des économies ; Université Hassiba Ben Bouali de Chlef ; Algérie ; 19-20 Novembre 2013; P 486.

² <http://www.financialislam.com/relationship-with-central-banks.html> (viewed on 12/03/2015)

Source : Bouyahiaoui Nasser et Ouendi Lynda; « *La gouvernance des institutions bancaires et financières islamiques : Quel rôle pour la banque centrale ?* » 8^{ème} colloque international sur Le rôle de la gouvernance dans l'activation de la performance des institutions et des économies ; Université Hassiba Ben Bouali de Chlef ; Algérie ; 19-20 Novembre 2013; P 487.

3.2. International Islamic standard-setting bodies

A number of multilateral institutions issue standards and best practices guidelines which are not legally binding, but they may become mandatory if approved by national regulatory authorities. Compliance with such standards helps an IFBI achieve a good reputation globally, and win customers confidence. The international standard-setting bodies also help governments and supervisory agencies gain a better understanding of the marketplace and may play a key role in promoting financial stability across the markets. The main goals of the international Islamic standard-setting organizations could be illustrated as follows¹:

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

Table 2 summarizes the governing purpose and mission of the major international Islamic standard-setting bodies.

Table 2: Primary international Islamic standard-setting bodies

AAOIFI	The Accounting and Auditing Organization for Islamic financial institutions prepares and issues accounting, auditing, and corporate governance standards, as well as ethics and Shariah standards, for IFBIs. It has also planned a Certified Islamic Public Accountant program for accountancy education.
IFSB	The Islamic Financial Services Board serves as an international standard-setting body for regulatory and supervisory agencies. It has pronounced on corporate governance, risk management, capital adequacy, supervisory review processes, transparency, market discipline, recognition of ratings on Shariah-compliant financial instruments, and the development of money markets. It also arranges summits, conferences, and workshops on issues relating to Islamic banking.
MASB	The Malaysian Accounting Standards Board's primary role is to develop accounting and financial reporting standards. Its financial reporting standards are developed in harmony with the international accounting standards organization and the AAOIFI. The standards are developed specifically to meet the needs of Islamic financial practices as well as the needs of the regulatory and economic structure in Malaysia.

¹ Shanmugam. B & Zahari A. R; op.cit; décembre 2009 ; p 87-88

GCIBFI	The General Council for Islamic Banks and Financial Institutions is an international autonomous not-for-profit corporate body that represents IFBIs globally. Its key aims are follows: <ul style="list-style-type: none"> • Disseminating information on Shariah concepts and the rules and provisions related to them in order to help develop the Islamic financial industry, • Enhancing cooperation among its members, • Providing information related to Islamic financial institutions, and • Promoting the interests of its members and helping them overcome common difficulties and challenges.
IIFM	The International Islamic Financial Market is one of the core infrastructure institutions of the Islamic financial industry. The not-for-profit organization was founded jointly by the central banks and monetary authorities of Bahrain, Brunei, Indonesia, Malaysia, Sudan, and the Islamic Development Bank (Jeddah, Saudi Arabia). Its primary function is to enhance cooperation among Islamic countries and their financial institutions, specifically in promoting trading in the secondary market for Shariah-compliant financial instruments.
IIRA	The Islamic International Rating Agency started operations in July 2005 with the aim of assisting the development of regional financial markets. It assesses the risk profiles of market participants and financial instruments to help inform investor decision making.
LMC	The Liquidity Management Centre seeks to develop an active secondary market for short-term Shariah-compliant treasury products. It helps Islamic financial institutions effectively manage their asset/liability mismatch and improve the quality of their portfolios.
BIS	The Bank for International Settlements of Basel (Switzerland) fosters international monetary and financial cooperation and serves as a bank for central banks. This international body has issued guidelines to mitigate supervisory issues and improve the quality of banking supervision worldwide. Like conventional banks, Islamic financial banks have to comply with Basel guidelines.
IMF	The International Monetary Fund was established to promote international monetary cooperation, financial stability, and arrangements for reforming the international financial system. Among its goals are to foster economic growth and support high levels of employment. It also provides temporary financial assistance to countries to help ease balance of payment problems.

Source: Shanmugam. B & Zahari A. R ; “A primer on Islamic finance”; The Research Foundation of CFA Institute; Virginia; December 2009, p 89

Conclusion

Through this paper, we have tried to present and explain how Islamic financial and banking institutions are governed. The organizational structure and governance of these institutions require specific framework of governance model, based on Shariah-compliant governance for all administrative and technical activities. But, as we have tried to explain, there is also a common governance model with conventional institutions, namely, “administrative governance” (according to management control and auditing regulatory compliance...). Hence, we can confirm both hypothesis and conclude that IFBIs are governed and regulated under dual governance.

IFBIs governance involves a major element to their development and performance, especially in this financial globalization area, as they face competition from their conventional counterparts. But also to hedge risks and failures related to the global financial system. For this purpose, only internal governance of IFBIs may not be sufficient to lead these institutions to ensure their role and mission, or to ensure their sustainability. Thus, external governance is necessary for these IFBIs, and that might be reflected through the role of central banks and the various international Islamic standards-setting organizations.

Nevertheless, to ensure a good governance and a sound reputation of IFBIs, they ought to adopt a better selection strategy and employee recruitment; a more rigorous and objective selection of Shari'a board members based on their qualifications and expertise, both in Islamic jurisprudence and Islamic finance functions; the development of specific regulations by central banks; the unification of governance standards, management and opinions of jurists among all IFBIs; and finally, a better cooperation between Islamic international organizations and their conventional counterparts which might allow a better understanding of the international governance standards (mainly, Basel standards).