

Current Developments of Corporate Governance in Islamic Banking and Finance.

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ABSTRACT

This research will investigate the issue of Corporate Governance . The focus of this topic will be on the role and development of Corporate Governance in Islamic Banking. It will also discuss the influence of the sources of Islamic Law and the Islamic philosophy on ethics in the area of Islamic Banking and Finance. This will be further complemented with the importance of Islamic Culture on the role of Corporate Governance in Islamic Banking and Finance. This area is important to the long time survival of Islamic Banking and Finance in the global arena. The responsibility of implementing the right corporate governance will reflect the success of Islamic Banking and Finance. This research will use case studies, theories and code of ethics in companies to evaluate the extent of the development and effect of corporate governance and ethics in Islamic Banking. A comparative study with UK, Australia and Malaysian Islamic financial and banking industry will be undertaken. The Guiding Principles on Corporate Governance will be used to study the effectiveness of Corporate Governance.

Keywords: Corporate Governance; Islamic Culture; Islamic Banking; The Guiding Principles; Islamic Law.

This paper is dedicated to my good friend and colleague the Late Ms Janalecthumii who passed away in a tragic white water rafting accident on 21st January 2007. May her soul rest in peace.

General Introduction

"Capacity should be established in all Commonwealth countries to create or reinforce institutions to promote best practice in corporate governance; in particular, codes of good practice establishing standards of behaviour in the public and private sector should be agreed to secure greater transparency, and to reduce corruption."¹

Corporate Governance – A general introduction

Interest in Islamic banking has grown considerably during the last decade. The main issues of concern are the conceptual framework and viability of interest-free banking, and the assessment of its performance and future. In a world where conventional interest-based finance is the dominant framework, Islamic banking faces many challenges that must be addressed. Today I shall be addressing the issue of governance pertaining to Islamic Banking and Finance

While corporate governance as a concept has received increasing attention in recent year, there peers to be some lack of clarity, at least in popular perception, as to what exactly is covered under this expression, Similarly, there is also a great delay of righteous indignation, particularly in hindsight, when something apparently goes along with the corporate world and frequently efforts are made to pinpoint responsibility and, perhaps, even seek retribution. This self, correcting reaction is, in most cases, the societal response towards chastising the wrong doers, and restoring order and balance in normative compliance,² It is important in a more material context to establish what the accepted conduct its under varying circumstance sand time frames, who is accountable and to whom, and what kind of an operating environment or infrastructure ought to be in place not lonely to ensure but also to enable proper discharge of assigned responsibilities.

The imperatives of corporate governance flow essentially form essentially form the3 concept of accountability for the safety and performance of assets and resources entrusted to the operating team. In a proprietary concern or small business, employees performing tasks will thus be accountable for their actions to the proprietor or partners or other owners of the business. The rigors of accountability under such circumstances are relatively easily managed since the liens of communication and supervision usually are short and straightforward. With the growth of business in size and complexity leading to the corporate form of organisation, ownership and management of enterprises get distance and consequently accountability and governance issues assume must greater significance and magnitude. A Board of directors is juxtaposed between the shareholders or owners own the one hand and the executives, manager, and other employees of the

¹ Commonwealth Business Forum Resolution, October 1997, endorsed by the Edinburgh Commonwealth Economic Declaration

² In an oft-quoted hymn in the Bhagawad Gita, the famous Hindu religious and mythological classic, Lord Krishna postulates the divine purpose of such periodical incarnations as being destruction of evil and the wrong-doers, support of the righteous, and upholding and restoration of Dharma, the upright and ordained conduct.

organization of the other. In effect, therefore, corporate governance basically, has to deal with power and accountability: who exercises power, on behalf of whom, and how the exercise of power is controlled.³

Corporate Governance in Banking Sector

Corporate Governance thus far has always been discussed in relation to corporations. Many may not realise but banks are corporations themselves. However banks are also very different from corporations. A corporation can be seen through a clear glass but in many ways banks are seen through an opaque glass. This is because the financial information is more obscure and it is far more difficult to check on the performance. Performance is imperative to the wellbeing of any banks therefore good corporate governance is the key criteria in any bank's performance. In order to perform, risks must be taken; therefore as in any corporation, in lieu of that, corporate governance must be in place for the overall well being of the banking system

Because of the special position of corporate governance in banks, banks are highly leveraged and heavily regulated. The regulations include activity restrictions and prudential requirement. Therefore the government i.e. through the Central Bank monitors the activities of banks. In Malaysia, banks are monitored by the Central Bank which a body regulated by the government. In Malaysia, there are government owned banks⁴, which makes it different from corporations. This important to ensure that there objective of monetary and financial stability is achieved. This will further ensure that the payments systems functions properly. In order to curb abuse in this type of banking system, the Central bank has gone one step further by ensuring that they share information amongst regulators across borders. This is important as the financial activities are becoming more globalised. The exchange of views will be able to solve key issues that are faced in their own jurisdictions.

Although much has been talked about CG in corporations, there is little evidence⁵ on the acceptable standards and models of CG in banking institutions and hardly any on issues of regulations and supervisions.

The key important elements of corporate governance are objective⁶, transparency⁷ and accountability⁸. In order to achieve should corporate governance, it is important to look

³ Sir Adrian Cadbury, in Reflections on Corporate Governance, Ernest Sykes Memorial Lecture, March 11, 1993, in London. Quoted by William G Bowen in Inside the Boardroom, (1994), John Wiley & Sons.

⁴ Bank Rakyat, Bank Pertanian, Bank Pembangunan Malaysia, Bank Simpanan Nasional, EXIM Bank to name a few examples.

⁵ Rethinking Bank Supervision and Regulations: Until Angels Govern - Ross Levine, James Barth and Gerard Caprio. Cambridge UK, Cambridge University Press (2006)

⁶ The objective of an organization is important , this is especially so in relation to managers incentives with the shareholders

⁷ Manager's action are observed by stakeholder and ensure they have access to information in order to form an opinion

at the roles of codes and best practices. However, they must be not only accepted but practised. These codes and best practise is a guide to gauge the corporate governance of an organisation. It must be understood that in order for corporate governance to work effectively it must be included and backed up by effective means to ensure compliance. However, if it is not clear, simple and transparent towards the fundamental goals of an organisation. Clearly here, it will not produce optimal effect of success in this area.⁹

Corporate Governance in Islamic Banking

The recent scandal and sinking of Islamic Bank in 2005¹⁰, the country's first Islamic bank has raised questions about the corporate governance in Islamic banks. Crucial questions were raised as to how strong and effective is the country's regulatory framework? Why were there no closer supervision or tighter accounting standards? Why was the risk managements not tightened? Why was there lack of autonomy from the executive and central bank? This crisis clearly showed that there was a problem in the corporate governance of Islamic Banking System and a timely reminder of that the enforcement of corporate governance has been to in place.

Corporate governance is strongly advocated in Islam¹¹. Proper recordkeeping and accountability¹² is stressed in the Quran, so that parties in business dealing will not suffer. The underlying importance in business dealings in regard to transparency and disclosure is implied¹³. Good corporate governance not only reinforces sound regulation and supervision but also promotes market confidence but also strengthens transparency¹⁴ and accountability.

⁸ Manager's accountable to the organization and they must show that they have achieved the objectives of the organization.

⁹ 'Lessons from international corporate governance standards: the ethical perspective of corporate governance' – a presentation by Malcolm D Knight General Manager of the BIS at the 2nd Islamic Financial Services Board Summit, Doha, Qatar 24 May 2005

¹⁰ A loss of RM400 million before taxation. This was a sharp dive as compared to a year earlier where the profit of RM118 million was recorded. And a gross total of 2.2 billion in Non Performing Loan.

¹¹ The Quran in verses 282 and 283 of Surah Al- Baqarah, states a detailed, step by step process for transacting:

- O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you.....You should not become weary to write your contract down, whether large or small, for its fixed term, that is more just with Allah, more solid as evidence, and more convenient to prevent doubts among yourselves.....Take witnesses whenever you enter into a commercial contract.... S.2, V. 282
- And if you are traveling and cannot find a scribe, then let there be a mortgage taken.....And do not conceal any evidence for he whoever hides it, surely his heart is sinful, and Allah is all Knower of what you do. S2.V.283

¹² "Each of you is a guardian, and each guardian is accountable to everything under his care". – One hadith by Prophet Mohammed.

¹³ See verses 282 and 283 of Surah Al-Baqarah

¹⁴ *ibid*

The elements that have given Islamic Banking a distinctive religious entity are *riba*¹⁵, *ghirar*¹⁶, *zakat*¹⁷ and *haram*¹⁸. The Holy Qur'an makes it clear that entering into transactions that involve *riba* is *haram*¹⁹. An essential feature of Islamic banking is the prohibition of interest ("riba")²⁰. The interest-free Islamic banking is based on the concept of profit-and-loss sharing²¹, where the lender shares losses with the borrower. In practise the twin pillars of Islamic banking has always been "mudharabah and "musharakah"²². Apart from these two methods that are used in banking, there are other methods.²³ An Islamic bank cannot charge any fixed return in advance, but rather participates in the yield resulting from the use of funds. The depositors also share in the profits according to predetermined ratio, and are rewarded with profit returns for assuming risk. Unlike a conventional bank which is basically a borrower and lender of funds, an Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment. These financial arrangements imply quite different stockholder relationships, and by corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations.

The Mudharabah principles ensure that disclosure and transparency is crucial to the success of good governance. This will further boost investor confidences they will have an informed knowledge on how the funds are managed which implies quality assurance in business operations, risk control and risk profile mechanism. To further strengthen the corporate governance in Malaysia, The Profit Equalization Reserve has been provided in the rate of return framework²⁴. This is a good mechanism to minimize the impact of fluctuations in rates of return, which serves for a better governance. For the profit

The question is whether this system can be relevant in the world of revolutionary, technology-driven global finance. Islamic banks mushroomed across the world. Many conventional banks nowadays have Islamic windows or separate branches that deal with Islamic financial products. The fact that Islamic banks have been around for the last decades and continue to prosper is a proof of the viability of Islamic finance in a world dominated by interest-based banking. However, clearly success of corporate governance

¹⁵ interest

¹⁶ an element of speculation

¹⁷ mechanism for redistribution of income and wealth

¹⁸ forbidden element

¹⁹ The Qur'an states: "O you who believe! Fear Allah (God) and give up what remains of your demand for interest, if you are indeed a believer." (Qur'an 2:278).

²⁰ The best analysis for forbidding *riba* is provided by an Islamic jurist, Ibn Rushd (Averroes) in his jurisprudential work entitled "Bidayat al Mujtahid wa Nihayat al- Muqtasid

²¹ Mudharabah

²² Both principles are in line with the Islamic principles, as the lenders in both areas share the profits and losses of the enterprise for which funds are provided and *shirkah* (partnership) is involved. –Nasser M Sulaiman in Corporate Governance in Islamic Banking

²³ *Bay' muajjal* (deferred payment) *Bai'salam* (prepaid purchase) *Istissanaa* (manufacturing *Ijara and ijara wa iqtina* (leasing); *Qard hasan* (beneficence loans)) and Islamic Securities.

²⁴ This is a means of examining the efficiency and efficacy of the banking institution, in terms of its profitability, management competency and fairness.

is disclosure; this must be further reinforced by educating the customer and creating awareness by conducting programmes to the public in general. The interpretation of the Quran and the Shariah principles will be an asset

Corporate Governance in Islamic Banking is different from that of a Conventional Banking. The former is governed by the rules of Holy Qur'an and the financing methods that are provided must be acceptable to the Muslim community as a whole. The interesting characteristics in this would be the issues of equity participation, risk and profit and sharing loss arrangements. Therefore, in order to ensure strict compliance with the Shariah principles, Islamic Banks employ Shariah Advisory Board/ Shariah Committee Council.

The main difference between Islamic banks and conventional banks is the sources of law which govern these banks. The functions and operations of conventional banks are based on man-made principles, while Islamic banks are based on the Shariah principles. Therefore, Islamic financial products should be in compliance with the Shari'ah (Islamic law)²⁵ and the establishment of any new practice should be compatible with the Shari'ah.²⁶ The necessary adjudicative forum is in place; however, more needs to be improved such as competent lawyers and judges who are readily equipped with sound knowledge and expertise²⁷ in both areas of law²⁸

The success of Islamic Banking system is dependent on whether the legal, regulatory and supervisory framework is in place and in place. This is an important criterion of any financial infrastructure. However, this framework for the purpose of IB must be in conformity with the Shariah principles. Without a doubt, Islam advocates all forms of good governance; this is clearly visible in the values and ethical conducts that are built in the community and also the underlying principles of justice, accountabilities and equitable distribution of income. This will have to be supported with a court system which would be able to enforce judgements in banking and financial cases.²⁹ This is important as an effective governance is not only through the advertisement but the application of it³⁰. The supervisory role should be dealt by the legal framework. The legal framework must ensure that clear guidelines and responsibility are given to the relevant agencies when carrying out the supervision of the Islamic financial institutions.

²⁵ The Islamic Banking Act 1983 and Takaful Act 1984 were enacted to govern the conduct of Islamic Banking institutions and takaful operators

²⁶ One Hadith states: From Jabir (peace is upon him) —the Prophet (peace and blessings of Allah be upon him) cursed the receiver and payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike in guilt". (Reported in Muslim, Tirmidhi and Ahmad)

²⁷ In early 2006 Bank Negara launched the International Centre for Education in Islamic Finance which complements the Islamic Banking and Finance Institution Malaysia and International Centre for Leadership in Finance. (Deputy Governor's speech at the Official Launch of HSBC Amanah Takaful (Malaysia) Sdn Bhd.

²⁸ Shariah and Civil.

²⁹ This would include cases in contracts, bankruptcy, and collateral and loan recovery.

³⁰ BIS Review 3/2004- Governor's Keynote Address at the 2nd International Conference on Islamic Banking: Risk Management, Regulation and Supervision – "Building a Robust Islamic Financial system"

There are several theoretical issues that constrain the growth of the Islamic finance industry. In addition, Islamic banks face numerous challenges regarding the implementation of the Basel II Capital Accord that is aimed at interest-based banking³¹. This is due to the fact that the Islamic bankings unique characteristics and risks on its products and services³². Therefore this standard³³ may not be suitable to Islamic Banking and this will result in loop holes particularly in relation to the capital treatment³⁴ and risks³⁵ associated. This will not be an effective method of governance. Just as in conventional banking, the Islamic banks in Malaysia are imposed with the minimum risk weighted capital ratio (RWCR) which are prudential standards for corporate governance and risk management, financial disclosures.

For successful and effective corporate governance the Islamic Financial Services Board had formulated a more rigorous risk management system which would facilitate cross-border supervision. This is to ensure that during periods of uncertainty, the financial sectors will face less adverse effect, if not none. The risk management infrastructure³⁶ is important. The Computer Crimes Act 1997³⁷ should be further developed to ensure that any issue related to the use of information technology in the banking industry be further strengthened. This is important as well developed IT systems will enhance the ability to manage risks. Further to this a derivatives market should be developed, in order to mitigate and manage new emerging risks globally. The Islamic Financial System needs introduce and develop more efficient money and capital markets. This will facilitate strong corporate governance by ensuring that the asset and liability and liquidity management is soundly managed by the Islamic Banking Institutions. The Central Bank of Malaysia in foreseeing these issues had introduced Sukuk al-Ijarah³⁸. Why this is important is because Sukuk belongs to a category of Asset Backed Securities, also known as securitized assets. An underlying tangible asset transaction in the form of ownership or a master lease. It must limit the debt to the value of the underlying assets. This is an

³¹ The Basel core principles are the minimum standard operations requirements for traditional banking system.

³² Islamic finance in Malaysia has evolved dramatically. The range of the products has expanded beyond murabahah or Bai Bithaman Ajil (BBA). New Islamic products were introduced including residential mortgage backed securities, commodity based financing, as well as investment and equity linked products based on musyarakah, mudabarab and ijarah.

³³ Although Basel standard has to an extent incorporated the identification of risks (credit, market and operational risks in product offering)

³⁴ Capital charge on its investment account.

³⁵ The overall risk management system has been drafted by Islamic Financial Services board to ensure good corporate governance

³⁶ Bank Negara has laid down a prudential framework to maintain investor confidence and public trust – Deputy Governors Speech at the Official Launch of HSBC Amanah Takaful (Malaysia) Sdn Bhd 12 Sept. 2006

³⁷ Under Islamic law, computer crime falls within the area of taazir offences, which operates according to the same principles of evidence law as civilian systems: the free introduction and evaluation of evidence (system de l'intime-conviction). In adjudicating taazir offences the judge weighs the reliability of evidence, and thus computer records are generally admissible in the prosecution of computer crime.

³⁸ The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued standards for 14 different Sukuk types. The most common in 2004 were Sukuk Al Ijarah based on leasing transactions. In Malaysia the Sukuk bithaman Al Ajil (Murabaha based) is very popular but not so for Middle Eastern investors.

effective investment policy which will ensure that in difficult financial turbulence the borrower and his debts handled in an ethical and proper manner³⁹.

The empowerment of shareholders is important and central to good governance as this will work as an incentive and they would be able to police the Management on basis of allocating capital as this is the essence of sound management. However, disclose is also important so that market players would be able to analyse and interpret the information so that to ensure on going effective corporate governance. Lack of transparency erodes market confidence as shareholders may not necessarily be protected. In order to enhance transparency⁴⁰ proper accounting standards⁴¹ must be in place.

As understood the principles of profit sharing agreements is a characteristics of this banking system. It is interesting to note that although this system is against the use of interest, the Islamic banks have grown rapidly not only in Malaysia but all over the world.⁴² The Accounting and Auditing Organisation for Islamic Financial Institutions is a body that ensures good corporate governance is in place as this is undertaken by improving quality of financial statements and the methods of reporting if Islamic Financial Institutions. The role of Shariah committee and code of ethics that govern accountant and auditors has been further improved by the Accounting and Auditing Organisation for Islamic Financial Institution⁴³. These developments become an integral part of the international financial system. What more of the fact that Malaysia had recently allowed the entry of new foreign players and that has increased the foreign participation in the domestic financial market. Due to the greater international integration, and in order to ensure greater effective a strong regulatory and supervisory framework reinforced by the monetary authority⁴⁴ must be in place.⁴⁵ Therefore the establishment of the Islamic Financial Services Board in 2002 and the development of standards on corporate governance⁴⁶ will ensure perpetual succession of Islamic Banking. The standards on corporate governance is referred to as the Guiding Principles which

³⁹ This is imperative for the future of Islamic Banking as it gives borrowers time to pay out by future generation regardless of whether there are any securities over the debts-Michael Saleh Gassner in Banker Middle East February 2005, Issue 56

⁴⁰ This is important as mudaharabah is an important aspect of sourcing funds

⁴¹ It must be however be noted, that this is only possible if a body of financial accountant are well experience in Shariah principles as it should be based not only on international accounting standard but also the Islamic principles.

⁴² Profitability surpassed the RM1 billion marked for the first time in 2005, and the first half of 2006 recorder a profit of RM800 millions. The total assets of Islamic Banking currently stand at RM 122 billion. – December 1: Speech- Abdul Kadir on Islamic Banking and Finance. Deputy Governor of Central Bank of Malaysia at the Official Launch of Kuala Lumpur International Islamic Finance Expo 2006.

⁴³ Accounting, Auditing and Governance Standards for Islamic Financial Institutions 2004-2005 Edition (AAOIFI Publications)

⁴⁴ The Central Bank of Malaysia.

⁴⁵ Governor's Keynote Address at the 2nd International Conference on Islamic Banking: Risk Management, Regulation and Supervision – “Building a Robust Islamic Financial system”

⁴⁶ Islamic Financial Services Board developed “Guiding principles on Corporate Governance For Institutions Offering only Islamic Financial Services (excluding Takaful and mutual funds) in December 2006

are divided to four parts⁴⁷ are there to ensure that IIFS identifies areas of proper governance structure and the process that is required and to recommend best practices in addressing the issues. The principles are not intended to replace the international standard of corporate governance but to complement the existing standards⁴⁸.

The implementation of these principles is crucial to a sound corporate governance of Islamic Banking Sector in Malaysia. The guiding principles under recommended best practises⁴⁹ are that that A governance committee⁵⁰ must consist a member of the Audit Committee, a Shariah Scholar and a non-executive director who should be an independent non executive director⁵¹. The Chairman of the Governance Committee must have skill and knowledge in financial statements and should be the conduit pipe between the governance committee and the Audit committee the governance committee should be empowered to oversee and monitor the implementation of the governance policy framework by working together with the management, the Audit Committee and the Shariah Supervisory Board. And to provide the Board of Directors with reports and recommendations based on its finding in the exercise of its functions. It must be noted however that there should not be an overlap of roles between Governance Committee and Audit Committee⁵². The governance committee is to protect the interest of the stakeholders other than the shareholders.

The Shariah Scholars must be included in the Governance Committee to lead the committee on Shariah related governance issue. This scholar will be the coordinator and the causal link between the Shariah Supervisory Board and the Governance Committee. The NED which is the third member should have legal and business skill and expertise. The primary objective of this GC is to protect the interest of the stakeholders other than the shareholders which is in line with the Basel Committee on Banking Supervision⁵³. Enhancing Corporate governance is based on eight key principles.⁵⁴ The compliance of

⁴⁷ (i) general governance approach of IIFS; (ii) the rights of investment account holders; (iii) compliance with Islamic Shariah principles and (iv) transparency of financial reporting in respect of investment account.

⁴⁸ The guiding principles have adopted terms “corporate governance” and “stakeholders” from the OECD (Organization for Economic Corporation and Development) principles and BCBS (Basel Committee on Banking Supervision). However this has been modified to suit the guiding principles.

⁴⁹ Part 1: General Governance Approach of IIFS

⁵⁰ Part 1 principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS’s accountabilities to various stakeholders.

⁵¹ Check and balance is enforced this way.

⁵² This is to prevent abuse and independence.

⁵³ BCBS recently published a document entitling “Enhancing Corporate Governance of Banking Associations 1999 revised in 2006, which acts as annexation of the OECD framework of corporate governance.

⁵⁴ **Principle 1:** Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank. This includes understanding the bank’s risk profile and approving the overall risk policy and risk management procedures. **Principle 2:** The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation. **Principle 3:** The board of directors should set and enforce clear lines of responsibility and accountability throughout the

the guiding principles is when an IIFS ensures that all relevant disclosures made to the supervisory authorities or to the public comprise of two components, firstly the reporting of how these principles is applied including any special circumstances of the approach of this application and whether an IIFS has either confirmed or not and reasons for non confirmation but be stated. However it must be borne in mind that the support of the Supervisory authorities is much needed here. If there is a conflict between the Governance Committee and the Audit Committee the former has the responsibility of acting as the reconciler.

The setting up of Audit Committee⁵⁵ is to ensure that non - compliance with Islamic Shariah rules and principles is reported to IIFS in a timely manner. Their primary objective on behalf of the stakeholders is to ensure that there is integrity of the financial reporting control and procedures implemented by the management are valid and relevant. This committee will comprise of at least three members (a chairman and tow other members) who are non executive members with the required skill and expertise in the ability to analyse the financial statements and documents. These members will be elected by the Board. Their responsibility will be to review and monitor the entire accounting process of the IIFS. This will be undertaken with the cooperation of the internal and external auditors and to inform the BOD whether the compliance with internationally recognised accounting standards applicable to the Islamic Financial services Industry is practised through their reports and recommendations.

The right of the Investment Account Holders⁵⁶ monitoring of performance in their investment does not mean that they have intervened in the management of investments by the IIFS. In order to promote transparency for good corporate governance, it has been recommended that IIFS should disclose their policies and practises. IIFS owes a fiduciary obligation to the IAHs and means that they must be accountable by ensuring that the investment accounts continued to be managed within parameters of the given mandated. IIFS must advise IAHs as to their contractual rights and risks in regards to the investments. Further the Governance Committee ensures that IIFS is responsible in protecting the rights of IAH by monitoring the performance of their investments and

organisation. **Principle 4:** The board should ensure that there is appropriate oversight by senior management consistent with board policy. **Principle 5:** The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions. **Principle 6:** The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment. **Principle 7:** The bank should be governed in a transparent manner. **Principle 8:** The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency.

⁵⁵ Part 1 , principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with Sahriah rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country

⁵⁶ Part 2, principle 2.1: IIFS shall acknowledge IAH's 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.

relevant disclosures are made in timely and effect manners, and also to ensure proper implementation of the investment contracts.

In terms of risk management⁵⁷, IAH generally seeks a low risk investment with stable return; this is different from the shareholders who favour a more challenging investment strategy of a higher return with higher risk. The profit distributed the IAH differs from their attributable share of the IIFS's earning. The practice of "smoothing the returns" is adopted by many IIFS, a special type of reserve that is the profit equalization reserve is used. The guiding principles notes that this enables the IIFS to pay a competitive rate of return in a year when the IAH's profit rate is below the market rate, however, the concerns⁵⁸ of transparency and accountability is looming ahead.

Therefore IIFS when acting on behalf of IAH must carefully consider the risk and return expectations by having imposing the know your customer policy, employing qualified investment managers and keeping the Governance Committee fully informed of all the investments practises. Profit Equalisation Reserves which is appropriated from the gross income and is shared by both the depositors and the banking institutions, to ensure this utilization is appropriate the Governance Committee must act as a scrutiny and any findings must be reported to the BOD. Therefore these risk management standards would serve as a guideline for the supervision of the Islamic banking.

The most important challenge in terms of poor corporate governance is the lack of Sarah principles compliant⁵⁹. This is imperative in the importance of integrity and credibility of IIFS and the BOD holds the ultimate responsibility by establishing a mechanism⁶⁰ to be mobilized in situations in order to obtain the rulings form Shariah Scholars (external or internal). The key success to this is to ensure it is obtained and mobilized efficiently and swiftly. The internal compliance reviews will be handled by SSB or Shariah Scholars of IIFS with a separate Shariah control department or a designated internal auditors/ Shariah reviewers. They are responsible for producing the internal Shariah compliance reports, training is important at to enhance their shariah compliance review skills. The external

⁵⁷ Principle 2.2: IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.

⁵⁸ Principles 2.2, 36these concerns are:

- (i) the IAHs' attributable share of profit earned and utilization of reserves – hence the IIFS's profit performance for their IAH may not be adequately disclosed; and
- (ii) Such practices may be used to mask the fact tat the IIFS has invested IAH funds in assets with more risky returns that IAH would expect, rather than achieving stable returns for their IAH by adopting an efficient and appropriate assets collection.

⁵⁹ Part 3: Compliance with Shariah Rules and Principles; Principles 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings form Shariah scholars, applying fatwa and monitoring Shariah compliance in all aspects of their products, operations and activities.

⁶⁰ Principle 3.1, Recommended Best Practices no 46: The mechanisms for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance shall cover:

- (i) both ex ante and ex post aspects of all financial transactions carried out by the IIFS – that is, to ensure Shariah compliance of the contracts and, later, the performance of obligations under the contracts; and
- (ii) Operations of the IIFS, including aspects such as Shariah compliance review, investment policies, disposal of non Shariah compliant income, charitable activities, etc.

compliance review, the Audit committee will be responsible so that external auditors are capable of conducting, ex post Shariah compliance review with in their terms of reference. Public confidence may be boosted by ensuring that a professional organization or an industry association is established for shariah scholars serving the IIFS in their respective jurisdictions.

The IIFS has decided to follow the fatwa of their scholars⁶¹. Although it is noted that there are many with differing views which will not necessarily be followed by IIFS. In order to ensure transparency and good governance, these views will be made public and upon request by the public, any decision fatwa that has been adopted must be explained. This is to provide transparency to the public. The Scholars are encouraged to publish their fatwa, as this will promote and create awareness to other scholars. This is a process of learning. Customers may also be allowed to access the fatwa's.

The investments by IAH should be monitored by them and they have a right to be informed as to the methods and procedure in relation to their investment account.⁶² Any Related Party Transactions and treatment of material events by IIFS will be informed to the IAH and public. This disclosure is pertinent in order to develop the transparency, accountability and risk management culture. However, it is remembered that transparency does not mean that when IAH is inundated with information, this may transpire in overload and collapse, therefore disclose must always be made promptly and orderly. This is to ensure that IAH knowledge and understanding and evaluation on their investment accounts. This information must have clarity and understanding and should be accessible to IAH and intermediaries. This is important since a mudarabah contract requires that profit distribution and allocation be declared in advance. PER and IRR are of public interest and therefore should be published in major media organs as well as IIFS annual reports. This should be made available promptly and adequately in event there are changes. The BCBS paper on disclosures should also be taken into consideration⁶³.

Although these guiding principles has only been recently designed to ensure that IIFS is assisted with an effective corporate governance, these principles are not exhaustive as they are merely serve as a guide to assist in the best practices of IIFS. These principles are not written in stone and from time to time it will be reviewed. These guiding principles are to complement the current corporate governance principles issues by

⁶¹ Principle 3.2: IIFS shall comply with the Shariah rules and principles as expressed in the rulings of the IIFS's Shariah scholars. The IIFS shall make these rulings available to the public.

⁶² Part 4: Transparency of Financial Reporting in respect of investment Accounts. Principle 4: IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment account that they manage.

⁶³ This paper lays out a number of recommendation which are: (i) information about the BOD; (ii) basic ownership structure; (iii) organizational structure; (iv) information about the incentive structure of the IIFS; (v) the IIFS code or policy of business conduct and/ or ethics and as well as any applicable governance structures or policies; (vi) where an IIFS is a state owned and (vii) the IIFS's policies related to conflict of interest, nature and extent of transactions with affiliated and related parties transactions..

OECD⁶⁴, BCBS and other international standards. Due to the loopholes in these standards, the guiding principles were established. However, it cannot be denied that many of these guidelines have been introduced by many countries prior to it being developed a set of proper guidelines. The issue of corporate governance is covered in all aspect of prudential regulations and there the enforcement of corporate governance should be dealt in a holistic manner. Good Governance structures are a pre-requisite to a successful and stable Islamic Banking system.

⁶⁴ In relation to Malaysia see Policy Brief on Corporate Governance of Banks in Asia (Asian Roundtable conference June 2006.

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