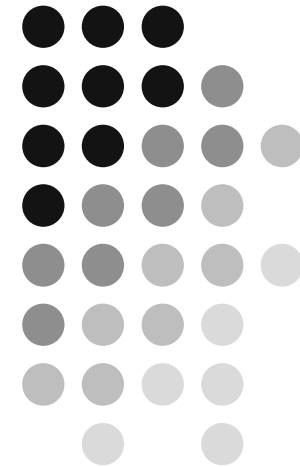


**CORPORATE GOVERNANCE
OF INSTITUTIONS OFFERING ISLAMIC
FINANCIAL SERVICES (“IIFS”):
An Insight of the Islamic Financial Services
Board’s Initiatives**



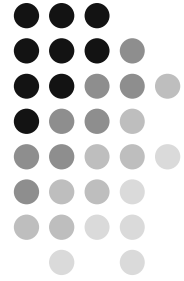
**MENA-OECD Initiative on Governance and
Investment Working Group 5
Amman, Jordan
14 February 2005**



Madzlan Mohamad Hussain
Project Manager

PRESENTATION OUTLINE

- Brief introduction to the IFSB and its mandate
- Corporate governance issues specific to IIFS
- The process of developing a standard
- Updates on standard development
- Outcomes expected from the standard



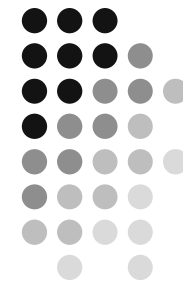
14 February 2005

2



WHAT IS THE IFSB?

- The IFSB is an **international standard-setting body** of the regulatory and supervisory agencies that have vested interest in ensuring the **soundness and stability** of the Islamic financial services (**IFS**) industry, which is defined broadly to include **banking, capital market and insurance**.
- Resulted from an extensive two-year consultative process initiated by a group of governors and senior officials of central banks and monetary authorities of various countries, together with the support from the Islamic Development Bank (**IDB**), the International Monetary Fund (**IMF**), and the Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI**).
- Was officially inaugurated on 3rd November 2002 with Malaysia as its host country.
- Started operation in March 2003.



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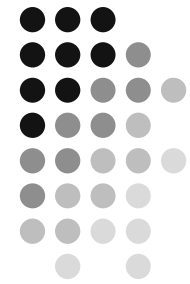
MANDATES OF THE IFSB

WHAT DOES THE IFSB ENVISAGE?

- To complement the prudential framework set out by:
 - Bank for International Settlements – Basel Committee on Banking Supervision (**BCBS**)
 - International Organization of Securities Commissions (**IOSCO**)
 - International Association of Insurance Supervisors (**IAIS**)

PRIMARY OBJECTIVES:

- To promote the development of a prudent and transparent IFS industry through international standards consistent with Shari'a principles
- To provide guidance on the effective supervision and regulation of IFS



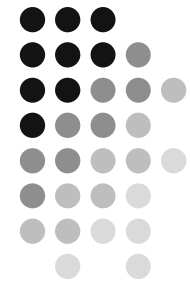
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MEMBERS OF THE IFSB ... (1)

Currently, we have 64 members comprising:

- 19 regulatory and supervisory bodies:

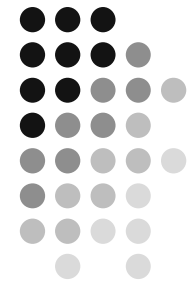
1. Bahrain Monetary Agency
2. Bangladesh Bank
3. Ministry of Finance Brunei
4. Central Bank of Egypt
5. Bank Indonesia
6. Central Bank of Iran
7. Central Bank of Jordan
8. Central Bank of Kuwait
9. Bank Negara Malaysia
10. State Bank of Pakistan
11. Qatar Central Bank
12. Saudi Arabia Monetary Agency
13. Bank of Sudan
14. Central Bank of United Arab Emirates
15. Bangko Sentral ng Pilipinas
16. The People's Bank of China
17. Labuan Offshore Financial Services Authority
18. Monetary Authority of Singapore
19. DIFC Financial Services Authority



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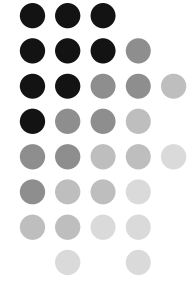
MEMBERS OF THE IFSB ... (2)

- 5 international inter-governmental agencies:
 1. Islamic Development Bank (**IDB**)
 2. International Monetary Fund (**IMF**)
 3. The World Bank (**WB**)
 4. Bank for International Settlements (**BIS**)
 5. Asian Development Bank (**ADB**)



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MEMBERS OF THE IFSB ... (3)



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- 40 financial institutions:

BAHRAIN

1. Al Amin Bank
2. Albaraka Banking Group
3. Bahrain Islamic Bank
4. BNP Paribas Islamic Banking Unit
5. First Islamic Investment Bank
6. Kuwait Finance House - Bahrain
7. Noriba Bank

EGYPT

1. Egyptian Saudi Finance Bank
2. Faisal Islamic Bank

IRAN

1. Bank Saderat
2. Bank Keshavarzi

JORDAN

1. Jordan Islamic Bank for Finance and Investment

KUWAIT

1. A'ayan Leasing & Investment Co.
2. Gulf Investment House
3. Investment Dar
4. Kuwait Finance House

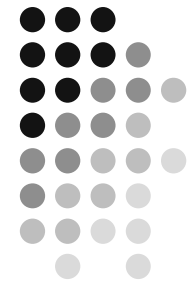
QATAR

1. Qatar Islamic Bank
2. Qatar International Islamic Bank

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MEMBERS OF THE IFSB ... (4)



MALAYSIA

1. Affin Bank
2. AmBank Group
3. Bank Islam Malaysia
4. Bank Kerjasama Rakyat
5. Bank Muamalat Malaysia
6. Commerce International Merchant Bankers
7. Hong Leong Bank
8. Malaysia Rating Agency
9. RHB Bank

UNITED ARAB EMIRATES

1. HSBC Amanah Finance
2. Dubai Islamic Bank

USA

1. Guidance Residential LLC.

SAUDI ARABIA

1. Al-Jazira Bank
2. Al-Rajhi Banking & Investment Corporation
3. Islamic Corporation for the Insurance of Investment and Export Credit
4. National Commercial Bank
5. Saudi British Bank

SUDAN

1. The National Pensions Fund
2. Omdurman National Bank
3. Sudanese Bank Associations
4. Sudan Financial Services Company

SOUTH AFRICA

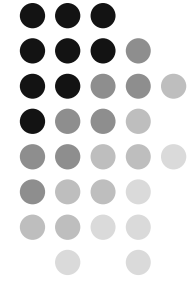
1. Oasis Crescent Capital

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STANDARDS IN THE PIPELINE



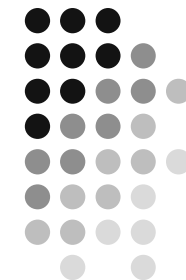
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For a start, IFSB has been working on 4 Standards, namely:

- Capital Adequacy
- Risk Management
- Corporate Governance
- Transparency and Market Discipline

ISLAMIC VIEWPOINTS ON IMPORTANCE OF GOOD GOVERNANCE

- The concept of vicegerency - Accountability to God as well as to others. Ethics of IFS are set out not only in contracts and residual contracts but ultimately accountability to God.
- Amongst the code of ethics set out in the Qur'an:
 - ❖ Honest fulfilment of all contracts (5:1)
 - ❖ Prohibition against betraying any trust (8:27)
 - ❖ Prohibition against deriving income from cheating, dishonesty or fraud (4:29)
 - ❖ Prohibition against bribery to earn unfair advantage (2:188)
 - ❖ Prohibition against concealing evidence (2:283), for e.g. to manipulate prices
- IFS must fulfil obligations to all stakeholders as long as within the confinement of the Shari'a.



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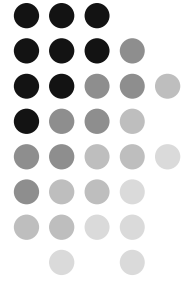
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SPECIFICITIES OF IIFS

In addition to general banking matters, organs of governance of IIFS also need to attend to:

- Shari'a compliance
- Ethics & social responsibility (in line with the concept of vicegerency)
- Interests of IAH, especially unrestricted
- Potential conflicts of interest between shareholders and unrestricted IAH especially where the funds are commingled - issues of asset allocation & 'risk appetite'
- Transparency in financial reporting, e.g. calculation of Mudharib share (where funds are commingled) and profit distribution



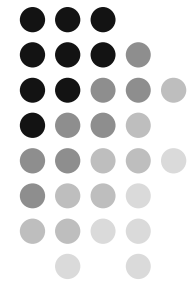
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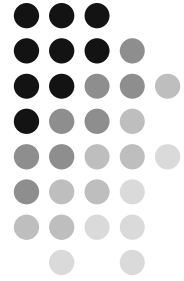
CORPORATE GOVERNANCE ISSUES IN IIFS

- Protection of Investment Account Holders (“IAH”)
 - ❖ Like Collective Investment Shareholders, IAH are exposed to potential conflict of interest with the management of an IIFS, which may look after the interest of shareholders at the expense of IAH.
 - ❖ As in the case of securities regulators, this requires more emphasis on fiduciary responsibility or establishment of detailed regulations designed to monitor potential conflicts of interest.
 - ❖ Furthermore, adequate disclosure of relevant information about the IIFS’ investment objectives and policies, operational guidelines that govern the relationship between the IIFS and IAH, etc. should be made available.
 - ❖ Albeit IAH may have no representation in the organs of governance such as the Board of Directors or Shariah Supervisory Board, they have every right to expect accountability and transparency on investment made on their behalf.



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CORPORATE GOVERNANCE ISSUES IN IIFS ...(2)



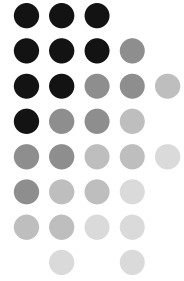
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- Shari'a Supervisory Board ("SSB")
 - ❖ SSB is a specific organ of governance. It should be concerned with **monitoring** Shari'a compliance and not just issuing fatwas.
 - ❖ Since SSB members may lack monitoring skills, auditors and audit committee should act in concert to assist SSB.
- Transparency in financial reporting
 - ❖ The current financial reporting practices of IIFS do not provide adequate information to their IAH regarding the revenues and expenses accruing to their particular investment fund
 - ❖ IAH is rightfully entitled to transparency, e.g. calculation of Mudharib share and profit allocation

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DEFINING 'STAKEHOLDERS' ...(1)



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BCBS paper:

- “Stakeholders” include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders [of banks].

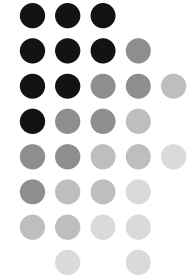
From **Islamic** financial services perspective:

- ‘Community’ should particularly connote the Muslim Ummah
- ‘Customers’ do not only cover normal depositors and borrowers but also Investment Account Holders and Current Account Holders

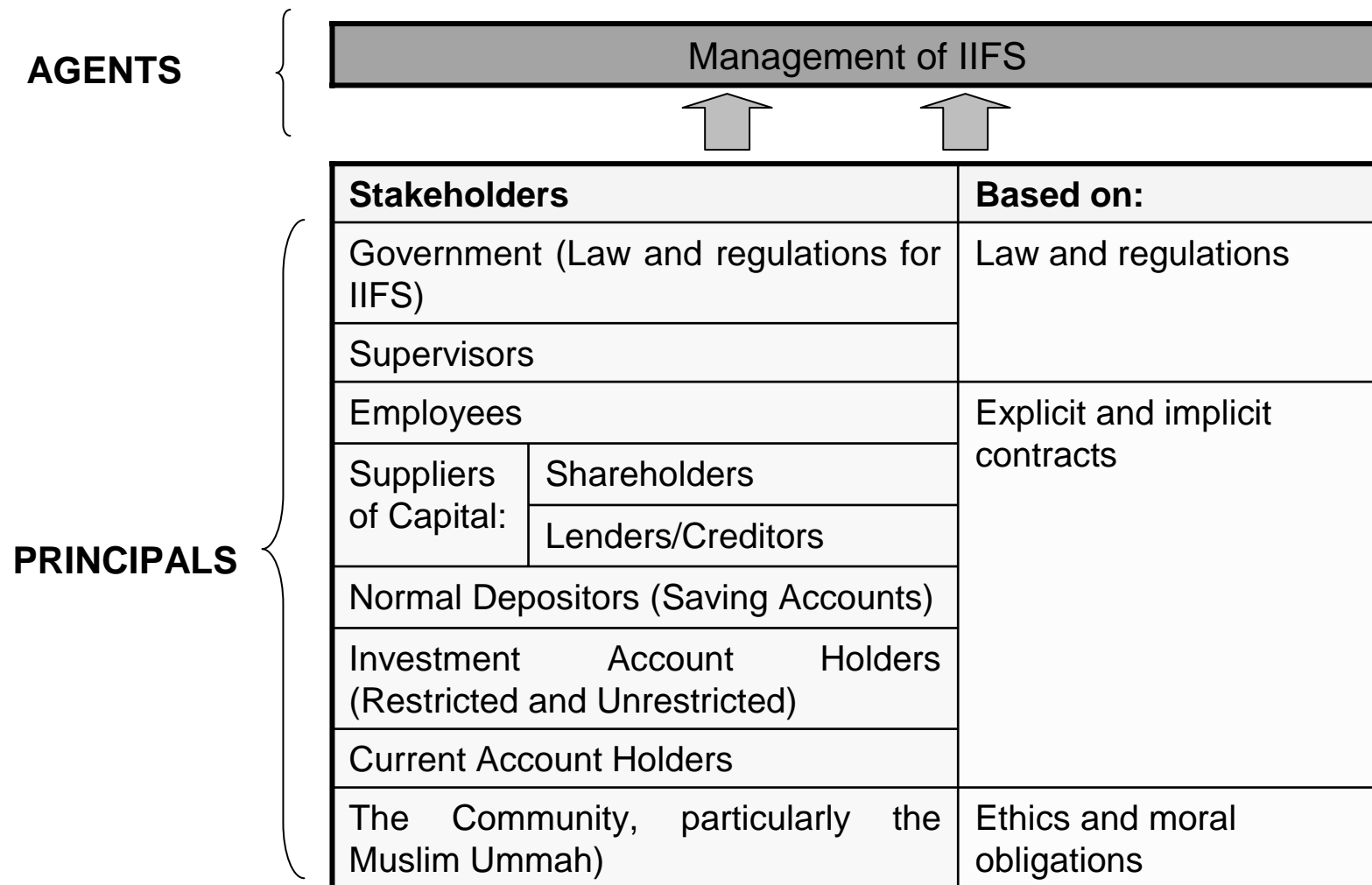
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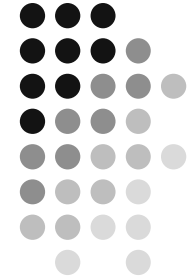
DEFINING 'STAKEHOLDERS' ...(2)



14 February 2005



RELEVANT CG ISSUES IN IIFS VIS-À-VIS THE STAKEHOLDERS ...(1)



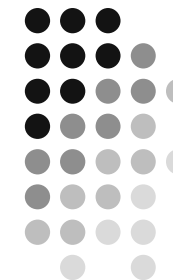
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Stakeholders	Relevant CG Issues	Responsibilities in CG
Government (Law and regulations for IIFS)	Enacting adequate and appropriate laws governing the operations of IIFS	To ensure the best CG practice is carried out by IIFS by providing clear laws and regulations
Supervisors	<ul style="list-style-type: none"> • Ensuring the stability and soundness of the financial system (eliminate systemic risk) • Developing internal controls, risk management procedures and standards of transparency 	To monitor overall operations of IIFS in general and risky behaviour in particular, by requiring IIFS to comply with the relevant guidelines
Employees	<ul style="list-style-type: none"> • Acquiring the relevant skills and work ethics • Obtaining the right incentive structure 	To meet the goals set by the Management and to minimise operational risks by applying the best ethics and practices

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RELEVANT CG ISSUES IN IIFS VIS-À-VIS THE STAKEHOLDERS ...(2)



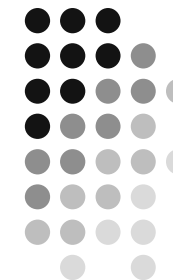
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Stakeholders	Relevant CG Issues	Responsibilities in CG
Suppliers of capital: <ul style="list-style-type: none"> • Shareholders • Lenders/Creditors 	Exercising shareholders or creditors rights to influence the IIFS' management towards maximising share value and/or profit	To elect a credible and capable Board of Directors
Normal Depositors Investment Account Holders (Restricted and Unrestricted) Current Account Holders	Expecting good service with comparable returns	<ul style="list-style-type: none"> • To act responsibly as account holders • To observe the investment made by the IIFS by obtaining relevant and adequate information
The Community, particularly the Muslim Ummah	Expecting efficiency in the Islamic banking system	To promote sound business and legal environment by supporting IIFS which practise good CG and isolating IIFS which do not

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PROPOSED SCOPE OF THE CG STANDARD ...(1)



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Filling in the Gaps

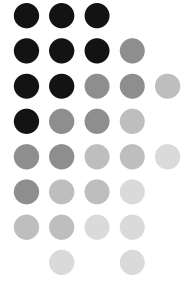
CG aspects already covered	OECD	BCBS	IOSCO	FRC/FSA
<u>Companies</u>				
Directors/The Board	√	√		√
Remuneration/Compensation	√	√		√
Accountability and Audit	√	√		√
Relations with Shareholders	√	√		√
<u>Shareholders</u>				
Rights and Key functions	√			√
Equitable Treatment	√			√
<u>Other Stakeholders</u>				
Employees/Manager	√	√		
Regulator/Supervisor	√	√	√	
Disclosure and Transparency	√		√	√

The issue of IIFS' accountability and transparency to its customers, as well as Shari'a compliance, have not been covered or contemplated in any of the above documents.

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PROPOSED SCOPE OF THE CG STANDARD ...(2)



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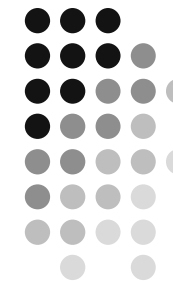
The CG Standard aims to cover these aspects:

- Information environment and transparency:
 - ❖ specifying and enforcing appropriate disclosure requirements
 - ❖ fostering auditors independence and enforce the relevant and applicable auditing standards
 - ❖ the focus is very specifically on protection of the IAH's interests – not to overlap with general transparent reporting which would be covered by the Transparency and Market Discipline Standard
- Organs of governance:
 - ❖ making arrangements for safeguarding interests of IAH, esp. unrestricted
 - ❖ providing for monitoring Shari'a compliance

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UPDATE ON STANDARDS DEVELOPMENT



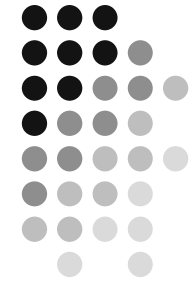
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- The IFSB is finalising the development of its first two prudential standards for the industry, namely **Capital Adequacy** and **Risk Management**.
- These two standards are expected to be issued next month.
- The standards prepared by the IFSB follow a lengthy due process as outlined in the Guidelines and Procedures for the Preparation of Standards/Guidelines which involve, among others, the issuance of exposure draft and, where necessary, the holding of a public hearing.
- The setting and harmonisation of standards would promote a level playing field and foster the development of the IFS industry as well as promote the effective supervision of the industry.

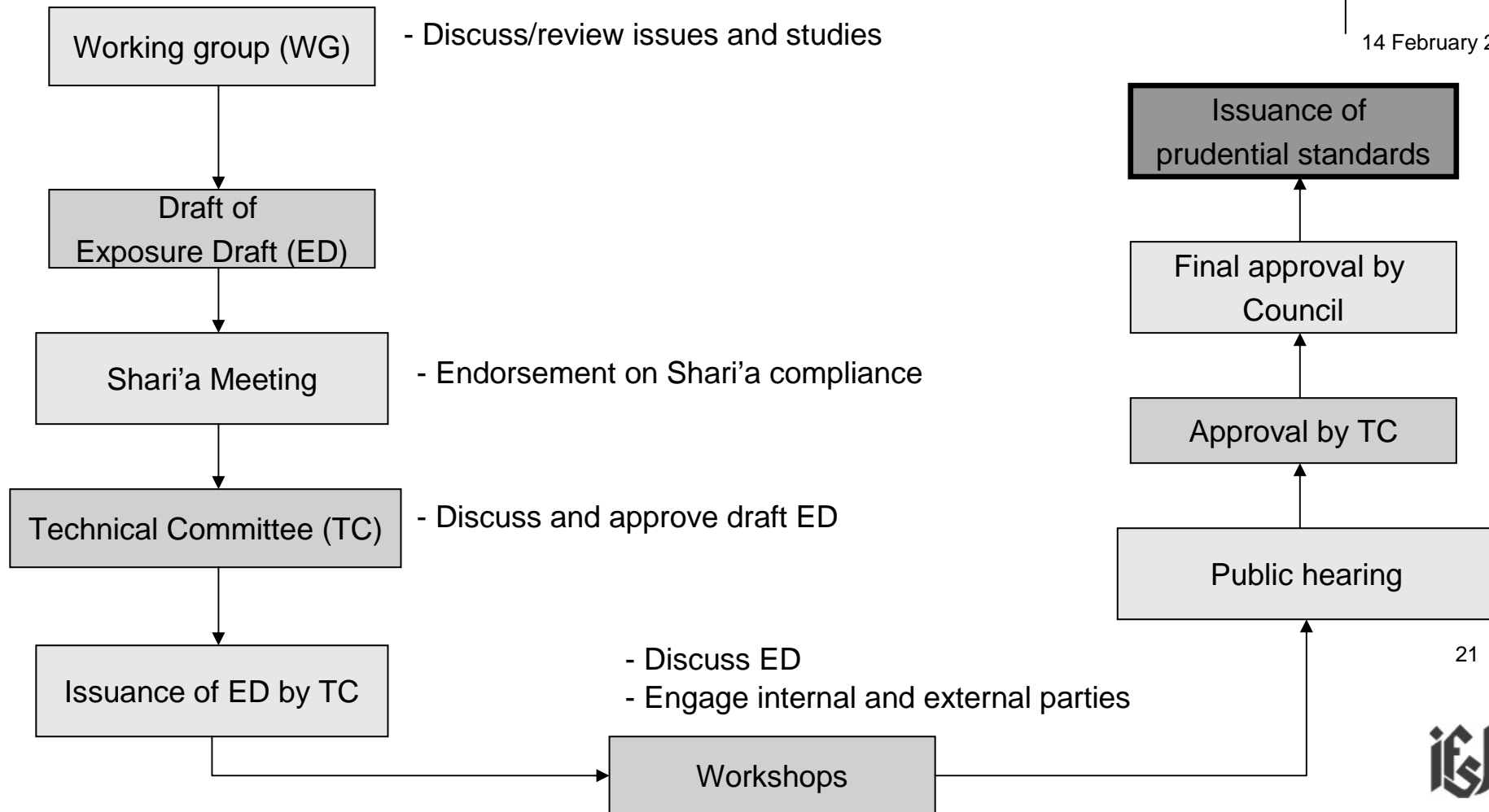
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DUE PROCESS OF DEVELOPING THE STANDARDS



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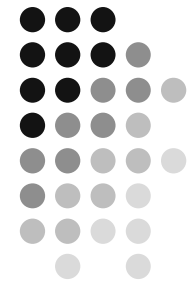


- Discuss ED
- Engage internal and external parties

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OUTCOMES EXPECTED FROM THE STANDARDS



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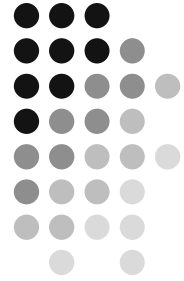
GENERALLY,

- Strengthen supervisors and regulators' commitment to embark upon **collective and systematic efforts** to develop supervisory and prudential infrastructure for this industry
- Support the **transformation of the industry**; from one that is regulated on an ad hoc basis to an industry that is based on a framework which caters for its specificities, thus enabling it to earn the respect of international organisations that are mandated to enhance the soundness and stability of the global financial system
- Enable concerned regulators to adopt an **international approach to regulation and supervision**; thereby enabling the industry to be part of today's global financial framework
- **Ease the fears and misunderstanding** of this industry amongst some regulators

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OUTCOMES EXPECTED FROM THE STANDARDS ... (2)



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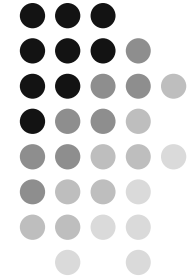
SPECIFICALLY,

- Adoption of OECD and BCBS recommendations will improve IIFS' Board and Directors' and Management's awareness of the importance of good governance
- Due recognition of IAH's rights and risks as residual claimants will lead to appropriate protection of IAH
- More professional approach for Shari'a compliance will mitigate compliance and reputational risks of IIFS
- Increased transparency in financial and non-financial reporting by IIFS will inculcate better risk management structure and discipline culture amongst IIFS

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THANK YOU FOR LISTENING



14 February 2005

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