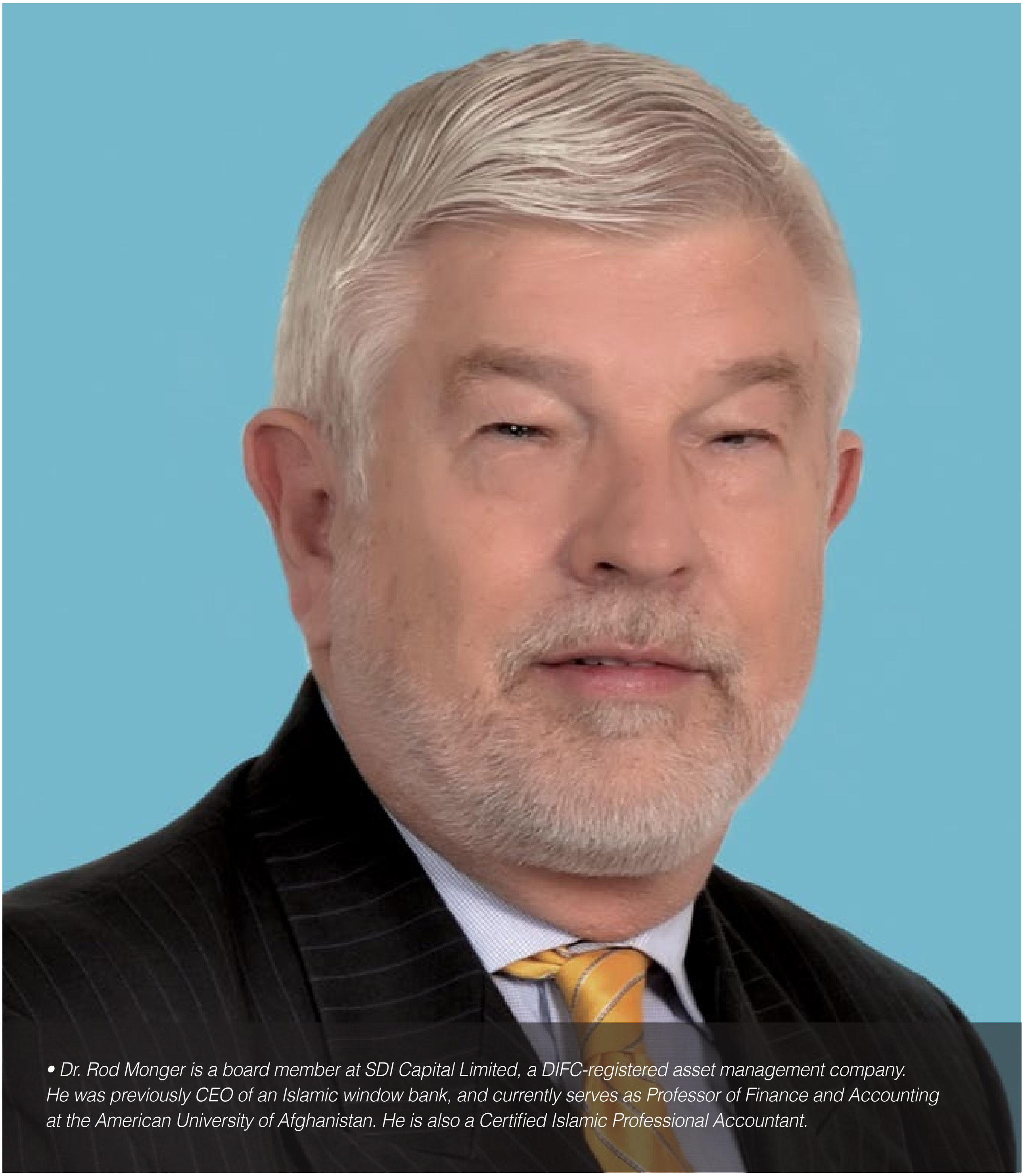
THE EVOLVING GOVERNANCE REQUIREMENTS OF ISLAMIC FINANCIAL INSTITUTIONS



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The Governance Environment

Between 2003 and 2013, Islamic finance assets grew at a compound annual rate of 24.6% to an estimated US $1.8 trillion driven primarily by Gulf Cooperation Council (GCC) countries, Iran and Malaysia. Banking represents four-fifths of these assets, Sukuk another 15 percent with the remainder in leasing, equity markets, investment funds, Takaful, and microfinance.

Yet, Islamic financial assets still represent less than 1 percent of global financial assets. As a result, Islamic finance lacks economies of scale and Islamic financial institutions still operate in an environment without adequate infrastructure, and without access to central bank liquidity and financial safety nets routinely available to conventional banks. In addition, the legal and regulatory environment often fails to take into account the special requirements of Islamic finance.

At the same time, boards are facing spiraling complexity in Islamic finance. Innovation often means that multiple Shari'ah compliant contracts are layered to mimic features available in conventional financing. This process sometimes involves third parties so that the resulting complexity elevates the uncertainties related to credit, market, operational, and legal risks.

Dual Challenge

This environment poses a dual challenge to boards of Islamic financial institutions.

1. Boards of Islamic financial institutions must first govern consistent with existing internationally recognized standards.

Most guidance including the Accounting, Auditing and Governance Standards from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and various standards from the Islamic Financial Services Board (IFSB) recognize that good governance of Islamic financial institutions begins with existing standards developed for all banks and financial institutions. The Islamic Financial Services Board notes, for example, that *many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices, which have been widely accepted as the international standards, and would be relevant and useful for (Islamic financial institutions).*

The observation is sometimes made that Islamic financial institutions are often located in developing countries where corporate governance is generally weak in any event, and that significant strides are needed to improve overall governance. But this article focuses specifically on issues related to Islamic governance rather than the broader question of compliance with general, non-Islamic standards.

2. Boards of Islamic financial institutions must also govern consistent with the specific characteristics of the Shari'ah.

Concurrently, Boards of Islamic financial institutions must pursue a second track, which is crafting their governance practices to comply with the characteristics of Islamic finance. As already noted, the supporting infrastructure for Islamic finance is less developed than for conventional. Thus, to some extent, it's fair to say that Islamic boards are thrown back on their own resourcefulness to ensure proper governance.

My own experience suggests that boards sometimes take a wait-and-see attitude when, for example, new legislation or regulation from the regulator is anticipated. Long lead times in the legislative and regulatory process induce a competitive paralysis. In the meantime, the issue remains about whether Islamic products and services are competitive.

In my judgment, this can be attributed to the lack of capacity on boards and in management to confidently move ahead with Islamic finance. Think, for example, of a conventional bank that delays reasonable innovation in products and services because the board fears new laws or regulations. That would be unreasonable, and so it is in Islamic finance.

Also, some boards may feel that because the Shari'ah committee approves proposed products and services, that all responsibility for governance is discharged. But that attitude simply will not serve. The special characteristics of Islamic finance, as we shall see, mean that all functions in credit, investment, operations, compliance, auditing, and risk management must be adapted to Islamic banking and finance requirements. These are not issues of Shari'ah compliance, but of good, comprehensive governance.

Shari'ah Compliance

Nonetheless, directors of Islamic financial institutions must start by ensuring that their products and services are Shari'ah compliant, and this is done through the Shari'ah committee. But creating an effective Shari'ah committee is easier said than done.

The root problem is the overall shortage of qualified Shari'ah scholars capable of serving on the committee. While finding mullahs who can issue fatwas consistent with the Shari'ah rarely poses a problem, identifying scholars who understand the financial services business, who can help implement competitive strategy consistent with the risk appetite of the institution, and who can work through proposals that involve complex Islamic products and services, as already mentioned, can present a real challenge.

1. Kammer, Alfred et al, Islamic Finance: Opportunities, Challenges, and Policy Options, IMF Staff Discussion Note, International Monetary Fund, April 2015. **2.** Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), Islamic Financial Services Board, December 2006. **3.** Here the term Shari'ah committee is used to distinguish from references to the board of directors. The term Shari'ah Supervisory Board or Shari'ah Board is sometimes used, but the meaning is the same.

High demand and low supply means that qualified scholars may overcommit. One recognized scholar served on forty-seven Shari'ah boards internationally. Regulators, as are boards of directors of Islamic financial services firms, are increasingly taking a dim view of these practices just as they would non-executive directors who overcommit and cannot adequately discharge their responsibilities.

What this means for directors is that boards need to be very clear about the qualifications of the persons to serve on the Shari'ah committee. The Shari'ah committee must be structured to ensure products and services are compliant but at the same time, consistent with the firm's risk appetite, innovative and competitive.

Further, boards must have well-defined nominations policies and procedures to ensure the sustainability of the Shari'ah committee. An internal Shari'ah committee is not necessarily required. These services could be wholly or partially outsourced to consultancy services including other financial institutions that offer the services of their committees to outside entities.

Boards also need to ensure that the institution's policies and practices reflect a single source for interpretation of the Shari'ah. Different scholars sometimes have different interpretations, and these differences are sometimes reflected in, for example, the Hanafi school which is more prevalent in the Middle East, versus Shafi'i which is more typical of Malaysia.

Even within schools of thought, different scholars have different interpretations. The practical point is that directors ensure that management is following the preferred source of interpretations and not flip-flopping between sources to secure the most favorable fatwas.

Control and Compliance

Boards, of course, rely on the audit committee, internal auditors and independent auditors for control. Thus, the board must ensure that the requisite level of competency exists within audit committee and the internal audit department. In window institutions, directors can establish such expertise within the conventional internal audit department or in a separate unit.

However, experience suggests that even in window institutions, it is better to avoid creating parallel systems to serve conventional and Islamic. Integrating the knowledge of both avoids silo-building and unnecessary administrative duplication. The audit committee should evaluate external auditors to ensure that they have sufficient expertise to audit from both Islamic and non-Islamic (e.g., International Financial Reporting Standards). The same advice applies to the compliance function. A single unit should be equipped to handle all laws and regulations whether they are specific to Islamic banking and finance, or not.

Investment Account Holders

Islamic finance involves the sharing of risk and reward. Paying or earning interest is prohibited. Thus, returns on deposits must be structured as investments and the depositors are investment account holders. The fiduciary relationship of the board to investment account holders resembles that of the entity with its shareholders. Thus, recognizing that the potential for conflict of interest exists between investment account holders and shareholders, directors must be mindful of their obligation to enforce the rights of investment account holders.

The Islamic Financial Services Board (IFSB) requires that the financial institution put investment account holders on an equal footing with shareholders by insuring their access to information related to their investment accounts. Likewise, Hawkamah7 recommends that Islamic financial institutions should treat investment account holders as pari passu with the shareholders with regard to the disclosure of information regarding the investment accounts, smoothing of reserves policy and returns on investments. In short, a higher standard of disclosure is required to investment account holders as opposed to interest-earning depositors in conventional finance. Disclosure extends to the general investment objectives related to unrestricted investment accounts including risk-sharing terms.

Profit Equalization. Boards must also ensure that smoothing of returns on investment accounts is handled in a transparent manner. Periodically, profits on investment accounts are tallied and adjustments made to holders' accounts. However, financial institutions earmark some of these returns into a profit equalization reserve (PER). One issue whether profit equalization reserves are being used to mask volatility of assets that are riskier than the risk and return parameters established for the investment account.

Other Implications. Profit sharing accounts also have implications for computation of capital adequacy ratios. In addition, monies retained in profit equalization reserves belong to the investment account holders. If that holder liquidates the investment, that provision must be made to distribute his or her share of the retained profit.

Risk Management

Overall, risk management tools specific to Islamic financial institutions remain underdeveloped and rating methodologies (e.g., CAMELS, stress testing) need to be further adapted.

4. An estimated 75 percent of Islamic bank assets are Murabahah, a type of mark-up financing whereby the bank buys goods from a third party and then resells them to the borrower on terms.

Other, specific issues boards may encounter include the following.

Credit Risk. Islamic financial institutions face many of the same credit risk factors as conventional banks such as collateral quality, effectiveness of the legal system, and size of the banking book. But Islamic institutions face additional risks partly due risk sharing inherent in the Shari'ah. For example, on the asset side, conventional debt can be restructured and even re-priced in the event of default or near-default, and repayment is not conditional on profitability. Not so with Islamic investments. Islamic investments.

Because an Islamic banking depositor is essentially an investor, except for current accounts that earn no return, credit risk spreads to the liability side. Credit losses mean a loss of earnings and as a practical matter that leads to a loss of investors who can presumably find better returns elsewhere. This places pressure on management to generate competitive returns and it also creates special pressures on dual window banks, a topic discussed later in this article.

Some experts have argued that Islamic banking actually presents a more conservative risk profile, but this is beside the point. The practical issue for the board goes back to the basics of whether comprehensive credit policies and procedures are in place that fully contemplate the credit risk differences inherent in Islamic financial instruments. In particular, boards should ensure that Islamic credit and investment committees are keeping a sharp eye on economic conditions that might cause a deterioration of payments to the bank.

Liquidity Risk. In general, liquidity risk for Islamic banks has tended to be low due in part to limited availability of investment opportunities and other factors. But boards need to be vigilant nonetheless. One reason is the potential for early, rapid withdrawal of amounts in current accounts that typically make up a high proportion of deposits in many Islamic banks. Also, Islamic banks may have more difficulty raising new funds quickly from Islamic market sources during a liquidity crunch.

Interest Risk. Though the Shari'ah forbids interest, the dominance of conventional finance means that interest rates affect earnings in Islamic institutions as well as asset values. Thus, even in fully compliant institutions, boards must ensure that the appropriate committees are monitoring interest rate movements to assess any potential impact on Islamic earnings and assets. Thus, mechanisms that examine interest rate risk are required even if the practice of paying or charging interest is not.

Fully Compliant Shari'ah Institutions versus Windows

Boards of window institutions face additional challenges compared to fully compliant banks, mostly with respect to operations. Dual window banks must ensure that Islamic and conventional funds are not co-mingled, and that Islamic banking operations are in compliance with Shari'ah principles.

As a practical matter, this means that carefully considered policies and procedures to address to enforce this separation must be in place. A weak point, previously discussed, is when dual window banks have significantly more Islamic deposits than investment vehicles, thus shifting the weight of Islamic earnings to the trading book. The temptation for management, of course, is to co-mingle invested funds. This may or may not be due solely to a shortage of Islamic trading book opportunities, but simply may be the result of poorly constructed policies and procedures.

In dual window institutions, the challenge of enforcing the rights of investment account holders can be complicated. In one case, an Islamic window bank's management was acutely aware that depositors were attracted to Islamic products because the bank offered the highest return in the marketplace.

Yet, that return was partially achieved because virtually all expenses of the business (i.e., facilities, information systems, overhead personnel) were charged to the conventional side of the business thus inflating Islamic profits. The issue was not so much one of deceit, but rather of management sloppiness. But it nonetheless raised ethical issues that the board remiss in ignoring.

A Duty of Extra Care

Islamic finance will continue to grow and its financial markets will continue to deepen. Evidence suggests that diffusion of Islamic finance is still highly influenced by oil prices, but that is likely to change in the future. Many Muslim countries have low rates of financial inclusion but as their populations increase their participation, Islamic financial institutions are likely to diversify and with it the complexity of the challenges facing their boards. In other words, Islamic banking and finance is very much an evolving sector.

The rapid rise of Islamic finance has meant that the boards must function as something of governance pioneers. Not only do boards have to be attuned to and comply with internationally accepted non-Islamic governance standards, but they must also understand and apply evolving Islamic standards. Also evolving is the art of governance as it applies to Islamic financial institutions.