



ISLAMIC FINANCIAL SERVICES BOARD

EXPOSURE DRAFT NO. 3

**GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR
INSTITUTIONS OFFERING ONLY ISLAMIC FINANCIAL SERVICES
(EXCLUDING ISLAMIC INSURANCE (TAKAFUL) INSTITUTIONS
AND ISLAMIC MUTUAL FUNDS)**

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ACRONYMS

BCBS	Basel Committee on Banking Supervision
BOD	Board of Directors
IAH	Investment account holders
IFSB	Islamic Financial Services Board
IIFS	Institutions offering only Islamic financial services (excluding (a) Islamic insurance (takaful) institutions and (b) Islamic mutual funds).
IOSCO	International Organisation of Securities Commissions
IRR	Investment Risk Reserve
OECD	Organisation for Economics Co-operation and Development
PER	Profit Equalisation Reserve
SSB	<i>Sharī'ah</i> Supervisory Board

PREAMBLE

1. This document sets out seven guiding principles (hereinafter collectively referred to as **The Guiding Principles**) of prudential requirements in the area of corporate governance for institutions offering only Islamic financial services (**IIFS**) (excluding (a) Islamic insurance (takaful) institutions; and (b) Islamic mutual funds). The Guiding Principles are divided into four parts:
 - (i) general governance approach of IIFS;
 - (ii) rights of investment account holders (**IAH**);
 - (iii) compliance with Islamic *Sharī'ah* rules and principles; and
 - (iv) transparency of financial reporting in respect of investment accounts.
2. The Guiding Principles are designed to facilitate IIFS in identifying areas where appropriate governance structures and processes are required and to recommend best practices in addressing these issues. An annotation is annexed to this document as a source to assist IIFS in understanding the rationale and objectives of each of The Guiding Principles. This document also aims to empower stakeholders with better knowledge and awareness of governance issues surrounding IIFS by becoming an authoritative reference, which can also be used as a monitoring and advocacy tool, in promoting good governance in IIFS.
3. While an essential feature of IIFS is the requirement to comply with Islamic *Sharī'ah* rules and principles, this document only contains the prudential requirements that aim to ensure *Sharī'ah* compliance by IIFS as a matter of corporate governance. It is not to be understood as approving any specific *Sharī'ah* opinion or *fatwā* of any kind.
4. Certain corporate governance issues are of equal concern to all institutions offering financial services, whether IIFS or others. The IFSB acknowledges 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 IIFS.¹ On this premise, the Guiding Principles do not intend to reinvent the wheel by proposing a wholly new corporate governance framework. Instead, the Guiding Principles aims to complement the existing internationally recognised standards of good corporate governance by particularly addressing the specificities of IIFS.²
5. It is well known that the fiduciary responsibility of IIFS towards their customers includes a primary undertaking by the IIFS to comply with Islamic *Sharī'ah* rules and principles at all times. In line with this unique characteristic of the Islamic financial services industry, the Guiding Principles call for a balanced approach by IIFS in the pursuit of their shareholders' value with the protection of the interests of the other stakeholders.

¹ For example, the widely recognised Principles of Corporate Governance promoted by the Organisation for Economic Co-operation and Development (**OECD**) – originally issued in 1999 and revised in 2004 – has been the primary reference in many jurisdictions when preparing a local corporate governance code to suit their market. The Basel Committee on Banking Supervision (**BCBS**) has published a document entitled “Enhancing Corporate Governance of Banking Organisations” – originally issued in 1999 and is currently under revision – which set out sound practices and principles pertaining to corporate governance of banks, as an extension of the framework laid out by the OECD.

² Correspondingly, the Guiding Principles find it appropriate to adopt the definitions of “corporate governance” and “stakeholders” from the OECD Principles and BCBS Paper with certain modifications to suit the context of IIFS. Please refer to page 26.

6. The IFSB shares the opinion of the OECD and the BCBS that there is no “single model” of corporate governance that can work well in every country; each country or even each organisation should develop its own model that can cater for its specific needs and objectives. Accordingly, this document shall be viewed as an evolving piece of work aimed at promoting efficient corporate governance that is goals-driven and goes beyond the act of box-ticking of compliance checklists.
7. Despite undergoing a very rapid development in recent decades, it should not be forgotten that the Islamic financial services industry is still in its infancy. Any hasty and rigid rule-based approach to strengthen the corporate governance of IIFS may riskily hinder the potentials and healthy growth of IIFS. Furthermore, there is no hard and fast rule that can be applied in nurturing good governance culture in IIFS. Hence, priority should be given in creating an enabling environment whereby IIFS are facilitated with adequate timeline, encouragement and incentives, so that good corporate governance culture would prosper within the Islamic financial services industry.
8. In complying with the Guiding Principles, IIFS shall ensure that all relevant disclosures made to the supervisory authorities or to the public comprise the following two components:
 - in the first component, an IIFS shall report how it applies these Guiding Principles. IIFS may determine by themselves the form and content of their disclosure based on their own governance policies in the light of the Guiding Principles, including any special circumstances applying to them which might have led to a particular approach; and
 - in the second component, an IIFS shall either confirm that it complies with the provisions of these Guiding Principles, or, where it does not confirm that it complies with these Guiding Principles, provide an explanation of the reasons for non-compliance.

Through this “comply or explain” approach, the implementation of these Guiding Principles should accommodate the diverse legal frameworks of the jurisdictions in which the IIFS operate and should commensurate with the size, complexity and nature of each IIFS.
9. While the Guiding Principles focus on addressing the relevant internal and external corporate governance controls from the perspective of IIFS; in order for the framework to be effective, supports and facilitation from supervisory authorities are also crucial.

THE GUIDING PRINCIPLES

Part 1: General Governance Approach of IIFS

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.

Structure and Process

10. IIFS shall establish a comprehensive governance policy framework which will guide them in cultivating a good governance culture. In its governance policy framework, the IIFS should be able to set out:
 - the strategic roles and functions of each organ of governance including the Board of Directors, its committees, the executive management, the *Sharī'ah* Supervisory Board (**SSB**), the internal and external auditors, etc; and
 - the mechanisms of balancing the accountabilities of each of the organs of governance to various stakeholders.
11. As a first point of reference, IIFS shall embrace applicable recommendations from internationally recognised corporate governance standards such as the OECD Principles and the BCBS Paper. In addition, IIFS shall comply with the existing prudential circulars/directives issued by supervisory authorities. Subsequently, IIFS shall follow these Guiding Principles, as well as comply with Islamic *Sharī'ah* rules and principles.
12. Each IIFS may tailor its governance policy framework to suit its business model; however, it should not ignore (whether deliberately or otherwise), the internationally recognised best practices. Instead, IIFS shall strive for consistent improvement of its governance policy framework by continuous adoption of international best practices, such as the recommended best practices in the Guiding Principles, with the ultimate objective of making sound corporate governance a hallmark of IIFS.

Recommended Best Practices

13. The Board of Directors of each IIFS as the ultimate internal policymaker shall be responsible for steering the establishment of the governance policy framework. To coordinate and integrate the implementation of the governance policy framework, the Board of Directors shall set up a Governance Committee comprising at least three members. This Governance Committee may comprise, for example:
 - (i) a member of the Audit Committee;
 - (ii) a *Sharī'ah* scholar (possibly from the IIFS's SSB); and
 - (iii) a non-executive director (selected based on the director's experience and ability to contribute to the process).Any increase of membership in the Governance Committee should preferably be filled by independent non-executive directors rather than non-independent directors.
14. The Governance Committee shall be empowered to:
 - (i) oversee and monitor the implementation of the governance policy framework by working together with the management, Audit Committee and SSB; and
 - (ii) provide the Board of Directors with reports and recommendations based on its findings in the exercise of its functions.

15. The roles and functions of the Governance Committee shall not duplicate or overlap with the roles and functions of the Audit Committee.³ Indeed, the Governance Committee shall complement the roles of the Audit Committee in some of the governance functions, taking into account that:
- (i) the Audit Committee already has a very demanding mandate and could be overburdened by its own primary responsibilities;
 - (ii) there could be some perceived conflicts of interests between shareholders and IAH, especially where the funds are commingled, which could be difficult for the Audit Committee to deal with. If IIFS have the Audit Committee to look into the shareholders' interests and the Governance Committee to look into the IAHs' interests, the scope of their duties and responsibilities would be clearer and more focused; and
 - (iii) the Governance Committee shall focus on the specificities of IIFS.
16. Consequently, in appointing members of the Governance Committee, the Board of Directors shall ensure that each member is capable of making a valuable contribution to the committee. A diverse outlook and experience among members is desirable, since a uniform point of view could lead to over-emphasis in one direction. Therefore, the Guiding Principles support the view that:
- (i) it would be preferable for an independent non-executive director to chair the Governance Committee. The Chairman of the Governance Committee should not only possess the relevant skills such as ability to read and understand financial statements, but should also be able to coordinate and link the complementary roles and functions of the Governance Committee and the Audit Committee;
 - (ii) it is necessary to include a *Shari'ah* scholar who is an SSB member for the purpose of leading the Governance Committee on *Shari'ah*-related governance issues (if any), and also to coordinate and link the complimentary roles and functions of the Governance Committee and the SSB; and
 - (iii) the third member of the Governance Committee should preferably be an independent non-executive director who can offer different skills to the Committee such as legal expertise and business proficiency, which are considered particularly relevant by the Board of Directors for cultivating a good corporate governance culture, and deemed "fit and proper" by the supervisory authorities.
17. It must be emphasised that, as the primary objective of the Governance Committee is to protect the interest of stakeholders other than the shareholders, the Governance Committee shall not be treated as just another Board Committee. Instead, the Governance Committee shall be accorded a special attention by the supervisory authorities.⁴ In the event that there are differences between the Governance Committee and the Audit Committee, the Board of Directors shall have the ultimate responsibility to reconcile these differences.

³ Please refer to paragraphs 19 and 20.

⁴ This is in line with the BCBS Paper which requires that banking organisations shall have in place adequate policies to identify, prevent or manage potential conflicts of interest arising from their various business activities.

Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards which are in compliance with *Sharīah* rules and principles and are applicable to the Islamic financial services industry as recognised by the supervisory authorities of the country.

Structure and Process

18. As the Islamic financial services industry increases its activities and influences in the global financial framework, IIFS should abide by globally recognised reporting standards. IIFS shall therefore ensure that the reporting of their financial and non-financial information is in accordance with internationally recognised accounting standards, particularly those relevant to Islamic financial services. The importance of appropriate accounting processes for good governance should be appreciated by:
- (i) utilising the work of the accountants, consultants and the findings of auditors in a timely and effective manner to address any problems identified by them; and
 - (ii) maintaining the independence of internal and external auditors.

Recommended Best Practices

19. The Board of Directors of each IIFS shall set up an Audit Committee comprising at least three members (a chairman and two other members) elected by the Board from those of its non-executive members, with relevant and adequate expertise in the analysis of financial statements and documentation. The Audit Committee shall be mandated to:
- (i) review and monitor the entire accounting process of the IIFS through close cooperation with the internal and external auditors; and
 - (ii) provide the Board of Directors with reports and recommendations with a particular reference to the IIFS's compliance with internationally recognised accounting standards applicable to the Islamic financial services industry in reporting their financial and non-financial information.
20. The Guiding Principles hold the view that there is adequate guidance available in various documents on the responsibilities of an Audit Committee⁵. These documents should be utilised in guiding IIFS to ensure that their Audit Committees are well equipped and supported to focus on their primary task, i.e. to oversee on behalf of the stakeholders the integrity of the financial reporting controls and procedures implemented by management.
21. The Audit Committee shall communicate and co-ordinate with both the SSB and the Governance Committee to ensure that information on compliance with Islamic *Sharīah* rules and principles by the IIFS is reported in a timely and adequate manner.

⁵ See for example the US Sarbanes-Oxley Act and UK Smith Reports – Audit Committees Combined Code Guidance 2003.

Part 2: Rights of Investment Account Holders (IAH)

Principle 2.1: IIFS shall acknowledge IAHS' rights 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.

Structure and Process

22. Conceptually, under the principle of *Muqārabah*, IAH as *Rabb al-Māl* bear the risk of losing their capital invested by the IIFS as *Muqārib*. Effectively, this means the IAHS' investment risk is similar to that of the shareholders of IIFS who bear the risk of losing their capital as investors in the IIFS. However, the IIFS as *Muqārib* owe a fiduciary duty to the IAH under the *Muqārabah* contract, which is parallel with their duty to their shareholders. In this context, the IIFS as *Muqārib* refer to both their management and their shareholders, not the management alone. Therefore, for the purpose of the Guiding Principles, discussions on the fiduciary duties of IIFS to the IAH shall always be understood as the fiduciary duties of both the management and shareholders of IIFS as *Muqārib* towards the IAH as *Rabb al-Māl*.
23. In this respect, whether the investment mandate is restricted or unrestricted, under a *Muqārabah* contract, the IIFS have a fiduciary duty to the IAH to uphold their interests no less than those of the IIFS's own shareholders. In other words, although as investors in the IIFS's assets the shareholders would rank *pari passu* with the IAH, they as a party in the *Muqārib* side of the *Muqārabah* contract also owe a fiduciary duty to the IAH and would have to ensure the protection of the IAHS' interests.
24. Hence, it is appropriate that IIFS put IAH on an equal footing with the IIFS's own shareholders by duly acknowledging the IAHS' right to access all relevant information in relation to their investment accounts. This would assist the IAH in making an informed decision on their selection or choice of the investment accounts in which to place their funds with the IIFS (for example if the IIFS offer different types of restricted investment accounts). In a situation where the local legal framework is not yet capable of facilitating the exercise of these rights by the IAH, the supervisory authorities should play a role in protecting the interests of the IAH vis-à-vis the shareholders of IIFS with regard to their rights, provided that they are in compliance with *Shari'ah* rules and principles.
25. There should not be a misunderstanding of the IAHS' right of monitoring the performance of their investment as intervening in the management of the investments by the IIFS. It shall be noted that shareholders of IIFS who are entitled to vote in general meetings, pass resolutions on appointment of directors and auditors and access the documents of the IIFS, are also not considered as intervening in the management of the IIFS. Therefore, it is only appropriate that IIFS disclose to the IAH their policies and practices in respect of the investment accounts which they offer.

Recommended Best Practices

26. IIFS shall always be aware that with their fiduciary responsibility to the IAH comes accountability. They shall be prepared to be accountable to the IAH in ensuring that the investment accounts continue to be managed within the parameters of the given mandate. IAH shall be adequately advised of their contractual rights and risks before opening an investment account with an IIFS by making available to potential IAH adequate information on their investment accounts products, including their primary investment and asset allocation strategies and the method of calculating the profit/loss made from their investments.

27. In accordance with the principal-agency structure that is embedded in the *Muḳārahah* principles governing the investment account contracts, it is only appropriate that IIFS recognise the IAHS' rights of monitoring the performance of their investment and put in place means for these rights to be exercised. The Governance Committee of the IIFS shall take responsibility for protecting the IAHS' rights of monitoring the performance of their investment by making sure that relevant disclosures to IAH are made in a timely and effective manner, as well as ensure proper implementation of the investment contracts.
28. For illustrative purposes, the principal-agent relationship between IAH and IIFS may be compared to that found in collective investment schemes (**CIS**), in which participants have mandated their fund managers to manage their investments. Both IAH and CIS participants:
- (i) entrust their money to be invested and managed by a fund manager (i.e. the IIFS in the case of IAH and the CIS operator in the case of CIS participants);
 - (ii) bear the risk of losing the capital of their investment; and
 - (iii) have very minimal rights in controlling the conduct of the fund manager; more often they would have to vote with their feet i.e. simply move their investment away if they find the fund manager's performance is unsatisfactory.
29. Nevertheless, at present the CIS participants stand in a better position than the IAH, since securities regulation usually ensures that CIS operators meet stringent requirements before they can operate a CIS. CIS participants enjoy more rights in particular concerning their access to information.⁶ Furthermore, CIS participants often know the net asset value of their investments, which would allow them to dispose the investments swiftly in a secondary market.
30. The Guiding Principles therefore requires that IIFS shall have an internal guideline that sets out:
- (i) the eligibility of the IIFS employees who are responsible for managing investment accounts operated by the IIFS;
 - (ii) the adequate protection of the IAH investments, including the case where the unrestricted IAHS' funds are commingled with shareholders funds;
 - (iii) the disclosure of relevant and material information to the IAH ; and
 - (iv) a proper and disclosed basis for profit allocation and investment policies to be based on the risk-expectations of the IAH.
31. Restricted IAH shall have the rights to obtain at least all the information usually available to participants of a CIS. As far as the unrestricted IAH are concerned, they shall be allowed access to all the necessary information in respect of their investment accounts, in particular, the profit allocation and investment policies of the IIFS.
32. IIFS shall inform the IAH from the outset when opening their investment accounts that, in accordance with the principle of *Muḳārahah*, particularly in the event of liquidation of the IIFS:
- (i) the IAH shall only bear the loss in proportion to the assets funded by their investment;
 - (ii) the IIFS shall be liable for losses arising from their negligence, misconduct or breach of their investment mandate; and
 - (iii) the restricted IAH shall not be liable for any obligation to other parties arising from the deficiencies of the IIFS or its liquidity unless it is specifically related to the restricted IAHS' funds. The unrestricted IAH shall only be liable for such

⁶ For example, CIS operators must furnish the CIS participants with a prospectus disclosing relevant information on the CIS before they are allowed to canvas for investments. The International Organisation of Securities Commissions (**IOSCO**) have also issued principles which specifically require the disclosure of all fees and charges that may be levied by a fund manager under the CIS.

obligations in accordance with the proportion of their share in the commingled funds.

33. For a better understanding of the issues and the impacts of their liabilities on IAH, IIFS should refer to the IFSB Capital Adequacy Standard. In addition, reference is drawn to Principle 4 on “Transparency of Financial Reporting in respect of Investment Accounts” for relevant recommendations.

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.

Structure and Process

34. IIFS shall use their best endeavours to implement an investment strategy which is appropriately aligned to the risk and return expectations of the IAH as mutually agreed in the investment account contracts between the IAH and the IIFS, taking into consideration any restrictions that may be imposed by the IAH at the time of concluding the investment contract.
35. IAH are generally seeking a low risk investment with stable returns (employing a “defensive” investment strategy), whereas shareholders may favour a more aggressive and robust investment strategy offering higher returns with more risk. This may lead to a conflict of interest when IAH funds and shareholders’ funds are commingled. Smoothing of the IAHs’ returns may mitigate this problem, but does not fundamentally affect the underlying risk and may have negative effects on transparency.
36. Dividends paid out to shareholders are likely to differ from, and be more stable than, the profits (earnings) attributable to them, with the differences being added to or released from reserves. Similarly, the amount distributed to IAH as profit share may differ from their attributable share of the IIFS’s earnings. Many IIFS have adopted the practice of ‘smoothing the returns’ (i.e. the profit distributed) for their IAH and shareholders by using a special type of reserve, the Profit Equalisation Reserve (**PER**). Whilst the Guiding Principles take note of the fact that this smoothing practice may enable IIFS to pay a competitive rate of return in years when the IAHs’ profit rate based on their attributable share of the IIFS’s earnings is below the going market rate, there are concerns about the transparency and accountability of this practice. In particular, these concerns are:
- (i) the IAHs’ attributable share of profit earned and utilisation 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 that the IIFS has invested IAH funds in assets with more risky returns than IAH would expect, rather than achieving stable returns for their IAH by adopting an efficient and appropriate asset allocation.
37. As with other types of reserves created for smoothing returns, the PER is also subject to the inter-generational problem. As the reserves are built up from setting aside a portion of the profits available for distribution to existing IAH and shareholders, it could happen that some IAH who have foregone part of their profit share in years with above-average profits will never receive any benefit from this. This would happen if throughout the tenure of their investment accounts the IIFS never releases the funds from the PER to increase the distribution to the IAH. Instead, if those IAH close their investment accounts today and the IIFS decides to utilise the PER tomorrow for the next profit distribution, new IAH who may never have contributed to the PER at all will get to enjoy “unearned” benefits. The Guiding Principles take note that in the event that an IIFS has to be liquidated, the PER should be disposed of in accordance with what was agreed upon at the time of establishing the reserves, which commonly would be one of the following:

- (i) distribution to the existing IAH and shareholders; or
 - (ii) donation to charities.
38. Therefore, the IIFS shall create practices, procedures and entitlements that adequately address any undesirable ambiguity in this area which could be ethically questionable and tantamount to *gharar* with regard to the PER. The IIFS shall appropriately disclose if the PER will not be distributed to the IAH in the event of liquidation.
39. Smoothing of returns distributed to IAH using the PER excludes turning a loss into a profit, for which purpose another special type of reserve, the Investment Risk Reserve (IRR), may be used. Similarly, the inter-generational problem also arises in the case of the IRR, whereby IAH who actually contributed to build it up may not get any benefit from it, whereas IAH who may never have contributed to it may be the ones to gain from its existence. It should be noted that in the case of reserves attributable to shareholders, their magnitude is normally reflected in the market value of their shares, so that the inter-generational problem is avoided. There is no such effect on the market value of investment accounts of amounts held in the PER or IRR. Also, it should be noted that while in principle shareholders have some controls over an IIFS's dividend policy and use of reserves, which have to be approved by them in the annual general meeting, IAH have no control over the use of reserves such as the PER and IRR.

Recommended Best Practices

40. In developing their investment strategy on behalf of IAH, IIFS shall carefully consider the risk and return expectations of IAH by:
- (i) having an appropriate and systematic know-your-customer mechanism which can effectively reflect the different risk-return profiles of restricted and unrestricted IAH;
 - (ii) employing qualified investment managers who fully understands the needs and expectations of IAH; and
 - (iii) being transparent to the Governance Committee in respect of the investment strategy adopted by IIFS, where appropriate.
41. The IIFS shall inform the IAH if it practises the smoothing of returns by way of building reserves in the form of PER. The IIFS shall announce to the IAH every time they use the reserves to smooth the dividend payout. Just as shareholders shall be appropriately guided when a company announces the use of reserves to pay dividends to shareholders, the IAH shall have the right to know when investments made on their behalf by the IIFS are not performing well and their paid-out returns exceed actual returns on investments because of upward smoothing.
42. In order to ensure that the utilisation of PER is appropriate, the Governance Committee shall be mandated to scrutinise and recommend such utilisation to the Board of Directors.
43. In addition, the IIFS shall clearly distinguish the 'distribution rate' i.e. the rate of profit distributed and the 'profit rate' i.e. the actual profit earned from investments made on behalf of the IAH in disclosing the returns to IAH. Effectively, the utilisation of PER shall clearly be understood as being for 'smoothing the dividend payout' rather than 'smoothing the profits earned' for IAH.
44. Similarly, if the IIFS has created an IRR to cushion any unexpected loss on the part of the IAH, the utilisation of IRR shall be placed under the scrutiny and subject to the recommendations of the Governance Committee to the Board of Directors.

Part 3: Compliance with *Sharī'ah* Rules and Principles

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining *Sharī'ah* rulings, application of *fatāwā* and monitoring of *Sharī'ah* compliance in all aspects of their products, operations and activities.

Structure and Process

45. Inevitably, the diversity of *Sharī'ah* opinions will continue to become a permanent feature in the Islamic financial services industry. It has been widely acknowledged within the industry that there are major requirements for new *fatāwā* as the industry progresses and faces contemporary challenges. *Sharī'ah* scholars in each locality should be allowed to arrive at their own opinions that can address appropriately and effectively the specific problems of the *ummah* within their respective localities.
46. Initiatives on harmonisation of *fatāwā* should continue to be pursued and applauded, as the industry in particular and the *ummah* in general can benefit from common understanding and co-operation amongst *Sharī'ah* scholars.

Recommended Best Practices

47. As *Sharī'ah* compliance is central in assuring the integrity and credibility of IIFS, and is one of the ultimate responsibilities of the Board of Directors, the Board needs to establish an appropriate mechanism for obtaining *Sharī'ah* rulings and monitoring which can be mobilised swiftly and efficiently as and when required. This may take the form of external or internal *Sharī'ah* scholars depending on the requirements of their business model.
48. The mechanism for obtaining *Sharī'ah* rulings, application of *fatāwā* and monitoring of *Sharī'ah* compliance shall cover:
 - (i) both *ex ante* and *ex post* aspects of all financial transactions carried out by the IIFS, i.e. to ensure *Sharī'ah* compliance of the contracts and later the performance of obligations under the contracts; and
 - (ii) operations of the IIFS including aspects such as *Sharī'ah* compliance review, investment policies, disposal of non-*Sharī'ah* compliant income, charitable activities, etc.
49. Where appropriate, the IIFS shall inform the supervisory authorities about their mechanics of obtaining *Sharī'ah* rulings, application of *fatāwā* and monitoring of *Sharī'ah* compliance, and make available the same information to the public.
50. For internal *Sharī'ah* compliance reviews, the SSB or *Sharī'ah* scholars of IIFS shall work together with the internal auditors/*Sharī'ah* reviewers in order to enable the SSB or *Sharī'ah* scholars to advise the internal auditor/*Sharī'ah* reviewers on the scope of audit/reviews required while the internal auditors/*Sharī'ah* reviewers shall be responsible for producing the internal *Sharī'ah* compliance reports. The internal auditors/*Sharī'ah* reviewers shall acquire the relevant and appropriate training to enhance their *Sharī'ah* compliance review skills.
51. For external *Sharī'ah* compliance reviews, the Audit Committee shall ensure as far as possible that the external auditors are capable of conducting, and do conduct *ex post* *Sharī'ah* compliance reviews within their terms of reference.
52. To enhance the public confidence in the *Sharī'ah* scholars sitting in the SSB, the supervisory authorities may wish to consider steering the initiatives towards the

establishment of a professional organisation or an industry association for *Sharī'ah* scholars serving the IIFS within their respective jurisdictions.⁷

53. Alternatively, supervisory authorities may establish a “fit and proper” test that clearly and carefully set out the criteria required prior to an IIFS appointing a *Sharī'ah* scholar into its SSB. Again, the “fit and proper” criteria shall take into account factors that can strengthen public confidence in the SSB, such as academic qualifications, professional training, recognition by local and international peers of *Sharī'ah* scholars, etc.

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

Structure and Process

54. Although the diversity of *Sharī'ah* opinions might tempt an IIFS to adhere to the *fatāwā* of other *Sharī'ah* scholars at the expense of differing *fatāwā* issued by the IIFS's *Sharī'ah* scholars, the IIFS shall not change their allegiance and obedience to *fatāwā* to suit their convenience. Such a practice could impair the independence of *Sharī'ah* scholars and have a damaging impact on the integrity and credibility of the individual IIFS in particular and the Islamic financial services industry as a whole. The adverse effect of such a practice on the reputation of the IIFS and the Islamic financial industry would be immense and difficult to repair. Therefore, the IIFS shall be transparent in the adoption and application of *Sharī'ah* rules and principles issued by the IIFS's *Sharī'ah* scholars.⁸

Recommended Best Practices

55. IIFS shall comply with the rules and principles issued by their *Sharī'ah* scholars. These rules and principles shall be made publicly available through appropriate publication and communication channels.
56. An IIFS shall make available to the public, upon request, an explanation of any decision to adopt a *fatwā* issued by its *Sharī'ah* scholars, whereby such explanation should be prepared in consultation with the *Sharī'ah* scholars. Similarly, an IIFS should be prepared to provide a transparent clarification to the public should they decide to abandon a *fatwā* issued by its *Sharī'ah* scholars.
57. *Sharī'ah* scholars serving IIFS are encouraged to expose their *fatāwā* to the scrutiny of fellow *Sharī'ah* scholars by publishing their detailed opinions. IIFS can also promote better awareness on the part of the public by publishing information on the *fatāwā* of their *Sharī'ah* scholars in their websites. The IIFS may also allow the customers to access the *fatāwā* issued by their *Sharī'ah* scholars as part of their customer services.

⁷ For example, as a preliminary step, supervisory authorities can establish a list of ‘approved’ *Sharī'ah* experts that are capable, experienced and qualified to be appointed as *Sharī'ah* advisors or consultants to IIFS within their respective jurisdictions. When the list has become long enough, the *Sharī'ah* scholars could form a self-regulated professional organisation or an industry association under the patronage of the supervisory authorities.

⁸ In countries where there is a central *fatwā*-making authority, IIFS shall comply with the rulings made by such authority. If they have a reason to divert from complying with the rulings made by the central *fatwā*-making authority, this should be appropriately disclosed and explained to the public.

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 accounts that they manage.

Structure and Process

58. In line with the IAHs' rights of monitoring the performance of their investments, they should be entitled to be informed of the methods of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of their investment accounts.
59. In addition, the IAH and the public should be entitled to be informed of any related party transactions and treatment of material events by the IIFS. Adequate and timely disclosure of such material information is vital in developing transparency, accountability and a better risk management culture in IIFS.
60. Inundating IAH with information does not make IIFS more transparent. In fact, the opposite can be the case. In order to avoid information overload, the disclosures shall be made in a timely and orderly manner. The aim is not to disclose as much information as possible, but to provide relevant and reliable information that is crucial to the IAH in understanding and properly evaluating how their investment accounts are managed.
61. It is important to ensure that information is readily available in a comparable, understandable, readable and reliable form, so that it is easily accessible not only by IAH, but by information intermediaries for consumers such as the media, financial advisors and consumer associations. The information intermediaries are likely to use the information to draw attention to good and bad features more effectively than consumers would typically be able to do for themselves. This process would be helped by:
 - (i) standardisation of terms and language,
 - (ii) comparable measures of, or ways of explaining, charges, risks, profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any); and
 - (iii) easy access to such information, for example through the internet.

Recommended Best Practices

62. Information on the basis for profit distribution and allocation shall be provided to the IAH prior to the opening of the investment account, especially since under a *Muḳārabah* contract the profit-sharing ratio must be declared in advance. Information that may change from time to time, such as significant changes in the investment strategies, should be included in the investment account statement issued to the IAH whenever there is any change made by the IIFS. Asset allocation shall be duly reported within the IIFS's financial statements.
63. The utilisation of PER for smoothing the returns to IAH and shareholders, as well as the use of IRR for covering losses (if any), is an issue of public interest and shall be publicised in major media organs as well as the IIFS's annual report.
64. IIFS shall make an adequate and timely public announcement in their annual report, website and in mainstream media organs should they make any material changes to their policies in respect of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that they manage.

65. IIFS are encouraged to publish in their annual report a policy statement issued and affirmed by the Board of Directors in respect of the investment accounts that they offer. In addition, it is recommended that IIFS make, in a form and medium accessible to IAH (e.g. public website and annual report), the other disclosures indicated in paragraph 47 of the BCBS Paper, namely:
- Information about the board of directors (bylaws, size, membership, selection process, qualifications, other directorships, independence, material interests in transaction or matters affecting the IIFS, committees of the board (membership, terms of reference and responsibilities, with particular reference to the Governance Committee or its equivalent, and the *Shari'ah* compliance function) and senior management (responsibilities, reporting lines, qualifications and experiences);
 - Basic organisational structure (major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management lines of business structure, legal entity structure, shareholder meetings);
 - Remuneration policies; executive compensation, bonuses, stock options, etc.;
 - The IIFS's code or policy of business conduct and/or ethics as well as any applicable governance structures or policies, with particular reference to their duties towards IAH (including the content of any corporate governance code or policy and the process of which it is implemented, as well as a self-assessment by the board of its performance relative to this code or policy);
 - Where an IIFS is state-owned, the overall objectives of state ownership, including any special obligations of the IIFS for social or public policy purposes and the impact of these obligations on the IIFS's finances, as well as the state's ownership policy and role in corporate governance; and
 - Nature and extent of transactions with affiliates and related parties, including any IIFS matters for which members of the board have material interests either directly, indirectly or on behalf of third parties.

RATIONALES AND OBJECTIVES OF THE GUIDING PRINCIPLES

Introduction

66. The Guiding Principles are designed to facilitate IIFS in establishing and implementing effective corporate governance practices. While Islamic mutual funds and Islamic insurance (takaful) institutions are excluded from the definition of IIFS, the Guiding Principles will be applicable to commercial banks, investment banks, finance houses and other fund mobilising institutions that offer only financial services and products complying with Islamic *Shari'ah* rules and principles, as determined by the respective supervisory authorities.
67. The seven Guiding Principles of corporate governance here would have impacts on several aspects of corporate governance underlying the business practices of IIFS. They provide some examples of current practices, recognising that these practices will and should change as markets change and as technology, financial engineering and improved coordination between supervisory authorities make other strategies available. However, the document does not detail every possible control procedure. The IFSB will keep these matters under review from time to time.
68. The Guiding Principles aims to complement the current corporate governance principles issued by the OECD, BCBS and other international standard-setting bodies. The existing applicable international principles in respect of corporate governance have not been found to contravene or be incompatible, in general, with Islamic *Shari'ah* rules and principles. Therefore, the IFSB considers it appropriate for these principles to be retained and their applicability expanded. However, the Guiding Principles primarily attempt to address specificities of IIFS which are not covered or given due consideration in other international standards.
69. The IFSB recognises that the specific corporate governance practices of each IIFS will vary in scope and content depending on its activities. In certain countries, IIFS are exploring advanced corporate governance practices. The IFSB shares the opinion of the OECD that there is no single model for good governance, which is why the Guiding Principles do not set out detailed prescriptions in addressing all corporate governance issues. All supervisory authorities are encouraged to review their current recommendations, if any, in the light of the principles set out in the Guiding Principles.
70. Undeniably, different prudential regulations covering the aspects of capital adequacy, risk management, investor protection, transparency and market discipline, accounting practices, etc. would all have a corporate governance dimension with regard to the structure and business practices of IIFS. **In this regard, the IIFS are expected to view compliance with these regulations from a holistic perspective.**

Part 1: General Governance Approach of IIFS

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.

Rationale

71. While the notion of “corporate governance” could be considered as a modern creation, the norms and values that are attached to this notion are already synonymous with Islam. Within its comprehensively prescribed way of life, Islam has always promoted good ethics, strong morals, unshakeable integrity and honesty of the highest order. The concerns of the proponents of good governance that the separation of ownership and management of a firm may lead to an agency problem have long been addressed in the *Qur’ān*, which enshrines the importance of ethics not only in contracts and in residual contracts but ultimately in accountability to God. The code of ethics that has been clearly set out in the *Qur’ān* includes:
- honest fulfilment of all contracts –
“O ye who believe! Fulfil (all) obligations” (*Al-Māidah*: 1);
 - prohibition of betraying any trust –
“O ye who believe! Betray not the trust of Allah and and the apostle, nor misappropriate knowingly things entrusted to you.” (*Al-Anfāl*: 27);
 - prohibition of deriving income from cheating, price manipulation, dishonesty or fraud –
“O ye who believe! Eat not up your property among yourselves in vanities. But let there be amongst you traffic and trade by mutual goodwill, nor kill (or destroy) yourselves; for verily Allah hath been to you Most Merciful!” (*An-Nisāa*: 29);
 - prohibition of bribery to derive undue advantage –
“And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people’s property.” (*Al-Baqarah*: 188); as well as
 - a concern for minimising problems arising from information asymmetry between contracting parties –
“... Disdain not to reduce to writing (your contract) for a future period, whether it be small or big; it is juster in the sight of Allah, more suitable as evidence, and more convenient to prevent doubts among yourselves ...” (*Al-Baqarah*: 282).
72. Accordingly, it is clear that an IIFS, as a corporate body governed by the principles laid out in Islam, must strictly fulfil its obligations to all stakeholders insofar as it operates within the confines of the Islamic *Sharī’ah*.
73. In recent times, institutions which have no specific interest in the development of the Islamic financial services industry have taken forward initiatives in the development and propagation of corporate governance frameworks and best practices. However, if we can agree on a broad definition of ‘corporate governance’ as ‘a set of organisational arrangements whereby the actions of the management of a corporation are aligned as far as possible with the interest of its stakeholders’⁹, then we would find that there are more similarities than differences between conventional and Islamic approaches towards good governance - especially in ensuring fairness, transparency and accountability. A

⁹ Archer, S., (2004) “Corporate Governance of Islamic Banks”, a public lecture delivered at International Islamic University Malaysia on 14 April 2004.

difference could be that the Islamic approach has religious values and requirements of the *Sharī'ah* entrenched in it.¹⁰

74. Therefore, in order to avoid “reinventing the wheel” in developing a set of corporate governance best practices for IIFS, the OECD Principles and the BCBS paper are among the leading references that can provide useful guidelines. These documents have already been the main source of references in many jurisdictions while developing their own codes of corporate governance.
75. The IFSB shares the governance philosophies subscribed to by the OECD and BCBS, as they can easily accommodate the needs and requirements of different national environments. In respect of investor protection, the OECD Principles lay down some compelling viewpoints:
- (i) *There is no single model of good corporate governance.* However, during the development of the OECD Principles, some common elements that underlie good corporate governance have been identified and the OECD Principles were built on these common elements and formulated to embrace the different models that exist.¹¹
 - (ii) *The OECD Principles are non-binding and do not aim to provide detailed prescriptions for national legislation.* Rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point. They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.
 - (iii) *The OECD Principles are evolutionary in nature and should be reviewed in light of significant changes in circumstances.* To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities. Similarly, governments have an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to expectations of shareholders and other stakeholders. It is up to governments and market participants to decide how to apply the OECD Principles in developing their own frameworks for corporate governance, taking into account the costs and benefits of regulation.
76. While the BCBS Paper, like the OECD Principles, concedes that no single model can fit into the various governance structure of banking organisations, it does highlight four important forms of oversight that should be included in the organisational structure of any bank in order to ensure the appropriate checks and balances. These are:
- (i) oversight by the Board of Directors or supervisory board;
 - (ii) oversight by individuals not involved in the day-to-day running of the various business areas;
 - (iii) direct line supervision of different business areas; and
 - (iv) independent oversight of risk management and internal audit functions.

¹⁰ For some discussion on the definitions of corporate governance, see Chapra, U. & Ahmed, H., (2002) “Corporate Governance in Islamic Financial Institutions”, *Occasional Paper no. 6*, Islamic Research and Training Institute - Islamic Development Bank: Jeddah.

¹¹ For example, they do not advocate any particular Board of Directors’ structure and the term “board” as used in the OECD Principles is meant to embrace the different national models of Board of Directors’ structures found in OECD and non-OECD countries. In the typical two-tier system, found in some countries, “board” as used in the OECD Principles refers to the “supervisory board” while “key executives” refers to the “management board”. In systems where there is a unitary Board of Directors with oversight by an internal audit body, the principles applicable to the Board of Directors are also, *mutatis mutandis*, applicable to the internal audit body. The terms “corporation” and “company” are used interchangeably in the text.

77. In addition, it reiterates the importance of having key personnel fit and proper for their jobs. It notes that government ownership of a bank has the potential to alter the strategies and objectives of the bank as well as the internal structure of governance. Consequently, the general principles of sound corporate governance are particularly beneficial to government-owned banks.
78. The recommendation for IIFS to have a Governance Committee whose functions are distinctly different from a conventional Audit Committee is made particularly because IIFS operate investment accounts which are not in the form of debt contract (as in the case of conventional fixed deposits), thus raising governance issues which have so far been overlooked. Conceptually, *Muḳārib* in the investment account contract comprises of both the IIFS's management and shareholders, not the management alone. Consequently, an IIFS as a whole (i.e. inclusive of both its management and shareholders) bears a fiduciary duty to the IAH. The significance of investment accounts as a source of funds for IIFS and the unique fiduciary duties that come with them under the principle of *Muḳārabah* certainly merits the establishment of a special organ of governance such as the Governance Committee.

Objectives

79. The IFSB assumes that IIFS have the best knowledge in terms of their own business model and corporate governance concerns. They should work out for themselves how improvements of various aspects of governance can facilitate the achievement of their strategic objectives. In order to remain competitive, IIFS need to ensure that their corporate governance policies and practices are benchmarked against internationally recognised corporate governance best practices and standards.
80. By having a comprehensive corporate governance policy framework, IIFS would be able to identify effectively the strategic roles and functions of each organ of governance and mechanisms for balancing their accountabilities to various stakeholders. The corporate governance policy framework should be effective, as it would have also taken into consideration the various elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are prevalent within a given country's business environment, reflecting its needs and culture.
81. The process of developing such a comprehensive corporate governance policy framework could be a useful learning process for the IIFS not just in improving their governance structure but also in increasing the technical expertise and in-depth knowledge of the IIFS with respect to their own business operations.
82. By having a tailor-made corporate governance policy framework, IIFS will help inculcate a culture of transparency and accountability within their organisations. Even for some IIFS which may not be publicly listed entities, they must learn to expose themselves to reasonable public scrutiny as part of their duties and responsibilities in ensuring the stability of the financial system.
83. Adherence to a policy framework benchmarked against international best practices would also allow IIFS and other supporting institutions such as rating agencies to rate or rank their compliance with locally or internationally recognised corporate governance codes in a comparable manner.
84. Bearing in mind the importance of compliance with good governance principles to the health of IIFS, they must continue to strive towards improving their corporate governance and should not hesitate to exceed public expectations in order to achieve effective competitiveness and a strong reputation. In the context of systemic stability of the financial system, good governance of IIFS plays an important role in maintaining public

confidence in them, just like other financial institutions, as any action (or inaction) which indicates poor governance could trigger a run that can eventually affect the stability of the whole system.

Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards which are in compliance with *Sharīah* rules and principles and are applicable to the Islamic financial services industry as approved by the supervisory authorities of the country.

Rationale

85. Amongst the most important lessons that can be derived from various corporate governance scandals around the world is that, transparency and accountability should be embedded in the corporate culture of any corporation. In this respect, the IFSB recognises that international accounting standard-setting organisations, as well as self-regulating professional bodies, have made tremendous efforts towards improving accounting best practices in response to corporate governance challenges, particularly in enhancing transparency and accountability.
86. With the advent of globalisation, many countries are also ensuring that their financial and non-financial reporting standards are in line with internationally recognised accounting standards.¹² As the Islamic financial services industry continues to grow within the global financial framework, the financial and non-financial reports of IIFS should also meet the globally recognised reporting standards.

Objectives

87. Through high quality and transparent financial and non-financial reporting practices, IIFS would earn more credibility. The importance of such credibility for IIFS can hardly be overstated if the Islamic financial services industry is to avoid marginalisation and to be well integrated into the global financial framework.
88. The adoption of IFRS or other international accounting and auditing standards depends largely on their recognition by the supervisory authorities, as well as by the relevant professional bodies in the respective jurisdictions. Hence, the IFSB urges such bodies to take a leading role in ensuring that the local accounting and auditing practices do not fall short of the international standards. If necessary, intensive education and training programmes should be undertaken in order to equip IIFS with the necessary technical knowledge and capacity to apply these international standards.
89. IIFS should support all initiatives and respond to the calls to improve their accounting and auditing practices. This is why the IFSB strongly recommends, as best practice, the establishment of an Audit Committee by IIFS. In a survey carried out by the IFSB, it was noted that most IIFS have established an Audit Committee. In this respect, IIFS should ensure that their Audit Committee functions efficiently and effectively in addressing all their financial reporting and auditing concerns. For example, adequate written rules governing the overall audit functions, i.e. for the Audit Committee and both external audit and internal audit, should be established and followed. The Audit Committee must also work very closely with the internal and external auditors in their routine review of the IIFS's risk exposures and accounting procedures.

¹² For example, the widespread adoption of the International Financial Reporting Standards (IFRS) including by the European Union certainly indicates a strong trend towards harmonisation of local accounting and auditing standards with the international standards.

Part 2: Rights of Investment Account Holders (IAH)

Principle 2.1: IIFS shall acknowledge IAHS' rights of monitoring the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.

Rationale

90. In a survey carried out by the IFSB, it was found out that there are more IIFS which operate only unrestricted investment accounts than IIFS which offer only restricted investment accounts or both types of investment accounts (restricted and unrestricted). It was also found that even for IIFS that offer restricted investment accounts, none of them would allow an IAH to restrict his investment mandate in accordance with his individual risk appetite, i.e. they offer "off the peg" investment funds not "tailor-made" according to the preferences of IAH. Although understandably investment accounts are often offered as 'off the shelf' products without accommodating the specific risk appetites of potential IAH, the issue of the fairness and transparency of the IIFS in managing the investment accounts gives rise to concern.
91. By providing to IAH the rights of monitoring the performance of their investments and the associated risks, an IIFS is giving due recognition to the IAHS' interest and ownership of the funds (as *Rabb al-Māl*) in the investment accounts. The notion of 'ownership' here is central to the corporate governance process. It is the separation of ownership from control that produces a situation where the interests of owner and ultimate manager (in this case IIFS as *Muḍārib*) may (and often do) diverge, and where there must be a structure to allow appropriate checks and balances to limit the manager's control over the funds (for example, through the Governance Committee mentioned earlier). Without adequate and appropriate check and balance mechanisms, the manager would have absolute control of the funds, and information asymmetry can only aggravate the risk of abuse on the part of the manager. In such circumstances, investors cannot exercise any of the rights of ownership of the funds.
92. Accordingly, depriving the IAH of rights of monitoring could facilitate potential abuse by IIFS in managing the investment accounts. From the perspective of maintaining the stability of the financial system, this would not be an ideal situation because ultimately it could lead to systemic risk following a loss of confidence in an IIFS by its IAH.

Objectives

93. Acknowledging IAHS' rights of monitoring the performance of their investments and putting into place adequate means for IAH to observe and exercise these rights is not only appropriate in complying with the principle of *Muḍārabah* - it would also strengthen the ethical values of transparency and accountability promoted by the Islamic *Shari'ah*. In addition, this can enhance the credibility of IIFS and can form a good marketing tool for mobilising more funds.

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.

Rationale

94. Adopting a sound investment strategy is a basic risk management tool that would not only mitigate any potential investment risks borne by an IIFS, but also opens the

opportunities for IIFS to tap a larger resource of funds from the public who are confident with the investment strategy adopted by it.

95. The literatures have highlighted the benefits and disbenefits of the practice of “smoothing the returns” by IIFS in the operation of the investment accounts by creating a PER. The main argument for such a practice is that it helps IIFS to remain competitive against the relatively stable rates of return offered by conventional banks. This argument could be valid especially if IIFS consider themselves as merely offering a product which is perceived as a *Sharī'ah*-compliant substitute for conventional deposits. However, its validity could be questioned if IIFS consider *Sharī'ah*-compliant investment accounts as not just a substitute for conventional deposits but a truly different type of investment product. This fact has to be duly recognised, as in principle, IAH must bear the risk of losing their capital in accordance with the *Sharī'ah* rules and principles of *Muqārabah* (even if this risk is minimal because of sound investment management and an appropriate asset allocation strategy).
96. In addition to smoothing the returns to investment accounts, additional reserves have been built up to provide for the mitigation of unexpected losses. In some countries, IIFS have been specifically required to set up IRR to cater for this objective.¹³
97. However, some have questioned the necessity of these practices when these concerns can be addressed by ensuring appropriate asset allocation.¹⁴ Furthermore, as noted in paragraph 39 above, whereas in principle shareholders have some controls over an IIFS's dividend policy and use of reserves (which have to be approved by them in the annual general meeting), IAH have no control over the use of reserves such as the PER and IRR.
98. In a survey carried out by the IFSB, it was found that only a small percentage of IIFS confirmed that they had practised “smoothing of returns” for the investment accounts. However, the IFSB are more concerned with the finding that some of the IIFS which operate PER and/or IRR have not informed their IAH that part of their share of profits from the investment accounts will be set aside into these reserve accounts. In fact, the results of our survey showed that none of the IIFS allows its IAH to choose not to have their returns “smoothed” via the PER.
99. Some of the IIFS that operate a PER for smoothing the returns to IAH admit to having used the reserves every year during the past 5 years to smooth the returns to the IAH. While this could indicate the importance of the PER in allowing IIFS to give returns to their accountholders that are very comparable to those paid by conventional financial institutions, it also raises the uncomfortable issue of whether such a reliance on reserves leads to a misconception on the part of IAH as to the actual performance of their investments.
100. The IFSB also found out from our survey that no supervisory authority has issued specific guidelines or rules for the practice of smoothing the returns. In the absence of such guidance, some IIFS may want to refer to the relevant international financial reporting standards in respect of disclosures relating to investment accounts. However it would be helpful if supervisory authorities could carry out a study of the practice of “smoothing the returns” within their respective jurisdictions and set out adequate guidelines or rules in this area.

¹³ For example please refer to Article 55 of Banking Law of Jordan (Law No. 28/2000).

¹⁴ Archer, S., *ibid.*

Objectives

101. By focusing on an efficient asset allocation strategy appropriate to the risk appetite of their IAH, IIFS would be practising good governance by aligning their actions with the interests of the IAH. They should not fail to ascertain and take account of the risk and return expectations of IAH even for unrestricted investment accounts, because that could amount to negligence, and IIFS are responsible for indemnifying IAH for losses if the losses are the result of their negligence.
102. Furthermore, reserves in the form of PER and IRR raise serious 'intergenerational' problems between different time-cohorts of IAH, which raise further questions regarding the transparency and accountability of the IIFS. The issue of 'ownership' of IAH funds is blurred by the operation of the PER and IRR. While the PER and IRR certainly work for the benefit of IIFS in terms of competitiveness and mitigating systemic risks, the benefits to the IAH are questionable. Obviously, the mechanics of PER and IRR strengthen the hand of those in control (i.e. manager or *Muḍārib*) compared to those who mainly own the reserves (i.e. IAH as *Rabb al-Māl*) and from a corporate governance point of view, this is a recipe for potential abuse.
103. Adequate and appropriate disclosures regarding the asset allocation and investment strategies of IIFS in respect of investment accounts and the utilisation of PER and IRR would allow organs of governance such as the Governance Committee, Audit Committee, and SSB to check and monitor the performance of IIFS as managers of the investment accounts. Similarly, such disclosure would enable other information intermediaries for consumers such as financial analysts and the media to play a more effective role in promoting market discipline.

Part 3: Compliance with *Sharī'ah* Rules and Principles

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining *Sharī'ah* rulings, application of *fatāwā* and monitoring of *Sharī'ah* compliance in all aspects of their products, operations and activities.

Rationale

104. The establishment of a panel of *Sharī'ah* scholars as advisors to the IIFS, commonly known as SSB, is the usual step taken by IIFS in putting in place appropriate *Sharī'ah* advisory and monitoring functions to guide their business operations. According to a survey conducted by the IFSB, the majority of the IIFS have SSB either in the form of a panel comprising several members or an individual advisor.
105. Considering that the foundation of every IIFS is the offering of financial services in strict compliance with the requirements of Islamic *Sharī'ah*, it would not be acceptable if any IIFS functioned without *Sharī'ah* supervision of any sort. An IIFS bank without any access to *Sharī'ah* scholars may not be able to distinguish itself as an institution that offers Islamic financial services and will not be able to attract investors and entrepreneurs who wish to invest their funds according to *Sharī'ah* precepts. Hence, it is of primary importance for IIFS to understand that, only when they establish appropriate *Sharī'ah* monitoring mechanisms would customers be convinced that the IIFS offer only *Sharī'ah*-compliant financial products and the customers will become involved only in transactions that comply with the rules and principles of Islamic *Sharī'ah*.
106. A particular aspect of *Sharī'ah* compliance, which still appears to be generally lacking amongst IIFS, is the conduct of external *ex-post* *Sharī'ah* compliance reviews. In its survey, the IFSB found that only a small minority of the IIFS have external *ex-post* *Sharī'ah* compliance reviews, even then mostly carried out by their governing central banks. The Audit Committee of IIFS should use their best efforts in ensuring that the external auditors are capable of accommodating *ex-post* *Sharī'ah* compliance reviews (relying - where appropriate - on work carried out by internal auditors/*Sharī'ah* reviewers) within their terms of reference. Where possible, the Audit Committee and the internal auditor/*Sharī'ah* reviewer shall work closely with the external auditors to enhance the external auditors' capabilities for conducting such *Sharī'ah* compliance reviews as part of their audits.
107. The IFSB survey also indicates that a majority of the IIFS do have internal *Sharī'ah* compliance reviews. Most IIFS have their internal auditor/*Sharī'ah* reviewer carrying out this review, while some have their SSB or *Sharī'ah* compliance review function conducting the reviews. Some of the IIFS have this function carried out by their Audit Committee or Executive Committee, while others leave it to internal set-ups such as the Risk Management Department, Compliance Department, Investment Department or *Fatāwā* and Research Department. In order to ensure that *Sharī'ah* compliance reviews are conducted by competent and adequately trained professionals, the internal auditors/*Sharī'ah* reviewers will be expected to carry out this task with the necessary competence.

Objectives

108. The rapid development of the Islamic financial services industry has created a need for specialisation among *Sharī'ah* compliance professionals. Takaful operations, for example, while based on many of the same principles, are nonetheless quite different from banking operations. The operations of commercial banks differ considerably from those of savings banks and investment banks. The Islamic financial services industry can

expect that in the future, there will be more specialised *Sharī'ah* compliance monitoring or supervision, geared toward specific sectors within the industry, as it grows in size and sophistication.

109. By promoting a more professional approach in the provision of *Sharī'ah* rulings, application of *fatāwā* and monitoring of *Sharī'ah* compliance, the credibility and integrity of *Sharī'ah* scholars as advocates and promoters of good governance can further be developed.

110. Although inevitably nowadays a small number of *Sharī'ah* scholars have been providing their services globally, the current practices is considered far from professional because of some serious inadequacies, whereby in most jurisdictions:

- the criteria in recognising a person as a qualified *Sharī'ah* scholar is still vague; and
- means of checking the legality, credibility and validity of a *Sharī'ah* ruling is still uncertain.

Considering the juristic nature of *Sharī'ah* rulings and the legal implications they would have on the validity of contracts entered into by IIFS, the ultimate test for their legitimacy should be the admission of such rulings into a credible court of law. The IFSB notices that for some IIFS, the *fatāwā* have legal force by virtue of the IIFS's constitution or statutes.¹⁵ However, in other cases, they do not, thus from a legal point of view the IIFS are not bound to follow the *fatāwā*. Accordingly, an IIFS must not enter into a contract which is not *Sharī'ah* compliant.

111. In certain countries they have a central SSB recognized by the regulatory and supervisory bodies to issues binding *fatāwā*.¹⁶ Nevertheless, so far, evidences of adoption of *Sharī'ah* rulings by a credible court of law in resolving Islamic finance disputes can hardly be found. Even if there are some, more records of these are needed to ensure that the system is running smoothly and with reliable credibility.

112. We cannot set aside the idea that in order to propel the *Sharī'ah* compliance framework of IIFS to a higher level, it may be preferable to have a professional organisation or an industry association that will set professional standards for *Sharī'ah* scholars serving the Islamic financial services industry. Such a professional association might look after the interests of membership, and promote understanding and exchange through publications and regular forums. It could also establish relationships with relevant academic, commercial and professional bodies. The Islamic financial services industry appears to have matured to the point where such an association, which lay down a transparent and accountable structure for *Sharī'ah* advisory services, would be of great value to everyone involved, whether as industry players or as consumers.

Principle 3.2: IIFS shall duly comply with the *Sharī'ah* rules and principles as expressed in the rulings issued by the IIFS's *Sharī'ah* scholars. The IIFS shall make these rulings available to the public.

Rationale

113. Modern Islamic financial services have evolved in many ways compared to practices during the early days of Islam. They continue to require fresh and innovative applications of Islamic *Sharī'ah* rules and principles. Some *Sharī'ah* scholars acting in advisory or monitoring roles to IIFS need to use their best knowledge and efforts in order to facilitate

¹⁵ For example, please refer to Article 58(a) of Banking Law of Jordan (Law No. 28/2000).

¹⁶ For example, IIFS in Malaysia licensed under Islamic Banking Act 1983 is required under section 13A of the Act to follow the rulings made by the Syariah Advisory Council established under subsection 16B(1) of the Central Bank of Malaysia Act 1958. Indonesia and Sudan also have a central *fatwā*-making authority for their Islamic financial services industry.

- the development of the industry and not to hamper it, since too many restrictions and prohibitions may lead customers to the only other alternative i.e. a conventional financial institution. In this respect, those *Sharī'ah* scholars are expected to consider carefully the many schools of thought and diverse branches of opinions that can be relied on while issuing *fatāwā*. Just like any other professional advisors such as lawyers and accountants, *Sharī'ah* scholars must strive to deal with the *Sharī'ah* compliance issues faced by IIFS to the best of their capability without neglecting the ethics of their profession and with due consideration for accountability to God as well as to the public.
114. Compared to their treatment of advice given by lawyers and accountants, IIFS must show a higher degree of respect to the opinions given by their *Sharī'ah* scholars. This is because the latter are entrusted to interpret Islamic *Sharī'ah* rules and principles and not man-made laws. Therefore, while it is acknowledged that genuine difference of opinions in interpreting Islamic *Sharī'ah* rules and principles is a blessing for the Islamic financial services industry, cynical “*fatwā* shopping” or “fishing for *fatāwā*” - i.e. asking *Sharī'ah* opinions from a variety of *Sharī'ah* scholars then picking the *Sharī'ah* opinion for one's own convenience – cannot be considered an acceptable practice.
 115. IIFS should realise that there is a reputational risk to be considered when they opt to follow certain *Sharī'ah* opinions at the expense of another. Hence, IIFS should be careful in managing such risk. Accordingly, they should consult the *Sharī'ah* scholars in preparing the relevant explanation to the public whenever they decide to adopt certain *fatwā*.
 116. The potential abuse in such a practice might be aggravated by the presence of unqualified *Sharī'ah* scholars who falsely claim to have the necessary credentials, experience or knowledge to issue *fatāwā*. Therefore, to enhance public confidence in them, it is appropriate that IIFS publish in their annual reports and websites details of the qualifications of *Sharī'ah* scholars who made the *fatāwā*, how they were arrived at and conditions for their applicability. This would not only cultivate cultures of transparency and accountability in IIFS but also among the *Sharī'ah* scholars, in line with the recommended best practices under Principle 3.1 which promotes a more professional approach in the provisions of *Sharī'ah* compliance advisory and monitoring services.

Objectives

117. An assurance by IIFS that they will uphold the *Sharī'ah* opinions of their chosen *Sharī'ah* scholars in the first place would uphold and indeed enhance the reputation, honour and ethical reliability of Islamic financial services, in line with the Islamic teaching of honesty and integrity.
118. To safeguard the credibility and integrity of the Islamic financial services industry at large, and the IIFS in particular, the professionalism and independence of the *Sharī'ah* scholars must be upheld with the highest respect. Adequate and appropriate disclosure by IIFS allows organs of governance such as the Governance Committee and information intermediaries for consumers such as financial analysts and the media to check and monitor IIFS's compliance with *Sharī'ah* rulings issued by its *Sharī'ah* scholars.

Part 4: Transparency of Financial Reporting in respect of Investment Accounts

Principle 4.1: IIFS shall make adequate and timely disclosure to IAH and the public, of material and relevant information on the investment accounts that they manage.

Rationale

119. The demand for transparency arises from a problem of asymmetric information. Transparency is “the opposite of secrecy”, as rooted in its connotations of honesty and clarity. In the context of good governance practices, transparency encompasses “self-disclosure” or “regulation by revelation” as a mechanism that facilitates the release of information about policies, capabilities, and preferences.
120. In the capital markets, transparency tackles the issue of ‘opacity costs’ that arises when a lack of information impairs market efficiency. The lower the level of transparency in information available to the market, the higher the transaction costs. Hence, a lack of transparency increases the cost of capital. Applying this scenario to investment accounts managed by IIFS (i.e. a poor information environment), the lack of transparency could prevent potential customers from opening an investment account with an IIFS, thus reducing the IIFS’s capability to mobilise more funds.
121. Transparency contributes to the efficient allocation of resources by ensuring that IAH have sufficient information to identify risks and distinguish one IIFS from another. Most importantly, transparency helps to inform the IAH about what to expect from an investment account, thereby creating credibility and accountability.
122. Transparency completely fits into the requirement of Islamic *Shari`ah* as the *Qur`an* has specifically forbidden the concealing of evidence:
“... Conceal not evidence; for whoever conceals it, his heart is tainted with sin. And Allah knoweth all that ye do.” (*Al-Baqarah*: 283).
This effectively means the prohibition of using information asymmetry to gain unfair advantage in a transaction. Adequate and timely disclosure by IIFS to supervisory authorities, IAH and the public, of information on profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that they manage manifests IIFS’s willingness to be accountable for their investment policies and decisions as *Rabb al-Māl*.

Objectives

123. By being transparent to supervisory authorities, IAH and the public on every aspect of the investment accounts that they manage, IIFS would help educate IAH and the public on the risk and return profiles of investment accounts managed by them. This would duly distinguish the nature of investment accounts from conventional deposits. Ultimately, it would inculcate a culture of transparency and discipline among IIFS, and promote a good information environment, which would encourage efficient use of capital and reduce its cost.
124. Transparency also facilitates monitoring of compliance with obligations under the respective contractual and regulatory requirements of IIFS, thus helping to avoid disputes. Further, transparency is an important tool to foster fair and equitable competition in the Islamic financial services industry through allowing equal availability and access to vital information. All potential IAH should have the same access to information on IIFS offering Investment Accounts to have a level playing field in finding investment accounts which suit their risk appetite.

DEFINITIONS

The following definitions are intended to help readers to have a general understanding on the terms used in this document and they are by no means an exhaustive list.

Corporate Governance	<p>A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which:</p> <ul style="list-style-type: none"> (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined. <p>In the context of IIFS, good corporate governance should encompass:</p> <ul style="list-style-type: none"> (i) a set of organisational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; (ii) provision of proper incentives for the organs of governance such as the Board of Directors, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and (iii) compliance with Islamic <i>Sharī'ah</i> rules and principles.
Investment Risk Reserves (IRR)	IRR is the balance of the amounts appropriated by the IIFS out of the income of IAH, after allocating the <i>Muqārib</i> 's share, in order to cushion against future investment losses for IAH.
<i>Muqārabah</i>	A <i>Muqārabah</i> is an investment agreement between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity which is to be managed by the entrepreneur as the labour provider or <i>Muqārib</i> . Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muqārabah</i> agreement, whilst losses are to borne solely by the capital provider unless the losses are due to the <i>Muqārib</i> 's misconduct, negligence or breach of contracted terms.
Profit Equalisation Reserves (PER)	PER is the balance of the amounts appropriated by the IIFS out of the gross income, before allocating the <i>Muqārib</i> 's share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
Restricted Investment Accounts	The account holders authorise the IIFS to invest their funds based on <i>Muqārabah</i> or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Stakeholders	Those with vested interest in the well-being of IIFS including: <ul style="list-style-type: none"> (i) employees; (ii) customers (including IAH and normal depositors); (iii) suppliers; (iv) the community (particularly the Muslim ummah); and (v) considering the unique role of IIFS in national and local economies and financial systems, supervisors and governments are also stakeholders.
Unrestricted Investment Accounts	The account holders authorise the IIFS to invest their funds based on <i>Muqārabah</i> contracts without laying any restriction. The IIFS can commingle these funds with their own funds.