



UNIVERSITI SAINS ISLAM MALAYSIA

جَامِعَةُ الْعُلُومِ الْإِسْلَامِيَّةِ الْمَالِيزِيَّةِ

ISLAMIC SCIENCE UNIVERSITY OF MALAYSIA

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CONTENTS

- What is Corporate Governance (CG)?
- Why Does CG matter in IFIs?
- Role of CG in IFIs
- Theoretical Framework
- CG Structure in IFIs
- Key Participants of CG in IFIs
- Shari'ah Governance (SG) as part of CG in IFIs
- Why does SG matter in IFIs?
- CG Issues
 - Governance to Serve IAH
 - Mechanism of Shari'ah Assurance
 - Disclosure and Transparency
- Concluding Remarks

What is CG?

- CG is the system by which business corporations are directed and controlled (Cadbury, 1992).
- “A set of relationships between a company’s management, its board, its shareholders and other stakeholders” (OECD, 2004) .
- “The manner in which the business and affairs of individual institutions are governed by their BOD and senior management affecting how bank sets its corporate objective, daily business, interest of the stakeholder, to align corporate activities operate in a safe and sound manner and to comply with laws and regulations and to protect the interest of depositors” (BCBS, 1999).

CG in IFIs

- “A set of relationships between a company’s management, its BOD, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined” (IFSB, 2006).
- In the context of IFIs: “a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, 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 compliance with Islamic Shari’ah rules and principles” (IFSB, 2006).

Why Does CG matter?

- Well governed UK companies posted 18% higher returns than those with poor governance after adjusting for risk (ABI Research Paper 7: 2008);
- Well governed firms in Korea have been found to trade at a premium of 160% to poorly governed firms (Black et al, 2004);
- A study of S&P 500 firms showed that companies with strong or improving CG practices outperformed those with poor or deteriorating governance practices by about 19% over a 2-year period (Grandmont et al, 2004).
- A worst-to-best improvement in CG predicted an astronomical 700-fold increase in firm value among Russian firms (Black, 2001).

Why Does CG matter in IFIs?

<ul style="list-style-type: none"> Ihlas finance in Turkey 	<ul style="list-style-type: none"> IF was closed in 10/02/2001 due to financial distress and weak corporate governance. Failure of CG and internal checks and balances (Ali, (2007).
<ul style="list-style-type: none"> Islamic Bank of South Africa 	<ul style="list-style-type: none"> The IBSA was closed in November 1997 with debt of between R50-R70 million. Lack of supervision from regulatory authority, bad management, weak risk management and numerous loans to insiders (Okeahalam, 1998: 37-38).
<ul style="list-style-type: none"> Islamic Investment Companies of Egypt 	<ul style="list-style-type: none"> The closure of the IICE in 1988 was due to the weak of corporate governance, irresponsible management, and improper regulatory frameworks as well as engaged in <i>Shari'ah</i> non-compliance activities (Zuhaida, 1990).
<ul style="list-style-type: none"> Dubai Islamic Bank 	<ul style="list-style-type: none"> This refer to the fraud case in DIB involving of USD501 million. Seven individuals have been charged including two Dubai Islamic Bank former executives (Morris, 2009). Weak internal control.
<ul style="list-style-type: none"> Bank Islam Malaysia Berhad. 	<ul style="list-style-type: none"> Losses, totaling RM457 million in 2005 (Parker, 2005). The composition of the board was not appropriate as there were no board members who were familiar with banking sectors as well as no sound and proper credit and debt collection (Parker, 2005).
<ul style="list-style-type: none"> Patni Cooperative Credit Society 	<ul style="list-style-type: none"> Failure to asses risk to compensate the regulatory constraints. The BOD and management failed to asses regulatory risk in which led to numerous problems and difficulties (Graiss and Pellegrini, 2006).

A rubber stamp board of directors,
Lax Attitude towards governance,
Some members appointed to the
board did not have requisite
experience, Only one institutional
member i.e. IDB as minority
shareholder and thus it was easy to
manipulate the Board

Board members are ignorant of
financial and economic facts and
working of the company , board
members are not motivated, Some
board members had conflict of
interest owing to their dual role as
board members as well as clients of
finance from Ihlas Finans Holdings

Control Failures

The Bank staff lack relevant
experience and training

The bank is run on trust
without proper systems of
internal control

Not preparing enough for changing regulations, No Crisis Management Plan, Decision making during crisis was ad-hoc and uncoordinated internally

Connected Lending and Investment Concentration, Executive Selection Hired a senior executive from a previously failed bank

Management Failures

Allowing Withdrawal from Investment Accounts, Failure to manage liquidity risk

Indulge in fraudulent practices, some of the mudharabah agency financing was done in the name of fictitious parties while the funds were used for solving internal financial problems

Drastic application
of rules

Lax Supervision

Regulatory
Failures








Lacuna in
supervision of law

Unclear scope of
deposit protection
law and confusion on
who is the authority

Guidelines on CG for IFIs

IFSB	AAOIFI
<ul style="list-style-type: none"> ■ 10 prudential standards for IFIs, 2 for capital adequacy requirements, 1 for risk management and 7 for governance, disclosure and supervisory review process ■ Guiding Principles on CG for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (<i>Takaful</i>) Institutions and Islamic Mutual Funds) ■ Guiding Principles on Governance for Islamic Collective Investment Schemes, ■ Guiding Principles on Governance for <i>Takaful</i> (Islamic Insurance) Undertakings ■ Guiding Principles on Governance for <i>Takaful</i> Operations ■ Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services ■ Guiding Principles on SG System for Institutions offering Islamic Financial Services 	<ul style="list-style-type: none"> ■ 81 standards and guidelines which include 25 accounting standards, 6 auditing standards, 7 governance standards, 41 <i>Shari'ah</i> standards and 2 codes of ethics. ■ Shari'a Supervisory Board: Appointment, Composition and Report; ■ Shari'a Review ■ Internal Shari'a Review ■ Audit and Governance Committee ■ Independence of Shari'a Board ■ Statement on Governance Principles for IFIs ■ Corporate Social Responsibility

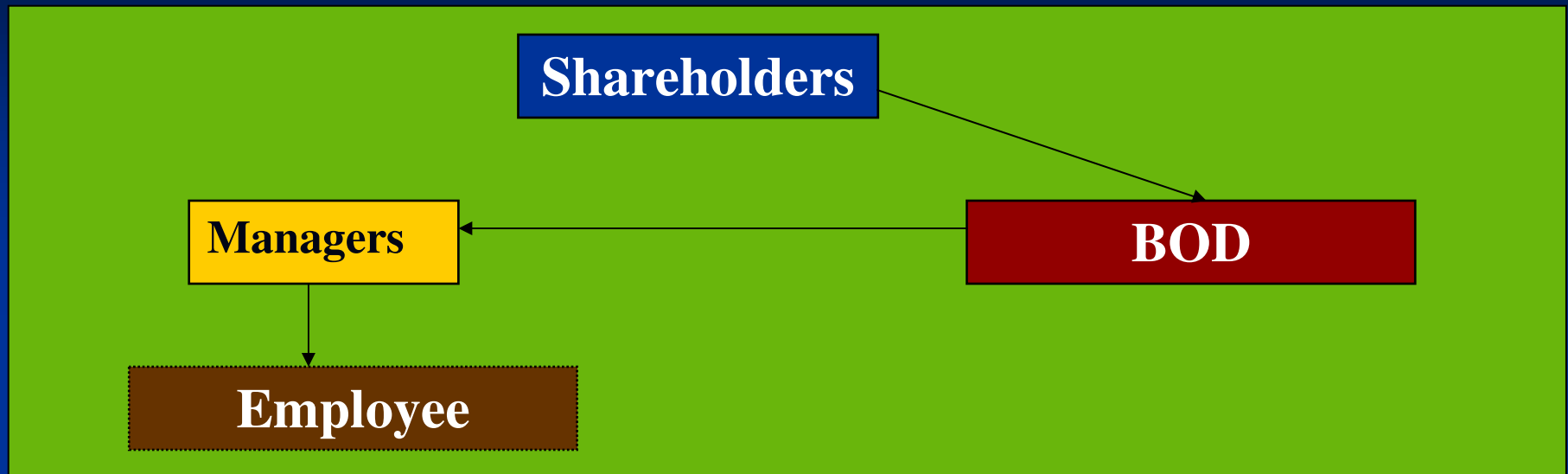
Role of CG

Roles and Functions	Typical FI	Exclusive to IFIs
Mechanism to address agency problems and conflict of interest amongst member of organization (Hart, 1995)		
To facilitate access to external finance, Lower cost of capital, Lead to better operational performance and reduce risk of contagion from financial distress (Claessens, 2003)		
Mechanism to maintain and to improve growth and able to prove the efficiency, stability and trustworthiness (Grais and Pellegrini, 2006).		
The need to reassure stakeholders that their activities are fully complied with <i>Shari'ah</i> principles (Grais and Pellegrini, 2006).		

Theoretical Framework of CG

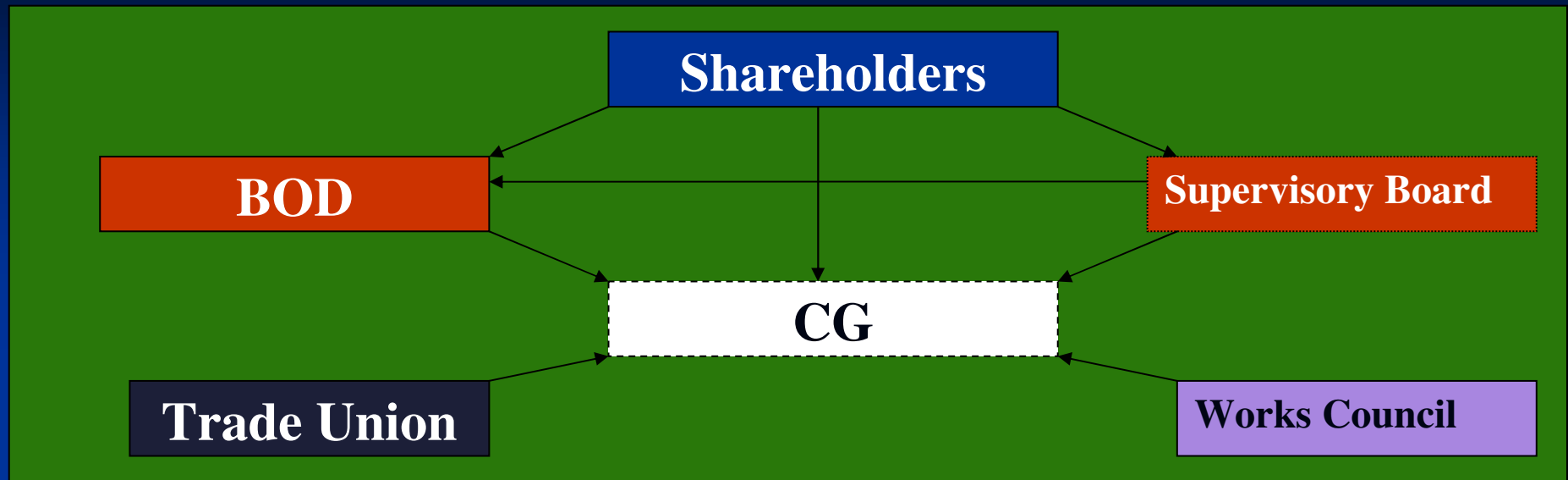
- There are two main corporate governance systems namely the Anglo-Saxon and the European models.
- The Anglo-Saxon/insider/ neo-liberal/shareholders' model of CG is considered as the most dominant theory.
- The European/ insider/stakeholders' model of CG is practiced by several European countries where many large firms are part of social and economic structure.
- Issue: What is an Islamic approach towards CG in Islamic corporation particularly to Islamic financial institutions?

The Anglo-Saxon Model



- Neo-liberal position
- Profit-oriented behavior.
- This conception is derived from the belief of market capitalism whereby the interest and the market can function in a self-regulating and balanced manner.
- The central preoccupation of CG is to protect the interest and rights of the shareholders.

The European Model



- It focuses on a relationship-based model that emphasizes the maximization of the interests of a broader group of shareholders.
- The stakeholders: Shareholders, internal stakeholders (employees and labor union), the operational partners (customers, suppliers, creditors and contractors) and the social community (state authorities, trade union, NGO and civil society)

CG From Islamic Perspective

- In the Islamic context, the interest of stakeholders is beyond the financial return or profit maximization.
- The foundational framework of CG in Islam is based on the element of *Tawhid*, *Shura*, *Shari'ah* rules, principles of contract and property rights and maintained the private goal without ignoring the duty of social welfare. This entails that the CG in Islam is inclined towards the stakeholders model.
- Equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not.
- CG model in Islam is a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se.

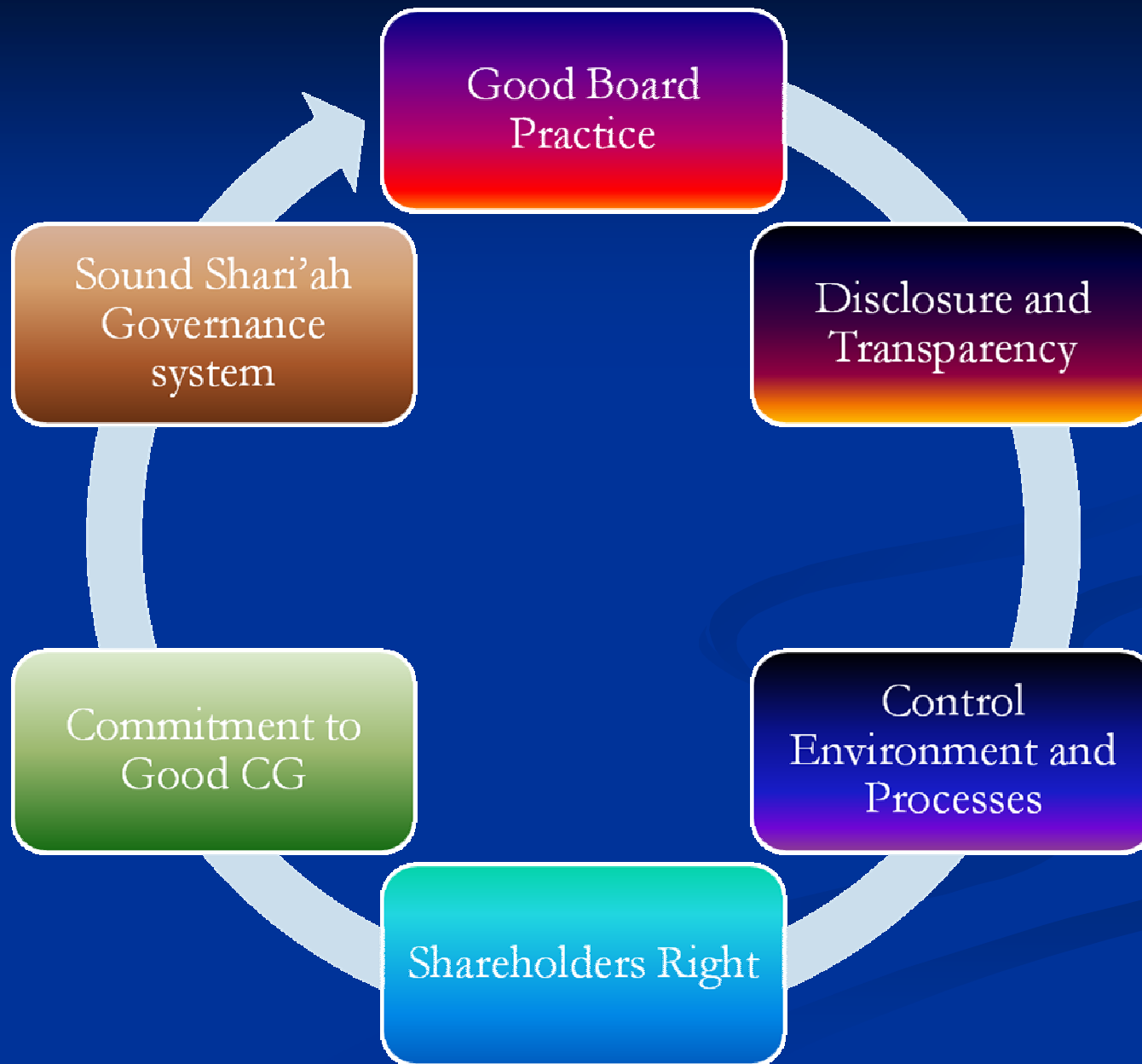
CG Structure in IFIs



Key Participants of CG in IFIs

Key Participants	Interest	Functional Roles
<ul style="list-style-type: none"> Regulatory /Supervisory authority 	<ul style="list-style-type: none"> Economic Stability and Compliance with the laws and regulation 	<ul style="list-style-type: none"> Set regulatory framework for sound and proper CG To supervise and monitor the effectiveness of CG and to check compliance with regulation
<ul style="list-style-type: none"> Shareholders 	<ul style="list-style-type: none"> Wealth maximization; Satisfactory earnings per share; Dividends; 	<ul style="list-style-type: none"> Appoint fit and proper boards, management auditors and <i>Shari'ah</i> board
<ul style="list-style-type: none"> IAH 	<ul style="list-style-type: none"> Repayment of deposits on the agreed terms; Protection of their interests and Profit 	<ul style="list-style-type: none"> To monitor the investment performance
<ul style="list-style-type: none"> <i>Shari'ah</i> Board 	<ul style="list-style-type: none"> Compliance with <i>Shari'ah</i> 	<ul style="list-style-type: none"> To ensure <i>Shari'ah</i> compliance and protect the rights and interest of depositors and other stakeholder.
<ul style="list-style-type: none"> BOD 	<ul style="list-style-type: none"> Monetary and non-monetary compensation; 	<ul style="list-style-type: none"> To set the IFIs direction and policies
<ul style="list-style-type: none"> Management 	<ul style="list-style-type: none"> Monetary and non-monetary compensation and commitment to claims of the contract. 	<ul style="list-style-type: none"> To implement policies set by the BOD

The Six Elements of Good CG in IFIs



Key Responsibility

Board and
Senior
Management

- Credit Risk
- Equity Investment Risk
- Market Risk
- Liquidity Risk
- Rate of Return Risk
- Operational Risk

Shari'ah Board

- Shari'ah Non-compliance Risk

Concluding Remarks

- The design of CG in IFIs has its own unique features and presents distinctive characteristics in comparison with their conventional counterparts particularly in the aspect of:-
 - Shari'ah compliance,
 - Accountability to the Almighty, Ethics and social responsibility,
 - A class of stakeholders (IAH); and
 - Potential conflict of interest between shareholders and the UIAH.
- CG framework in IFIs must be able to address issues that equally applicable to typical financial institutions as well as specific issues that solely relevant to them such as mechanism of Shari'ah assurance and governance to serve IAH.

Thank You

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