



## ISLAMIC FINANCIAL SERVICES BOARD

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### EXPOSURE DRAFT

### GUIDING PRINCIPLES ON CONDUCT OF BUSINESS FOR

### INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES

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Comments on this Exposure Draft should be sent to the IFSB's Secretary-General not later than 15 May 2009 via email at [ifsb\\_sec@ifsb.org](mailto:ifsb_sec@ifsb.org) or facsimile +603-26984280

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## **ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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## ACRONYMS

CBWG	Conduct of Business Working Group
IAH	Investment account holders
IAIS	International Association of Insurance Supervisors
ICIS	Islamic Collective Investment Scheme
IIFS	Institutions offering Islamic financial services
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IOSCO	International Organization of Securities Commissions
OECD	Organisation for Economic Co-operation and Development
PIA	Participant's investment account
SRO	Self Regulatory Organisation
SSB	<i>Shari'ah</i> Supervisory Board
UIAH	Unrestricted investment account holder

**Bismillahirrahmanirrahim**

*Allâhumma salli wasallim 'ala Sayyidina Muhammad wa'ala âlihi wasahbihi*

**INTRODUCTION**

1. The sound functioning of a financial system depends, *inter alia*, on the users of the system having confidence in the quality of the conduct of business by the participants offering financial products and services, and that there are adequate systems of control over the conduct of business. A framework of the principles and rules that govern effectively the conduct of business of Islamic financial services industry (IFSI) participants, whether mandatory or voluntary, can play a significant role in supporting the growth of the IFSI. Such a framework would not only promote a climate of confidence and a supportive environment that upholds transparency and fair dealing comparable to the conventional frameworks, but would also strengthen the relevant moral, social and religious dimensions in conducting business.
2. In consideration of the above, and in line with its mandate to promote the soundness and stability of the Islamic financial system, the Council of the IFSB at its ninth meeting held on 29 November 2006 in Jeddah, Kingdom of Saudi Arabia, supported the formation of a Conduct of Business Working Group (CBWG), intended to complement existing and future Islamic Financial Services Board (IFSB) standards and guidelines in the IFSI. To this end, the present document aims to complement and “add value” to other existing internationally recognised frameworks that set out sound principles and best practices pertaining to the conduct of business by participants and institutions in the conventional banking, insurance and capital market industry segments, by addressing the specificities of the IFSI.

**THE SCOPE OF APPLICATION**

3. The Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services (“Guiding Principles”) are applicable to all firms operating in the IFSI – that is, to fully fledged institutions offering Islamic financial services (IIFS) in the Islamic banking, *Takāful* or capital market segments, and to Islamic “windows” of conventional firms. In what follows, the term “IIFS” should therefore be understood as applying also to Islamic “windows”. In accordance with the objectives of the IFSB, the Guiding Principles will not “reinvent the wheel” but will instead, wherever appropriate, reinforce the existing internationally recognised frameworks or standards for the conduct of business so that institutions that fall within the scope of these Guiding Principles operate on a level playing field with their conventional counterparts. However, in order to avoid putting them at any competitive disadvantage, due consideration shall be given to their specificities.
4. In addition to the various existing internationally recognised conduct of business frameworks as issued by other international organisations,<sup>1</sup> as well as the other standards issued by the IFSB, it is acknowledged that many regulators may have established their own conduct of business regulations that are mandatorily imposed on entities licensed by them. Accordingly, these Guiding Principles seek to complement and strengthen those codes of business conduct that are already in place as part of the general regulation of financial services firms, by highlighting appropriate perspectives on certain conduct of business issues specific to Islamic finance.

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<sup>1</sup> (a) The International Conduct of Business Principles – IOSCO; and (b) Principles for the Conduct of Insurance Business – International Association of Insurance Supervisors (IAIS).

5. The IFSB takes the view that addressing the Guiding Principles through high-level principles on the conduct of business will allow the IIFS to develop the necessary structures for compliance and adapt them to local circumstances. These Guiding Principles are also intended to provide guidance to supervisory authorities in their supervision of IIFS. The IFSB considers that since supervisory authorities have varying degrees of responsibility for regulating conduct of business in their respective countries, the Guiding Principles will provide sufficient room for supervisors to tailor the rules in a variety of ways – e.g. laws, regulations, internal rules within a company or institution, and unwritten principles and customs.

## UNDERSTANDING THE APPLICATION OF THE GUIDING PRINCIPLES

6. Conduct of business principles are defined as those principles of conduct that are intended to govern the activities of financial services firms with regard to (a) the protection of the interests of their customers, and (b) the integrity of the market. For IIFS, a code of ethical business conduct derives from principles of the *Sharī'ah* as set out in the Holy *Qur'ān* and the *hadīth*. A number of relevant quotations from these sources that support these Guiding Principles (summarised in paragraph 10 below) are included in the Appendix. Not only is it socially desirable for IIFS to observe principles of good business conduct, as their failure to do so may have unacceptable consequences, but it is also a *Sharī'ah* obligation and in some cases a requirement in order for a contract to be valid or enforceable. It is worth noting that principles of ethical business conduct were enunciated in the Holy *Qur'ān* and the *hadīth* many centuries ago, whereas the need for a code of business conduct in the conventional business context has generally been recognised only in recent decades. For all management and staff of IIFS, irrespective of their religious beliefs, observance of principles of good business conduct is certainly a crucial matter of professional ethics. This may be particularly relevant in the case of Islamic “windows”.
7. The implementation of a code of business conduct would benefit more from a principles-based approach, rather than a purely rules-based approach, which tends to result in a “box-ticking” attitude towards compliance. This is not to say that in such an approach rules are unimportant, but that their spirit is more important than the letter of the rules. A principles-based approach encourages voluntary efforts by IIFS to develop their own systems and internal controls for governance, risk management and regulatory compliance, and leaves room for IIFS to choose the structures and processes that best suit their business models without compromising on the objectives set out by these principles. This approach would also provide IIFS with a fluid range of options when there is a gap in the existing rules for newly introduced products, services and/or sales methods. Moreover, a principles-based approach is far more conducive to self-regulation,<sup>2</sup> as discussed below. To this extent, the framework for good conduct of business would be considered and applied in conjunction with the framework for good corporate governance.
8. The IFSB shares the opinion of the Organisation for Economic Co-operation and Development (OECD) that there are two underlying reasons why institutions can be expected to comply with voluntary codes. First, companies that take voluntary action to redress a policy concern may stave off a more onerous regulation from the supervisory authority. In many developed jurisdictions, regulatory and supervisory authorities rely to a substantial extent on self-regulation by private sector bodies such as industry and professional associations. A supervisory authority that can deploy a credible threat of possible future regulation may persuade an industry to deal with the issue itself by self-regulation, rather than taking the step of introducing mandatory

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<sup>2</sup> “Self-regulation” in this context refers to “voluntary” compliance by an individual institution, as opposed to the generally understood self-regulation process by which a statutory regulator delegates day-to-day supervision to a self-regulatory organisation (SRO), which has a formal and official status. In the case of an SRO, the statutory regulator can choose to compel adoption of certain regulations or can overturn decisions made by the SRO. On the other hand, “voluntary” describes a process by which individual organisations, or groups of organisations through a trade association, agree to abide by certain principles that are not enforceable in law (although some regulators may choose to make adoption of a trade association voluntary code obligatory).



regulation. Second, IIFS may enhance their reputation – and hence increase market penetration – by participating in self-regulatory associations. For the industry as a whole, arrangements that are undertaken and implemented by IIFS on a voluntary basis offer the advantages of speed, consensus and flexibility, as opposed to formal rule-making, which can be onerous, lengthy and adversarial. A self-regulatory approach can lower the costs of compliance, while providing incentives to comply that are more effective than the use of sanctions in a mandatory approach.

9. Any supervisory authority that wishes to monitor compliance with these principles may still observe the IIFS based on (i) their business model, or (ii) the nature of the activity taken, although a combination of both would be desirable. In certain countries, breaches of rules of business conduct are not subject to sanctions in the strict sense of the word. They result simply in recommendations by the authorities to the parties concerned.
10. IIFS are expected to undertake continuous adoption of best practices as these evolve, including alternative practices; provided that they satisfy, in substance, the objectives set out by these Guiding Principles and are appropriately explained through relevant disclosures. IIFS are also expected to make their best efforts, over time, to adopt and apply international best practices in order to raise their conduct of business commitments to a level that is at least on a par with that of their conventional counterparts.
11. The International Conduct of Business Principles were developed by the IOSCO with the key objective of focusing the conduct of financial intermediaries (brokers, banks, portfolio managers, financial analysts and investment advisers) and other market participants. The focus is to protect customer interests and enhance market integrity. These principles have been adopted as one source for the seven Guiding Principles set out below, in which the term “customers” should be understood as referring also to investors and policyholders. However, for IIFS, the requirements for ethical business conduct have their basis in the *Shari’ah*, and these Guiding Principles can be shown to follow from the *Shari’ah* principles as set out in the Appendix. It is a requirement that IIFS must uphold their integrity by complying with *Shari’ah* rules and principles at all times. With regard to *Shari’ah* governance issues, for pragmatic reasons and to avoid unnecessary duplication, IIFS are expected to refer to and adapt the recommendations from the IFSB *Shari’ah* governance standard. More generally, these Guiding Principles have the following premises:
  - They are intended to complement the other IFSB standards.
  - They should take their place within the mainstream international conduct of business framework, and IIFS must demonstrate adherence to principles of business conduct that meet the highest expectations of the international financial community.

The seven Guiding Principles are set out in the following section. As highlighted above, in order to avoid taking a “box-ticking” attitude towards compliance, IIFS are expected to adopt a self-certification approach to complying with these Guiding Principles. A list of self-assessment questions included in the Appendix provides further assistance with regard to compliance. In the Guiding Principles, the term “clients” is used to refer to customers, *Takāful* participants (policyholders) and investors. The term “stakeholders” has a wider meaning that includes not only clients but also other parties that are stakeholders as defined in the IFSB Guiding Principles on Corporate Governance for Institutions offering Islamic Financial Services, such as employees, supervisory authorities and the Muslim *umma*.

## THE GUIDING PRINCIPLES

### Principle 1: Honesty and Fairness

**An IIFS shall aspire to the highest standards of truthfulness and honesty in all its statements and dealings, and must treat its customers fairly.**

12. The fundamental requirement with regard to honesty and fairness is that an IIFS should not, either deliberately or through negligence, issue information that is potentially misleading to stakeholders or the market, nor should it manipulate prices by using any of the means whereby this may be done. Such means include making a false market, issuing misleading price-sensitive information and price-fixing in conjunction with other market players. In addition, an IIFS should not, either deliberately or through negligence, issue information that is misleading to stakeholders or the market regarding the *Sharī'ah* compliance of its products or services, or of *sukuk* issuances with which it is involved. Nor should an IIFS mislead clients or the market through the withholding of material information.
13. A further key requirement implied by this principle is the existence of appropriate procedures whereby whistle-blowers are treated honestly and fairly, with no cover-ups or victimisation. With regard to fairness, IIFS should follow best practice in establishing procedures for handling complaints from clients.<sup>3</sup>

#### *Recommended best practices*

14. It is recommended that IIFS establish a procedure that can be made clear to the public whereby their employees and representatives are contractually obliged to carry out their duties and responsibilities in accordance with a code of business conduct that requires fairness and honesty. To embody this self-binding commitment, it is recommended that IIFS publish a Client's Charter<sup>4</sup> that sets out the relevant parts of its code of business conduct as a written promise to guarantee the delivery of honest and fair service to its clients as demanded by *Sharī'ah*. In this regard, IIFS shall refer to the Sample Guidelines in the Appendix to establish their own Client's Charter. This charter will include such matters as procedures for dealing fairly, honestly and efficiently with complaints from customers, investors or policyholders, and with whistle-blowers and any problems to which they draw attention.
15. In addition, with regard to their public disclosures, IIFS should apply the IFSB Standard on Disclosures to Promote Transparency and Market Discipline.

#### *Illustration No. 1*

16. In general, market manipulation is defined as any practice that distorts prices or trading volume in the market with the intent to deceive people or entities that rely on the publicly available information, in order to make profits by selling at inflated prices or buying at artificially depressed prices. For IIFS, other forms of manipulation can also be used to mislead the market. For example, the process of obtaining *Sharī'ah* approval of new products or services can be manipulated by selecting only one *Sharī'ah* scholar or a group of *Sharī'ah* scholars who are inclined to give a ready approval. While this is not easily captured under conventional codes of conduct, it has something in common with "opinion shopping" by audit clients among different external audit firms, which is recognised as being unacceptable business conduct.
17. In another example, IIFS can also manipulate the process of obtaining *Sharī'ah* approval by non-disclosure of material information that is crucial in assisting the

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<sup>3</sup> Refer to Appendix (item 1) on the concept of honesty and fairness required by *Sharī'ah*.

<sup>4</sup> A Client's Charter is a written commitment made by an institution in terms of the deliverance of its outputs or services to its clients (customers, investors and policyholders). It is an assurance by the institution that outputs or services rendered will comply with the standards declared as quality standards. Generally, quality standards of outputs or services are standards that will fulfil clients' needs and tastes.

*Sharī'ah* scholars to give a complete, fair and independent opinion. All of the issues highlighted above are made more complicated by the fact that it is difficult to prove an act of manipulation in these situations. Hence, the good faith of the board of directors and senior management of the IIFS in being committed to practising good business conduct is essential. See also under Principle 2 below.

#### *Illustration No. 2*

18. The concept of honesty in Islamic finance can be observed in a transaction that is based on a promise (*Wa'd*). In this type of transaction, *Sharī'ah* considers a promise as an undertaking that is entered into unilaterally and is ethically binding. Therefore, IIFS must always enter with sincerity into a *Wa'd*, with every effort being made to fulfil the promise. It is a form of deceit – and thus not acceptable business conduct – for a promise to be given with no serious intent to fulfil it, on the grounds that it is not legally enforceable.

#### *Illustration No. 3*

19. In an Islamic Collective Investment Scheme (ICIS), the fund manager may engage in various practices that result in its making undisclosed profits at the expense of investors (such as churning assets in the fund portfolio to generate commissions for itself or its affiliates, or dealing with the fund as a principal on terms that are contrary to the investors' interests – see the IFSB Guiding Principles on Governance of Islamic Collective Investment Schemes. Any such practices are incompatible with this principle.

### **Principle 2: Due Care and Diligence**

**An IIFS shall exercise care and diligence in all its operations, including the way it structures and offers its products and provides financing, with particular regard to *Sharī'ah* compliance, and to the thoroughness of research and risk management.**

20. This principle requires IIFS to act with due skill, care and diligence, in the best interests of their stakeholders. In essence, it includes any duty of best execution. In the context of conventional financial institutions, there may be only one category of equity investor (such as the shareholders) to whom the management owes a fiduciary duty. By contrast, in Islamic finance, there are typically two major categories of investors – i.e. the shareholders and the investment account holders (IAH), or in the case of a *Takāful* undertaking, the participants (policyholders). IIFS are required to exercise due diligence in safeguarding the interests of such investors (see also Principle 6).
21. IIFS should have in place an appropriate process for dealing with potential or actual instances of misconduct and negligence. This process should be publicly disclosed.
22. IIFS offering *Sharī'ah*-compliant financing are also required to exercise due diligence in making such financing available to customers, in the interests of both its fund providers and its customers. It is not acceptable business conduct for an IIFS to be lax in applying criteria of creditworthiness, relying on collateral to mitigate credit losses, especially in cases where the IIFS exercising its rights over the collateral would inflict hardship on the debtor. Where an IIFS has not exercised due diligence in extending a financing facility, it has a share of the responsibility for any resultant financial distress. The IIFS must avoid taking steps to recover an amount owed to it that would inflict hardship on a debtor whose financial distress is not due to the debtor's misconduct.<sup>5</sup>

#### *Recommended Best Practices*

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<sup>5</sup> Refer Appendix (item 2) on the concept of due diligence as required by *Sharī'ah*.

23. IIFS are required to exercise due diligence in the placement of funds from investors and *Takāful* participants, in extending financing facilities, in accepting risks in *Takāful*, and in any other activities where a proper evaluation of risks, with the collection and analysis of the information necessary for this purpose, is called for.
24. Due diligence also applies to the process of obtaining *Sharī'ah* approval and in keeping the *Sharī'ah* compliance of asset portfolios under review (see Principle 7). As well as avoiding the types of conduct that were pointed out as being unacceptable under Principle 1 above, IIFS should follow *Sharī'ah* opinions that are supported by a majority of *Sharī'ah* scholars internationally. Consensus is rare among *Sharī'ah* scholars in reporting *Sharī'ah* rulings.

*Illustration No. 4*

25. For various reasons, such as building market share, financial institutions may knowingly take on poor credit risks (e.g. sub-prime mortgages). If the debtor then falls into financial distress, a conventional financial institution may, in order to limit its losses, behave in a manner that inflicts potentially avoidable hardship on the debtor. *Such business conduct is not permissible for IIFS.* However, IIFS are in business to make legitimate profits, and can reasonably expect to have their financing duly serviced according to the *Sharī'ah*-compliant contracts under which they were extended, *provided that the IIFS exercised due diligence in extending those financings.*

*Illustration No. 5*

26. The *Sharī'ah* compliance of certain *sukuk* structures is a matter of disagreement, but in general a majority opinion may be identified. Features of *sukuk* structures that may not be widely agreed upon include, *inter alia*:
  - a purchase agreement from the originator to repurchase assets from the issuer at a *pre-agreed price* so as to repay the *sukuk* holders the amount of their original investment at maturity;
  - an arrangement in a *sukuk Muḍārabah* structure whereby, if the available profit falls below a benchmark, the *Muḍārib* will make an interest-free loan to the issuer in order to pay a return to the *sukuk* holders that is higher than the available profit and, if possible, equal to the benchmark; and
  - a tranching structure in which the senior tranches have priority rights to the available cash flows from the underlying investment, the rights of the junior tranches to the available cash flows being subordinated.
27. While Principle 1 demands honesty in seeking and applying *Sharī'ah* opinions on such matters, and transparency as regards the structure of *sukuk* issuances, Principle 2 requires due diligence in seeking *Sharī'ah* opinions that are representative of majority opinion among *Sharī'ah* scholars. This is important, as the *sukuk* may be purchased by investors in a number of countries in the belief that they are generally accepted as being *Sharī'ah* compliant. If investors find out that this belief is mistaken, they may be obliged to dispose of the *sukuk* at a loss.

### Principle 3: Capabilities

**An IIFS shall ensure that it has in place the necessary systems and procedures, and that its employees have the necessary knowledge and skills, to comply with these principles and other IFSB standards.**

28. This principle requires that the senior management, staff and representatives (such as agents) of an IIFS must be capable of discharging their duties competently. The required capabilities must include having an understanding of the rules and principles of *Sharī'ah* that is appropriate to their responsibilities. For members of the board of directors and senior management, "fit and proper" tests may be applied by the industry supervisor. Capabilities may relate to designing products, to selling and distributing the products, or to the competencies necessary for successfully carrying out the business activities of the IIFS, such as risk management, including asset-liability and liquidity management, underwriting of risks in *Takāful*, and the placement and management of funds. Lack of the necessary capabilities may result in flawed products, defective contracts and other paperwork, bad credit decisions, poor and costly underwriting decisions, products that do not meet legal or regulatory requirements, operating losses or underwriting deficits resulting from the above or products being mis-sold.<sup>6</sup> IIFS should include the need for such capabilities in job descriptions and job specifications for recruitment purposes.

#### *Recommended best practices*

29. In addition to having the necessary professional competence, and understanding the applicable laws, rules and regulations of any government, regulatory authorities, licensing agency or self-regulating professional organisation, IIFS must ensure that the persons entrusted to deal on behalf of the IIFS are equipped with an appropriate level of knowledge of the *Sharī'ah*-compliant characteristics of the financial products and services offered by the institution. Having staff with the necessary capabilities is key to avoiding excessive levels of operational risk in banking, and as such is a matter that falls under the supervisory review process (see IFSB Guidance on the Supervisory Review Process).
30. Lack of the necessary capabilities would make it impossible for an IIFS to comply effectively with these Guiding Principles (or to be an effective competitor in the marketplace). Developing the necessary capabilities is a matter of both recruitment and training. Whereas recruitment is subject to a competitive market for staff with the necessary skills, staff training and development are not subject to the same market constraints and must be a major concern for IIFS. They are also consistent with the *Sharī'ah* injunction that encourages self-improvement.
31. Staff training and development are most important in fostering the required capabilities and should include an emphasis on the Code of Business Conduct that the IIFS has developed, which should be consistent with these Guiding Principles. Continuous training and development of awareness of employees at all levels are required in order to arrive at a clear framework of guidance that indicates what is acceptable conduct, as well as the sanctions to be applied to violators of the code.

#### *Illustration No. 6*

32. IIFS may require that their employees and representatives concerned with providing advice to customers (who wish to invest in *Sharī'ah*-compliant financial products) take a course and pass the related examination provided by a recognised academic institution, financial services institute or training organisation that can fulfil the following objectives:
- providing an internationally accepted qualification that will equip candidates with a practical understanding of Islamic finance;

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<sup>6</sup> Refer to Appendix (item 3) on the concept of capabilities as required by *Sharī'ah*.

- providing professional recognition for employees, which will demonstrate that successful candidates have undergone rigorous training and sat a professional examination to reach their level of competence; and
- providing candidates with an understanding of the requirements of *Sharī'ah* in a business context and prepare them to hold key positions in the Islamic finance and *Takāful* (Islamic insurance) industries.

The absence of suitable academic institutions or training organisations in a given country can often be dealt with by the use of distance learning facilities. In addition, comprehensive staff training manuals may be developed.

*Illustration No. 7*

33. It is particularly important that personnel who sell the financial products offered by an IIFS (whether as employees, or as agents or brokers) should be capable of understanding the products they sell (especially the more complex ones) and explaining their features clearly to potential clients so that the latter can make an informed choice as to whether a particular product is suitable for them (see also Principles 1 and 5). This applies to the *Sharī'ah* issues relevant to the products.

**Principle 4: Information about clients**

**An IIFS shall take steps to ensure that it understands the nature and circumstances of its clients, so that it offers those products most suitable for their needs, as well as offering financing only for *Sharī'ah*-compliant projects.**

34. The principle of “know your customer” (KYC) is well known in banking circles and has particular relevance in the context of avoiding money-laundering and transactions intended to finance criminal or terrorist organisations. In these Guiding Principles, the principle regarding information about clients obviously includes KYC but has a broader import, as it also includes having the capability of understanding a client’s needs in order to avoid mis-selling (see Principles 1 and 2).<sup>7</sup> In addition, an IIFS needs to know that its customers’ businesses and the purpose of any financing provided are consistent with the *Sharī'ah*.

*Recommended best practices*

35. IIFS need to gauge the exact needs of their clients to ensure that the products or services rendered will reasonably meet these needs. Among the methods that are commonly used to gauge clients’ needs are questionnaires and interviews with the clients, a written record being required. Questionnaires should be either completed by or signed by the client, and where appropriate there should be a summary of any interview also to be signed by the client. The principle of due diligence also applies to any such information seeking.
36. In this connection, prospective *Takāful* participants must not withhold from the *Takāful* undertaking any facts that are material to the cover being provided; if they do so, this is likely to invalidate the contract.

*Illustration No. 8*

37. A client is seeking *Sharī'ah*-compliant housing finance for a residential property that he wishes to acquire as a family home. He needs a housing finance product that is affordable for him and which involves minimal risk that he will be unable to meet the financial obligations associated with the product. In order to give the client sound advice and to propose a suitable product, an employee or representative of an IIFS will need to obtain the following information from the client: the amount of any deposit

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<sup>7</sup> Refer to Appendix (item 4) on the concept of information for clients as required by *Sharī'ah*.

or initial payment he is able to provide; the amount and source of his annual income and how secure it is; and the maximum amount of monthly payments he can reasonably afford to make taking into account other financial commitments he may have, his age, and the term of the facility he seeks (number of years over which he wishes to spread payments).

#### **Principle 5: Information to clients**

**An IIFS shall provide clear and truthful information both in any public document issued and to its actual and prospective clients, both during the sales process and in subsequent communications and reports.**

38. This principle is concerned with transparency in dealings with clients and prospective clients. In conjunction also with Principle 1 (honesty and fairness), an IIFS is required to provide appropriate and clear information to all clients and prospective clients regarding its products and services and the rights, obligations and risks they involve for the client. This requirement also applies to information to clients and prospective clients concerning the *Sharī'ah* compliance of products and services.
39. Consumer or investor protection laws are now quite common in developed market economies and have the effect of giving consumers or investors recourse – for example, by making sellers liable for any defects that would not be apparent to a diligent buyer, or by providing a “cooling off period” during which a client may reconsider and cancel an agreement to purchase certain types of financial services products – as a protection against “hard selling”. In the absence of such laws, the concept of “*caveat emptor*” – or “let the buyer beware” – tends to apply, and implies that customers are expected to make their own independent judgement based on reasonably diligent practice, thus relieving sellers or suppliers from liability for any defects that would be apparent to a diligent buyer. While this concept may be acceptable within conventional legal systems (subject to customer or investor protection laws), the *Sharī'ah* places a limitation on its applicability. In other words, the principle of “*caveat emptor*” is not applicable without qualification in Islamic finance. This is because an IIFS can absolve itself from liability only when it has exhausted all means to be transparent to its counterparty regarding any defect of the subject matter that is known to it.<sup>8</sup>

#### *Recommended best practice*

40. A classical example of achieving fairness through transparent business dealing from the *Sharī'ah* perspective is in the requirement that for a *Murabahah* contract to be valid, the seller has to disclose the original cost (including any discounts received) and the profit margin/mark-up. Best practice requires that similar transparency should apply to commissions and agency fees for financing or *Takāful* products.
41. The use of “small print” to make potentially important information less visible is not compatible with good business conduct, and must be avoided. Likewise, there should be no “hidden costs” in financing or *Takāful* products, such as commissions or agency fees that are not disclosed to the client. Good practice requires that all commission and similar arrangements be fully disclosed to clients, and that in selecting a product for recommendation to a client the overriding criterion should be the benefits to the client and not the attractiveness of the commission to the IIFS or its representative.
42. The use by an IIFS or its representatives of “hard selling” techniques intended to push a client into an agreement without having properly evaluated the benefits and costs is not consistent with good business conduct. In addition, given the complexity of many financial products, good business conduct requires that in appropriate cases

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<sup>8</sup> Refer to Appendix (item 4) on the concept of information to clients as required by *Sharī'ah*.

clients be given a “cooling off period” so as to have ample time to evaluate the benefits and costs of a product before finally committing themselves.

43. An IIFS that is recommending a *Takāful* product to a client should disclose any relationship that it has with the *Takāful* undertaking, which may be a subsidiary or affiliated company. The same requirement for transparency applies if an IIFS is recommending an Islamic Collective Investment Scheme of which it is the manager.
44. With reference to paragraph 36 above, prospective participants must be warned clearly in writing that if they withhold from the *Takāful* undertaking any facts that are material to the cover being provided, this is likely to invalidate the policy.

*Illustration No. 9*

45. An agent or broker of a *Takāful* undertaking is proposing a savings product to a client which has the features of a with-profits endowment family plan, under which the client makes monthly contributions until he reaches a certain age, at which time he will be entitled to receive a lump sum the size of which will depend on the performance of his investment. The client may surrender the policy during this period, in which case he will receive a certain sum representing the amount of his contributions plus any investment profits, minus any investment losses and expenses. A major part of the expenses may be the acquisition costs paid up front to the agent or broker for selling the policy, as a result of which the policy will have no surrender value for several years and will take a number of years to acquire a surrender value that exceeds the amount of the contributions paid by the client. Good business conduct requires that all this should be clearly explained to the client before he commits himself to the policy. It also requires that the client be allowed a short “cooling off period” (for example, two weeks) during which he may cancel his agreement to the policy.

*Illustration No. 10*

46. An IIFS offers an Unrestricted Investment Account product to its retail customers which is based on a *Mudarabah* contract according to which the IIFS as *Mudarib* has the right to appropriate out of the profit before deduction of the *Mudarib* share up to 25% for transfer to a Profit Equalisation Reserve, and out of the IAH share of profit up to a further 20% for transfer to an Investment Risk Reserve. Amounts transferred into these reserves in respect of IAH profits will not be available to be paid out to customers if they withdraw their funds. In addition, the terms of the Investment Account product state that, given the withdrawal rights attaching to the product, 20% of any amount placed by the customer in such an account will in fact be treated as a current account and will receive no share of profit or any loss. Good practice requires that these features of the product, and their implications for the returns that the customer may reasonably expect, be explained to the customer fully and clearly.

*Illustration No. 11*

47. An IIFS offers a *Murabahah* financing to a customer that involves penalties (*garamah*) for late payment of instalments. It is essential that the existence of these penalties be made perfectly clear to the customer, by being spelled out in the contract and brought to the customer’s attention prior to signature of the contract.



## Principle 6: Conflicts of interest and of duty<sup>9</sup>

**An IIFS shall recognise the conflicts of interest between it and its clients that arise from the type of products it offers, and either avoid them, or disclose and manage them.**

48. In addressing the issue of conflicts of interest, the principle stresses the importance of institutions doing their best to avoid conflicts of interest, and when they cannot be avoided, the need to ensure that stakeholders are fairly treated. This principle recognises that conflicts of interest may be managed, and that proper management to ensure fair treatment of stakeholders may require disclosure, internal rules of confidentiality, or other appropriate methods or combinations of methods. Conflicts of interest may arise in fund management which require proper management so as to achieve honesty and fairness in accordance with Principle 1.
49. In IIFS, conflicts of duty may occur since their management is required to act in the best interests of two categories of stakeholders who may have differing interests, such as shareholders and IAH or shareholders and *Takāful* participants. Hence, conflicts of interest between two categories of stakeholders are translated into conflicts of duty for the board of directors and management of the IIFS. This raises issues of corporate governance that are addressed in other IFSB standards or exposure drafts, namely the Guiding Principles on Corporate Governance of IIFS excluding *Takāful* Operations, the Guiding Principles on Governance of Islamic Collective Investment Schemes, and the Guiding Principles on Governance of *Takāful* Operations.

### *Recommended best practices*

50. Good business practice is linked to good governance, particularly with regard to the proper management of conflicts of interest and of duty. The existence of such conflicts should not be hidden, but IIFS should be transparent about them while making clear what mechanisms are in place to manage them properly. In addition, IIFS should ensure that their systems of remuneration and compensation do not provide perverse incentives to their management, staff, agents, brokers or other representatives that could lead to conflicts of interest.

### *Illustration No. 12*

51. In an IIFS offering Unrestricted Investment Accounts (UIAH), the IIFS as *Muḍārib* is entitled to a percentage of the income on the investments of the UIAH. As the proportion of shareholders' equity to UIAH funds is normally quite small, and the percentage *Muḍārib* share may be quite high, the result may well be that the rate of return on equity to the shareholders is several times the rate of return on their funds to the UIAH, even when shareholders' and UIAH funds are commingled in one asset pool and exposed to the same risks. The fact that management feel accountable to the shareholders and not to the IAH tends to lead to a situation in which conflicts of interest between shareholders and UIAH are not well managed.
52. One way of mitigating this problem in accordance with good business practice would be to link a significant element of management's performance-related pay to the rate of return enjoyed by UIAH and not just to returns for shareholders.

### *Illustration No. 13*

53. A somewhat similar conflict of duty could exist in a Family *Takāful* undertaking, where the *Takāful* operator (TO) manages the Participants' Investment Accounts (PIA) as *Mudarib*. The TO's duty to manage the PIA funds in the best interests of the

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<sup>9</sup> Refer to Appendix (item 5) on the concept of conflict of interest and of duty as required by *Shari'ah*.

participants must not be subordinated to the duty to create value for shareholders via the *Mudarib* share of the income on those funds.

### Principle 7: *Sharī'ah* Compliance

**An IIFS must be able to demonstrate that its operations are governed by an effective system of *Sharī'ah* governance and that it conducts its business in a socially responsible manner.**

54. With regard to compliance, a requirement of good business conduct is that an IIFS must comply with all applicable legal and regulatory requirements. In the case of an IIFS, *Sharī'ah* compliance is of course paramount, and may raise difficult issues (for example, in the case of some *Sukuk* structures as noted under Principle 2 above).<sup>10</sup>

#### *Recommended best practices*

55. IIFS should employ highly competent *Sharī'ah* compliance officers (see Principle 3: Capabilities) having a sufficient level of authority to make compliance with all applicable legal, regulatory and *Sharī'ah* requirements a key management policy that is applied effectively in practice. With regard to *Sharī'ah* compliance, an IIFS should apply the IFSB Standard on *Sharī'ah* Governance as well as ensuring that it has in place the necessary mechanisms and procedures for effective *Sharī'ah* compliance both *ex ante* and *ex post*. The requirement for compliance also relates to the IIFS's internal requirements, and in particular to the code of business conduct that it has adopted.
56. IIFS should be aware of their *Sharī'ah* obligation to conduct their business in a socially responsible manner, including appropriate charitable activities.

#### *Illustration No. 14*

57. The conduct of IIFS in finding a balance between generating high profits and complying with the limits set by *Sharī'ah* should be addressed through the objectives of this principle. For example, IIFS involved in investment management and advisory services, or in Family *Takāful*, should identify and implement a proper process to achieve a balance between meeting their clients' expectations and respecting the limitations placed on them by employing only *Sharī'ah*-compliant instruments. This may involve a process of educating clients so that they understand why certain features of conventional financial products are not available in the case of *Sharī'ah*-compliant financial products.
58. Thus, UIAH need to be made aware that the IIFS as *Mudārib* or *Wakeel* cannot guarantee that there will be no capital impairment of their funds, although the IIFS can guarantee that it will exercise due diligence in protecting the funds from losses by prudent asset allocation and other means while seeking a competitive level of return for the UIAH.
59. Similarly, a Family *Takāful* operator needs to explain to potential participants why it cannot offer a defined benefit pension product, but undertakes to invest the participant's funds prudently so as to produce a lump sum on maturity which represents a fair return on the participant's contributions and which can be reasonably expected, when invested, to yield a given level of income.

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<sup>10</sup> Refer to Appendix (item 6) on the concept of compliance as required by *Sharī'ah*.

## DEFINITIONS

The following definitions are a general understanding of the terms used in this document. It is by no means an exhaustive list.

Conduct of business	Those principles of conduct that should govern the activities of IIFS in protecting the interest of their customers and the integrity of the Islamic finance industry.
Corporate governance	A defined set of relationships between a company's management, board of directors, shareholders and other stakeholders that provides the structure through which: (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined. In the context of IIFS, good corporate governance should encompass: (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, the <i>Shar'ah</i> Supervisory Board (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>Shar'ah</i> rules and principles.
<i>Muḍārabah</i>	A contract 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 <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib</i> 's misconduct, negligence or breach of contracted terms.
Restricted investment accounts	The account holders authorise the IIFS to invest their funds based on <i>Muḍārabah</i> or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Stakeholders	Those with a vested interest in the well-being of IIFS, including: (i) employees; (ii) customers (including IAH and normal depositors); (iii) suppliers; (iv) the community (particularly the Muslim <i>ummah</i> ); and (v) supervisors and governments, based on the unique role of IIFS in national and local economies and financial systems.
<i>Takāful</i>	<i>Takāful</i> is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as wholly or partially <i>tabarru'</i> (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage.
<i>Takāful</i> participants	A party that has participated in the <i>Takāful</i> product with the TO who has a right to benefit under a <i>Takāful</i> contract. It is similar to the "policyholders" in conventional insurance practices.

<i>Takāful operator</i>	Any establishment or entity that manages a <i>Takāful</i> business.
<i>Unrestricted investment accounts</i>	The account holders authorise the IIFS to invest their funds based on Muqārabah or Wakālah (agency) contracts without laying any restriction. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints the IIFS as agent (wakīl) to carry out the business on their behalf where a fee (or no fee) is charged to the principal based on the contract agreement.

**Verses of the Holy Qur'ān and hadīth of the Prophet Muhammad (PBUH) addressing conduct of business:**

1. *On Honesty and Fairness:*

*“Successful indeed are the believers...those who are faithfully true to their Amanāt (all the duties which Allāh has ordained, honesty, moral responsibility and trusts) and to their covenants.” [Qur'an 23:8]*

*“Woe to those that deal in fraud, – those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due. Do they not think that they will be called to account – on a Mighty Day when (all) mankind will stand before the Lord of the Worlds” [Qur'an 133:1–6]*

Prophet Muhammad's teachings on business and economic issues in general are many and they cover almost every aspect of business and economics. The Prophet emphasised that honesty and truthfulness will raise the level of rewards that will be given to the merchant in the hereafter. He said:

*“God shows mercy to a person who is kindly when he sells, when he buys and when he makes a claim.” [Al-Bukhari, 1934]*

Fairness in Islam means placing something in its rightful place. Three very important aspects of fairness in this context are: (1) placing someone in a post or function appropriate to his capabilities; (2) meting out sentence or making a decision appropriate to a situation or the person about to receive it; and (3) placing wealth or property with those who rightly deserve them.

*“Eat not up each other's property by unfair and dishonest means.” [Qur'an 4:29]*

2. *On Due Care and Diligence:*

The Prophet's exhortation to Muslims means that a creditor should be easy and generous in demanding back his money. The debtor, in turn, should also give back the debt to the creditor on time with due thanks and politeness. The Prophet (PBUH) was the best of all people in repaying debts.

The Holy Qur'an says:

*“...If the debtor is in a difficulty, grant him time till it is easy for him to repay; but if you waive the sum by way of charity, it will be better for you, if you understand it.” [Qur'an 2:280]*

3. *On Capabilities:*

*“And prepare against them what force you can and horses tied at the frontier, to frighten thereby the enemy of Allah and your enemy and others besides them, whom you do not know (but) Allah knows them; and whatever thing you will spend in Allah's way, it will be paid back to you fully and you shall not be dealt with unjustly.” [Qur'an 8:60]*

4. *On Information to and about Clients:*

One of the most common unethical practices in modern business is to exploit one's ignorance of market conditions. Sometimes it may happen that a buyer arrives in a town with objects of prime and general necessity with the intention of selling them in the market. A local trader may persuade the newcomer to transfer all of the goods to him so that he will sell them on his behalf in the market. He obtains the commodities for a price that is lower than the market price and then sells them at a high or exorbitant price. Islam condemns this act of intermediary intervention which involves exploitation of someone's ignorance of market conditions. The practice was prevalent in pre-Islamic society. The Prophet (PBUH) has prohibited this practice through a number of instructions:

*"A town dweller should not sell the goods of a desert dweller." [Bukhari, No: 2006]*

The jurists say that the seller can extend this period, and it is also the choice of the seller to agree to take it back even after the product has been used by the buyer. This transaction is valid as long as it is with the mutual agreement of the buyer and seller. However, it is unethical to misuse this option. It should be used only if one is not satisfied with the item for some reason. One should not buy the item with the intention of using and then returning it, because that is not the purpose of this option.

Prophet Muhammad (PBUH) in another *hadīth* also said:

*"The seller and the buyer have the right to keep or return goods as long as they have not parted or till they part; and if both the parties spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost." [Bukhari, 3:293]*

5. *On Conflicts of Interest and of Duty:*

Islamic finance is characterised by certain norms that take care of the interests of all the transacted parties. The Holy *Qur'an* says:

*"Do not devour one another's property wrongfully, nor throw it before the judges in order to devour a portion of other's property sinfully and knowingly." [Qur'an 2:188]*

The above verses prohibit the believers in no uncertain terms from devouring the property of others by illegal means. The Prophet (PBUH) endorsed the importance of legitimate ways of earning,

From the above it is clear that a Muslim trader must be determined to earn only through legitimate means. He should not only avoid illegitimate means in earning his provisions and livelihood, but should also distance himself from matters dubious and doubtful.

In another verse, the *Holy Qur'an* says:

*"Stand out firmly for justice, as witnesses to Allah, even as against yourselves, or your parents, or your kin, and whether it be (against) rich or poor: for Allah can best protect both. Follow not the lusts (of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily Allah is well acquainted with all that ye do. [Qur'an 4:32]*

6. *On Compliance and Shari'ah Compliance:*

*"We have sent down to you (O Messenger) the Book with the truth (embodying it, and with nothing false in it), confirming (the Divine authorship of and the truths that are*

*still contained by) whatever of the Book was revealed before it, and guarding over (all the true teachings in) it. Judge, then, between them by what God has sent down (to you), and do not follow their desires and caprices away from the truth that has come to you. For each (community to which a Messenger was sent with a Book) have We appointed a clear way of life and a comprehensive system (containing the principles of that way and how to follow it). And if God had so willed, He would surely have made you a single community (following the same way of life and system surrounded by the same conditions throughout all history); but (He willed it otherwise) in order to test you by what He granted to you (and thereby made you subject to a law of progress). Strive, then, together as if competing in good works. To God is the return of all of you, and He will then make you understand (the truth) about what you have differed on." [Qur'an 5:48]*

*"What is lawful is clear and what is unlawful is clear, but between them are certain doubtful things which many people do not recognise. He who guards against the doubtful things keep his religion and his honour blameless, but he who falls into doubtful things falls into what is unlawful, just as a shepherd who pastures his flocks round a preserve will soon pasture them in it. Every king has a preserve, and God's preserve is the things he had declared unlawful." [Bukhari, 50]*

## SUGGESTION FOR MODEL SELF-ASSESSMENT QUESTIONNAIRE

This can be used either by an IIFS that has adopted a voluntary approach to compliance with the IFSB Conduct of Business Standard, or by a regulator that decides to make compliance mandatory. Even if the regulator does not choose to make compliance mandatory, he may decide to ask to see the self-test as part of his routine supervision.

[This questionnaire is designed only to be an assessment of compliance with the Conduct of Business Standard and not with other IFSB standards. The concept could be extended to them, if required, or turned into a comprehensive self-assessment for compliance with all IFSB standards.]

### 1. Honesty and Fairness

- 1.1 Has a Client's Charter been written and published? If yes, provide it.
  - 1.1.2 *Verify the procedure for ensuring that all clients have received a Charter.*
  - 1.1.3 *Does the Charter contain a description of customer complaints and redress procedures?*
  - 1.1.4 *List any instances where the Charter was not observed, or where any complaints about failure to meet its standards were received.*
  - 1.1.5 *Is the Charter regularly reviewed and updated? If yes, give date of last review.*
  
- 1.2 In the process of obtaining *Sharī'ah* approval, was more than one *Sharī'ah* scholar or group of *Sharī'ah* scholars consulted? If yes, state reason why.
  - 1.2.1 *Would the Sharī'ah opinion on the basis of which the product was validated represent the mainstream view of scholars internationally? If not, how would it differ?*
  - 1.2.2 *What information about the product was given to the scholars?*
    - a) *All founding documents*
    - b) *Application to regulator for authorisation (if applicable)*
    - c) *Prospectus of offering document*
    - d) *Brochures and publicity material*
    - e) *All available material*
  - 1.2.3 *Were any promises or guarantees given to clients in respect of each or any product?*
  - 1.2.4 *Were all promises fulfilled? If not, give details, reasons and the explanation given to clients.*
  - 1.2.5 *Did the fund management company or its affiliates deal with the fund or account as a principal – either a seller to, or a buyer from, the fund or account? If so, list each transaction, and indicate whether it was done at a verifiable market price (or fair price) at the time of the transaction.*
  - 1.2.6 *If a transaction was done at a price that was not the market price (or fair price) at the time of the transaction, explain why.*
  - 1.2.7 *Show turnover in the fund or account, and list transactions for the period under review and a previous comparable period. Express turnover as: (purchase transactions + sale transactions)/((starting value + final value)/2)\*100*
  - 1.2.8 *Show the proportion of transactions carried out with the IIFS or its affiliates and with each external intermediary that accounted for more than a certain percentage of all transactions.*

### 2. Diligence

- 2.1 Provide evidence of research and risk assessment for each transaction recommended or made.
- 2.2 If there is an investment committee guideline on asset allocation for different kinds of funds or accounts, show what it was at each point during the period under review.
  - 2.2.1 *Is there an established risk management procedure, and are VAR calculations regularly carried out for individual or pooled managed accounts?*



- 2.3 Are all accounts or portfolios subject to a regular formal review process for performance and compliance with prospectus objectives and asset allocation guidelines?
- 2.4 Is continuing *Sharī'ah* compliance an important consideration in such reviews? If yes, how frequent is the review?
- 2.5 Show an example of the minutes of the review committee. If no example is available, explain how a client's assets are managed and reviewed by other means.
- 2.5.1 *Show which funds or accounts were not in line with investment committee guidelines and which had experienced significant variations in the VAR ratio, and explain why.*
- 2.5.2 *As a result of 2.3, show investments that have performed exceptionally poorly or made significant losses, or that are found not to have been, or are no longer, Sharī'ah compliant. Explain whether the initial research and analysis was inadequate, or whether excessive risks were knowingly taken, or other reasons for the poor results.*
- 2.6 Show unusual *sukuk* structures – for example:
- An agreement by the originator to repurchase assets from the issuer at a pre-agreed (i.e. guaranteed) price
  - An arrangement for the *mudarib* to subsidise the return by means of an interest-free loan in the event that the profit falls below the benchmark (in effect, a guarantee of interest)
  - A structure by which certain tranches have priority over others
  - Any other structure with unusual or not generally accepted features

### **3. Capabilities**

- 3.1 Does the IIFS have a policy for training all relevant employees in the understanding of *Sharī'ah* principles for Islamic finance generally and as they apply to the IIFS's business?
- 3.1.1 *If the training is provided according to an established syllabus or an international benchmark qualification covering Islamic finance, give details.*
- 3.1.2 *Was the training provided by an accredited training organisation or done in-house? If by an accredited organisation, give details.*
- 3.2 Provide a schedule for all relevant employees who received training, with details and the date on which training was given; or if there are employees who should have received training but have not yet received it, explain why.
- 3.2.1 *If there was an examination or test following the training, give details of which employees passed, and which did not.*
- 3.3 Does the IIFS provide specific training of employees in terms of understanding the nature and risk of the particular products that it offers? Show details of the training provided for each product or product type.

### **4. Information about Clients**

- 4.1 Does the IIFS have a standard client fact-finding procedure? If yes, provide an example of the form that is to be completed.
- 4.1.1 *Is the fact-finding form completed by an employee of the IIFS in conjunction with the client, or by the client without assistance? Are the outcomes satisfactory and sufficient to enable the IIFS to fulfil client needs? Provide examples.*
- 4.1.2 *Verify that the established procedure has been followed for each new client and has been signed off by both the client and the employee by checking sample client files.*
- 4.2 What checks were undertaken to verify that the client was appropriate and that the investment or financing was for *Sharī'ah*-compliant purposes? Illustrate the procedures used.
- 4.2.1 *Provide evidence that the checks required in 4.2 were undertaken and signed off by a senior manager.*
- 4.3 Undertake a sample check that advice given to clients was in line with the clients' circumstances and needs as established by the fact-finding procedure and the document showing what specific advice was given that led to the investment (see 5).

- 4.4 Record all changes in client circumstances and requests by clients for change in risk profile or needs. Undertake a sample check of client files to ensure that this process has been carried out.

## **5. Information to Clients**

- 5.1 Was each client who made an investment given a full description of the investment, either by means of a prospectus or other offering document or verbally, and a statement of any risks, additional costs, penalties, or limitations on benefits, including withdrawal or early redemption penalties, involved?

5.1.1 *Are such prospectuses or offering documents regularly reviewed for factual accuracy and to bring them into line with the most recent regulatory requirements? Show and verify the procedure.*

- 5.2 Was the client made aware in writing of the profits or commissions that the IIFS or any affiliate, including a *Takāful* undertaking, a fund management company or brokerage, might earn in carrying out the transaction?

5.2.1 *Verify by a sample check of a client file showing a signed statement by the client that the client had been given all the necessary information, including that required under 5.1 and 5.2, and that he had understood the nature and risk of the investment, and that it was suitable for his needs.*

- 5.3 Does each client receive regular reports of the progress of his investment or position of his account, including any costs or management charges deducted, or transfers to reserves or equalisation accounts, for the period under review?

5.3.1 *Does the report contain a record of transactions made for the account during the period and the reasons for them?*

5.3.2 *Does the report explain the rationale for the deduction of costs and transfers to reserves or equalisation accounts? If not, explain why.*

5.3.3 *Does the report show the methodology by which the valuation of the client assets or account was made (cost, mark to market, fair value, independent assessor, IIFS estimation or other)?*

5.3.3.1 *If account calculation was based only on cost, was the client told that market or realisation value might be different (lower or higher)?*

5.3.4 *If yes to 5.3, 5.3.1 and 5.3.2, provide sample reports to verify that appropriate actions had been taken. If no, explain why.*

## **6. Conflicts of Interest and Duty**

- 6.1 Does the Client's Charter cover instances in which the IIFS may have a conflict? If yes, what is done to manage or resolve these conflicts?

- 6.2 If the IIFS, or any affiliate, is acting as a principal or has a financial or other interest in any transaction done for clients, is this fact disclosed at the time of the transaction?

6.2.1 *Review and explain all transactions in which the IIFS or affiliates had an interest, to verify that disclosure had been made on each occasion.*

## **7. Compliance and Sharī'ah Compliance**

- 7.1 Each IIFS should have a designated compliance officer, who is given sufficient power and authority, and who reports to a designated board member or member of senior management.

7.1.1 *The compliance officer (as well as being responsible for compliance with any general licensing requirements) should have a high degree of expertise in the Sharī'ah as it applies to Islamic finance and to the specific business of the IIFS.*

7.1.2 *The compliance officer should be responsible for continuous self-assessment of the IIFS's compliance, particularly Sharī'ah compliance; and should report regularly to the board on the results of his assessments. Show an example of a board report.*

- 7.2 The compliance officer should be responsible for ensuring that all clients' objectives and all investment procedures and actual investments made are *Sharī'ah* compliant, as part of the assessment in 7.1.2. This should be verified and signed by the compliance officer and a board member. Show an example.

- 7.2.1 *In particular, the compliance officer should ensure that new product offerings have been properly examined and approved by Sharī'ah scholars (see 1 above). Verify by reference to a scholar's opinion on file.*
- 7.3 The compliance officer should be responsible for maintaining a record of customer complaints, which, at a minimum, should record: the date and nature of the complaint; action taken to resolve it; whether the complaint was a breach of *Sharī'ah* principles or of general conduct of business requirements; acceptance by the complainant of the solution and the date; and regulatory action if that was an outcome. Show samples of complaints according to the register of complaints.

## **Guidelines for IIFS to Develop Own Client's Charter**

It is envisaged that the Client's Charter will bring about numerous improvements to the conduct of business of the IIFS. In fact, the assurances contained in the Charter will ensure the generation of more disciplined, prepared and responsible IIFS. Various benefits will be obtained from the establishment of the Client's Charter.

### *Benefits to the Public:*

- enables the public to know specifically the quality of service to expect from the IIFS;
- enables the public to evaluate the performance of the services rendered;
- reduces uncertainties over the delivery of services;
- facilitates comparisons between IIFS that offer similar services; and
- allows the public to be more aware of the conduct commitment of each IIFS.

### *Benefits to the IIFS:*

- acts as a performance indicator, which will enable the IIFS to evaluate its conduct practices; and
- upgrades the discipline, responsibility and accountability of the IIFS, which in turn will contribute to a more transparent Islamic finance industry.

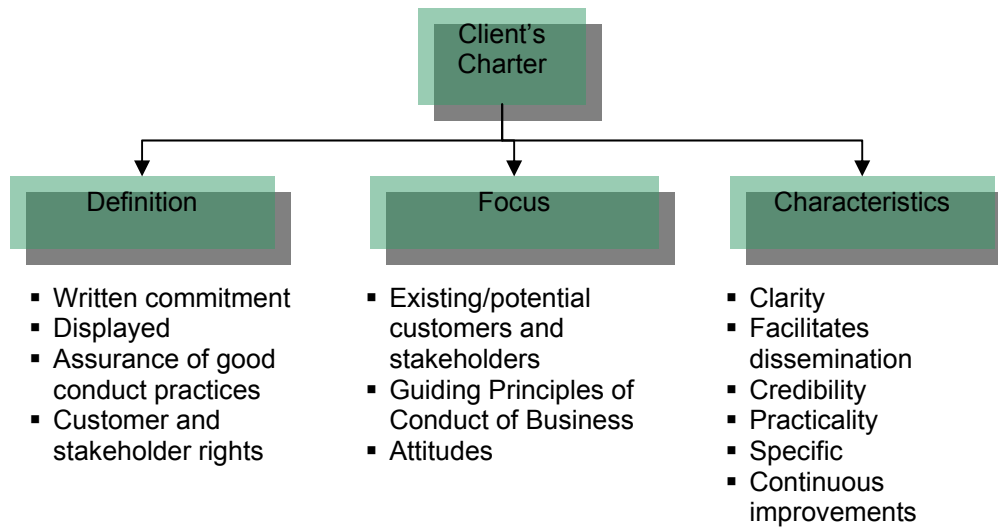
## **The Concept of Client's Charter**

### *Definition*

A Client's Charter is a written commitment made by an IIFS or organisation in terms of the deliverance of its outputs or services to its customers (inclusive of stakeholders). It is an assurance by the IIFS or the organisation that outputs or services rendered will comply with the standards declared as quality standards. In the case of IIFS, apart from fulfilling the above commitment, it is crucial that its Client's Charter addresses, at minimum, the objectives of the Guiding Principles on Conduct of Business issued by the IFSB.

The overall concept of a Client's Charter is made up of three main aspects, as depicted in Figure 1. These are: (i) the definition of a Client's Charter; (ii) focus; and (iii) characteristics necessary for the institution of the Charter.

**Figure I: Three Main Aspects of a Client's Charter**



### *Focus*

The Client's Charter focuses on the existing and potential customers and stakeholders, as they are the recipients of the outputs or services provided by the IIFS. They should be assured of quality products and services that fulfil the requirements of *Shari'ah*. At the same time, IIFS are responsible for the provision of services that have the following characteristics as required by the clients: efficiency, safety, accuracy of facts, timeliness, trustworthiness, accessibility, friendliness and sensitivity.

The Client's Charter of a particular IIFS explains to the customers and the stakeholders the types and levels of services that they can expect. It is a written commitment that informs them of their rights to such services. In view of that, the IIFS has to be responsive and sensitive towards such needs and requirements.

The quality of outputs and services must be based on the customers' needs and requirements. The standards set are in accordance with the IIFS's capabilities. Thus, the Client's Charter is not a static statement but one that could be improved from time to time.

The implementation of the Client's Charter not only emphasises quality and delivery, but is also geared towards changing the attitudes of IIFS. It will ensure more disciplined, ethical, accountable and sensitive IIFS. Focus on these three factors will improve public trust and confidence in the outputs and services given by the IIFS.

### **Implementation of the Client's Charter**

Implementation of the Client's Charter consists of five principal stages, as depicted in Figure 2:

- formulation of the Client's Charter;
- promotion of the Client's Charter;
- service delivery;
- monitoring; and
- evaluation and improvement.

**Figure 2: Principal Stages in the Implementation of the Client's Charter**

