Zeti Akhtar Aziz: The rise and effectiveness of corporate governance in the Islamic financial services industry

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd Islamic Financial Services Board (IFSB) Summit, Doha, 24 May 2005.

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"The hallmark of the Islamic financial system lies in the high ethical values that underpins the governance and business operations of Islamic finance. As the pace of development of the industry accelerates and as the environment becomes increasingly more complex and challenging, securing a robust and resilient financial system has increased the demands for having a solid governance structure for the Islamic financial institutions. The challenge is essentially to evolve strategies that will promote the adoption of strong and effective corporate governance practices that also facilitates innovation and that supports business operations. Central to this common vision is to create a comprehensive governance framework for Islamic institutions and to formulate appropriate implementation strategies that will be able to meet the requirements of the dynamic industry while promoting confidence and stability in the Islamic financial system."

It is my honour to be invited to speak before this distinguished audience at this summit organised by the Islamic Financial Services Board on the rise and effectiveness of corporate governance in the Islamic financial services industry.

While the adoption of governance best practices is not an end in itself, it is an important supporting infrastructure that is vital to achieving high performance and the continued advancement of the industry. Strengthening the robustness of the corporate governance framework and practices has become even more important in today's environment of greater uncertainty and heightened risks. Indeed, it is timely that efforts are focused to strengthen the corporate governance in Islamic financial institutions given the wider range of contracts entered into by the Islamic financial institutions and their customers that inherent in Islamic finance. In particular, the efforts should include the formation of an appropriate governance structure of the institution and the requirement for full disclosure.

My remarks today will focus on five key areas important for securing an enhanced governance framework for the Islamic financial institutions that takes into account the role and responsibilities of the shareholders. My presentation will also touch on the experience and approach that Malaysia has adopted to secure a robust governance framework for the Islamic financial institutions.

Firstly, the task is to ensure the design and implementation of the corporate governance strategy should not impose a regulatory burden to the business objectives and the growth potential.

In designing and implementing corporate governance standards and core principles for Islamic financial institutions, the challenge is to formulate a framework that does not only take into account the unique characteristics peculiar to Islamic financial business, but that fosters innovation and competition thereby support the growth potential of the industry. Essentially, the design and strategies needs to secure the twin objectives of achieving continuous business performance and robust corporate accountability.

As the level of innovation increases in a more liberalised and deregulated environment, a governance framework that is more principle-based rather than rule-based becomes relevant. The approach would thus need to develop the broad but clear guidance, standards and core principles rather than prescriptive rules and regulations. The process would involve identifying the risks and ensuring that the institutions have the capacity and mechanisms of internal controls and the systems to undertake and manage the recognized risks.

While good governance is indispensable, the relevant principles needs to be applied in a manner that is in harmony with the nature of the different transactions peculiar to Islamic finance. In particular, the framework should endeavour to engender the support of all the stakeholders of the Islamic financial institutions. This entails having in place the systems that will ensure that the obligations to all the major stakeholders - the customers, depositors, investors, entrepreneurs, owners and the community at large - are met with integrity and with adherence to the rules and regulations. Indeed, in an environment where businesses needs to balance between the interests of the various stakeholders which at times could be conflicting, an appropriate governance framework for active checks and balances becomes particularly important. While the roles of shareholders and board of directors are certainly critical, it should not diminish the roles of the other stakeholders.

Secondly, there must be robust corporate governance framework at the institution level with the shareholders and the board as key players.

At the institution level, corporate governance is essentially about how the company is managed and controlled and the manner to ensure proper accountability for those in-charge. Central to the corporate governance framework is thus to ensure integrity, strong internal controls and risk management practices. In this connection, the shareholders' greatest influence is in the appointment of both the independent and non-independent directors; to ensure the selection of those who are able to set clear direction and drive for effective corporate governance at the institutional level. The shareholders have a role to ensure that the board comprises a good mix of competent persons with relevant experience to provide effective representation.

The board of directors must be able to protect the long-term objectives of the institution and provide leadership for good governance by setting a clear corporate governance framework for the institution, and effectively monitoring its implementation. The institutional broad governance framework will serve as the focal point of reference for management and staff in relation to corporate governance. It is also a manifestation of the institution's vision and strategy to achieve good governance whereby shareholders and other outside stakeholders are able to evaluate the level of commitment of the institution towards enhancing good governance.

Islam strongly advocates all forms of positive governance. The design of the framework however, should not be made in isolation of the universal values expounded in the existing governance principles and standards that are consistent with Islamic principles. This framework must set out the functions of each component and level of governance in a manner to ensure accountability of each respective jurisdiction with appropriate division of powers to avoid possible conflict of interests. In this context, consideration may be given to four main ingredients important to the governance framework for Islamic financial institutions.

(i) Firstly, to ensure that the guidance, standards and core principles are able to translate the values consistent with the injunctions of Shariah. The core values of honesty and integrity are key ingredients of the governance framework of the Islamic financial transactions with heavy reliance on the trust relationship. The significance of these core values is clearly highlighted in the Qur'an, Sunnah and the "fiqh". The banking institutions, as user of public funds must act in good faith for the benefit of all stakeholders. If the relationship between the financier and entrepreneur can be built on honesty, efficiency and equity, a durable equilibrium can be established that will serve the mutual interest of both parties.

(ii) Secondly, the governance framework needs to take into account the multi-faceted role performed by the Islamic financial institutions and treat all the relevant stakeholders fairly, including minority shareholders and the investment account holders. It is an embodiment of the concept of justice in Islam as stated in Qur'an, which is nearest to righteousness (taqwa) in the Islamic faith.

(iii) Thirdly, that the Shariah governance framework must be put in place as a additional dimension and a distinct feature in the governance structure of Islamic financial institutions. This is crucial in instilling public confidence on the purity of the operations of the Islamic financial institutions. The Shariah board or committee therefore represents another stratum in the governance structure. The Shariah Committee serves to ensure that the management of the Islamic banking institutions are in compliance with Islamic principles.

(iv) Fourthly, the framework should promote greater transparency and higher level of disclosure to address information asymmetry of the different stakeholders in the different structures of the transactions in Islamic finance thereby facilitating the effective functioning of market discipline. This is critical for the investment account holders who are in the position to influence the Islamic financial institutions if they were given adequate information on the investment strategy and results, as well as the applicable rate of return. The disclosure would also allow the market to assign appropriate risk premiums to respective companies and thereby enforce effective market discipline.

The third key area is to strengthen existing mechanisms to translate Islamic values into business operations and governance.

With the broad governance framework in place, the Islamic financial institution needs to have adequate mechanisms for effective implementation of the framework. This includes the systems of internal controls, internal and external audit, risk management, transparency and disclosure, and a strong compliance culture. It also includes having in place the nominating and remuneration committee to ensure the right persons for the job are appointed and that the reward or penalty are commensurate with the accountability and performance. Indeed the prophet refers to this in the words, "whoever employs a person out of favouritism and there is someone who is better than that person, he has committed breach of trust with God, His prophet and all Muslims".

The risk management committee needs to review the risks peculiar to Islamic finance and consider the means by which they should be managed. Expertise needs to be developed to address the audit for the Shariah risk. The audit committee therefore needs to examine not only the risks associated with banking operations, but also complementing the Shariah Committee in ensuring full compliance with the Shariah principles. The role of the Shariah committee may also be expanded beyond product approval, in particular to strengthen the governance of the Islamic financial institutions by ensuring for each new product, proper disclosure is made and the rights of the customers and the responsibilities of the Islamic banking institutions are clearly provided.

Fourthly, the role of the regulator in strengthening the standards and best practices in inculcating good governance.

The government and regulator has an important role in putting in place an enabling environment that supports the development of a strong governance structure and that provides for enforcement.

In Malaysia, corporate governance reform is a priority agenda. Malaysia has adopted a hybrid approach towards governance reform that includes legal reform, self-regulation as well as measures to encourage market-based regulation. The approach balances between prudential regulation, market discipline and shareholders surveillance. Malaysia has proceeded on the basis that there are aspects of corporate governance where statutory regulation is effective and necessary and in others where self-regulation is more appropriate. Building the necessary legal and institutional framework to support the development of good corporate governance practices within the capital and financial markets is therefore an important part of the process.

Among the various measures initiated includes the law that provides the statutory framework to protect the interest of the depositors, customers and shareholders as well as the prudential framework to promote financial stability. This includes the legal provisions prescribing the maximum permissible shareholding limit to avoid concentration of ownership. There is also a restriction on extension of credit to related parties to avoid conflict of interest, as well as a limit on the lending to single customer. Other measures include the issuance of specific guidelines on the role and responsibilities of directors and the creation of various board committees. Greater emphasis is also accorded to the role of independent directors, minimum qualifications of such directors and their compensation to ensure sufficient independence to act in the best interest of the institution.

In the area of Shariah governance, guidelines have been issued on the governance structure of the Shariah Committee in the Islamic financial institutions. The guidelines define the role and responsibilities of the Shariah Committee, which extends beyond endorsement of Shariah-compliant products to also ensure that the operations of the Islamic banking institution complies with Shariah requirements at all times. The guidelines also prescribe the fit and proper criteria for members of the committee, and places emphasis on the independence of the committee to report directly to the Board and to accord to the Board the responsibility to ensure that the Shariah Committee can effectively discharge its duties. In addition, members of the Shariah Committee may not sit on the Shariah Committee of other Islamic banking institutions as well as on the Shariah Advisory Council of the Central Bank so as to preserve the confidentiality and avoid potential conflict of interests.

To promote greater financial transparency and disclosure and to safeguard the interests of investment depositors, guidelines have also been issued on the model financial statement of the Islamic banks. In this connection, Islamic banking institutions are required to provide disclosure of information, among others, on the segregation of income and expenses from the categories of instruments including the investment of unrestricted investment deposits, restricted investment deposits and investment of shareholder's funds. Islamic banking institutions are also required to disclose information on the profit equalization reserves.

In addition to disclosure requirements in the financial statement, a standard framework for the calculation of the rate of return for Islamic banking operations has been introduced. The framework requires Islamic banks to clearly segregate the income and expenses of the Islamic banking operations based on the management of funds, on a restricted and unrestricted basis. The framework provides the basis for calculation of dividends to the investment depositors to reflect the average actual net rate of return of each deposit based on their respective tenures. An accurate calculation of dividends is essential to ensure that the investment depositors receive their fair share of investment returns. In addition, the framework allows the provision of profit under the profit equalization reserve mechanism for the purpose of smoothing the fluctuations in the rate of profit.

Finally, amplifying the role of other standard setting bodies.

As Islamic finance expands, there are common areas where collective efforts by the Islamic financial industry, including the domestic and international standard setting bodies can bring benefits to the overall financial system.

In this regard, bankers associations have an important role in spearheading initiatives to promote high standards of ethical code of market conduct to meet consumers' rising expectations and demands. Bankers associations can play an important complementary role to the efforts of the regulatory authorities' in promoting a more progressive, dynamic and resilient banking system. For the Islamic financial services industry, there are several areas of common interest that the industry associations can contribute to strengthen corporate governance

In the international scene, AAOIFI has made contributions towards improved quality of financial statements and reporting methodology of the Islamic institutions via issuing accounting and auditing standards for Islamic financial institutions. Standards and code of ethics have also been issued to govern the conduct of the accountant and auditors of the Islamic institutions. Undoubtedly, the efforts by AAOIFI has assisted to accelerate the pace of transparency and corporate governance of the Islamic financial institutions in the international environment.

Needless to say that the role of Islamic Financial Services Board is crucial in enhancing the level of transparency and quality of corporate governance of the Islamic financial institutions. The Islamic Financial Services Board through the promulgation of the international prudential standards on corporate governance that are consistent with Shariah principles will have a prominent role in promoting prudent, transparent and robust development of Islamic financial services.

Conclusion

Good governance is, essentially participatory, transparent and accountable. These elements are embedded in Islam and therefore an integral part of the governance framework of the Islamic financial institutions. Consequentially, effective Islamic governance framework requires involvement of all stakeholders - the government, the industry associations, the shareholders, the directors, the management and other persons relevant to the business such as auditors, accountants, lawyers and Shariah advisors - to responsibly complement each other in providing checks and balances, and in strengthening the corporate governance practices. At the international level, the Islamic Financial Services Board and other standard setting bodies have an important role to harmonise the practices and complete the framework by setting the broad governance framework for international application. It is with this integrated and cumulative approach, insyaAllah, that strong and effective corporate governance framework will be successfully implemented. Each one of us regardless of our position, as regulators or bankers, is accountable. Let me conclude with reference to the saying of the Prophet, "Each one of you is a guardian, and each guardian is accountable to everything under his care".