Zeti Akhtar Aziz: Corporate governance and aspects of the regulatory framework instituted in Malaysia

Special address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd Seminar for Central Banks and Monetary Agencies on AAOIFI's Accounting Standards, Kuala Lumpur, 29 May 2002.

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Assalamu`alaikum Warahmatullahi Wabarakatuh and Good Morning

Malaysia is indeed honoured to host this annual Seminar organised by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for Central Banks and Monetary Agencies on AAOIFI's Accounting Standards for Islamic financial institutions.

Since its establishment in 1990, AAOIFI has made a significant contribution in formulating and issuing accounting and auditing standards for Islamic financial institutions. The standards issued by AAOIFI have contributed towards the improved quality of financial statements and reporting methodology of Islamic financial institutions. AAOIFI has also issued standards on the role of Syariah committees as well as the code of ethics that should govern the accountants and auditors of Islamic financial institutions. Undoubtedly, efforts by AAOIFI have accelerated the pace of transparency and corporate governance of Islamic financial institutions globally.

Ladies and Gentlemen,

A well functioning and efficient banking system is vital for achieving robust economic performance. Within the context of the economy, the banking institutions perform the important function of mobilising funds that are channelled to productive investments thereby generating economic activity. In performing their intermediation function of channelling funds between the savers and investors, depositors need to be assured of the safety of their deposits and the efficiency in the manner in which the funds are mobilised and channelled to productive investment. Through their extensive branch network, and now through internet banking, banking institutions are able to efficiently reach an extensive customer base nationwide. As a custodian of public funds, maintaining integrity and confidence in the banking sector is vital towards ensuring the stability and soundness of our financial system.

The trust of the public in banking institutions is inspired by the confidence in the safety and security of deposits, and that these funds will be professionally managed. Banking business involves risks and these risks need to be rigorously managed if public confidence in the banking system is to be secured. These risks involves credit risks, market risks, sovereign risks and foreign exchange risks, to name a few. There is therefore no room for negligence. This emphasize that the business of banking is too important to be left to self regulation. The regulatory framework put in place by Central Banks are aimed to ensure the soundness and efficiency of the system and the protection of the interest of depositors and investors.

Before proceeding further, I would like to touch some aspects of the regulatory framework instituted for the Islamic banking industry in Malaysia. In Malaysia, we have embarked on the concept of dual banking where the Islamic banking system operates in parallel with the conventional banking system. In our context, the Islamic banking system comprises the Islamic banks and the conventional banks offering Islamic banking products and services. In this regard, the main challenge to the regulator is to formulate a regulatory framework for Islamic banking that is in line with Syariah principles. Our approach is two-fold, firstly to adopt the existing international regulatory standards where it complies with Syariah, and secondly to develop a separate regulatory framework to address the unique characteristics of Islamic banking.

As far as the first approach is concerned, the Islamic banks and the conventional banks with Islamic windows observe similar international standards as well as the prudential and supervisory concerns such as the Basel Concordat on minimum RWCR of 8%, statutory reserve requirement, corporate governance standards, risk management standards, financial disclosure and know your customer policy. They are also subject to similar supervision, surveillance and monitoring by the Central Bank. These policies have been implemented efficiently as most of these requirements, if not all, are not against the injunctions of Syariah.

The second approach refers to the implementation of Islamic banking within the conventional set-up. Bank Negara Malaysia has advocated for the “bank within a bank” concept for the conventional banks with Islamic windows to enable the Islamic banking divisions in the conventional bank to provide the strategic focus and autonomy, maximise synergy for economies of scale and capitalise on cost efficiency. These measures would also act as a firewall to ensure strict compliance to Syariah. To achieve this objective, we have made it mandatory for the conventional banks to establish a dedicated Islamic banking division within the bank, create and observe a minimum Islamic banking fund, opening separate clearing account with the Central Bank to facilitate effective separation in the payments system as well as to have a separate accounting disclosure. Having these policies and infrastructure in place, we have been able to operate the dual banking system in a structured and systematic manner.

Ladies and Gentlemen,

Although the regulations are in place, close oversight and updated statistical reporting, supported by close monitoring through the early warning system, are necessary as measures to avoid banking failures. The global experience has shown that not all banking failures are due to economic and financial crises. The global experiences has shown that banking failures can be caused by the lack of good corporate governance in the banking institutions. Lack of transparency, lack of oversight, weak internal controls, lack of checks and balances, incompetent directors and abuse of power are among the elements of poor corporate governance. Hence, even the best regulations and supervision and the best financial safety nets cannot prevent such banking failures.

The regulation of banking institutions therefore needs to be complemented and reinforced with good corporate governance. In the context of the banking industry, corporate governance involves the manner in which the business and the affairs of the individual banking institutions are being governed by their board of directors and senior management, how the economic returns are generated to the owners, the day-to-day running of the operations of the business and the consideration of the interests of recognised stakeholders including depositors; and how they behave in a safe and sound manner, in compliance with applicable laws and regulations. In this context, the transparency in the conduct of banking institutions, facilitated by the proper accounting standards that reflect the true and fair value of banking operations would lead to greater accountability and responsibility of the part of the bank’s management.

Islam strongly advocates all forms of positive governance. These values and ethical conduct have already been in built and inherent in the Muslim community. Islamic corporate governance serves through its underlying principles of economic well-being of the Ummah, universal brotherhood, justice and equitable distribution of income. Therefore, while the virtues of Islam have always advocated corporate governance, the challenge to us lies in its application. For Islamic banking institutions, good corporate governance should have already been embedded in all aspects of their operations. The issue of corporate governance is therefore not foreign to Islamic banking.

In Malaysia, the principles of corporate governance have been well documented and applied across all business entities, particularly public listed companies. As good corporate governance is part of Islamic values, Islamic banking institutions need only to adapt to the code of ethics of the corporate governance to their business. In the Malaysian context, the same good corporate governance practices are applied for both conventional and Islamic banking institutions. To enhance the standard of corporate governance in the banking sector Bank Negara Malaysia has introduce measures including among others, specific guidelines on the code of conduct for directors, officers and employees of the banking institutions and guidelines on the directorship and the prohibition of loans to directors, staff and their interested corporations. The main objective of these guidelines is to engender public confidence in banking institutions and to ensure that the management and board of directors exhibit integrity and professionalism in the running of the banking institutions.

Banking institutions are prohibited from the extension of financing and credit facilities to related parties including its directors and staff as well as family members and interested corporations. Such prohibitions are aimed at preventing misconduct and irregular practices in provision of finance whilst ensuring fair and equitable treatment to the public. These governance are universal in nature and therefore, Islamic banking institutions would not be faced with any difficulty in adopting these values.

Secondly, the objective is to prevent conflict of interests and accord responsibility on the banking institutions to provide complete and accurate information. Bank Negara Malaysia has undertaken a number of initiatives in promoting transparency and good banking practices in Islamic banking institutions. To achieve these objectives, Bank Negara Malaysia has adopted an all-encompassing approach which is focussed on strengthening the institutional capacity of the Islamic banking institutions, broadening the range of financial products and services and deepening the Islamic financial markets by intensifying research and development efforts as well as creating awareness in addition to strengthening the regulatory framework for Islamic banking.

One aspect that has been carried out by Bank Negara is the introduction of a structured framework in the determination of the rate of return for Islamic banking operations. Previously, there were various modes of framework in the disclosure of the rate of return used by the Islamic banking institutions and it has, to a certain extent, made it difficult to assess the performance of the Islamic banking industry. It also created distortions in the rate of return as the spreads can vary significantly among Islamic banking institutions. The new framework addresses the issue of uniformity as banks are required to observe a single framework, thereby reducing the potential for distortions in the rate of return, and generating a more equitable distribution of income, as well as increasing the level of transparency. On the part of the regulator, it has provided us with better means of assessing the efficiency of Islamic banking institutions as well as their profitability, prudent management and fairness.

In a dual banking system as that operating in Malaysia where conventional banks also provide Islamic banking facilities, the regulator is accountable to instil confidence to the public of the existence of firewalls between the conventional and Islamic funds. Since the introduction of a dual banking system in Malaysia and the inception of the Islamic banking institutions participating in Islamic Banking Scheme (IBS banks), Bank Negara Malaysia has made it mandatory for the Islamic banking operations in these institutions to be separated from the conventional banking operations. Apart from the requirements for the internal separation of the accounting books, the further step has been taken to require the conventional banks to disclose the fair and true value of the Islamic banking operations in the form of Balance Sheet and Profit and Loss Statements as part of the Notes to the Accounts in the principal financial statements of the conventional banks. This is to duly reflect the different risks and unique characteristics inherent in the Islamic banking as compared to conventional banking.

A distinct feature of Islamic banks vis-à-vis conventional banking is the requirement to set-up a Syariah advisory council within the Islamic bank. From the perspective of corporate governance, the establishment of Syariah advisory council is important to instil public confidence on the purity of the operations of the Islamic banking institutions. The Syariah advisory council serves as a check and balance to ensure that the management and operations of the Islamic banking institutions does not deviate from the Islamic principles in the formulation of the policies. Towards this end, Bank Negara Malaysia is currently drawing up the guidelines to strengthen further the existing Syariah advisory committees at Islamic banking institutions. Amongst others, the guidelines will outline the role and responsibilities of the Syariah advisory committee of the Islamic banking institutions with the view to ensuring that the decision-making process that require Syariah inputs have undergone the necessary thorough and rigorous process.

Ladies and Gentlemen,

With the establishment of the Islamic Financial Services Board (IFSB), it is envisaged that the level of transparency and quality of corporate governance of Islamic banking institutions will be further enhanced. The IFSB is expected to play a prominent role in promoting prudent, transparent and the robust development of the Islamic financial services industry through the promulgation of international prudential standards that are consistent with the Syariah principles. We are honoured that Malaysia has been chosen to be the IFSB secretariat and hope that the IFSB will achieve its noble objectives as an effective prudential standard setting body for Islamic financial institutions.

Ladies and Gentlemen,

While significant progress has been achieved in Islamic banking there remains much to be undertaken both by the regulators as well as the industry if the true potential is to be realised. This Seminar is one of the platforms for regulators and financial institutions to come together to share views and experiences in regulatory issues particularly pertaining to accounting standards, financial framework and transparency in the Islamic banking operations. I also hope the participants would take the opportunity to acquire as much knowledge as possible during these two days from the invaluable insights presented by the distinguished speakers.

On that note, I wish you a successful Seminar. Thank you.