

# THE REVIEW



مصرف البحرين المركزي  
Central Bank of Bahrain

Published by the Central Bank of Bahrain (CBB)

2030

البحرين  
BAHRAIN

September 2012 Issue 32



# Evolution of corporate governance in Islamic banks

*The continuing fallout from the global financial crisis underscores the need for good corporate governance practices, particularly for Islamic banks which have the additional commitment to Shari'a principles. Sabeen Saleem, Chief Executive Officer of the Islamic International Rating Agency (IIRA), outlines a three-step approach to strengthening Shari'a governance in Islamic financial institutions.*



The recent spate of banking scandals involving certain high profile European banks, once again reminds us of the vulnerability of banking institutions, given the highly global nature of banking services.

Islamic financial institutions (IFIs) have remained largely protected from corporate scandals stemming from poor governance. This is partly owing to the fact that IFIs have generally not scaled the level of globalisation that many of their conventional counterparts have. The sheer volume of transactions in a multinational bank exposes these institutions to a myriad of operational risks and potential for loss of control. However, institutionalised control systems and their unfailing effectiveness remains key to managing the ever growing Islamic banking system, justifying the continuing emphasis on risk management and adopting sound governance standards.

With the institutionalisation of corporate governance and regulatory evolution in this area, governance runs the risk of becoming a matter of compliance, rather than good practices becoming institutionalised and thereby defining how business is to be done.

In our bid to tick down the checklist of governance related requirements, we lose sight of the ultimate goal of instituting strong controls all across honest conduct, and protecting fairly the interest of even the smallest stakeholder. There is not enough evolution in the area of tailoring supervisory and control practices for varying organisational structures even in the area of conventional banking. Rethinking governance and risk management should therefore be an institutional priority with regulatory impetus providing the necessary pressure to keep the focus alive.

## Shari'a Governance

It is a well-established fact that IFIs are not only just as vulnerable to operational risks and risk management failures as their conventional counterparts, but that their commitment to Shari'a imposes a host of additional responsibilities. Even in the more developed banking jurisdictions, governance standards pertaining to an IFI's Shari'a framework have not received the attention that these deserve. While abundant scholarly guidance is available on governance standards specific to Shari'a infrastructure, the regulatory stance

in most countries affords greater discretion to institutions and only a few requirements are generally mandated.

As a result, in general, the Shari'a governance framework generally does not find as much focus as does the organisational good practices common to all banks - Islamic and conventional. An IFI's Shari'a infrastructure seems usually to exist alongside the organisation's overall governance structure without achieving optimum interaction between these two systems. The seamless entrenchment of a Shari'a-mindful approach to business is rarely achieved.

## Multi-layered Approach

To strengthen IFIs, and with special regard to ensuring that Shari'a principles are embedded in banking functions, a three-step approach may be helpful. Firstly, it is virtually impossible for an institution to achieve very high standards of Shari'a compliance and near-perfect application of governance standards, without smoothing out the multiple risks emanating from the environment. A bank, be it Islamic or otherwise, largely mirrors the state of affairs in its environment and the society it operates in. Therefore, a focus on resolving long-standing and much-debated issues pertaining to Islamic markets, which include further standardisation of products and services, availability of standardised documentation facilitating sukuk issuances, and availability of ancillary services like *takaful*, can serve the industry well.

As a second step, we see much value in the availability of external professionals overseeing business practices, as is the case with external auditors giving an opinion on compliance with general governance standards and corporate governance ratings that have found increasing utility over the last decade or so. Thirdly, independent opinions on the relative positioning of institutions, on the front of Shari'a-compliance, also serve the same purpose, while also affording comparability and, thereby, 'choice' to investors. The strongest impetus to all this comes from regulatory authorities, which give both guidance and set minimum benchmarks in any market.

## Fiduciary Rating Concept

The Islamic International Rating Agency's (IIRA) fiduciary rating approach for IFIs

attempts to recognize and assess the

institutionalisation of values central to Islamic finance, while also delineating the institution's ability to protect the investments of account holders and generate expected returns. With fairness to all stakeholders being a pillar of Islamic banking, the framework implicitly incorporates an evaluation of an institution's governance system, central to which is the diligence applied to the institutionalisation of practices which ensure that business is conducted in a Shari'a compliant manner. While extensively evaluating the Shari'a infrastructure itself, i.e. the extent to which Shari'a personnel are aware of and involved in mainstream business and the overall framework of self-regulation, IIRA's rating approach is centered on the protection of joint investment account holders (IAH).

The framework is built around mechanisms in place to involve and inform the account holders regarding investments made using their funds, in acknowledgement of the greater risk that they take as against depositors in conventional banks. Even in jurisdictions where loss is not generally passed on to investors, IAH do take greater exposure, in the sense that legal protection and security offered by central banks, as lender of last resort for conventional banks, is generally not available to IFIs and their investors.

Much has been said and written on the subject of greater disclosure being warranted to IAH. This may not make a material difference in jurisdictions, where disclosure requirements are almost as high as they can be; however, in several other markets, regulators need to enhance disclosure requirements for the benefit of the IAH.

## Timeless Standard

On a final note, Islamic finance existed in smaller communities well before the prevailing conventional financial order came to be in its present form. While globalisation has added a more complex dimension to international finance, good governance remains a function of a genuine appreciation of high moral standards and individual ethics of all those in charge, and derives strength from the prevailing standards of honesty and fairness in the society at large.