

*Corporate Governance and  
Stakeholders' Financial Interests in  
Institutions Offering Islamic Financial Services*

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**Abstract**

This paper focuses on the corporate governance (CG) arrangements of Institutions offering Islamic financial services (IIFS) aimed at protecting stakeholders' financial interests. Many IIFS CG issues are common with those of their conventional counterparts. Others are distinctive. In particular they offer unrestricted investment accounts that share risks with shareholders but without a voting right. This paper first reviews internal and external arrangements put in place by IIFS to protect stakeholders' financial interests. It discusses shortcomings notably in terms of potential conflict of interest between shareholders and holders of unrestricted investment accounts. It then suggests a CG framework that combines internal and external arrangements to provide safeguards to unrestricted investment account holders without overburdening IIFS' financial performance. The paper uses a review of 13 IIFS and regulatory information from countries where IIFS have developed the most.

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## List of Abbreviations

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS:	Basel Committee on Banking Supervision
BCCI:	Bank of Credit and Commerce International
BCFS:	Businesses offering Conventional Financial Services
CAH:	Current Account Holders
CB:	Central Bank
CFICFB:	Cooperative Financial Institutions Businesses
CG:	Corporate Governance
CIBAFI:	General Council of Islamic Banks and Financial Institutions
FDIC:	Federal Deposit Insurance Corporation
FAS:	Financial Accounting Standards
FSA:	Financial Services Authority
IFH:	Ihlas Finance House
IFRS:	International Financial Reporting and Accounting Standards
IFSB:	Islamic Financial Services
IIFM:	International Islamic Financial Market
IIFS:	Institutions offering Islamic Financial Services
IIRA:	International Islamic Rating Agency
IRR:	Investment Risk Reserve
IOSCO:	The International Organization of Securities Commissions
LMC:	Liquidity Management Center
OECD:	Organization for Economic Cooperation in Europe
PER:	Profit Equalization Reserve
PLS:	Profit and Loss Sharing
PQBC:	Publicly Quoted Corporation Bank
RIA:	Restricted Investment Account
RIAH:	Restricted Investment Accounts Holders
SME:	Small and Medium Enterprise
SSB:	<i>Shariah</i> Supervisory Board
UIA:	Unrestricted investment account
UIAH:	Unrestricted Investment Account Holders

## Introduction<sup>1</sup>

After a long period of lull since the Middle Ages, there has been a large and growing interest in Islamic finance in the last three decades, particularly following the first oil price shock of 1973-74. Beyond the surge in liquidity, other major factors have been the introduction of innovative Islamic financial products and a demand by Muslim populations for financial services compatible with their religious beliefs. More recently, a new impetus has been provided by the uneven performance of western financial markets, a perception of increased risk for Gulf Cooperation Council capital in traditional financial markets, and the development of managerial skills in Islamic financial services.<sup>2</sup> The global Islamic financial services industry now includes 284 institutions offering Islamic financial services (IIFS) in 38 countries, both Muslim and non-Muslim.<sup>3</sup>

Initially, IIFS developed without a clear view on the legislative and regulatory framework that should apply to them.<sup>4</sup> However, their conceptual foundations and operational practices have specific features that pose challenges to regulators and call for solutions beyond the simple extension of existing legislation and regulation applying to businesses offering conventional financial services (BCFS). To that effect, a number of countries have put in place laws and regulations for IIFS, and international bodies have been established to adapt conventional standards and promote harmonization of practices.<sup>5</sup>

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<sup>2</sup> According to the General Council of Islamic Banks and Financial Institutions (CIBAFI), total assets have roughly doubled in the period 1998-2001, soaring from \$134 to 261 Billion. Source: <http://www.islamicfi.com> (last visited April 04, 2005).

<sup>3</sup> The term IIFS includes finance houses, that offer retail commercial and investment services. The paper does not deal with *Takaful* (insurance) companies. These figures were reported in a press release by CIBAFI dated May 8, 2005, ("CIBAFI Raises the Glance toward IFSI Growth with a Unique Statistic-Based 10-Year Strategic Plan").

<sup>4</sup> For example, in some cases the general prudential regime was extended to IIFS without recognizing any specific feature. In other cases, IIFS registered as non-bank commercial businesses. For an introduction to the principles and instruments of Islamic finance as well as regulatory arrangements applying to IIFS, refer to El-Hawary, Grais, and Iqbal (2004).

<sup>5</sup> These include the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International

Good governance is crucial to the ability of a business to protect the interests of its stakeholders. These interests may extend beyond the purely financial to the stakeholders' ethical, religious, or other beliefs. In the case of an institution offering Islamic financial services, its operations are required to be carried out in compliance with the principles of *Shariah* (Islamic Law). A corporate structure that enables a financial institution to implement good governance through *Shariah*-compliant operations is therefore essential for the stability and efficiency of Islamic financial services.<sup>6</sup>

The practices of IIFS raise specific corporate governance (CG) challenges. While a number of problems are common to all financial institutions, two broad sets of CG issues are specific to IIFS. The first one arises from the need to reassure stakeholders that IIFS activities fully comply with the precepts of Islamic jurisprudence.<sup>7</sup> Ultimately, the core mission of such an institution is to meet its stakeholders' desire to conduct their financial business according to *Shariah* principles. The same stakeholders also need to be assured that the firm will nonetheless actively promote their financial interest, and prove to be an efficient, stable and trustworthy provider of financial services. This combination of *Shariah* compliance and business performance raises specific challenges and agency problems, and underlines the need for distinctive CG structures. This paper focuses on CG arrangements aimed at protecting stakeholders' financial interests.<sup>8</sup>

Given that the core mission of an Islamic financial institution is to enable its stakeholders to pursue their financial interests without breaching their religious beliefs, the CG arrangements for IIFS cannot underestimate the importance of having a framework that credibly protects these financial interests. Mission statements appear to identify four categories of stakeholders: shareholders, "depositors", "borrowers" and

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Islamic Financial Market (IIFM) and the Liquidity Management Center (LMC). Rather than seeking to replace existing regulation, these bodies propose solutions whenever conventional regulation fails to address the distinctiveness of the Islamic financial industry.

<sup>6</sup> Annex I provides a glossary of Arabic terms.

<sup>7</sup> Islamic jurisprudence is also known as *Fiqh*. It covers all aspects of life: religious, political, social and economic. It is mainly based on interpretations of the *Qur'an* and *Sunna* (saying and deeds of the prophet).

<sup>8</sup> For an overview paper of CG of IIFS, see Grais and Pellegrini (2006a). Grais and Pellegrini (2006b) deals with the protection of shareholders' ethical interests.

socially vulnerable groups. Internal CG mechanisms should be designed to ensure that the interests of all these stakeholders' are looked after. Broader institutional arrangements, or external mechanisms, would complement internal arrangements and enhance their effectiveness.

Section A of this paper reviews prevailing internal and external CG arrangements to protect stakeholders' financial interests in IIFS and identifies shortcomings. Section B suggests measures to overcome these shortcomings.

## ***A. Protecting Stakeholders' Financial Interests: Current Practice and Shortcomings***

### **1. Internal Arrangements**

IIFS generally put in place CG structure and systems similar to those of BCFS to handle traditional agency problems between *shareholders* and management. Although not specific to IIFS, the protection of small shareholders may be equally important for them. Indeed, concentrated ownership and control may be more widespread in IIFS than with BCFS. Table I shows that out of a sample of 21 IIFS for which shareholder information was exhaustive, 9 appear to be family owned and controlled, about 43% of the sample.<sup>9</sup> This translates into a concentration of control of executive decisions and a monolithic board of directors that may be biased in favor of specific interests, unless adequately checked. Small shareholders as well as other stakeholders may accordingly be at risk. For example, management may use discretion in the funds they commingle to finance specific investments and provide better yields to dominant shareholders.<sup>10</sup>

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<sup>9</sup> Data were collected through IIFS websites as well as the Bankscope and Capital Intelligence databases. Control is defined as effective control power over the enterprise. Further research may want to analyze more rigorously ownership structure differences between IIFS and BCFS. In particular, research may want to explore the ratio of independent directors to all directors in IIFS to verify whether family ownership effectively leads to episodes of board capture.

<sup>10</sup> Paradoxically, family ownership in non-financial firms may solve the problems deriving from Bearle and Means' (1932) separation of ownership from control. However, in financial firms, where substantial funds are contributed by depositors and not equity holders, this type of ownership worsens the position of non-shareholder stakeholders. Given the importance attached by IIFS to stakeholders, this represents a relevant problem for them.

Table I - Ownership structure of IIFS				
	<u>Family Owned</u>	<u>State Owned</u>	<u>Dispersed ownership</u>	<u>Total sample</u>
<i>Number</i>	9	5	7	21
<i>%</i>	43	24	33	100

Public ownership is also a frequent feature of IIFS (Table I).<sup>11</sup> This raises the issue of contingent liability for public finances and the protection of the ultimate shareholder, the public at large. It also points to the need to pay attention to CG features that would provide management with enough leeway to operate at arms length from public authorities. Nonetheless, these CG issues are not specific to IIFS, and conventional approaches can be helpful to IIFS in addressing them.

Next to *shareholders*, *depositors* are a second category of IIFS' stakeholders. Generally, IIFS offer three broad categories of deposit accounts: current, restricted investment and unrestricted investment.<sup>12</sup> Each category raises some CG issues, but those of unrestricted investment account holders (UIAH) may be the most challenging. Current and restricted accounts are briefly considered before turning to UIAH.

*Current accounts (CA)* in Islamic finance may take three general forms depending on national jurisdictions. In *Amana* deposits, the financial institution acts as a trustee and promises to pay back the deposit in full. An example is the Jordan Islamic bank that offers "trust deposits". As the bank's terms and conditions state, "the bank may use such deposits at its own risk and responsibility in respect of profit and loss as these accounts do not share in investment risks and consequently do not share in investment profit or losses". Likewise, in a *qard hassan*, goodwill loan, the bank receives a loan from

<sup>11</sup> The survey shows that 24% of IIFS are fully state controlled (i.e. the state is the ultimate controller through golden shares of majority ownership). However, state ownership rises to 57% when one includes partial state ownership (without ultimate control).

<sup>12</sup> Most IIFS also offer savings accounts. However, they usually fall in either the category of term investments or in that of current accounts. We therefore only distinguish between investment deposits and current account deposits.

depositors and owes them only the principal amount. “Iran’s Law for Usury (Interest) Free Banking” stipulates “banks are obliged to repay the principals of “*gharz-al-hasaneh*” (saving and current) deposits”.<sup>13</sup> Last, *Wadiah* current accounts are also based on principal amount guarantees. For instance, Bank Muamalat states that “the bank guarantees the value of the deposit thus creating a *Wadiah Yad-Dhamanah* contract”. In all cases, the financial institution obtains an implicit or explicit authorization to use the deposit money for whatever purpose permitted by *Shariah*, but pay no fixed interest or profit shares to the depositors, with the exception of gifts (*hiba*) distributed at the bank’s discretion.<sup>14</sup> Given the similarities with conventional checking accounts, Islamic current accounts do not pose CG issues specific to IIFS.

In the case of restricted investment accounts (RIA), the bank acts only as fund manager -- agent or non-participating *Mudarib* -- and is not authorized to mix its own funds with those of investors without their prior permission. The IIFS operate these accounts under the principle of *Mudaraba* and tailor modes of investments as well as profit distribution to the risk appetite and needs of the individual clients. Funds provided by restricted investment account (RIA) holders are off balance-sheet. The relevant information about such accounts is provided in the statement of changes in restricted investments and their equivalent, or as a footnote to the statement of financial position, a treatment similar to that for funds’ management in BCFS. This treatment is confirmed by AAOIFI standards, which prefer to consider restricted investment accounts as off-balance sheet items, since the financial institution has no unconditional right to use or dispose of these funds. Investments for RIA depositors are not considered assets of the institution (under the assumption that the underlying *mudaraba* contract is non-participating).

RIA holders would want to be reassured that the financial institution conforms to their investment mandates. However, this should not be a major distinctive issue for IIFS. First, RIA depositors are normally savvy high net worth investors, whose holdings are large enough to induce them to directly monitor the agent’s behavior. Second, disclosure

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<sup>13</sup>Article 4, Iran’s Law for Usury (Interest) Free Banking, [www.cbi.ir/simplelist/1457.aspx](http://www.cbi.ir/simplelist/1457.aspx)

<sup>14</sup> In the case of *Amana* deposits, the authorization must be obtained from the depositor while in *qard hassan*, this is not needed. For more, refer to Ahmad (1997).

practices for RIA holders can be drawn from the ones in place for fund management in BCFS where AAOIFI standards do not apply. RIAs in IIFS are similar to managed investments in BCFS.

UIA holders are the third and often most important category of IIFS depositors. They are a characteristic feature of Islamic finance, raising a distinctive CG challenge. Essentially, it is the asymmetry between the extent of these depositors' participation in bearing the financial institution's risks and their ability to influence the institution's business conduct. Usually, UIA holders enter into a *mudaraba* contract with the institution.<sup>15</sup> The essence of the contract is that the financial institution manages their funds and shares with them returns according to a predetermined ratio. Funds provided by the UIA holders are placed in investment pools and profits on investments, if any, are distributed at maturity according to the profit and loss sharing (PLS) ratio specified in the contract. The UIA holders, and not the financial institution, bear the risk of the performance of the investment pool, except for misconduct on the part of the institution.<sup>16</sup> Thus, UIA holders are stakeholders akin to shareholders. They are principals entrusting their resources to an agent, in this case the management of the Islamic financial institution. A significant difference, however, is that the agent is appointed by another principal, the shareholder. Whereas the latter can influence business conduct through CG structures and processes in place, UIA holders do not have any similar channel to express their views. Their only option is the withdrawal of their funds, i.e. "exit" from the enterprise, when feasible. In short, UIA holders constitute a *sui generis* category of depositors with neither the capital value nor the returns on their deposits ex-ante guaranteed in principle. They do not have an institutional "voice" on the conduct of the business, and delegate the appointment of their agent to another principal whose interests may not always accord with theirs.

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<sup>15</sup> The case of *Wakalah* UIAs, which are based on an agency relationship with the IIFS earning a flat fee, rather than a share of profits, is not considered here.

<sup>16</sup> This risk-sharing feature has led some to argue that UIA are not liabilities for the IIFS and accordingly they should not be required to meet the same capital requirements as BCFS. In particular, the credit and market risk would fall on depositors, while the bank would only be subject to operational risk.



The investment decisions in IIFS are controlled by a board of directors that is accountable to shareholders whose interests may be at odds with those of UIA holders. In particular, the larger the share of profits distributed to such investors, the lower will be the dividend payments to shareholders. In principle, this should not constitute a problem, given that the allocation of returns is governed by the ratio specified in the *mudaraba* contract. However, IIFS commingle shareholders and investment funds in common pools, which gives the management the leeway to direct resources of influential principals to projects with the likelihood of better returns. The incentive may be stronger in periods of high growth and profits on investment accounts when shareholder controlled management and boards may favor shareholders' investments.<sup>17</sup> A high degree of concentrated ownership in the institution may exacerbate this issue. Commingling also impacts other stakeholders. Current account holders could be subsidizing other stakeholders with their safekeeping deposits. Likewise, RIA profits can be transferred to the corporate balance sheet.<sup>18</sup>

In addition, UIA holders do not have a say in the management and use of reserve funds to which they are implicitly required to contribute. IIFS generally put in place reserve funds with the stated objective of providing a cushion of resources that can be used to weather adverse developments in the investment portfolio.<sup>19</sup> They are considered important to deal with competitive pressure from BCFS and other IIFS. Returns to UIA holders vary according to the performance of the financial institution. Therefore, UIA holders may be induced to transfer their funds to better performing IIFS. To mitigate such a risk, IIFS set up profit equalization reserves and use them in periods of poor performance to complement the returns that would be due to these depositors. The funds

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<sup>17</sup> This is indeed what happened in the case of Ihlas Finas House, which used the impressive growth in the deposit base to mask transfers of funds to shareholder, as mentioned in the paper "Corporate Governance: Overview of Issues and Options" by the same authors. It is to be noted that the expropriation process could also be inverse: in years of poor performance, losses borne by investment accounts may be shifted to other stakeholders, including shareholders, to prevent a flight of depositors. This practice, commonly known as displacement risk, was adopted by Kuwait Finance House when it was engulfed in the crash of the Souk al Manakh.

<sup>18</sup> The prohibition to transfer funds from RIA to the IIFS' balance sheet is an established practice in some jurisdictions. In Bahrain, for instance, the Monetary Agency must give prior approval to such types of transfers.

<sup>19</sup> These reserves are generally known as Profit Equalization Reserves (PER) and Investment Risk Reserves (IRR). We follow AAOIFI's definition in Financial Accounting Standard (FAS) 11.

are fed by retaining earnings of UIA holders in periods of high returns on investment. Similar arrangements help the IIFS protect the principal of UIA holders. A special risk investment reserve is used for compensating a loss of principal resulting from poor investment results.

The use of profit equalization and risk investment funds raises issues pertaining to the governance of these funds and the protection of UIA holders' rights.<sup>20</sup> First and foremost, smoothing of returns to these depositors as currently practiced is a significant obstacle to transparency. By maintaining a stable return to this category of depositors, managers automatically send the signal that the firm is healthy and profitable, while the reality may be otherwise. Smoothing of returns therefore introduces a veil of opacity between depositors and the firm. This problem is heightened by the limited transparency on the use, size and allocation of these funds. An informal survey of 13 IIFS shows that of the 4 IIFS that admitted resorting to reserves, only 2 provide information in their financial statements and annual reports on the share of funds transferred from or to these reserves.<sup>21</sup> Limited disclosure does not provide comfort to UIA holders on their fair treatment. Second, these depositors lack the rights to influence the use of such resources and verify the degree of risk of management's investments. Such reserves are considered retained earnings, at least in the AAOIFI definition, and reinvested in profit-bearing activities.<sup>22</sup> Third, individual UIA holders may not be able to opt out of their participation to the accumulation of these reserves. A UIA holder with a long-term investment perspective may find it useful to delegate the inter-temporal allocation of his income to a financial intermediary.<sup>23</sup> However, a UIA holder with a high discount rate may be negatively affected by the imposition of this practice. Finally, a UIA holder who

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<sup>20</sup> We are not here concerned with the fact that the existence of such funds may be contrary to the theory of Islamic financial intermediation, in that it creates a de facto insurance against market risk.

<sup>21</sup> For the sample used please refer to footnote 54. The only two banks that disclose use of PER are Bank Muamalat and Dubai Islamic Bank.

<sup>22</sup> AAOIFI FAS 16

<sup>23</sup> According to a recent study by Allen and Gale (2004) financial intermediaries appear to be as efficient as markets in inter-temporal consumption smoothing.

withdraws his deposits loses his claim on the accumulated reserves and would be practically contributing to the future consumption of other UIA holders.<sup>24</sup>

IIFS' stakeholders also include "*borrowers*" that need access to financial resources to pursue economic activities. IIFS' mission statements often mention the special place they give to contributing to the development of the communities they serve. Data on the comparative performance of IIFS in this regard are not yet available. However, it is noticeable that many IIFS attach a high importance to preferential policies for residents of their local communities. Several IIFS offer vocational training for local residents in the form of awards, or traineeships for local school or university students. However, further research on the comparative treatment of borrowers by IIFS and BCFS is needed.

A last, but equally important, category of stakeholders is that of *socially vulnerable groups*. The emphasis by IIFS on their social role is not uniform. However, there is a noticeable consistency in respecting the social obligations of Islamic finance. IIFS usually take pride in social services provided as signaled by the disclosure of their accomplishments in their annual reports. In our sample of 13 IIFS, we found that all of them discharged their almsgiving duties (*Zakat*) as required by the *Shariah* from all responsible corporate citizens. The majority also provided charitable loans (*Qard Hassan*) to help disadvantaged groups meet social obligations like marriage. Three IIFS also conducted charitable activities in the form of competitions, prizes, and awards. Activities financed range from the implementation of development and humanitarian programs, and the construction of hospitals and mosques, to the financing of education, house refurbishments and in-kind donations. In general, it appears that IIFS live up to their social goals as claimed in their mission statements.

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<sup>24</sup> In this regard some banks require customers to waive their rights on these funds. For example, the terms and conditions of Islamic Bank of Britain state: "you (the UIAH) authorize us to deduct from net income your profit stabilization reserve contribution for payment into the profit stabilization reserve account. Upon such deduction you agree that you relinquish any right you may have to the monies in the profit stabilization reserve account. ([www.islamic-bank.com](http://www.islamic-bank.com), last visited April, 18, 2005)

## 2. External Arrangements

Internal CG arrangements are generally reinforced by external ones that set the framework governing business activity and provide the information necessary for their official and private monitoring. These external arrangements relate to (a) the legal and regulatory prudential framework governing IIFS activities, and to (b) the financial information infrastructure that permits their monitoring. The development of external CG arrangements for IIFS would seem to lag those for their BCFS counterparts.

### a) Legal and Regulatory Arrangements

One significant issue is what body of legislation and regulation should apply to IIFS. To date, three broad approaches have been adopted to provide for the legal and regulatory regime that governs IIFS activities. (i) Maintaining the same body of legislation and regulation that applies to BCFS, and applying it unchanged to IIFS; (ii) maintaining the same body of legislation and regulation, but adapting it through interpretation and procedures to accommodate IIFS *Shariah* compliance requirements; and (iii) developing a separate body of legislation and regulation to govern IIFS. Overall, it appears that there is a movement towards recognizing the peculiarities of IIFS by issuing IIFS specific regulations, as shown by the passing of such regulations in countries that have generally promoted the development of IIFS under the umbrella of conventional finance rules.<sup>25</sup> Table II illustrates the approaches taken in different countries where IIFS operate.

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<sup>25</sup> The most important examples are the passing of Kuwait's Islamic banking law in 2003; Lebanon's 2004 Law for "Establishing Islamic Banks"; and the British authorities' continuing willingness to adapt rules on to the needs of IIFS, as shown in the 2005 revision of taxation rules. In the summer of 2005, it is reported similarly that the Reserve Bank of India is considering ways to "introduce Islamic banking".

Table II - Approaches to the Regulation of IIFS			
<u>Country</u>	<u>Same body of regulation</u>	<u>Same body of regulation but flexible interpretation</u>	<u>Separate body of regulation</u>
<i>Bahrain</i>		✓	
<i>DIFC</i>			✓
<i>Egypt</i>	✓		
<i>Indonesia</i>			✓
<i>Jordan</i>			✓
<i>Kuwait</i>			✓
<i>Lebanon</i>			✓
<i>Malaysia</i>			✓
<i>Pakistan</i>			✓
<i>Saudi Arabia</i>	✓		
<i>Philippines</i>			✓
<i>Thailand</i>			✓
<i>Turkey</i>	✓		
<i>U.A.E</i>			✓
<i>USA</i>	✓		
<i>UK</i>		✓	

In principle, each of these approaches presents opportunities but also challenges. For instance, maintaining a clear body of legislation and regulation applying to all deposit taking banking institutions presents the advantage of clarity and familiarity of regulators with existing rules. However, rules that have emerged in a conventional finance framework may not be suited to the operating principles of Islamic finance. The premise that IIFS function on a PLS principle and do not engage in transactions where interest is charged raises questions on the integration of IIFS in conventional regulatory systems. Existing rules may have a negative impact on the overall performance of IIFS and consequently influence the extent to which they operate on a level playing field with their BCFS counterparts. To ensure that IIFS specificities would be accommodated in the regulatory and supervisory process, some central banks have set up Islamic banking departments or Islamic finance divisions in Securities Commissions entrusted with the regulation and supervision of IIFS (Table III).<sup>26</sup>

<sup>26</sup> Annex IV details the names and powers of these departments/authorities.

Table III- Regulatory institutions specific to IIFS by country*		
<u>Country</u>	<u>Separate Islamic Banking &amp; Takaful Department at CB</u>	<u>Separate Islamic Capital Market Department within Securities regulator</u>
<b>Jordan</b>	No	No
<b>Malaysia</b>	✓	✓
<b>Sudan</b>	N/A**	N/A**
<b>Bahrain</b>	✓	No
<b>Kuwait</b>	No	No
<b>Pakistan</b>	✓	✓
<b>UAE</b>	No	No
<b>Indonesia</b>	✓	No
* Annex IV details the names and powers of these departments/authorities. ** The entire financial system is Islamic.		

Legislative and regulatory issues that impact the profitability and stability of IIFS may be broadly categorized under rules on taxation, rules on permissible activities, stakeholder protection rules, and capital adequacy regulations. As regards taxation, the asset-based nature of Islamic finance requires that in a single transaction property may change ownership several times. For instance, in *Shariah* compliant mortgage, the property must change hands twice – from seller to bank and from bank to customer. Accordingly, a *Shariah* compliant mortgage involves the payment of two sets of stamp duty while a conventional mortgage is subject to a single stamp duty. This is tantamount to an additional fee levied on IIFS. This issue has been tackled in several countries but has not attracted regulatory attention in others.<sup>27</sup>

<sup>27</sup> In the USA, double stamp duties on Islamic financial instruments may still apply. In the UK, on the contrary, the issue has been resolved by the gradual introduction of practical measures to tackle the issue of unfair taxation for Islamic financial products. These include relief from double stamp duty for Islamic property finance products as well as the simplification of taxation procedures for profits earned by UIAH. Until recently, no tax has been imposed on the profits disbursed to UIAH. However, such profits were fully taxable in the hands of UIAH. From now on, a small tax comparable to that levied on conventional savings accounts will be deducted at source. Accordingly, UIAH won't have to include profits from their UIA in their tax declarations. In countries with separate legislation the issue of taxation is generally addressed.

Second, some *Shariah* compliant activities may be incompatible with conventional finance regulatory framework. By their nature, IIFS utilize a series of transactions that may be prohibited by conventional regulations. For instance, an Islamic financial transaction may require that an Islamic financial institution owns property for short lapses of time. However, in some countries, deposit-taking institutions are explicitly prohibited from investing in moveable or immoveable assets for business purposes.<sup>28</sup> Similarly, no IIFS transaction must involve interest. However, conventional payment systems, or reserve requirement rules may oblige them to do so.<sup>29</sup> Likewise, conventional lender-of-last-resort mechanisms may not be deemed to be *Shariah* compliant.<sup>30</sup> The problem can be acute in the case of liquidity management instruments, such as for satisfying short-term liquidity needs, because of the non-existence of Islamic secondary markets. Some regulators and IIFS have addressed the problem through the establishment of the Bahrain-based IIFM and LMC.<sup>31</sup> Nevertheless, it would appear that the majority of IIFS still lack access to secondary markets and are forced to maintain unusually high levels of liquidity, thus curbing investment opportunities and profits.

Third, rules to protect stakeholders often imply principal amount guarantees in the form of deposit protection schemes. Indeed, in most countries, stakeholders may not be fully aware of the profit and risk-sharing implications of *Shariah* compliant investment

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<sup>28</sup> In countries with established dual financial systems, derogations on ownership of property are usually granted to IIFS. For instance, Article 54 of the Banking Law of Jordan (Law No. 28 of 2002) exempts IIFS from rules that would otherwise constrain their investments in movable and immovable properties.

<sup>29</sup> For instance, in India a strict interpretation of reserve requirement rules that oblige banks to open interest-bearing accounts with the central bank prevents the licensing of IIFS as fully-fledged banks. Accordingly, IIFS opt for non-banking statuses that may impose operational limitations on their activities. This has repercussion on investors as underlined in section II. In other jurisdictions where IIFS must maintain statutory deposits with central regulators, IIFS usually use interest earnings for charitable purposes. This is the case of Bahrain-based IIFS. In Malaysia, on the contrary, the deposits with the central bank are ex-ante non-interest bearing as provided for by an amendment to the Central Bank Act, 1958 (Section 37 1c, revised 1994).

<sup>30</sup> In Indonesia, Malaysia and Sudan, central banks have established *Shariah*-compliant lending facilities. For instance, regulation 5/3/2002 on “Short-term Financing Facility for *Shariah* Banks” allows IIFS licensed in Indonesia to overcome short term liquidity shortages by borrowing in *Shariah*-compliant *Wadiah* certificates. However, in other countries, the issue has not been addressed

<sup>31</sup> The IIFM is sponsored by several regulators and its role is the creation of an active *Shariah*-compliant secondary market. The LMC is a joint private sector initiative (Dubai Islamic Bank, Bahrain Islamic Bank and Kuwait Finance) with the same purpose.

accounts.<sup>32</sup> Guided by concerns on depositor protection, regulators may refuse to treat UIA as *sui generis* deposits, and opt for regulating them as interest bearing deposits, thus extending to them the provisions of deposit insurance legislation. Nonetheless, applying insurance schemes to what are essentially investment accounts may be unacceptable in terms of *Shariah* prescribed risk-sharing and may altogether induce IIFS to renounce to mobilize savings with such an instrument. In practice, some IIFS have addressed this issue by licensing UIA as mutual funds. This solution brings UIA under securities regulation that meshes with the profit and risk sharing nature of UIA. However, the mutual fund product may limit the scope of services IIFS offer their clients. Alternatively, UIA may be insured as conventional deposits. This option does nevertheless represent a second-best, if unacceptable, solution for Islamic jurists.<sup>33</sup>

Finally, due to the distinctiveness of financial instruments used by IIFS, conventional Basel risk weighting may not be suited to Islamic banks. For instance, in a profit and risk sharing account, credit and market risk would fall normally on the investor while operational risk would fall on the IIFS, solely responsible for losses deriving from failure to comply with *Shariah*. Likewise, instruments on the assets side of an Islamic financial institution's balance sheet may be subject to risks that are different from those arising in conventional counterparts. To address this deficiency, some countries have adopted a capital adequacy calculation that accounts for IIFS specific risks.<sup>34</sup> However, it appears that several countries have simply extended the Basel framework to IIFS. This latter practice may be contrary to the trend toward risk-based regulation.

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<sup>32</sup> This does not simply apply to non-Islamic countries. In fact, the case of IFH underscored a general unawareness on the non-applicability of conventional deposit insurance to IIFS in Turkey. It also showed the risks that such unawareness may result into panic and systemic banking crises.

<sup>33</sup> In the USA, there is at least one UIA facility (University Bank, Ann Arbor, MI) that has been licensed as a deposit and insured along Federal Deposit Insurance Corporation (FDIC) provisions. The Bank's SSB has certified that the application of insurance was the best possible solution within regulatory constraints. In the UK, the FSA has adopted a solution that tries to reconcile depositor protection with risk and profit sharing. All UIA are insured as prescribed by the EU Directive on Deposits (94/19/EC). However, if the IIFS incurs into losses, the individual UIAH may waive its deposit insurance and voluntarily decide to bear investment losses.

<sup>34</sup> Some national regulations are based on AAOIFI's "Statement on the Purpose & Calculation of the Capital Adequacy Ratio for Islamic Banks". AAOIFI recommends the inclusion of 50% risk-weighted assets of the UIA to cover "fiduciary risk" and "displaced commercial risk", that are arise in UIA operations. However, it does not address the risk peculiarities of IIFS assets side. This problem will be resolved by the forthcoming IFSB capital adequacy standard, which will deal with UIA and instruments on the assets' side of the balance sheet.



Generally, a regulatory framework that does not address specific IIFS issues may lead Islamic financial institutions to pursue a licensing status (e.g. non-bank) that may not correspond to the nature of their activities. It may adversely affect market development and stability as well as the institutions' performance. A careful assessment of the impact of the regulatory arrangements governing IIFS is warranted.

## **b) Financial Information Infrastructure**

Widely available and affordable financial information supports official and private monitoring of financial businesses' performance. It promotes transparency and supports market discipline, two important ingredients of sound CG. Financial information may be particularly important for IIFS due to the private equity nature of UIAs and the assumption that UIA holders have more at stake than conventional depositors. UIA holders should therefore be interested in directly monitoring IIFS' performance. However, this requires an institutional infrastructure which facilitates the production of accurate financial information, the availability of agents that can interpret and disseminate it, as well as arrangements to protect its integrity. On all these counts, the Islamic financial industry faces challenges. Existing limited infrastructure reduces the role that information flows may play in promoting competition and market activities that would induce managers to adopt sound CG practices.

Issues such as the *protection of information integrity* concern both IIFS and BCFS. Other issues have a special connotation in the context of Islamic finance and are the focus here. For instance, a core component of *financial information infrastructure* is a chart of accounts that businesses would use to organize and produce credible financial statements. The accounting profession has gradually developed standards, at the national and international levels, generally with official support. An increasing number of countries have adopted International Financial Reporting and Accounting Standards (IFRS) in the wake of an apparent consensus to promote international convergence. However, IFRS are designed for conventional businesses, including BCFS. The nature of IIFS products, their practice of setting up reserve funds to smooth profit distribution and

protect the UIA holders' principal, and the commitment to distribute *Zakat* are among IIFS features that may not directly fit into the IFRS framework. This realization has led to the establishment in the early nineties of AAOIFI that gradually developed standards dealing with IIFS specificities.<sup>35</sup> While progress has been achieved with AAOIFI's work, the accounting pillar of the financial information infrastructure for IIFS continues to present two sets of weaknesses. Wherever IFRS are the only rule, they may not induce the production of financial statements reflecting IIFS' genuine performance and may give a false sense of reliability. AAOIFI standards, on the other hand, would be expected to deal adequately with IIFS specificities. However, they reduce cross-sector comparability. In addition, the direct references to religion may discourage application in secular countries. A review of 13 auditors' reports confirms that practices vary across countries. In particular, only 7 of the 13 sampled IIFS utilize some form of IIFS specific standards. Table IV shows which countries have issued standards based on, or inspired by, AAOIFI's work.

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<sup>35</sup> AAOIFI's standards are mandatory for the following markets: Bahrain, Jordan, Sudan, Qatar, and Dubai International Financial Center. Syria is considering their adoption. The standards are used as guidelines in Saudi Arabia, Kuwait, Malaysia, Lebanon, and Indonesia. Most Islamic banks' *Shariah* supervisory committees use AAOIFI standards as guidelines.

Table IV - Country Approaches to Accounting and Auditing Standards for IIFS		
<u>Country</u>	<u>AAOIFI standards (adopted adopted/recommended/ adapted) or national IIFS specific standards</u>	<u>Non-IIFS specific standards</u>
<b>Bahrain</b>	✓	
<b>DIFC</b>	✓	
<b>Egypt</b>		✓
<b>Indonesia</b>	✓	
<b>Jordan</b>	✓	
<b>Lebanon</b>	✓	
<b>Malaysia</b>	✓	
<b>Philippines</b>		✓
<b>Qatar</b>	✓	
<b>Saudi Arabia</b>	✓*	
<b>Sudan</b>	✓	
<b>Syria</b>	✓	
<b>Thailand</b>		✓
<b>Turkey</b>		✓
<b>USA</b>		✓
<b>UK</b>		✓
* The Saudi Arabian Monetary Agency recommended IIFS to seek guidance from AAOIFI FAS in compiling their statements, but officially requires IFRS.		

The *provision of financial information* on IIFS remains constrained by a series of issues. First of all, providers, and analysts may not be entirely familiar with the nature of IIFS and with AAOIFI standards. However, market forces have already brought about substantial progress. For instance, leading international rating agencies now monitor and rate IIFS and are acquainted with AAOIFI prescriptions.<sup>36</sup> They have also tailored their rating mechanisms to the risk profile of Islamic banks.<sup>37</sup> However, the lack of internationally accepted and standardized accountancy practices for IIFS derived from the still limited application of AAOIFI's standards, as pointed out above, reduces comparability across markets and banks and may reduce consistency in ratings.

<sup>36</sup> These are Fitchratings, Capital Intelligence and Moody's Investors Service. Capital Intelligence was the pioneer in rating and analyzing IIFS. It now covers 21 IIFS across 8 countries.

<sup>37</sup> Capital Intelligence uses the same categories to rate IIFS and BCFS, falling namely in 6 areas: regulation and supervision, operating environment, franchise strength, management quality, financial fundamentals and external support. However, given the nature of IIFS, the analytical focus is adjusted. For instance, liquidity risk management may be more important in rating a IIFS than in a BCFS given the lack of *Shariah*-compliant secondary markets.

These financial information weaknesses do not serve to create a *competitive environment* for IIFS. Instead, they limit the contribution that competition can bring to sound IIFS CG.<sup>38</sup> The principal information weakness in IIFS is the limited application of internationally accepted standards tailored to IIFS. This has the effect of reducing the accuracy of information reported as well as of diminishing comparability across IIFS. In addition, it reduces the scope for product competition and diminishes incentives to adopt corporate control mechanisms that would minimize costs. Weaknesses in producing and analysing financial information do not provide either the means for a fluid merger and acquisition activity and hence shelter managers from the threat of takeover in the event of poor performance.

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<sup>38</sup> Grosfeld and Tressel (2001) provide evidence that competition has an important complementary effect where good CG mechanisms are already in place.

## ***B. Protecting Stakeholders' Financial Interests: Empowerment and Enabling Regulations***

### **1. Internal Governance: Stakeholders' Empowerment**

The protection of IIFS stakeholders' financial interests requires the application of established CG principles, adapted to the framework of Islamic finance. In addition, regulators need to implement solutions that address problems specific to IIFS. First, regulators need to focus on transparency requirements, given the limited disclosures that characterize IIFS. Second, mechanisms to ensure protection of minority shareholders would seem to be at least as important in IIFS as in BCFS. Third, the practice of commingling would need attention as it decreases investors' confidence in a fair and proper use of their funds. Fourth, UIA holders need to be empowered to look after their own interests; this may require, among other things, clear and harmonized rules on the use of reserves.

Islamic financial institutions generally appear less transparent than their conventional counterparts. It is therefore necessary for an Islamic financial institution to focus on creating a culture of transparency that protects all investors. Taking the cue from the OECD principles, "disseminating information should provide for equal, timely and cost-efficient access to relevant information by users".<sup>39</sup> Thus, an Islamic financial institution would need to publish its corporate governance code or policy, and the process by which it is implemented.

The particular need to protect the interests of minority shareholders in an Islamic financial institution arises out of the concentration of ownership frequently observed in such institutions. For instance, in an environment where the largest stockholders are also likely to occupy executive positions, CG mechanisms like executive stock options and registered shares may be counterproductive for the fair governance of the institution. Likewise, relying on the markets for corporate takeovers is not an option when managing

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<sup>39</sup> OECD (2004)

families are solidly in control through super-voting shares or majority stakes.<sup>40</sup> In such a situation, the ownership structure needs to contain guarantees for minority shareholders, such as the attribution of a fixed number of minority directors, or independent safeguards in the nomination of outside directors. Alternatively, regulators could consider the introduction of remedies that would allow minority owners to sue the ultimate controlling shareholders rather than managers.<sup>41</sup>

Next, the widely prevalent practice of commingling funds in an Islamic financial institution can limit the transparency of the institution's compliance with its clients' investment objectives. Accordingly, regulatory authorities need to consider rules on firewalls and sanctions for breaches. This is of paramount importance in the case of UIA holders, whose funds are usually common-pooled with those of shareholders.

Finally, the regulatory framework needs to address UIA holders' rights and their protection. Three alternative options to empowering and protecting UIA holders could be considered. One, rights that normally belong to equity-holders can be extended to UIA holders. Two, going in the opposite direction, UIA holders could be granted full debt-holding status and the protection it carries. Three, the *sui generis* status of UIA holders could be maintained, *provided that* specific governance structures for protecting their interests are in place. Each of these options is discussed below.

On the first option, of extending shareholders' rights and duties to UIA holders, it can be argued that, given the equity-like investment of these depositors, they should be on an equal footing with shareholders and thus have the right to elect board representatives. This would increase their ability to air their demands and concerns with

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<sup>40</sup> This does not consider the already limited use of hostile takeovers in banking due to the opacity of the system and regulatory restrictions. In general, the disciplining power of competition is hindered in banking by limited product market competition as banks construct long-term relationships with customers. Even if product markets were fully competitive, capital markets would still ill-function due to waves of irrational optimism and pessimism that result in shareholders looking at immediate revenues rather than the long-term ability of firms to pay dividends. For more see Levine (2004) and Prowse (1998).

<sup>41</sup> In Canada, for instance, shareholders have a right to apply to courts for relief if any act or omission by their corporation or its directors is oppressive, unfairly prejudicial or unfairly disregards the interests of any shareholder or if the business or affairs of the corporation are conducted in a manner which has this effect.

management. It would also satisfy depositors' demand for greater involvement in the strategic management of the bank.<sup>42</sup>

However, the election of UIA holders' representatives may fragment the board of directors along conflicting demands of different groups. Operationally, this could lead to decisional deadlocks to the detriment of efficient management and profit performance. In addition, the extension of shareholders' rights to UIAH raises a legal issue. This category of depositors and shareholders are subject to two very different types of legal liabilities. The liability of investment account holders is limited to losses occurring on their investments. On the other hand, the liability of shareholders covers *all* losses which the bank may incur in the course of its business, including losses from funds provided by current account holders. In this light, the power to elect board representatives would give UIA holders a role in the strategic management of the entire institution that might not be commensurate with their risks.

If extending shareholders' rights to UIA holders is deemed impractical, depositors' protection could be another option. In most financial systems, regulators act on behalf of debt-holders by requiring insurance on all deposits and taking control away from equity holders in case of distress. The PLS nature of investment accounts prevents however the application of deposit insurance as it is. Accordingly, a *Shariah*-compliant version of deposit insurance could be put in place. It would cover current account holders under all circumstances of bank insolvency and UIA holders only in cases of insolvency resulting from proven fraudulent mismanagement.<sup>43</sup> Such a measure may reduce systemic risk associated with bank panic behavior and permit redress for UIA holders affected by the failure of an Islamic financial institution.<sup>44</sup>

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<sup>42</sup> In a survey of IIFS consumers' preferences, Chapra and Ahmed (2002) record an interest by depositors to be involved in the strategic management of the bank.

<sup>43</sup> In case of bank liquidation, the Central Bank of Jordan distinguishes between investment accounts and deposits accounts. While the latter can be covered by deposit insurance, the former are charged with the expenses and disbursements of the liquidator and only subsequently their entitlements are distributed according to PLS ratios. See Banking Law Art 56.

<sup>44</sup> This is the system that is currently in place in Turkey. As outlined in the paper "Corporate Governance: Overview of Issues and Options" by the same authors, it was introduced following the runs on Special Finance Houses' deposits following the collapse of IFH.

The objections to deposit protection schemes are well documented in a vast body of literature that stresses the moral hazard of deposit insurance as well as the collective action implications.<sup>45</sup> The latter point may be especially relevant in the case of IIFS. In theory, UIA holders could be considered to have a higher degree of sophistication than conventional bank depositors, and therefore be less inclined to leave the monitoring of the institution's performance to others. Thus, deposit protection schemes may prove to be a more significant disincentive to oversight of managers' decisions. More importantly, the establishment of protection mechanisms does not guarantee *per se* an impartial conduct of business, because it leaves unchanged those governance structures that would permit a shareholder-controlled management to be biased against UIA holders in determining investment policies.

A third option would be to put in place new governance structures that cater to the specific needs of UIA holders. One possibility is the election of a special representative or a body that would act as intermediary and, if necessary, whistle blower. The main rationale for such a mechanism would be the creation of a permanent institutional channel to facilitate information flows from and to this category of depositors. While theoretically feasible, this policy presents drawbacks. In particular, the creation of a new agent would bring with it additional agency problems and the risk of multiplying, rather than diffusing, the asymmetries of information to which these depositors are subject. There is no guarantee that UIA holders would effectively monitor the conduct of their representative or that the representative would be immune from opportunistic behavior, such as collusion with the units of the institution in charge of appointments and remuneration. The creation of a composite body, made up of representatives from several parts of the firm, would perhaps reduce the tendency to collusion, on the assumption that the different members would check each other's behavior.

It appears, therefore, that the creation of governance bodies for the protection of UIA holders may be a reasonable solution to the immediate problem. Nonetheless, it does

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<sup>45</sup> For an empirical treatment of this issue, please refer to Demirgüç-Kunt and Detragiache (2002)



not resolve the tension between the debt-holding status of these depositors and the equity nature of their investments. Ultimately it would be necessary to find organizational solutions that resolve this conflict.<sup>46</sup>

In conjunction with mitigating conflicts of interest, regulatory efforts would need to emphasize a transparent conduct of business. In this regard, the smoothing of returns to UIA holders as currently practiced appears to be a significant obstacle to transparency. By maintaining a stable return to this category of depositors, managers could mislead them on the institution's true performance and introduce a veil of opacity between these depositors and the institution. In addition the accumulation of PER may be an appropriation of resources by the bank, unless the choice to smooth returns is left to the investor instead of the institution's management. Accordingly, where practiced, smoothing of returns should be subject to strict requirements. Waivers on resources contributed to PER should be eliminated.

Another option is to issue "profit equalization certificates" against PER to UIA holders that they could redeem on leaving the financial institution.<sup>47</sup> In all circumstances, however, the financial institution should be fully transparent in the use of such funds. AAOIFI FAS 11 provides clear principles and guidelines on this issue. In particular, it guides IIFS to disclose the shares of actual profits and use of the PER in the returns they receive<sup>48</sup>. In addition, each Islamic financial institution would need to adopt clear provisions regulating contributions to the PER and their disclosure in financial statements and annual reports.<sup>49</sup>

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<sup>46</sup> One option is the licensing of UIA as collective investment schemes.

<sup>47</sup> This would imply acceptance by UIAH that they may lose part of their principal if the IIFS has had negative profits during the term of their investments. The problem with such a scheme is that UIAH would probably extend financing in the hope of future returns. This would be tantamount to a restriction of their exit options

<sup>48</sup> Some IIFS have already established the practice of distinguishing between profit distribution and reserve distributed.

<sup>49</sup> Decisions pertaining to PER and IIR should ideally be left to the business. However, concerns over maintaining the UIAH principal and the systemic consequences that losses may provoke have led some regulators to intervene. For instance, the Banking Law of Jordan as amended in 2003 establishes a minimum deduction of 10% on earnings to be invested in an investment risk fund in order to cover losses in mutual investment accounts. Such minimum deduction may be increased by the CB (Art. 55).

## 2. Strengthening the External Environment

An external environment that takes account of IIFS specificities would enhance the soundness of CG at the broader institutional level. Public and private sector activities can converge to provide a sound framework for the protection of the financial interests of IIFS' stakeholders.

### a) Flexible Regulatory Approach and Private Initiatives

As earlier observed, IIFS would require regulatory and legislative solutions that differ in certain respects from those governing BCFS. Regulators would therefore need to adapt the underlying institutional and regulatory infrastructure, as well as encourage private sector self-regulatory initiatives. Likewise IIFS should consider applying for licenses that best suit their needs. Supervisors need to be conversant with the arrangements put in place to ensure effective supervision without overburdening IIFS operations.

There is *no single ideal model of regulation* for IIFS. In practice, though, Islamic finance is the most developed in countries which have separate arrangements for Islamic financial institutions. This would suggest that application of CG principles in a manner that recognizes IIFS specificities and results in an IIFS-specific regulatory infrastructure may support sounder CG. A rationale for separate arrangements can also be found in the enacting of Islamic finance laws in countries that had previously opted for a homogenous regulatory framework as well as by the creation of specialized Islamic finance regulatory divisions in the regulatory bodies. Nevertheless, establishing separate laws or institutions for the regulation of IIFS could be an issue in non-Islamic countries. Also, IIFS seem to flourish even in some countries that did not address the specificities of IIFS through specific legislation. This is the case, for instance, in the UK, Saudi Arabia or Bahrain, where the lack of an IIFS-specific legal framework does not equate with a neglect of the industry. In particular, regulators in these countries have shown willingness to adapt

regulatory arrangements whenever needed, guided by the imperatives of fair competition, systemic stability, and investor protection.

In some situations, *private initiatives* may play a role when IIFS and regulators cannot find workable solutions to address regulatory concerns. For instance, the issue of last-resort lending may be addressed by setting up a *takaful*-like arrangement. Each Islamic financial institution would contribute a fixed amount to a *Shariah*-compliant mutual insurance pool and tap from its profits in times of distress.<sup>50</sup> Creating a lending facility of this type outside central banks may be desirable in those countries where central banks are reluctant to establish separate lending instruments for IIFS. Likewise, in the case of liquidity risk, an Islamic financial institution may replicate or reinforce private liquidity risk management arrangements along the lines of the LMC.

In those countries, where regulators would not consider adapting their arrangements to IIFS, the latter may wish to seek an alternative *licensing status* that does not conflict with the nature of Islamic finance. For example, licensing IIFS as financial cooperatives would present CG advantages.<sup>51</sup> However, it would raise other CG issues. Furthermore, it may place the IIFS on a non-level playing field with BCFS in those countries where legislation restricts the scope of activities by non-banking institutions.

## **b) Enhancing Financial Information Flows**

A comprehensive flow of quality financial information requires the standardization and harmonization of accounting and auditing practices for IIFS. Accounting standards that permit clear financial reporting by IIFS would enhance stakeholders' confidence, while lowering the costs of information collection would induce reputable private agents to extend their operations to the IIFS market. This would

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<sup>50</sup> This idea echoes Chapra and Ahmed (2002) that propose the set up of a common pool at central banks where banks could deposit a percentage of their deposits and borrow interest-free in case of need provided that the net use of this facility is zero. While the ideas are essentially equivalent, creating a private *takaful*-like structure outside central banks may be a more workable solution for non-Muslim jurisdictions.

<sup>51</sup> For instance, to better manage their liquidity, IIFS could emulate the financial cooperatives' practice of organizing in conglomerates or networks and commit to satisfying each other's liquidity needs.

enable synergies between supervisors, market monitors, and rating agencies, thereby encouraging sound CG.

A chart of accounts that permits IIFS to provide clear and reliable financial reporting is a priority to improve their CG. Significant progress has been achieved by AAOIFI in this respect. Adoption of AAOIFI standards, creation of AAOIFI inspired national standards, or recommendation of selected AAOIFI standards to integrate existing accounting and auditing standards need to be considered in countries with significant IIFS presence. AAOIFI's standards present advantages. First, they are the only existing comprehensive source of accounting standards for IIFS. Their periodical review process should ensure that up to date accounting and auditing practices are retained. Second, they allow comparability across Islamic banks in different countries, although they may limit comparability across IIFS and BCFS.<sup>52</sup> Third, it may be easier for various stakeholders involved in Islamic finance to gain familiarity with a single accounting framework instead of a multiplicity of national ones. In spite of increased comparability across sectors, the simple extension of IFRS or national conventional standards is likely not to bring the same clarity, because it may not fully disclose all relevant information.<sup>53</sup>

Information reported in a consistent and accurate manner would provide the needed inputs to rating agencies, financial media, investment advisors, and CG analysts. Current progress by rating agencies on covering IIFS augurs well for the future. In the short term, public authorities may also play an active role in supplying the infrastructure for information sharing, by creating, for instance, public rating agencies, without the intention of usurping the private sector role and exclusively where such markets are missing. Adequate provision of information also requires authorities to put in place enabling norms that allow reputable private agents to access the necessary information and respect its integrity.

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<sup>52</sup> One criticism of AAOIFI standards is that they depart too significantly from the format of IFRS. However, thanks to the ongoing review process, one may envisage a progressive adaptation of AAOIFI standards to the general IFRS format.

<sup>53</sup> When AAOIFI standards were issued, Moody's observed the following to convey the scope of the problem: "(...)when reading these standards, the most striking realization is how little is disclosed in the current financial statements (i.e. not based on IIFS specific standards)

## **Conclusion**

Overall, the introduction of new internal and external CG structures, together with the reinforcement of existing ones, can provide stakeholders with sufficient comfort on the actions of management and other organs of the financial institution. Internally, this requires procedures for the protection of minority shareholders and provisions for increased disclosure. In addition, concrete approaches to addressing the problems of commingling, UIA holders' rights, and the utilization of reserves would complete the internal CG of IIFS. Externally, recognizing the specificity of IIFS will contribute to the stability of the industry and the protection of its stakeholders. Regulators need to be flexible and to work with the Islamic financial institutions to fully understand the needs of the industry and thereby develop an appropriate regulatory framework. Also, recourse to private self-regulatory initiatives may be more important in Islamic finance than in BCFS. In those countries where regulations present constraints on Islamic finance, IIFS need to evaluate the available options to determine which licensing status is best tailored to their needs and those of their stakeholders. Also, in order to be able to meaningfully oversee the institution's operations, the regulatory and other authorities, as well as market participants, would need to have a full understanding of the various nuances of the legal and regulatory framework in which the institution operates. The role of public authorities should be further complemented and supported by reputable agents that would send signals to market players. This requires the existence of an IIFS specific accounting and auditing infrastructure that would facilitate timely and reliable financial information.

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<b>Annex I: Glossary of Arabic Terms</b>	
<i>Amana</i> (Demand deposits)	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value and earn no return.
<i>Fatwa</i>	Legal opinion issued by a qualified scholar on matters of religious belief and practice
<i>Fiqh</i> (Islamic jurisprudence)	It refers to Islamic jurisprudence that covers all aspects of life: religious, political, social and economic. <i>Fiqh</i> is mainly based on interpretations of the <i>Qur'an</i> and <i>Sunna</i> (sayings and deeds of the prophet).
<i>Fiqh al-Muamalat</i>	Islamic Commercial Jurisprudence
<i>Gharar</i>	Literally, : uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, such as fish in water or a bird in the air.
<i>Halal</i>	That which is permissible according to <i>Shariah</i> Law
<i>Haram</i>	Unlawful according to the <i>Shariah</i> . It indicates transactions which are not permissible under Islamic law.
<i>Hibah</i>	Literally gift. A gift awarded voluntarily in return for a loan.
<i>Ju'ala</i> (Service charge)	A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
<i>Kifala</i>	It is a pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
<i>Mudaraba</i> (Trustee finance contract)	<i>Rabb -al- mal</i> (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers his labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by <i>rabb-al-mal</i> . The liability of the entrepreneur is limited only to his time and effort.
<i>Murabaha</i> (Mark-up financing)	The seller informs the buyer of his cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
<i>Musharaka</i> (Equity participation)	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
<i>Qard Hassan</i> (Beneficence loans)	These are zero-return loans that the <i>Qur'an</i> encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
<i>Quran</i>	Islamic scriptures believed by Muslims to be God's revelation to the Prophet
<i>Riba'</i>	Literally, an excess or increase. Technically, an increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party.
<i>Shariah</i> (Islamic Law)	The Islamic Law extracted from the <i>Qur'an</i> and <i>Sunna</i> (sayings and deeds of the Prophet).
<i>Sunna</i>	Deeds of the Prophet
<i>Takaful</i>	Arabic name for insurance based on <i>Shariah</i> rules. An Islamic Insurance is a collective protection scheme. It literally means solidarity. <i>Takaful</i> reflects solidarity and is akin to mutual insurance.
<i>Umma</i>	Community of the faithful within Islam
<i>Wadiah</i>	A safe custody contract between the depositor (customer) and the custodian (bank).

<i>Wakala</i>	An Agency contract which may include in its terms a fee for the agent. Same contract can also be used to give a power of attorney to someone to represent another's interests.
<i>Zakat</i>	Religious tax to be deducted from wealth to be paid to the needy.
Compiled from El-Hawary, Grais, and Iqbal (2004) and the glossary of the IIFM website ( <a href="http://www.iifm.net">www.iifm.net</a> ).	