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**SHARI'AH GOVERNANCE SYSTEMS: INTERNATIONAL COMPARATIVE  
STUDY OF ISLAMIC FINANCIAL INSTITUTIONS**

**Extract**

**Section 2: Executive Summary**



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## **SHARI'AH GOVERNANCE SYSTEMS: INTERNATIONAL COMPARATIVE STUDY OF ISLAMIC FINANCIAL INSTITUTIONS**

This document contains **Section 2: Executive Summary** from the research paper "**Shari'ah Governance Systems: International Comparative Study of Islamic Financial Institutions**" dated 1 November 2010, the full version of which can be obtained by email request to [tim@timtravers.com](mailto:tim@timtravers.com). The Table of Contents and List of Tables to the full version of the research paper are attached as **Annexes A and B**. This research was carried out between 1 June and 1 November 2010 and submitted to Cass Business School on 1 November 2010.

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### **Section 2: Executive Summary**

#### **1.1 Purpose**

The primary aim of this paper is to examine the different components of *Shari'ah* Governance Systems of Islamic financial institutions (**IFIs**) in different countries and how they operate in practice.

#### **1.2 Situation**

*Shari'ah* corporate governance, in its broadest terms, is the single most important current issue for the Islamic finance and insurance industries. There are many current drivers towards further developments. The global financial system continues in a state of flux and is not without further threats and stresses. Infrastructural changes to the way such a system works, and should work, have been, and remain, a source of major debate. An alternative, or parallel, financial system based on Islamic economic principles is one option.

Corporate governance is generally in a constant state of change as graphically demonstrated by the trends in country and pan-country governance codes and guidelines issued over the last 20 years.

Alarm bells continue to ring in relation to the influence of the world's leading Scholars. Further research into the detailed preparatory work that results in their *Fatwa* and decisions is an essential next step. The time commitment of the Scholars as SSC Members is a material factor. Comparisons with Non-Executive Directors are valid, in that Non-Executive Directors, on average, would appear *prima facie* to spend significantly more time working for their institutions than do SSC Members.

#### **1.3 Analysis**

*Shari'ah* corporate governance has special features in addition to the commonly accepted components of corporate governance as applied to conventional banking and insurance businesses, namely the ultimate stakeholder, *Allah*, the Investment Account Holders and observance of the *Maquasid Al-Shari'ah* (which is that the goals and objectives of *Shari'ah* law are to support five essential benefits to human and community life on earth). It also contains inherent overarching features derived directly from the core principles of Islamic economics. Finally, *Shari'ah* corporate governance has a further defining overarching feature, which is that IFIs continue to operate within the institutional framework of a

conventional financial system. Mirakhor and Krichene (2009)<sup>1</sup> argue this is completely inappropriate as a regulatory and supervisory framework and challenge the industry to aspire towards a single global regulatory-supervisory framework for Islamic finance and insurance.

The OECD Principles and the Basel Principles continue to provide IFIs with two important and continuous governance reference points, but they provide real challenges. From the OECD Principles, levels of disclosure and transparency and legal responsibility are highlighted as areas to examine more closely. From the Basel Principles and the Walker Report, the absence of a *Shari'ah* expert on the Board, the in-house depth of *Shari'ah* expertise within the IFI and risk management as a whole are similarly highlighted.

The IFSB standards provide a very useful definition of a *Shari'ah* Governance System. The AAOIFI standards do not provide a formal definition of a *Shari'ah* Governance System, but the same components as are described in the IFSB definition can be equally deduced from the AAOIFI standards. Bank Negara Malaysia's New Framework (October 2010) has consolidated much AAOIFI and IFSB thinking into a single document. Although it only applies to Malaysian IFIs, it is the most recent of the published *Shari'ah* corporate governance standards and, therefore, represents some of the latest thinking on governance. It provides a valuable model or reference point for IFIs in other countries. The OIC *Fiqh* Academy and Muslim World League *Fiqh* Academy are very influential and, from time to time, issue recommendations on *Shari'ah* corporate governance.

An effective Corporate Governance System is made up of a number of distinct components. The framework diagram from the New Framework in **Table 7** is illustrative of this. As regards the various roles and responsibilities of personnel working within a *Shari'ah* Governance System, there are difficult issues relating to separation of powers, skills and competencies. Risk management, review, research and internal audit each require different sets of skills and competencies. Independence in relation to both the internal audit function and external audit function is paramount. Dusuki (2005), in his paper on CSR<sup>2</sup>, highlights the fundamental governance pathway that an IFI should be following both in principle and in practice.

To compare the various *Shari'ah* corporate governance standards is not an easy task. **Appendix 5** contains a series of checklists of the substantive principles covered in the different sets of standards. A quick comparison of AAOIFI and IFSB reveals a very different structure to each set of standards and each goes into similar topics in very different levels of detail. Both sets of standards provide rich material for any IFI seeking to produce a consolidated version. The tone of the AAOIFI standards is partly prescriptive. The tone of the IFSB standards is "comply or explain". The primary area of overlap between AAOIFI and IFSB is in the area of their guiding principles. In the GCC and North African region, also of relevance in terms of standards is *Hawkamah*, which makes a series of seventeen policy recommendations on *Shari'ah* Governance Systems in its Working Draft Policy Brief (August 2010).

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<sup>1</sup> Mirakhor A. and Krichene N. (2009) The Recent Crisis: Lessons for Islamic Finance. International Financial Services Board, IFSB 2nd Public Lecture on Financial Policy and Stability (November 2009), *International Financial Services Board* [http://www.ifsb.org/docs/OTHER\\_IFSB\\_Lecture02\\_Dr%20Abbas%20Mirakhor.pdf](http://www.ifsb.org/docs/OTHER_IFSB_Lecture02_Dr%20Abbas%20Mirakhor.pdf) (accessed on 25 August 2010).

<sup>2</sup> Dusuki A.W. (2005) Corporate Governance and Stakeholder Management: An Islamic Perspective. International *Shari'ah* Research Academy for Islamic Finance (ISRA), <http://www.isra.my> (accessed on 4 July 2010).

The influence of Malaysia globally within the Islamic finance and insurance community remains substantial, but its centralised system would not necessarily translate successfully to other jurisdictions, such as the GCC. But this may change in 2011 as AAOIFI is in the final stages of a plan recommending governments appoint panels of Scholars and experts at the national level to rule whether products are *Shari'ah* compliant. The new UAE Takaful law 2010 is a recent counter example of a more centralised model of governance in the GCC region. How the UAE Takaful industry develops from a governance perspective will be important to watch. Malaysia's influence is capable of increasing significantly further if, in relation to cross-border transactions, Malaysian laws were chosen by the majority of counterparties as the governing law of their Islamic transaction documents, in preference to the current choice of English laws. In September 2010, the Malaysian authorities announced their ambitions to become the world's leading hub for legal disputes in relation to Islamic contracts.

The design of the online survey was specifically influenced by the various components of a *Shari'ah* Governance System as set out in the standards of AAOIFI, IFSB and the OIC *Fiqh* Academy and, in relation to Malaysian IFIs, the New Framework.

#### **1.4 Survey and Results**

The analysis is based on data collected from 29 IFIs covering ten countries. The principal source of the data was either the head, or another senior member, of the IFI's *Shari'ah* department. Approximately two thirds of the IFIs answered online, while approximately one third submitted their responses by email.

Malaysia was the biggest provider of respondents (ten or 34.5%), followed by the UAE (eight or 27.6%) and the UK (three or 10.3%), with the GCC countries together (thirteen or 44.8%).

The main category of IFIs was Domestic Full-fledged IFIs (thirteen or 44.8%), followed by Domestic Takaful Operators (five or 17.2%) and Domestic Financial Institutions with Islamic Window (four or 13.8%). There were six Takaful Operators in total (20.7%).

A substantial majority of the IFIs were unlisted (20 or 69.0%).

KPMG is the leading auditor in terms of number of IFI clients (nine or 31.0%).

93% of Board members are male, with 7.0% female and 37.7% independent directors. The average SSC size is just under 4.2 SSC Members, with 0.3 female members. The overwhelming majority of SSC Members (27 or 93.1%) do not also have a seat on the Board.

24 IFIs (85.8%) have a formally appointed *Shari'ah* Secretary/Secretariat and 22 IFIs (75.8%) appoint SSC Members for a fixed term. An overwhelming majority of IFIs (27 or 93.1%) have no limit on the number of times a SSC Member can be reappointed. But for eight IFIs (27.6%) their head of compliance is not the *Shari'ah* Secretary/Secretariat.

The average length of service was 6.4 years for the longest standing SSC Member and 3.1 years for the most recently appointed SSC Member.

There is no single *Shari'ah* governance standard which is applicable on *Shari'ah* annual reporting. Various IFIs follow a combination of AAOIFI, IFSB and other standards.

The average number of meetings held by an IFI in its last full financial year was 7.9 and in its current financial year to date 5.9.

The average attendance rate for each SSC Member is generally high ranging between about 75% to 85%.

A significant percentage of SSC Members have been on the SSC for ten or more years. This ranges between about 50% to 55% for the first three SSC Members recorded. With regard to the number of overseas countries where a SSC Member sits on an SSC outside his/her home jurisdiction, the percentage of ten or more countries is also significant (41.2%).

There appears to be no strong correlation between total number of employees in the Islamic business and total number of SSC Members. Simple comparisons of different employee numbers indicate, *prima facie*, a substantial shortfall of available human resources within the *Shari'ah* compliance group and the audit/review group.

A significant minority of IFI's (twelve or 41.4%) indicated that the *Shari'ah* review/audit function is not independent from the ongoing compliance function.

The majority of IFIs (19 or 65.5%) indicated that they do not use external *Shari'ah* Advisory Firms to assist in the process of the annual audit/review.

Only fifteen IFIs (51.7%) responded with an approximate number of days (13.9) to start and complete the internal *Shari'ah* annual audit/review. Twelve IFIs (41.4%) indicated that audit/review is a continuous process throughout year and only four IFIs (13.8%) indicated that they are undertaken annually.

Only eleven IFIs (37.9%) responded with a relevant month in which the annual audit/review takes place. These were correlated to financial year end months in the case of ten IFIs (90.9%). These months fall either in the month immediately following the financial year end (four or 36.4% of total), in the same month as the financial year end (one or 9.1%), or three months before the financial year end (three or 27.3%).

In relation to where the *Shari'ah* risk management division/unit sits in relation to compliance, twelve IFIs (41.4%) indicated that no such formal division/unit exists. Only four IFIs (13.8%) have a completely separate internal *Shari'ah* risk management division/unit.

Fifteen IFIs (51.7%) do not have the research function as a separate function from general compliance.

The majority of IFIs (sixteen or 55.2%) indicated that there is a clear division of responsibility between the different parts of the internal *Shari'ah* compliance division/unit, but this is only just over half. Moreover, responses to various other survey questions indicate that the same *Shari'ah* employees are carrying out a range of distinct *Shari'ah* Governance System activities and the division of responsibilities may not be clear.

The main area which uses external *Shari'ah* Advisory Firms is the compliance division (seven IFIs or 24.1%), but other responses indicate that the use of external *Shari'ah* Advisory Firms is the exception, rather than the rule.

There is no "single model" of corporate governance as to whether the functions of audit and governance are combined in a single committee or performed by separate committees.

Ten IFIs (34.5%) indicated that the Nomination Committee has the duty to consider the appointment of the SSC Members while sixteen IFIs (55.2%) comprise those who principally responded that the Board has the duty.

The majority of IFIs (16 or 55.2%) indicated that it is primarily the Board, and not either the Audit Committee or a combined Audit and Governance Committee, which has the duty to review the various reports produced by the research division/unit, the audit/review division/unit and the SSC.

There are training programmes in only a minority of IFIs: 41.4% for the SSC; 13.8% for internal compliance; 17.2% for internal research and 20.7% for internal risk management

Twelve IFIs (41.4%) indicated that there is no formal assessment of the SSC Members and seven IFIs (24.1%) "Don't Know".

Nearly half of IFIs (14 or 46.4%) indicated that there is no succession planning programme for SSC Members and eight IFIs (27.6%) "Don't Know".

Nearly half of IFIs (14 or 48.3%) indicated that the SSC's pronouncements are not the intellectual property rights of the IFI.

## **1.5 Key Issues**

The time commitment of SSC Members appears to be a major issue, demands further investigation and needs urgently addressing.

This issue is inextricably tied up with the dominant position and multiple seats held by the leading Scholars in many SSCs globally. A significant percentage of SSC Members have been on the SSC for ten or more years. With regard to the number of overseas countries where a SSC Member sits on an SSC outside his/her home jurisdiction, the percentage of ten or more countries is also significant.

The SSC remains exclusively dominated by men, with very few women represented, save in Malaysia. As a result, IFIs do not benefit from the diversity which a mix of men and women on the SSC would bring to an IFI.

The overwhelming majority of SSC Members do not also have a seat on the Board. The absence of a *Shari'ah* expert on the Board is a major weakness in the governance system. Having at least one SSC Member on the Board would act as a valuable "bridge" between the SSC and the Board.

The New Framework provides that the number of SSC Members must not be less than five. The current average for all the IFIs surveyed is 4.2 SSC Members and for the Malaysian IFIs is slightly higher at 4.3 Members. This change will, therefore, see a material increase in the number of newly appointed Scholars to the Malaysian SSCs. One would expect this trend to be followed by other IFIs around the world.

The survey evidence indicates, *prima facie*, a substantial shortfall of available human resources within the various operational groups comprising the *Shari'ah* Governance System. The same *Shari'ah* employees appear to be carrying out a range of distinct *Shari'ah* Governance System activities and the division of responsibilities may not be clear.

The functions of *Shari'ah* review and internal audit are not made unequivocally clear in the AAOIFI and IFSB standards and are misunderstood by the majority of IFIs.

The nature of the different functions of *Shari'ah* governance each requires a particular set of skills and competencies, which may not be present in the same individual. The absence of specialists increases the risk of weak points emerging in the governance system.

Disclosures by IFIs to their shareholders, Investment Account Holders and Participants are so varied and there is much variety in accounting treatment between IFIs as to make comparative financial and other performance analysis very difficult.

Protecting the unrestricted Investment Account Holders's interests remains one of the main challenges of *Shari'ah* corporate governance.

The process of external audit is inherently weak with potential conflicts of interest and lack of independence.

IFIs appear not to be using *Shari'ah* Advisory Firms as much as might be expected for various *Shari'ah* Governance System activities that are better performed by external persons, rather than internal staff, for example, the annual compliance audit.

The absence in a substantial majority of IFIs of formal assessments of SSC Members by the Board and succession planning programmes for SSC Members is a major weakness in the governance structure.

The availability of training programmes for SSC Members and *Shari'ah* department employees is varied and another major weakness in the governance structure.

The current level of website disclosure and transparency is not of an acceptable and satisfactory standard and, furthermore, full-fledged IFIs are lagging their conventional competitors, which are operating Islamic windows, in providing *Shari'ah* compliant related information on their websites.

Standard Operating Procedures (SOPs) to cover products/transactions *ex post* launch are the "guardians of compliance", but they are not yet well developed in the majority of IFIs.

The gaps and conflicts in laws and regulations at country level, whether in common law or civil law jurisdictions, mean that many IFIs have to operate in conflict with the principles of *Shari'ah*.

## **1.6 Key Conclusions**

The author conducted face-to-face and remote interviews with a range of IFI industry experts. All of them agreed that *Shari'ah* corporate governance, in its broadest terms, continues to be the single most important current issue for the Islamic finance and insurance industries. There is no single model of *Shari'ah* corporate governance (one size does not fit all).

The Islamic finance and insurance industries do not currently have sufficient human capital to develop effectively to the next stage of their development. Much continued investment is needed to develop and promote *Shari'ah* Governance Systems to further the growth and global influence of Islamic finance and insurance as a principal source of ethical finance and insurance for Muslims and non-Muslims alike.

## 1.7 Key Recommendations

The recommendations are listed in **Table 62** in **Section 21** (not included in this extract) in order of priority, although attempting to prioritise them in any order was a difficult task. Actual improvements to the existing *Shari'ah* governance environments in which different IFIs operate will be achieved, in practice, by the recommendations being grouped together in different sets and then implemented together as a single set of measures, either consecutively or concurrently with other sets of measures. The sub-headings below are designed to suggest such groupings. The order of priority described above refers to the order of the sub-headings, rather than the order of the individual measures as listed.

### **Shari'ah Secretary (or Shari'ah Secretariat)**

Mandatory appointment of a person in the role of “*Shari'ah* Secretary” (or “*Shari'ah* Secretariat”). On this point, there should be 100% compliance by all IFIs.

The *Shari'ah* Secretary/Secretariat must ensure that the SSC has full access to the IFI's senior management for all the information he/she needs.

Mandatory disclosure on the IFI's website of his/her details in the same way that a company secretary to the main Board is disclosed. The role is of a paramount importance and these details should be visible to all stakeholders.

Mandatory disclosure on the IFI's website of details of the teams and functions supporting the SSC, with the name, contact details and profile of the relevant *Shari'ah* heads of department. These officers may be the same as or additional to the *Shari'ah* Secretary/Secretariat, but if their support of the work of the SSC Members is business critical, then their identities should be disclosed.

### **Board and SSC Relationship**

Boards to appoint at least one SSC Member to the Board to act as a “bridge” between the Board and the SSC.

Review of the terms of reference of each committee of the Board to understand fully the various interrelationships between the Board and all of its committees, and between the SSC and all of the Board's committees, and to identify whether governance as a whole would be better split out from the primary audit work of the Audit Committee into a separate Governance Committee.

### **Appointment, Re-appointment and Rotation of SSC Members**

Review of the whole end-to-end business process of appointment and re-appointment of SSC Members.

Rotation of SSC Members on a rolling basis after a term of between one and up to two/three years in order to release one seat to a new Scholar.

Rotation of the SCC Chairman on a regular basis.

### **Terminology and Definitions**

Each of the standards setting bodies to agree a common nomenclature in both Arabic and English for the description of the SSC.

### **Standards**

AAOIFI, IFSB and the OIC *Fiqh* Academy to review and amend their existing standards to make unequivocally clear the meaning of the different functions of review and internal audit. The New Framework provides a valuable model for the required changes.

Development of a composite set of the AAOIFI and IFSB standards combining the best of each to promote more effective comparison between the performance of different IFIs.

### **Risk Management**

Appointment of a Chief *Shari'ah* Risk Officer or equivalent.

### **Disclosures relating to the SSC**

Mandatory disclosure on the IFI's website of the *Fatwa* of the SSC, or at least edited versions of the *Fatwa* after removing any confidential information, as they should be made "available to the public" in accordance with applicable existing governance standards.

Mandatory disclosure of whether there are training programmes being undertaken by the SSC Members and the various *Shari'ah* departments.

Mandatory disclosure of whether there are formal assessments of the SSC Members annually by the Board.

Mandatory disclosure of whether there is a succession planning programme for the SSC Members managed by the Board.

### **SSC Member Meetings**

Case studies to monitor and understand the actual working practices at SSC meetings and to examine whether the attendance rate of SSC Members is improved by the use of virtual meetings or constrained because of the need to travel long distances for face-to-face meetings.

### **SSC Member Activities**

Case studies to analyse the specific activities and itineraries of SSC Members in more micro detail.

### **Roles and Responsibilities within *Shari'ah* Governance Systems**

Case study research to review how IFIs manage each component of a *Shari'ah* Governance System to identify the separation of powers and overlaps between employees and the level of misunderstanding as to the different governance purposes between review and internal audit.

### **Standard Operating Procedures (SOPs)**

A concerted drive by IFIs to prepare more SOPs to cover products/transactions *ex post* launch to serve as the "guardians of compliance".

### **Continuous Professional Development and Training**

Substantial investment in developing and training the human capital of IFIs and other key IFI stakeholders and prospective stakeholders.

### **Licensing System for Scholars and other *Shari'ah* Advisers**

Development of a globally recognised system of licensing *Shari'ah* Advisory Firms and *Shari'ah* Advisers.

Mandatory disclosure of the ownership and Board structure of *Shari'ah* Advisory Firms on websites and in applicable public registers.

### **Legal**

Amending the companies law at individual country level to offer IFIs and their customers a totally new form of corporate structure that is not a "classic mix" of equity share capital and debt, but has been best adapted to the founding principles of Islamic finance. The new "Islamic mix" might contain new classes of ownership and investment rights between, at the one conventional end, ordinary share capital and, at the other conventional end, unsecured debt.

Annual review of the legal enforceability of the IFI's contracts from both governing law and *Shari'ah* perspectives to ensure there is no conflict.

### **Shari'ah Advisory Firms**

Research to understand where external *Shari'ah* Advisory Firms are brought in to IFIs to plug which gaps in expertise and/or perform which activities.

Research into the roles of the big four accountants as *Shari'ah* Advisory Firms, given the potential for conflicts of interest in performing the external audit and providing other *Shari'ah* related services.

### **CSR Initiatives**

IFIs to undertake continuous promotional, educational and training programmes in their local communities to:

- a. improve the general dearth of knowledge of Islamic finance and insurance among students in schools, universities and others in higher education; and
- b. raise awareness levels of the increasing importance of Islamic finance and insurance business to the stability of the global financial system.

Senior management and Boards to encourage more women into the industry and support their elevation towards senior executive positions and governance roles.

Annual internal benchmarking of the IFI's CSR activities to Dusuki's five-level CSR continuum.

### **Special Overarching Recommendation**

All of the recommendations will stand a greater chance of sustainable success if one special overarching recommendation is followed. This is that full support and action must be given to the proposal of Mirakhor & Krichene (2009) to create a single global regulatory-supervisory framework for Islamic finance and insurance. While this may not be easily achievable without an incredible amount of hard work, it can nevertheless stand as an overarching mission of all those stakeholders of IFIs, who wish to develop and grow Islamic finance and insurance as a principal source of ethical finance and insurance for Muslims and non-Muslims alike.

**End of Section 2: Executive Summary.**

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