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International Convergence and Public Oversight of Accounting and Auditing Standards

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GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

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Outline

GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

Section 1: **Introduction**

Thank you Mr. Chairman for your introduction. I would like to also thank you, Mr. Scott and Ms. Ricol for your contributions to this public panel. I am actually honored to speak with this distinguished group of leaders in the profession.

Your excellencies, ladies and gentlemen:

As I was thinking of what to address this distinguished group, I thought this would be a good opportunity to take advantage of your presence here in Jordan – an Islamic country - to present the case of Governance of Islamic Financial Institution.

The Islamic world has had a somewhat long and proud tradition in Banking, and it is of particular significance to understand why we should start debating Governance in Islamic Financial Institutions.

- There are approximately 1.5 billion Muslims worldwide.
- A survey by HSBC shows that approximately 65% of Muslims in the United States stated that religious prohibitions would play a role in their financial decisions. Meaning that there is an increased need for banking
- There are more than 200 Islamic financial institutions operating in 48 countries. Islamic financial institutions are those institutions dealing partially or completely in Shariah complaint products.
- Islamic financial institutions combined assets exceed US$ 200 billion with an annual growth rate of 12% and 15%
- It is expected that Islamic banks will be able to attract 40% to 50% of the total savings of the Muslim population worldwide within the next few years.
- A number of global financial institutions including but not limited to, Citibank, Goldman Sachs, BNP-Paris-Bas and USB have established Islamic banking Shariah compliant services in many countries.

Accordingly, all of the interested parties - central banking authorities, individual banks, auditors, chief executives and finance officers need to get together to look at the whole Islamic culture and attitude which determines the environment within
which Islamic corporate governance is exercised.

I believe a document recently issued by the Organization for Economic Co-Operation and Development (OECD) would represent a sufficient framework for Islamic governance of financial institutions. This document entitled the "OECD Principles of Corporate Governance" lays out the priciples on which Corporate Governance is based:

- Ensuring the Basis for and Effective Corporate Governance Framework.
- The Rights of Shareholders and Key Ownership Functions.
- The Equitable Treatment of Shareholders.
- The Role of Shareholders in Corporate Governance.
- Disclosure and Transparency.
- The Responsibilities of the Board

Corporate Governance in General

While corporate governance was highlighted by the Enron affair it had been a matter of concern for many years before that again largely instigated by the collapse of major corporations. The phrase "corporate governance" refers to the processes and structure by which the business and affairs of the company are directed, and managed.

Every Islamic organization/group/corporate body is directed and controlled so we are not talking about introducing something which has not existed before. The question is not, therefore, whether you have corporate governance but rather whether it is good or bad as judged against what is seen as best practice. We will be discussing later what is currently regarded as best practice but two words can perhaps sum up what this is - "Independence" and "Stakeholders". The system should allow for the exercise of independent objective judgment without fear or favor by competent individuals who are aware of the legal and ethical responsibilities of the corporate body not only to its shareholders but also the other stakeholders such as employees, suppliers, customers, government and the Islamic society at large.

Advantages of Corporate Governance Standards

It can be, and indeed has been, argued that even without the pressures of government and its agencies through legislation and other means the case for good Islamic corporate governance is strong. A company with good corporate governance is much more sensitive to the needs and objectives of its stakeholders and builds greater confidence with them. It is a powerful weapon in the prevention of fraud and overall makes the company much more sensitive to the risk factors which affect the carrying out of its business. By reducing the perceived level of risk in the business it facilitates access to capital markets and improves the market acceptance of those who buy and sell its goods and services.

Anything which improves the situation i.e. reduces the perceived investment risk must be given serious consideration. Too high an investment risk leads to a lack of inward investment and an increase in the flow of outward capital. We all know that for many years Islamic communities around the world has been a net exporter of capital. What might our social and economic position have been today if the reverse had been the case?

Acceptable Standards for Corporate Governance That Could be Considered by Islamic Financial Institutions

There is of course no single recognized best model of corporate governance. However the key factors in assessing corporate governance in any organization usually involves an examination of:

a) The appointment, roles, responsibilities and accountability of the board of directors and those of the chief executive and other senior management and the authority, experience and independence of all.

For ease I will call these people the Directors whether they are legally such or not and

b) The compliance, control, and audit arrangements - both internal and External.

The Directors

Underlying all the various comments and suggestions on this issue, one underlying theme emerges. All individuals should be accountable and no one individual or group should be able to dominate decision making in the organization. This can be achieved by firstly establishing clear lines of responsibility and authority. Those for the Chairman should clearly distinguish his role from that of the Chief Executive. It should be exceptional that these two posts are held by the same individual. If so, good reason should be given and the other directors should review and report on this.

Secondly every board should have independent, directors with special responsibilities. We need to distinguish clearly between independent directors and non-executive directors. An independent director, by definition, must be non-executive. But a non-executive director need not be independent. The father or son of the Chairman might well be non-executive but could never be independent. Independent directors should be appointed for their ability and expertise and not simply because they are important relatives of the Chairman or customers or suppliers or "friends". They should always be particularly conscious of the obligations to stakeholders.

It is clear from developments in the USA and the UK that enhancing the role and quality of the independent directors is seen as a very important tool in the creation of good corporate governance. However it has also caused much controversy about how you determine independence and what precisely the independent director’s role should be. The appointment of large numbers of independent directors is not a solution which will instantly cure the ills of corporate governance. They have an important role to play and it may be a necessary condition for improving corporate government but it is not a sufficient one. Every organization needs clear and decisive leadership.

Thirdly the independent directors, or a committee of them, would be responsible for the remuneration packages of the chairman, chief executive and other executive directors. In terms of those individuals’ ownership interest, the potential impact on profits of such interest would have to be made clear on an annual basis.

Fourthly the Board of Directors and its Committees should be supplied with timely, relevant and appropriate information relating to all of the company's activities. Meetings should allow for sufficient time to discuss this information adequately. While the chairman of the meeting will set the agenda, all directors should have the right to comment on the agenda and request the inclusion of any matter. Directors should not be denied access to any employee if they so wish.

Compliance and Control Arrangements

A key factor in corporate governance is the monitoring of and the reporting on the internal control system.

Every board of directors should have an Audit Committee. This committee would be formed from the independent directors. It has been suggested that at least one of the members should be a qualified accountant. I would not like to be thought of as trying to create employment opportunities for accountants or auditors but certainly the members should be financially literate.

The Audit Committee would recommend to the Board of Directors the appointment of the external auditors and such appointment would be reviewed regularly. The external auditors and the internal auditors would report direct to the Audit Committee, which would in turn report annually on the state of the internal control system and its adequacy in light of current circumstances.

Many countries e.g. the USA and the UK are reviewing the external auditor's responsibilities and whether this should include a requirement to include in their report formal comments on the system of corporate governance. In some countries auditors are recommended to consider whether this should be reported on. While in other countries consideration is being given to making this a statutory requirement. In order to ensure the auditors are truly independent it has been suggested in the USA that for certain corporations - the very large and the major financial institutions - the auditors should not be appointed by the company shareholders or directors but rather by a special body established to carry out this task. It is worthy to mention that some Islamic countries mandate the rotation of auditors or the direct appointment of auditors for Development Fund organizations.

This is not unusual in the public sector where some form of independent commission appointed by the government determines who shall audit e.g. local governments and state owned enterprises.

The Importance of Communication

Underlying all our discussions will be the presumption that there is good communication between all of the interested parties i.e. the stakeholders.

This is easy to say but difficult to achieve. All businesses and banking in particular, have a long tradition of confidentiality and of concern about disclosing valuable information. Trust, including financial trust, is built around this. I am of course not suggesting that this should be weakened.

"My word is my bond" is a principle still strongly adhered to in the Islamic communities. However we do need to spend more time considering transparency and what and how we communicate. The answer is not producing longer and longer annual reports. Many are far too big already. We live in an electronic age where recording, updating and indexing of information can be done in an efficient manner.

This of course also applies as to how governments and their agencies communicate with all stakeholders.

The Impact of Culture

The main work on, and consideration of, corporate governance has taken place not surprisingly in the industrialized nations in the developed world.

While it is always wise to learn from such nations it is not wise simply to copy without giving consideration to the different Islamic concepts and culture which exist and how this might affect the acceptability and success of what is being considered.

Progress had been made in harmonizing and converging accounting and auditing standards around the world, but the most significant barrier to convergence of Islamic standards is the rightful adherence to the concepts Shariah (The Islamic Religious Law).

The Islamic governance practices should consider the application of many of the general characteristics of good practice for example the role of independent and non-executive directors, the power and authority of the chief executive.

It would be interesting to have a survey done in the Islamic world to see what the current position is for the impact of culture Islamic Institutions' governance.

Section 2: The Role of the Board of Directors , the Chairman , the Chief Executive/General Manager and Components of the Executive Management

In looking at perceived best practice for the roles and responsibilities of the Board of Directors, the Chief Executive Officer/General Manager we have seen that there is one overriding theme - all individuals should be accountable and no one individual or group should be able to dominate the decision making in the organization. A system of checks and balances should be in place based on clear lines of responsibility and authority.

All commentators agree that a major task for the Board of Directors is policy formulation so that a clear set of policies are available to the management.

The purpose of such policies is to achieve value for the owners and the other stakeholders by operating in an effective and ethical manner. Policy formulation is for the Board but policy implementation is not. This is the role of the Chief Executive/General Manager and the senior management team and the Board of Directors should not seek to duplicate this. The directors are of course required to monitor policy implementation to ensure that its policies are being followed.

Many believe that this cannot be achieved if the roles of Chairman and Chief Executive are combined even if this is common in practice as in the USA. However laws should be changed to prohibit the same person holding these two positions except in two cases. Firstly if the Board of Directors appoints the Chairman as General Manager it can only be for a limited period of time and has to be renewed each time that period expires. Secondly if the owners decide that the Chairman is the General Manager then it must be stated upon the founding of the company and written clearly in the company's articles. If the same individual holds both positions then there should be a clear statement as to why this is the case and what other steps have been taken to ensure that proper checks and balances are in place. It has been suggested that the main function of any Board of Directors is to appoint a Chief Executive/General manager and if this is so it would then seem odd that once appointed and until his departure the Chief Executive should then assume the mantle of Chairman. Much of Corporate Governance in many parts of the world seeks to find some way of stopping too much power being vested in one individual.

I believe that in terms of corporate governance at least equally if not more important is the role of the Directors in creating a climate of integrity, transparency, social responsibility and compliance within which the operation of the business takes place. How it is made and how it is used, however, have not to be improper as well.

The role of the Chairman of the Board of Directors is to ensure that, through his chairmanship, the Board carries out its duties and responsibilities efficiently, ethically and legally. However it has to be emphasized that each individual director has to exercise his function as a general director in a diligent and professional manner and has to ensure that timely and relevant information is received for this to be done. He should not be restricted in any way.

While the Chairman may well set the agenda for meetings any director must have the right to request that certain items should be included and the right of access to senior management. This is in addition to any specialist work a director is required to do on behalf of the Board such as serve on a Board Committee.

We will deal with the question of independent directors later. Many commentators and regulators list various functions and responsibilities. The Board of Directors monitors management on behalf of the owners, select and compensate and evaluate a well qualified and ethical Chief Executive Office, should not represent the interests of particular constituencies, act with integrity and commitment to the corporation, exercise diligent oversight over a corporation's affairs.

Specific responsibilities include planning for management succession, understanding, reviewing and monitoring implementation of strategic plans, understanding and reviewing annual operating plans and budgets, focusing on the integrity and clarity of financial statements and financial reporting, engaging outside auditors and considering independence issues, advising management on significant issues facing the corporation, reviewing and approving significant corporate activities, nominating directors and committee members and overseeing effective corporate governance.

All of us will have one view, and I suspect it is a common one, of the detailed role and responsibilities of the Chief Executive and Senior Management with different emphasis being placed on individual aspects.

The role of the Chief Executive and Senior Management is implementing policy decisions of the Board of Directors and carrying out the strategic objectives within annual operating plans and budgets which have been reviewed by the board. They take the lead in fashioning strategic plans which will achieve the board's objectives and present them to the Board for approval.

The CEO/GM is accountable for proposed policies, evolving and adapting implementations strategies in respect of Board-approved policies, initiating measures for business growth in short term. The CEO is expected to provide leadership by establishing style and spirit that enhances the image and reputation of the Islamic Financial Institutions.

Section 3: **The Role of Committees of the Board and those of Executive Management**

Before we look at this subject we should first of all spend a little time on the concept of the Independent Director. In recent years and in terms of corporate governance much emphasis is being placed on having on the Board of Directors a number of well-qualified people who are non-executive and totally independent in a personal and business sense of the organization and its executive directors and management. Indeed this seems to be the foundation upon which the whole concept of the monitoring of good governance is to be based. Some authorities argue that indeed a majority of the board should be independent and that one of them should be nominated as the senior independent director who would chair meetings of independent directors and would also be available to for example shareholders to hear any points of concern that they had. While an independent director has to be non-executive the other independence requirements have often been left to judgment and good sense.
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However, from my own experience, few directors in modern times have seen their interests as separate from those of the CEO, who effectively appointed them and presumably, could remove them from future slates of directors submitted to the shareholders.

We should always be reminded though that Boards of Directors and Senior Management are always authorized, explicitly or implicitly, to establish committees with delegated responsibilities. Good corporate governance will usually require at least the following - An Audit Committee, A Remuneration Committee, and a Nominating Committee.

Audit Committee

The Audit Committee is seen as the key vehicle for monitoring and reporting on corporate governance. It will usually be suggested that it be composed entirely of independent directors and that at least one should have financial experience. Its role would include monitoring of the financial statements, the internal control system, the internal audit function – with direct access to the internal auditor who if he does not report directly to the Audit Committee will be required to submit his reports to them and provide an annual assurance report, the external auditor's independence and effectiveness and their provision of non-audit services. It will also recommend to the board the appointment of the external auditors and also approve their terms of engagement and remuneration. The Audit Committee should also include a report to shareholders as part of the overall annual reporting system and its Chairman should be available to answer questions on this.

One of the most controversial subjects which over the years has periodically emerged is the extent to which the external auditors can be truly independent if at the same time they are providing other professional services such as taxation advice, management consultancy and so on.
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The audit firms have sought to alleviate the fears of independence by setting up independent firms and making certain that different people are involved. However it should be known that Enron and other corporate disasters have brought this subject to the table, and until this date, not specific legal requirements are mandated to prevent this type of conflict of interest.

Remuneration Committee

The Remuneration Committee should again be composed entirely of independent directors and as its name implies is concerned with determining the total remuneration package for the other directors and senior management. This would include targets for performance related pay packages, which do not reward failure, such as bonuses, ownership options, pensions, covering expenses of the Chairman and Chief Executive. The remuneration committee should work in a transparent manner by making public its terms of reference, the frequency of its meetings, and reporting annually to shareholders.

Nominating Committee

Lastly there is the Nominating Committee where again there should be a majority of independent directors. It is concerned with the whole process of how individuals are firstly appointed and then re-appointed to the Board of Directors or as Chief Executive/General Manager. This also includes the time requirements of the job and whether existing individuals are devoting sufficient time to it. Some of the most important aspects of its remit is succession planning, the structure and composition of the Board of Directors, and the nature and requirements of the position of Chief Executive.

Section 4: Conclusion

No one would of course argue against good corporate governance in all sectors in general and the banking sector in particular. The role of banking is so fundamental to our economic and social development that anything that tarnishes it has serious consequences for all of society. Social progress for Islamic communities only becomes a reality when we have progress and we are dependent largely on the business sectors industrial sectors for this. However this does not mean simply accepting the norms or standards that are currently used elsewhere without questioning as to how they will fit into the Islamic culture and traditions.

We need a cultural change in how we perceive the responsibilities of Chief Executives and Boards of Directors without at the same time impeding their determination to succeed and generate successful growth.

I would like to urge the Islamic financial intuitions, represented possibly by the Islamic Development Bank or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to further foster the establishment or strong rules of corporate governance and to work with IFAD, the SEC, OCED and others in this regard.

Knowledge is also an important requirement to both sides of the equation. The norms and the techniques of Islamic financing and contracting should be well known to international standard setters. As practically as possible, International Accounting Standards should take into consideration the boom in Islamic financial products and the increased demand on these products.

This is the challenge that faces all of us – accountants, bankers, and governments. Let us work together in meeting this challenge so that in the future we are faced much more with the problems of success rather than with the problems of failure.

Thank you for your time and for listening.

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