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CIBAFI BRIEFING

On Corporate Governance

This briefing on Corporate Governance Standards for Banks is published to advance CIBAFI's third Strategic Objective: "Awareness and Information Sharing." Its objective is to inform CIBAFI members and others on the recent updates to international standards and Islamic banking industry's corporate governance practices. This document will also identify key points from those updates that are relevant to the work of banks' directors, senior management, and other stakeholders.

During the summer of 2015, two important sets of Corporate Governance standards were updated and re-published. In July 2015, the Basel Committee on Banking Supervision (BCBS) published "Corporate Governance Principles for Banks", updating its October 2010 Principles for enhancing corporate governance, which were themselves an updated version of the original Principles published in 2006. In September 2015, the Organization for Economic Co-operation and Development (OECD) published "Principles of Corporate Governance", updating the version that appeared in 2004, which had been an update of the original Principles published in 1999.

The Basel and OECD updates are wider efforts, at both national and international levels, to strengthen and update standards on corporate governance. These efforts have included the publication of new codes and standards in many countries where Islamic banks play a significant role in the financial system. It is therefore timely and important to address the requirement of any distinctive corporate governance practices pertaining to the Islamic banking industry, particularly as the industry moves towards its formative stages to an established industry globally.

The Evolution of Corporate Governance Codes and Regulations

The principles and practices of good corporate governance have been part of the corporate landscape for decades, but they came into sharp focus in the early 1990s following the collapse of Polly Peck International and Maxwell Communications, two high profile British companies that were operated by dominant shareholders with little oversight from other directors or senior managers; and the closure of Bank of Credit and Commerce International (BCCI). All of these corporate failures were seen as being due in part to poor corporate governance and internal controls.

In 1991, a commission led by Sir Richard Cadbury was created to investigate the financial aspects of corporate governance. Although the commission was created before the failures of Maxwell Communications and BCCI (but after the failure of Polly Peck), Cadbury's report was able to take into account lessons from the failures of those two firms. The recommendations of the Cadbury Report were subsequently merged into recommendations produced by other commissions sponsored by the UK authorities (the "Hempel" report and the "Greenbury" report) and became known as "the Combined Code".

About CIBAFI Briefing

In line with the CIBAFI Strategic Objectives, CIBAFI is pleased to launch its first "Briefing". CIBAFI Briefing aims to keep its members and other Islamic financial institutions informed about certain issues, updates and practices in a specific areas of interest of the Islamic Financial Services Industry (IFSI). The key features of this document are:

- To present the most recent emerging issues and updates in the Islamic finance industry
- To address the issues in a solid, short, analytical way to be able to heighten the awareness amongst practitioners in IFSI
- To propose either a few key recommendations or a forward-looking analysis.

CIBAFI Briefing will be a need-based publication, covering the most relevant areas of the Islamic finance industry. Stay tuned!

In the United States, a series of corporate scandals in the early 2000s (including the failure of Enron, and accounting irregularities at WorldCom and Tyco International) led to the US Congress passing the Sarbanes-Oxley Act. This required directors to be actively involved in overseeing the company's operations, and Chief Executive Officers and Chief Financial Officers to attest the accuracy of their company's financial statements.

The global financial crisis of 2008 gave further impetus to the development of corporate governance standards: directors of banks were heavily criticized for failing to understand the risks to which their banks were exposed to and for failing to exercise stewardship over their senior managers.

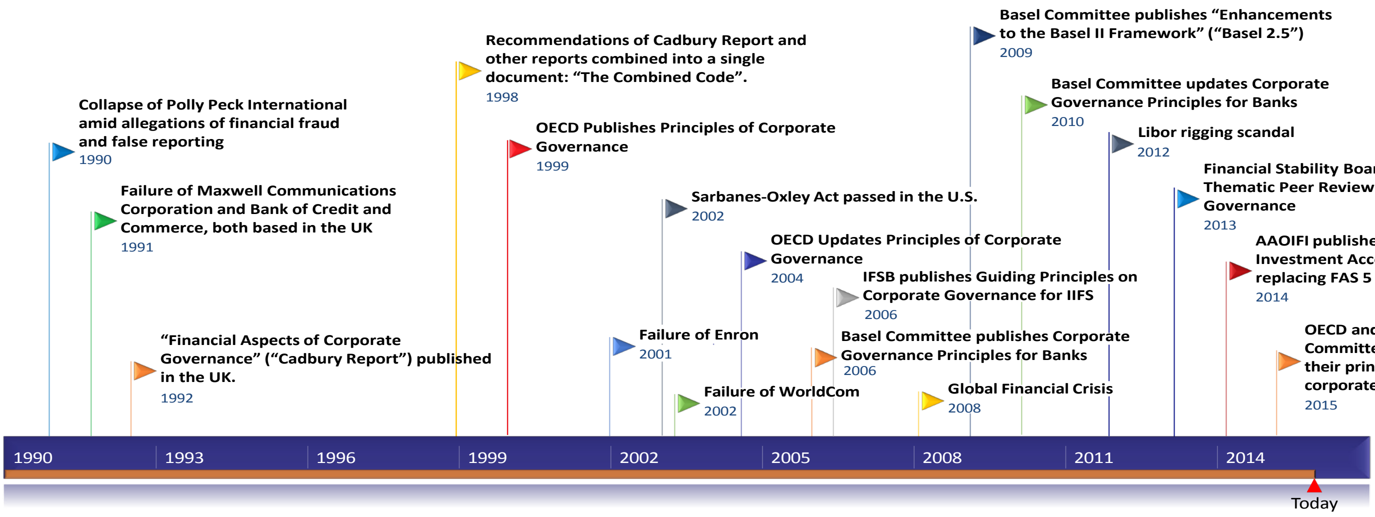
Outside the US, UK and other highly developed financial markets, there has been an increasing focus on corporate governance by both regulators and investors. In less developed financial markets, upgrading corporate governance is seen as an integral part of financial market development, as well as a tool to facilitate outside investment into domestic companies. Financial regulators in many emerging markets, including those in which Islamic banks play a significant role, have developed corporate governance codes in recent years. In 2006, the Islamic Financial Services Board (IFSB) issued a Guidance Note on Corporate Governance Principles for Institutions offering only Islamic Financial Services (IFSB-3). The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has also published a series of Governance Standards for Islamic financial institutions.

The 2015 Update to the OECD Principles

The OECD Principles of Corporate Governance are widely viewed as the foundation of modern Corporate Governance standards, applicable to all types of companies, whether small or large. The OECD Principles are heavily focused on the rights of shareholders and the role that they should play in the oversight of companies, but they also include recommendations on the responsibilities of the Board, and it is in this area that some of the most significant updates to the previous Principles can be seen. For example, the updated Principles are more prescriptive about specialized committees that the Board should create.

Where the 2004 Principles said that when committees of the Board are established, they should have clear mandates, the 2015 Principles suggest that all Boards should consider establishing audit committees and,

GLOBAL CORPORATE GOVERNANCE TIMELINE



depending on the company's size and risk profile, committees to oversee risk management and remuneration (IV.E.2). The updated principles also recommend, for the first time, that the Board should review its own performance and assess whether it has the right mix of backgrounds and skills (IV.E.4).

The updated Principles also give greater focus to the role that institutional investors, stock markets and other intermediaries can play in contributing to good corporate governance. The 2015 version contains a new Principle (I.D.) recommending that stock market regulation should support effective corporate governance.

OECD PRINCIPLES (6)

1. Ensuring the basis for an effective corporate governance framework
2. Rights and equitable treatment of shareholders and key ownership functions
3. Institutional investors, stock markets, and other intermediaries
4. Role of stakeholders in corporate governance
5. Disclosure and transparency
6. Responsibilities of the Board

The 2015 Update to the Basel Principles

The Basel principles on corporate governance are aimed specifically at banks rather than companies in all their forms. They also place greater weight on internal operations than the OECD principles, which are more concerned with the role that external factors, such as shareholders, investors and financial markets, can play in promoting good governance. The Basel Principles are therefore more directly relevant to the directors and senior managers of banks.

The 2015 update was prompted in part by ongoing developments in the field of corporate governance since the previous update, but, more specifically, it was also prompted by the findings of the Financial Stability Board's (FSB) THEMATIC REVIEW ON RISK GOVERNANCE, which was published in 2013. The FSB's thematic review was based on actual governance practices reported by leading international banks and by national regulators. Among the conclusions of the FSB's thematic review were that banks should establish more effective risk governance frameworks and take greater steps to secure independent reviews of the effectiveness of those frameworks; that the authority and independence of Chief Risk Officers (CRO) should be enhanced; and that national supervisors should engage more frequently with directors and with Board audit and risk committees.

Drawing on the FSB's review, and on broader developments in global corporate governance practices, the Basel committee made several changes in emphasis to its 2010 Principles. These include:

- *Re-enforcing the Board's responsibility to oversee the bank's risk governance;*
- *Re-enforcing the key elements of risk governance, such as risk culture, risk appetite and the relationship of these two to the bank's risk capacity; and*
- *Ensuring specific roles for the Board, the Board risk committee, senior management, and the control functions such as the CRO and internal audit.*

The re-definition of the Board's responsibilities in relation to risk governance is one of the most significant revisions that 2015 update makes to earlier versions. The First Principle – "Board's overall responsibilities" – contains a new section on risk appetite, management and control that addresses the Board's responsibility to develop a Risk Appetite Statement (RAS), to clearly define responsibilities for risk management and broad control functions within the bank, and to develop a strong risk culture. Whereas the 2010 Principles use terms such as "approve and oversee" to describe the Board's role in relation to a bank's risk strategy, risk policies and internal controls, the 2015 update says the Board should "take an active role in defining risk appetite" and "play a lead role in establishing the bank's corporate culture and values."

This re-positioning of the Board's role has implications for the types of directors who should comprise a bank's Board of Directors. If Boards are to follow Basel's updated recommendations, they will have to recruit directors who have more specialized knowledge of risk management.

Principle 2 of the 2015 updated version – Board qualifications and composition – contains much more detail than the previous documents. For example, after stating that Board members should have a range of knowledge and experience in relevant areas, it gives specific examples of what such 'relevant areas' could include: "capital markets, financial analysis, financial stability issues, financial reporting, information technology, strategic planning, risk management, compensation, regulation, corporate governance and management skills."

The 2015 update adds a new principle (9) on Compliance, reflecting the huge increase in laws, standards and other rules that now govern banking activity. The BCBS puts the compliance function unambiguously into a bank's 'second line of defense' alongside risk management (the first line being the business lines and the third being internal audit).

The 2015 update also stresses the responsibility of directors and senior managers to address 'conduct risk'. The update identifies bank misconduct, the mis-selling of financial products, the violation of national and international rules (such as anti-money laundering and economic sanctions), and the manipulation of financial markets as examples. Not an area of focus until recently, failures in these areas are now resulting in banks paying huge financial penalties. 'Conduct risk' is now seen as one of the major risks that banks face.

Basel Principles (13)

1. Board's overall responsibilities
2. Board qualifications and composition
3. Board's own structure and practices
4. Senior management
5. Governance of group structures
6. Risk management function
7. Risk identification, monitoring and controlling
8. Risk communication
9. Compliance
10. Internal audit
11. Compensation
12. Disclosure and transparency
13. The role of supervisors

Increased Regulatory Focus

Following the Global Financial Crisis of 2007-08, the BCBS published "Enhancements to the Basel II Framework" in July 2009. Commonly referred to as "Basel 2.5", the enhancements greatly expanded the recommendations in Basel II for how supervisors could strengthen their oversight of banks through the Pillar 2, the Supervisory Review Process. A new section, "Firm-wide risk oversight", sets much higher expectations for Board and senior management oversight than those contained in Basel II. For example, under Basel 2.5, supervisors will expect the Board and senior management to:

- *define the bank's risk appetite and ensure that its risk management framework includes detailed policies that set prudential limits;*
- *possess sufficient knowledge of all the bank's major business lines so that managers can ensure that policies, control and risk monitoring systems are effective; and*
- *to identify and review changes in firm-wide risks that could arise from new products and activities.*

Basel 2.5 also specifies that a bank's CRO, or equivalent position, should be independent of the business lines and report directly to the Chief Executive and to the Board. The enhancements presented as part of Basel 2.5 remain valid within the framework of Basel III.

Remuneration of Senior Managers

Pay and bonuses paid to senior managers has for several years been recognized as an important element in a bank's governance structure. Financial remuneration is one of the tools that the Board can use to provide incentives for managers to act in ways that are consistent with the risk appetite and the risk policies that it has defined. (Conversely, poorly structured remuneration can provide managers with incentives to act in ways that are contrary to the Board's policies.) The 2010 version of the BCBS Principles added two Principles (10 and 11) on "Compensation". They recommended that the Board should be actively involved in overseeing the bank's compensation system, and that employees' compensation should be aligned with prudent risk taking. Although the 2015 update does not add much to the 2010 Principles, national regulators, and banks themselves, have been trying to find ways to align compensation with risk policies. These efforts have had two key themes: limiting bonus payments; and deferring bonus payments, with the possibility of reducing them or taking them back if the assumptions that underlay them turned out to be false.

For example, in April 2013, the European Parliament approved rules that limit bonuses to 100% of fixed pay, with the possibility of raising this to 200% of fixed pay if shareholders give their approval. The rules also say that at least 40% of bonuses must be deferred for 3–5 years and that at least 50% of bonuses must comprise shares or instruments that can be converted into equity in adverse circumstances. These rules which are in force in all 28 members countries of the European Union apply to senior managers and risk takers, and any other staff who earn similar remuneration.

Bonuses are often seen as rewarding short-term performance or anticipated profits, rather than the creation of long-term value or actual profits. To mitigate this problem, banks are increasingly deferring bonus payments and opening the possibility that deferred bonuses could be cancelled. For example, in 2012, Lloyds Bank reduced the bonuses that had been awarded to some senior managers after it became clear that the bank would suffer large fines as a result of the way in which departments supervised by those managers had acted in previous years.

Governance standards for Islamic Banks

In 2006, the Islamic Financial Services Board (IFSB) published a Guidance Note on Corporate Governance for Islamic Banks (IFSB-3)[1]. IFSB-3 addresses four areas of governance: the general governance approach of Islamic banks; the rights of Investment Account Holders; the transparency of financial reporting in respect of such accounts; and compliance with Shariah rules and principles. Although the concepts of trustworthiness, transparency and accountability are deeply rooted in the Islamic principles, there is a need to align these with modern business and banking practices.

IFSB-3 gives references to the OECD standards (2004 version) and the Basel Principles (2006 version) and urges Islamic banks to comply with those of their recommendations that are applicable (though it does not give any guidance on applicability). Although IFSB-3 recognizes the role of the Board of Directors in steering the establishment of a bank's governance policy framework, it calls on the Board to establish a Governance Committee that in practice will oversee the implementation of governance practices.

Governance committees do feature in corporate governance codes that are aimed at conventional banks, but they are not a common feature and neither the OECD Principles nor the Basel Principles recommend the creation of a Board Governance Committee, preferring instead to place the onus for Corporate Governance development and implementation on the full Board.

The treatment of Investment Account Holders is a particular issue for Islamic banks and one which attracts considerable attention in view of the position that such investors hold between depositors (who are entitled to receive their deposit returned to them in full, but have no ownership claim on the bank) and shareholders (who are entitled to a share of profits and equity as a result of their ownership).

Several particular governance issues arise from this intermediate position between customer and owner. For example, although profits may be owned by the account holders, the bank (not the account holders) may choose to postpone the distribution of such profits in order to be able to maintain distribution in a year when the assets perform less well[2]. IFSB-3 offers recommendations on information that Islamic banks should disclose to Investment Account Holders and the role of the Governance Committee in overseeing the appropriate use of reserves in which the account holders have an interest[3]. Since the publication of IFSB-3 in 2006, considerable work has been done to define the rights of Investment Account Holders (IAH). Most recently, in December 2014, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued Financial Accountting Standard Number 27 on Investment Accounts (FAS 27).

The new standard replaced and updated two previous standards related to the accounting treatment of investment accounts. The main thrust of the updates is to clarify (and therefore, hopefully, standardize) the difference in the reporting of financial statements of restricted investment accounts (where banks play a fiduciary role) and unrestricted investment accounts (where the banks enjoy some authority over the deployment of funds). However, the focus is on accounting treatment, rather than governance. From a governance perspective (as opposed to an accounting perspective) the question of how to treat IAH can be seen as part of the broader corporate governance agenda that addresses the rights of shareholders and stakeholders, and the steps that companies should take to treat them fairly, including the level of disclosure and transparency they should enjoy. The OECD Principles address the treatment of shareholders (Section II) and the role of stakeholders (Section IV), while the Basel Principles address Risk communication (Principle 8) and Disclosure and Transparency (Principle 12). Of course, neither addresses the hybrid status of Islamic banks' Investment Account Holders.

Owing to their relative infancy in the global financial marketplace, Islamic financial institutions run a perception-risk to the shareholders and other stakeholders in providing expected returns which require robust corporate governance standards and practices of integrity, fairness and transparency. Unlike the Basel and OECD standards, IFSB-3 has not been updated to take account of lessons learned from the global financial crisis, nor, perhaps more importantly, the development of Islamic finance over the last ten years. For example, it was written before the growth in " Compliance" that occurred in banks worldwide in recent years. The position of a Compliance Function within an Islamic bank's Shariah Governance framework is important. Similarly, IFSB-3 was written before the increased focus in Risk Governance that is not a central feature of corporate governance standards for banks.

IFSB's Corporate Governance standards for IFIs (4)

General Governance Approach:

- Comprehensive Governance Policy Framework
- Reporting of financial and non-financial information that meets Shariah, and OECD and Basel principles

Rights of the Investment Account Holders (IAH):

- Monitor performance of IAH
- Adopt sound investment strategy for managing IAH

Compliance with Shariah rules and principles:

- Obtain Shariah rulings
- Comply with Shariah rules

Transparency of financial reporting

1. *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds.)*
2. *Among Investment Account Holders, an important distinction has to be made between " un-restricted accounts" which sit on the bank's balance sheet and over which the bank has discretion, and "restricted accounts" which are held off the balance sheet and over which the bank has fiduciary responsibility but no discretion.*
3. *Specifically, IFSB-3 recommends that holders of Restricted Investment Accounts should be able to obtain at least all the information usually available to participants in a Collective Investment Scheme (CIS), while holders of Unrestricted Investment Accounts should have access to all necessary information in respect of their accounts, and in particular the calclation and the investment policies of the bank.*

Key Messages

Since the Global Financial Crisis of 2007-08, corporate governance standards have been strengthened and made more detailed. Furthermore, banking supervisors have attached greater importance to governance during their prudential reviews. A consistent theme of this work has been that banks' risk governance should be strengthened, and that directors should be more heavily involved in risk governance. Directors are now being expected to be actively involved in developing their bank's Risk Appetite Statement, in clearly defining risk management and internal control responsibilities within the bank, and in developing a strong risk culture.

'Compliance' has become a significant area of any bank's internal control system and directors are responsible for overseeing the management of their bank's compliance risk. Within Islamic banking, more consideration has been given to the treatment of Investment Account Holders, with new accounting treatment being developed by AAOIFI. Shariah governance (which lies outside the scope of this paper) has also been developed. However, there is a need for the Islamic finance industry to update its broad corporate governance standards in the way that the Basel Committee and the OECD have done over the last ten years.

As a result, Islamic banks lack industry-specific guidance in areas such as Risk Governance and Compliance which are the key areas of focus globally, where the practices and needs of Islamic banks may differ from those of conventional banks. Those setting Corporate Governance standards for Islamic banks may wish to consider the following points:

- How should Corporate Governance standards for Islamic banks be updated to reflect the rapid development of Islamic finance over the last ten years?
- How, if at all, should Corporate Governance standards for Islamic banks be updated to reflect the lessons learned from the Global Financial Crisis of 2007-08?
- To what extent should the new global standards on risk governance be enhanced or amended to ensure that they are applicable for Islamic banks?
- How should the Shariah compliance function be aligned with the bank's compliance function, which is now a major feature of global governance standards for conventional banks?
- How should the role of Shariah audit be aligned with the enhanced role of Internal Audit within a bank?
- How should Islamic banks implement the new global standards on disclosure and transparency, in view of the enhanced disclosure that is generally considered appropriate for Investment Account Holders?
- How should Islamic banks in different jurisdictions adapt to the global corporate governance practices to meet their individual needs and objectives?

About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With nearly 120 members from over 30 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

Contact Information:

General Council for Islamic Banks and Financial Institutions (CIBAFI)
Jeera 3 Tower, Office 51, Building No. 657, Road No. 2811, Block No. 428
Manama, Kingdom of Bahrain. P.O. Box No. 24456

Email: cibafi@cibafi.org
Telephone No.: +973 1735 7300
Fax No.: +973 1732 4902
www.cibafi.org

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– **Corporate Governance Guidelines for Banks.**
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