ISLAMIC FINANCIAL SERVICES BOARD

GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR INSTITUTIONS OFFERING ONLY ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (TAKAFUL) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS)

December 2006
About the Islamic Financial Services Board (IFSB)

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org
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Deputy Chairman
Dr Mulya Effendi Siregar – Bank Indonesia

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<td>Mr Jameel Ahmed</td>
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Sheikh Mohamed Mokhtar Sellami

Deputy Chairman
Sheikh Saleh Al Husayn

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<tr>
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<td>Sheikh Mohammad Ali Taskhiri</td>
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<td>Sheikh Mohamed Hashim Bin Yahaya</td>
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* In alphabetical order

SECRETARIAT, ISLAMIC FINANCIAL SERVICES BOARD

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<td>Professor Simon Archer</td>
<td>Consultant, Capital Adequacy Working Group and Corporate Governance Working Group</td>
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<td>Mr Hamid Yunis</td>
<td>Taylor Wessing, United Kingdom and Consultant, Corporate Governance Working Group</td>
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# ACRONYMS

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<th>Full Form</th>
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<td>Basel Committee on Banking Supervision</td>
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<td>BOD</td>
<td>Board of Directors</td>
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<td>CIS</td>
<td>Collective investment scheme</td>
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<td>IAH</td>
<td>Investment account holder</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IFSB</td>
<td>Islamic Financial Services Board</td>
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<td>IIFS</td>
<td>Institutions offering only Islamic financial services (excluding (a) Islamic insurance (takaful) institutions and (b) Islamic mutual funds)</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>IRR</td>
<td>Investment risk reserve</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PER</td>
<td>Profit equalization reserve</td>
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<td>SSB</td>
<td>Shari'ah Supervisory Board</td>
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Bismillahirrahmanirrahim
Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālīhi wasahbihi

PREAMBLE

1. This document sets out seven guiding principles (hereinafter collectively referred to as the Guiding Principles) of prudential requirements in the area of corporate governance for institutions offering only Islamic financial services (IIFS) (excluding (a) Islamic insurance (takaful) institutions and (b) Islamic mutual funds). The Guiding Principles are divided into four parts:
   (i) general governance approach of IIFS;
   (ii) rights of investment account holders (IAH);
   (iii) compliance with Islamic Shari‘ah rules and principles; and
   (iv) transparency of financial reporting in respect of investment accounts.

2. The Guiding Principles are designed to facilitate IIFS in identifying areas where appropriate governance structures and processes are required, and to recommend best practices in addressing these issues. An annotation is annexed to this document as a source to assist IIFS in understanding the rationales and objectives of each of the Guiding Principles. This document also aims to empower stakeholders with better knowledge and awareness of governance issues surrounding IIFS by becoming an authoritative reference that can also be used as a monitoring and advocacy tool in promoting good governance in IIFS. The Guiding Principles are not intended to establish a new regulatory framework in addition to existing national legislation, regulations or codes; rather, they are intended to assist IIFS in enhancing their corporate governance frameworks, and to assist supervisory authorities in assessing the quality of those frameworks. The implementation of the Guiding Principles should be proportionate to the size, complexity, structure, economic significance and risk profile of the IIFS and the group (if any) to which it belongs. The application of corporate governance standards in any jurisdiction will depend on relevant laws, regulations, codes and supervisory expectations.

3. While an essential feature of IIFS is the requirement to comply with Islamic Shari‘ah rules and principles, this document only contains the prudential requirements that aim to ensure Shari‘ah compliance by IIFS as a matter of corporate governance. It is not to be understood as approving any specific Shari‘ah opinion or fatwā of any kind.

4. Certain corporate governance issues are of equal concern to all institutions offering financial services, whether IIFS or others. The IFSB acknowledges that many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices, which have been widely accepted as the international standards, and would be relevant and useful for IIFS. On this premise, the Guiding Principles do not intend to reinvent the wheel by proposing a wholly new

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1 Islamic insurance (takaful) institutions and Islamic mutual funds are excluded from the scope of this document, as they constitute different segments of the Islamic financial services industry. The Islamic Financial Services Board (IFSB) feels that it is more appropriate for governance issues of Islamic insurance (takaful) and Islamic mutual funds to be addressed in separate documents, and plans to undertake this are already under way.

2 For example, the widely recognized Principles of Corporate Governance promoted by the Organisation for Economic Co-operation and Development (OECD) (hereinafter referred to as the OECD Principles) – originally issued in 1999 and revised in 2004 – have been the primary reference in many jurisdictions when preparing a local corporate governance code to suit their market. The Basel Committee on Banking Supervision (BCBS) has published a document entitled “Enhancing Corporate Governance of Banking Organisations” (hereinafter referred to as the BCBS Paper) – originally issued in 1999 and revised in 2006 – which sets out sound practices and principles pertaining to corporate governance of banks, as an extension of the framework laid out by the OECD.
corporate governance framework. Instead, the Guiding Principles aim to complement the existing internationally recognized standards of good corporate governance by particularly addressing the specificities of IIFS.\(^3\)

5. It is well known that the fiduciary responsibility of IIFS towards their customers includes a primary undertaking by the IIFS to comply with Islamic \textit{Shar\'\i}h rules and principles at all times. In line with this unique characteristic of the Islamic financial services industry, the Guiding Principles call for a balanced approach by IIFS in seeking to create value for their shareholders while paying due attention to the interests of their other stakeholders.

6. The IFSB shares the opinion of the OECD and the BCBS that there is no “single model” of corporate governance that can work well in every country; each country, or even each organization, should develop its own model that can cater for its specific needs and objectives. Accordingly, this document shall be viewed as an evolving piece of work aimed at promoting efficient corporate governance that is goals-driven and goes beyond merely completing compliance checklists.

7. Despite undergoing a very rapid development in recent decades, it should not be forgotten that the Islamic financial services industry is still in its infancy. Any rigid, rule-based approach adopted in haste with the aim of strengthening the corporate governance of IIFS may jeopardize and hinder their potential and healthy growth. Furthermore, there is no hard and fast rule that can be applied in nurturing good governance culture in IIFS. Hopefully, by creating an enabling environment whereby IIFS are given an adequate timeline, encouragement and incentives, a good corporate governance culture will continue to strengthen and prosper within the Islamic financial services industry.

8. In complying with the Guiding Principles, IIFS shall ensure that all relevant disclosures made to the supervisory authorities or to the public comprise the following two components:

(i) In the first component, an IIFS shall report how it applies these Guiding Principles. IIFS may determine by themselves the form and content of their disclosure based on their own governance policies in the light of the Guiding Principles, including any special circumstances applying to them which might have led to a particular approach.

(ii) In the second component, an IIFS shall either confirm that it complies with the provisions of these Guiding Principles, or, where it does not so confirm, provide a clear and adequate explanation of the reasons for non-compliance.

Through this “comply or explain” approach, the implementation of these Guiding Principles should accommodate the diverse legal frameworks of the jurisdictions in which the IIFS operate and be commensurate with the size, complexity and nature of each IIFS.\(^4\)

9. While the Guiding Principles focus on addressing the relevant internal and external corporate governance controls from the perspective of IIFS, in order for the framework to be effective it must have the support of and be facilitated by the supervisory authorities.

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\(^3\) Correspondingly, the Guiding Principles find it appropriate to adopt the definitions of “corporate governance” and “stakeholders” from the OECD Principles and BCBS Paper with certain modifications to suit the context of IIFS. Please refer to page 27 of this document.

\(^4\) The “comply or explain” approach builds on the idea of market discipline, whereby stakeholders are empowered to react to unsatisfactory governance arrangements or substandard disclosures (which can be either false, substantially incomplete or misleading). The stakeholders’ sanctions may range from reputational damage for the IIFS, to loss of trust in the management – forcing some managers to quit, to legal actions based on contractual terms. Supervisory authorities particularly should have adequate enforcement instruments, from the power of directing necessary disclosures, to imposing reprimands and fines to curb deliberate serial non-compliances.
THE GUIDING PRINCIPLES

Part 1: General Governance Approach of IIFS

Principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders.

Structure and Process

10. IIFS shall establish a comprehensive governance policy framework which will guide them in cultivating a good governance culture. In its governance policy framework, the IIFS should be able to set out:
   (i) the strategic roles and functions of each organ of governance, including the Board of Directors (BOD), its committees, the executive management, the Shari'ah Supervisory Board (SSB), the internal and external auditors, etc; and
   (ii) the mechanisms of balancing the accountabilities of each of the organs of governance to various stakeholders.

11. As a first point of reference, IIFS shall embrace applicable recommendations from internationally recognized corporate governance standards such as the OECD Principles and the BCBS Paper. In addition, IIFS shall comply with the existing prudential circulars/directives issued by supervisory authorities. Subsequently, IIFS shall follow these Guiding Principles, as well as comply with Islamic Shari'ah rules and principles.

12. Each IIFS may tailor its governance policy framework to suit its business model; however, it should not ignore (whether deliberately or otherwise) the internationally recognized best practices. Instead, each IIFS shall strive for consistent improvement of its governance policy framework by continuous adoption of international best practices, such as the recommended best practices in the Guiding Principles, with the ultimate objective of making sound corporate governance a hallmark of IIFS.

Recommended Best Practices

13. The BOD of each IIFS, as the ultimate internal policy-maker, shall be responsible for steering the establishment of the governance policy framework. The BOD shall set up a Governance Committee, comprising at least three members, to coordinate and integrate the implementation of the governance policy framework. This Governance Committee may comprise, for example:
   (i) a member of the Audit Committee;
   (ii) a Shari'ah scholar (possibly from the IIFS’s SSB); and
   (iii) a non-executive director (selected based on the director’s experience and ability to contribute to the process).

   Any increase of membership in the Governance Committee should preferably be filled by independent non-executive directors rather than non-independent directors.

14. The Governance Committee shall be empowered to:
   (i) oversee and monitor the implementation of the governance policy framework by working together with the management, the Audit Committee and the SSB; and
   (ii) provide the BOD with reports and recommendations based on its findings in the exercise of its functions.

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5 In jurisdictions which adopt a two-tier system, the "Board of Directors" in this document shall refer to the "supervisory board" rather than the "management board".
15. The roles and functions of the Governance Committee shall not duplicate or overlap with the roles and functions of the Audit Committee. Indeed, the roles of the Governance Committee shall complement those of the Audit Committee in some of the governance functions, taking into account that:

(i) the Audit Committee already has a very demanding mandate and could be overburdened by its own primary responsibilities;

(ii) there could be some perceived conflicts of interest between shareholders and IAHs, especially where the funds are commingled, which could be difficult for the Audit Committee to deal with. If the Audit Committee monitors primarily from the standpoint of the shareholders’ interests and the Governance Committee monitors primarily from the standpoint of the IAHs’ interests, the scope of their duties and responsibilities would be clearer and more focused; and

(iii) the Governance Committee shall focus on the specificities of IIFS.

16. Consequently, in appointing members of the Governance Committee, the BOD shall ensure that each member is capable of making a valuable contribution to the committee. A diverse outlook and experience among members is desirable, since a uniform point of view could lead to over-emphasis in one direction. Therefore, the Guiding Principles support the view that:

(i) it would be preferable for an independent non-executive director to chair the Governance Committee. The Chairman of the Governance Committee should not only possess the relevant skills, such as the ability to read and understand financial statements, but should also be able to coordinate and link the complementary roles and functions of the Governance Committee and the Audit Committee;

(ii) it is necessary to include a Shari`ah scholar who is an SSB member for the purpose of leading the Governance Committee on Shari`ah-related governance issues (if any), and also to coordinate and link the complementary roles and functions of the Governance Committee and the SSB; and

(iii) the third member of the Governance Committee should preferably be an independent non-executive director who can offer different skills to the Committee, such as legal expertise and business proficiency, which are considered particularly relevant by the BOD for cultivating a good corporate governance culture, and deemed “fit and proper” by the supervisory authorities.

17. It must be emphasized that, as the primary objective of the Governance Committee is to protect the interests of stakeholders other than the shareholders, the Governance Committee shall not be treated as just another Board committee. Instead, the Governance Committee shall be accorded special attention by the supervisory authorities. In the event that there are differences between the Governance Committee and the Audit Committee, the BOD shall have the ultimate responsibility for reconciling those differences.

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6 Refer to paragraphs 19 and 20.
7 In a best-case scenario, each Board committee should have a different Chairman; hence, if possible, the Chairman of the Governance Committee should not be Chairman of another Board committee. However, it should be sufficient for a representative of the Audit Committee also to sit on the Governance Committee. This would allow the required understanding of financial issues to be addressed. Additionally, and preferably, the third member of the Governance Committee should not be a member of the Audit Committee or the SSB. Adopting such a recommendation allows the widest range of views to be expressed within the Governance Committee.
8 This is in line with the BCBS Paper, which requires that banking organizations shall have in place adequate policies to identify, prevent or manage potential conflicts of interest arising from their various business activities.
**Principle 1.2:** IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with Sharī'ah rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.

**Structure and Process**

18. As the Islamic financial services industry increases its activities and influences in the global financial framework, IIFS should abide by globally recognized reporting standards. IIFS shall therefore ensure that the reporting of their financial and non-financial information is in accordance with internationally recognized accounting standards, particularly those relevant to Islamic financial services. The importance of appropriate accounting processes for good governance should be appreciated by:
   (i) utilizing the work of accountants and consultants, and the findings of auditors, in a timely and effective manner to address any problems identified by them; and
   (ii) maintaining the independence of internal and external auditors, as well as the compliance function.⁹

**Recommended Best Practices**

19. The BOD of each IIFS shall set up an Audit Committee comprising at least three members (a chairman and two other members) elected by the Board from those of its non-executive members with relevant and adequate expertise in the analysis of financial statements and documentation. The Audit Committee shall be mandated to:
   (i) review and monitor the entire accounting process of the IIFS through close cooperation with the internal and external auditors; and
   (ii) provide the BOD with reports and recommendations with a particular reference to the IIFS’s compliance with internationally recognized accounting standards applicable to the Islamic financial services industry in reporting their financial and non-financial information.

20. The Guiding Principles hold the view that there is adequate guidance available in various documents on the responsibilities of an Audit Committee.¹⁰ These documents should be utilized in guiding IIFS so as to ensure that their Audit Committees are well equipped and supported to focus on their primary task, which is to oversee on behalf of the stakeholders the integrity of the financial reporting controls and procedures implemented by management. The Audit Committee shall regularly check with those responsible for the compliance function of the IIFS to ensure that the institution is in full compliance with applicable requirements.

21. The Audit Committee shall communicate and coordinate with both the SSB and the Governance Committee to ensure that information on compliance with Islamic Sharī'ah rules and principles by the IIFS is reported in a timely and adequate manner.

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⁹ While the definitions of “independence” for directors, internal auditors and compliance functions, as well as for the SSB, may vary somewhat across different jurisdictions, and are often reflected in regulations or supervisory standards, the Guiding Principles consider that the key characteristic of independence is the ability to exercise sound judgment after fair consideration of all relevant information and views without undue influence from management or inappropriate outside interests. The extent to which supervisory authorities establish stringent tests of either independence or non-independence for the respective organs of governance may depend, amongst other things, on the extent to which there is a party or parties who are in a special position to influence the IIFS in an abusive or manipulative manner.

¹⁰ See, for example, the BCBS Paper, the US Sarbanes-Oxley Act and UK Smith Reports – Audit Committees Combined Code Guidance 2003.
Part 2: Rights of Investment Account Holders (IAHs)

Principle 2.1: IIFS shall acknowledge IAHs’ right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.

Structure and Process

22. Conceptually, under the principle of Muḍārabah, IAHs as Rabb al-Māl bear the risk of losing their capital invested by the IIFS as Muḍārib. Effectively, this means the IAH’s investment risk is similar to that of the shareholders of IIFS who bear the risk of losing their capital as investors in the IIFS. However, the IIFS as Muḍārib owe a fiduciary duty to the IAH under the Muḍārabah contract, which is parallel with their duty to their shareholders. In this context, the IIFS as Muḍārib refer to both their management and their shareholders, not the management alone. Therefore, for the purpose of the Guiding Principles, discussions on the fiduciary duties of IIFS to the IAH shall always be understood as the fiduciary duties of both the management and shareholders of IIFS as Muḍārib towards the IAH as Rabb al-Māl.

23. In this respect, whether the investment mandate is restricted or unrestricted, under a Muḍārabah contract, the IIFS have a fiduciary duty to the IAH to uphold their interests no less than those of the IIFS’s own shareholders. In other words, although as investors in the IIFS’s assets the shareholders would rank pari passu with the IAH, they as a party in the Muḍārib side of the Muḍārabah contract also owe a fiduciary duty to the IAH and would have to ensure the protection of the IAH’s interests.

24. Hence, it is appropriate that IIFS put IAHs on an equal footing with the IIFS’s own shareholders by duly acknowledging the IAH’s right to access all relevant information in relation to their investment accounts. This would assist the IAH in making an informed decision on their selection or choice of the investment accounts in which to place their funds with the IIFS (for example, if the IIFS offer different types of restricted investment accounts). In a situation where the local legal framework is not yet capable of facilitating the exercise of these rights by the IAH, the supervisory authorities should play a role in protecting the interests of the IAH vis-à-vis the shareholders of IIFS with regard to their rights, provided that they are in compliance with Shari`ah rules and principles.

25. The IAHs’ right to monitor the performance of their investment should not be misconstrued as a right to intervene in the management of the investments by the IIFS. It shall be noted that shareholders of IIFS who are entitled to vote in general meetings, to pass resolutions on the appointment of directors and auditors, and to access the documents of the IIFS are also not considered as intervening in the management of the IIFS. Therefore, it is only appropriate that IIFS disclose to the IAH their policies and practices in respect of the investment accounts which they offer.

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11 Shareholders and IAH rank pari passu as residual claimants in regard to assets financed by funds commingled in the same asset pool. Where current account (unremunerated) funds are also commingled in the same pool, the current account holders rank as creditors in regard to the shareholders’ portion of the assets in the pool, but not in regard to the IAH’s portion. This follows from the nature of the Shari’ah-compliant contract on the basis of which the IAH funds are mobilized.

12 In some jurisdictions where the deposit-taking activity of IIFS is underlined by Wadiah (custodian trustee) or Wakālah (agency) principles rather than Muḍārabah, the IIFS still owe fiduciary duties towards the account holders and, as such, the recommendations of the Guiding Principles should still be of some relevance.
Recommended Best Practices

26. IIFS shall always be aware that with their fiduciary responsibility to the IAH comes accountability. They shall be prepared to be accountable to the IAH in ensuring that the investment accounts continue to be managed within the parameters of the given mandate. Before opening an investment account with an IIFS, IAH shall be adequately advised by the IIFS of their contractual rights and risks in regard to investment account products, including primary investment and asset allocation strategies and the method of calculating the profit/loss made from their investments.

27. In accordance with the Mudārabah principles governing the investment account contracts, it is only appropriate that IIFS recognize the IAHs’ right to monitor the performance of their investment and put in place means for this right to be exercised. The Governance Committee of the IIFS shall take responsibility for protecting this right of the IAH by ensuring that relevant disclosures to IAH are made in a timely and effective manner, as well as ensuring proper implementation of the investment contracts.

28. For illustrative purposes, the relationship between IAH and IIFS may be compared to that found in collective investment schemes (CIS), in which participants have mandated their fund managers to manage their investments. Both IAH and CIS participants:
(i) entrust their money to be invested and managed by a fund manager (that is, the IIFS in the case of IAH and the CIS operator in the case of CIS participants);
(ii) bear the risk of losing the capital of their investment; and
(iii) have very minimal rights in controlling the conduct of the fund manager; more often they would have to vote with their feet – that is, simply move their investment away if they find the fund manager’s performance is unsatisfactory.

29. Nevertheless, in most cases, at present CIS participants stand in a better position than the IAH, since securities regulation usually ensures that CIS operators meet stringent requirements before they can operate a CIS. CIS participants enjoy more rights – in particular, concerning their access to information. Furthermore, CIS participants often know the net asset value of their investments, which would allow them to dispose of the investments swiftly in a secondary market.

30. The Guiding Principles therefore require that IIFS shall have an internal guideline that sets out:
(i) the eligibility of the IIFS employees who are responsible for managing investment accounts operated by the IIFS;
(ii) the adequate protection of the IAH investments, including the case where the unrestricted IAHs’ funds are commingled with shareholders’ funds;
(iii) the disclosure of relevant and material information to the IAH; and
(iv) a proper and disclosed basis for profit allocation and investment policies to be based on the risk expectations of the IAH.

31. Restricted IAH shall have the right to obtain at least all the information usually available to participants of a CIS. Unrestricted IAH shall be allowed access to all the necessary information in respect of their investment accounts – in particular, the calculation and allocation of profits and the investment policies of the IIFS.

13 For example, CIS operators must furnish the CIS participants with a prospectus disclosing relevant information on the CIS before they are allowed to canvas for investments. The International Organization of Securities Commissions (IOSCO) has also issued principles which specifically require the disclosure of all fees and charges that may be levied by a fund manager under the CIS.
32. IIFS shall inform the IAH from the outset when opening their investment accounts that, in accordance with the principle of Muḍārabah, particularly in the event of liquidation of the IIFS:
   (i) the IAH shall only bear the loss in proportion to the assets funded by their investment;
   (ii) the IIFS shall be liable for losses arising from their negligence, misconduct or breach of their investment mandate; and
   (iii) the restricted IAH shall not be liable for any obligation to other parties arising from the deficiencies of the IIFS or its liquidity unless it is specifically related to the restricted IAHs’ funds. The unrestricted IAH shall only be liable for such obligations in accordance with the proportion of their share in the commingled funds.

33. For a better understanding of the issues and the impacts of their liabilities on IAH, IIFS should refer to the IFSB Capital Adequacy Standard. In addition, reference is drawn to Principle 4 on “Transparency of Financial Reporting in respect of Investment Accounts” for relevant recommendations.

**Principle 2.2:** IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.

*Structure and Process*

34. IIFS shall use their best endeavours to implement an investment strategy which is appropriately aligned to the risk and return expectations of the IAH as mutually agreed in the investment account contracts between the IAH and the IIFS, taking into consideration any restrictions that may be imposed by the IAH at the time of concluding the investment contract.

35. Arguably, IAH are generally seeking a low-risk investment with stable returns (employing a “defensive” investment strategy), whereas shareholders may favour a more aggressive and robust investment strategy offering higher returns with more risk. This may lead to a conflict of interest when IAH funds and shareholders’ funds are commingled. Smoothing of the IAHs’ returns may mitigate this problem, but does not fundamentally affect the underlying risk and may have negative effects on transparency.

36. Dividends paid out to shareholders are likely to differ from, and be more stable than, the profits (earnings) attributable to them, with the differences being added to or released from reserves. Similarly, the amount distributed to IAH as profit share may differ from their attributable share of the IIFS’s earnings. Many IIFS have adopted the practice of “smoothing the returns” (that is, the profit distributed) for their IAH and shareholders by using a special type of reserve, the profit equalization reserve (PER). Whilst the Guiding Principles take note of the fact that this smoothing practice may enable IIFS to pay a competitive rate of return in years when the IAHs’ profit rate, based on their attributable share of the IIFS’s earnings, is below the going market rate, there are concerns about the transparency and accountability of this practice. In particular, these concerns are:
   (i) the IAHs’ attributable share of profit earned and utilization of reserves – hence the IIFS’s profit performance for their IAH may not be adequately disclosed; and
   (ii) such practices may be used to mask the fact that the IIFS has invested IAH funds in assets with more risky returns than IAH would expect, rather than achieving stable returns for their IAH by adopting an efficient and appropriate asset allocation.

37. As with other types of reserves created for smoothing returns, the PER is also subject to the inter-generational problem. As the reserves are built up from setting aside a portion of
the profits available for distribution to existing IAH and shareholders, it could happen that some IAH who have forgone part of their profit share in years with above-average profits will never receive any benefit from this. This would happen if, throughout the tenure of their investment accounts, the IIFS never releases the funds from the PER to increase the distribution to the IAH. Instead, if those IAH close their investment accounts today and the IIFS decides to utilize the PER tomorrow for the next profit distribution, new IAH who may never have contributed to the PER at all will get to enjoy "unearned" benefits. The Guiding Principles take note that in the event that an IIFS has to be liquidated, the PER should be disposed of in accordance with what was agreed upon at the time of establishing the reserves, which commonly would be one of the following:

(i) distribution to the existing IAH and shareholders; or
(ii) donation to charities.

Therefore, the IIFS shall create practices, procedures and entitlements that adequately address any undesirable ambiguity in this area which could be ethically questionable and tantamount to gharar with regard to the PER. The IIFS shall appropriately disclose if the PER will not be distributed to the IAH in the event of liquidation.

39. Smoothing of returns distributed to IAH using the PER excludes turning a loss into a profit, for which purpose another special type of reserve, the investment risk reserve (IRR), may be used. Similarly, the inter-generational problem also arises in the case of the IRR, whereby IAH who actually contributed to building it up may not get any benefit from it, whereas IAH who may never have contributed to it may be the ones to gain from its existence. It should be noted that in the case of reserves attributable to shareholders, their magnitude is normally reflected in the market value of their shares, so that the inter-generational problem is avoided. There is no such effect on the market value of investment accounts of amounts held in the PER or IRR. Also, it should be noted that while in principle shareholders have some controls over an IIFS’s dividend policy and use of reserves, which have to be approved by them in the annual general meeting, IAH have no control over the use of reserves such as the PER and IRR.

Recommended Best Practices

40. In developing their investment strategy on behalf of IAH, IIFS shall carefully consider the risk and return expectations of IAH by:

(i) having an appropriate and systematic know-your-customer mechanism which can effectively reflect the different risk–return profiles of restricted and unrestricted IAH;
(ii) employing qualified investment managers who fully understand the needs and expectations of IAH; and
(iii) keeping the Governance Committee fully informed of the investment strategy adopted by IIFS, where appropriate.

41. The IIFS shall inform the IAH if the institution practises the smoothing of returns by means of building up and drawing on reserves such as a PER. The IIFS shall also inform the IAH whenever it transfers profits to such reserves, or draws on the reserves in order to enhance the profit distribution to IAH. Just as shareholders are entitled to be informed appropriately when a company makes use of reserves to pay dividends to shareholders, the IAH shall have the right to know when, because investments made on their behalf by the IIFS are not performing adequately, the returns distributed to them exceed the actual returns earned on investments because of upward smoothing.

42. In order to ensure that the utilization of PER is appropriate, the Governance Committee shall be mandated to scrutinize such utilization and to make appropriate recommendations to the BOD.
43. In addition, the IIFS shall clearly distinguish the “distribution rate” – that is, the rate of profit distributed – and the “profit rate” – that is, the actual profit earned from investments made on behalf of the IAH – in disclosing the returns to IAH. Effectively, the utilization of PER shall clearly be understood as being for “smoothing the dividend payout” rather than “smoothing the profits earned” for IAH.

44. Similarly, if the IIFS has created an IRR to cushion any unexpected loss on the part of the IAH, the utilization of IRR shall be placed under the scrutiny and subject to the recommendations of the Governance Committee to the BOD. Refer to Principle 4 for some disclosure requirements with regard to PER and IRR.
Part 3: Compliance with Sharī'ah Rules and Principles

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings from Sharī'ah scholars, applying fatāwā and monitoring Sharī'ah compliance in all aspects of their products, operations and activities.

Structure and Process

45. Inevitably, the diversity of Sharī'ah opinions will be a permanent feature of the Islamic financial services industry. It has been widely acknowledged within the industry that there are major requirements for new fatāwā as the industry progresses and faces contemporary challenges. Sharī'ah scholars in each locality should arrive at their own opinions that can address appropriately and effectively the specific problems of the ummah within their respective localities.

46. Initiatives on harmonization of fatāwā should continue to be pursued and applauded, as the industry in particular, and the ummah in general, can benefit from common understanding and cooperation amongst Sharī'ah scholars.

Recommended Best Practices

47. As Sharī'ah compliance is central in assuring the integrity and credibility of IIFS, and is one of the ultimate responsibilities of the BOD, the Board needs to establish a mechanism that can be mobilized swiftly and efficiently, as and when required, to obtain rulings from Sharī'ah scholars and monitor Sharī'ah compliance. The Sharī'ah scholars may be external or internal, depending on the requirements of the IIFS’s business model.

48. The mechanism for obtaining rulings from Sharī'ah scholars, applying fatāwā and monitoring Sharī'ah compliance shall cover:
   (i) both ex ante and ex post aspects of all financial transactions carried out by the IIFS – that is, to ensure Sharī'ah compliance of the contracts and, later, the performance of obligations under the contracts; and
   (ii) operations of the IIFS, including aspects such as Sharī'ah compliance review, investment policies, disposal of non-Sharī'ah-compliant income, charitable activities, etc.

49. Where appropriate, the IIFS shall inform the supervisory authorities about their mechanics of obtaining rulings from Sharī'ah scholars, applying fatāwā and monitoring Sharī'ah compliance, and make available the same information to the public.

50. For internal Sharī'ah compliance reviews, the SSB or Sharī'ah scholars of IIFS shall work together with either a separate Sharī'ah control department or the designated internal auditors/Sharī'ah reviewers. This would enable the SSB or Sharī'ah scholars to advise the Sharī'ah control department or designated internal auditor/Sharī'ah reviewers on the scope of audit/reviews required. As the Sharī'ah control department or designated internal auditors/Sharī'ah reviewers shall be responsible for producing the internal Sharī'ah compliance reports, they shall acquire the relevant and appropriate training to enhance their Sharī'ah compliance review skills.

51. For external Sharī'ah compliance reviews, the Audit Committee shall ensure as far as possible that the external auditors are capable of conducting, and do conduct, ex post Sharī'ah compliance reviews within their terms of reference.
52. To enhance public confidence in the Shari’ah scholars sitting in the SSB, the supervisory authorities may wish to consider steering the initiatives towards the establishment of a professional organization or an industry association for Shari’ah scholars serving the IIFS within their respective jurisdictions.\(^{14}\)

53. Alternatively, supervisory authorities may establish a “fit and proper” test that clearly and carefully sets out the criteria required prior to an IIFS appointing a Shari’ah scholar into its SSB. Again, the “fit and proper” criteria shall take into account factors that can strengthen public confidence in the SSB, such as academic qualifications, professional training, recognition by local and international peers of Shari’ah scholars, etc.

Principle 3.2: IIFS shall comply with the Shari’ah rules and principles as expressed in the rulings of the IIFS’s Shari’ah scholars. The IIFS shall make these rulings available to the public.

Structure and Process

54. Although the diversity of Shari’ah opinions might tempt an IIFS to adhere to the fatāwā of other Shari’ah scholars at the expense of differing fatāwā issued by the IIFS’s Shari’ah scholars, the IIFS shall not change their allegiance and obedience to fatāwā to suit their convenience. Such a practice could impair the independence of Shari’ah scholars and have a damaging impact on the integrity and credibility of the individual IIFS, in particular, and on the Islamic financial services industry as a whole. The adverse effect of such a practice on the reputation of the IIFS and the Islamic financial industry would be immense and difficult to repair. Therefore, the IIFS shall be transparent in the adoption and application of Shari’ah rules and principles issued by the IIFS’s Shari’ah scholars.\(^{15}\)

Recommended Best Practices

55. IIFS shall comply with the rules and principles issued by their Shari’ah scholars. These rules and principles shall be made publicly available through appropriate publication and communication channels.

56. An IIFS shall make available to the public, upon request, an explanation of any decision to adopt a fatwā issued by its Shari’ah scholars, whereby such explanation should be prepared in consultation with the Shari’ah scholars. Similarly, an IIFS should be prepared to provide a transparent clarification to the public should they decide to abandon a fatwā issued by its Shari’ah scholars.

57. Shari’ah scholars serving IIFS are encouraged to expose their fatāwā to the scrutiny of fellow Shari’ah scholars by publishing their detailed opinions. IIFS can also promote better awareness on the part of the public by publishing information on the fatāwā of their Shari’ah scholars on their websites. The IIFS may also allow customers to access the fatāwā issued by their Shari’ah scholars as part of their customer services.

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\(^{14}\) For example, as a preliminary step, supervisory authorities can establish a list of “approved” Shari’ah experts that are capable, experienced and qualified to be appointed as Shari’ah advisers or consultants to IIFS within their respective jurisdictions. When the list has become long enough, the Shari’ah scholars could form a self-regulated professional organization or an industry association under the patronage of the supervisory authorities.

\(^{15}\) In countries where there is a central fatwā-making authority, IIFS shall comply with the rulings made by such authority. If they have a reason to divert from complying with the rulings made by the central fatwā-making authority, this should be appropriately disclosed and explained to the public.
Part 4: Transparency of Financial Reporting in respect of Investment Accounts

Principle 4: IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Structure and Process

58. In line with the IAHs' right to monitor the performance of their investments, they should be entitled to be informed of the methods of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of their investment accounts.

59. In addition, the IAH and the public should be entitled to be informed of any related party transactions and treatment of material events by the IIFS. Adequate and timely disclosure of such material information is vital in developing transparency, accountability and a better risk management culture in IIFS.

60. Inundating IAH with information does not make IIFS more transparent. In fact, the opposite can be the case. In order to avoid information overload, the disclosures shall be made in a timely and orderly manner. The aim is not to disclose as much information as possible, but to provide relevant and reliable information that is crucial to the IAH in understanding and properly evaluating how their investment accounts are managed.

61. It is important to ensure that information is readily available in a comparable, understandable, readable and reliable form, so that it is easily accessible not only by IAH, but by information intermediaries for consumers such as the media, financial advisers and consumer associations. The information intermediaries are likely to use the information to draw attention to good and bad features more effectively than consumers would typically be able to do for themselves. This process would be helped by:
   (i) standardization of terms and language;
   (ii) comparable measures of, or ways of explaining, charges, risks, profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any); and
   (iii) easy access to such information – for example, through the Internet.

Recommended Best Practices

62. Information on the basis for profit distribution and allocation shall be provided to the IAH prior to the opening of the investment account, especially since under a Mudārabah contract the profit-sharing ratio must be declared in advance. Information that may change from time to time, such as significant changes in the investment strategies, should be included in the investment account statement issued to the IAH whenever there is any change made by the IIFS. Asset allocation shall be duly reported within the IIFS’s financial statements.

63. The utilization of PER for smoothing the returns to IAH and shareholders, as well as the use of IRR for covering losses (if any), is an issue of public interest and shall be publicized in major media organs as well as the IIFS’s annual report.

64. IIFS shall make an adequate and timely public announcement in their annual report, website and in mainstream media organs should they make any material changes to their policies in respect of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that they manage.
65. IIFS are encouraged to publish in their annual report a policy statement issued and affirmed by the BOD in respect of the investment accounts that they offer. In addition, it is recommended that IIFS make, in a form and medium accessible to IAH (for example, a public website and annual report), the other disclosures as recommended by the BCBS Paper, namely:

(i) information about the BOD – for example, bylaws, size, membership, selection process, qualifications, other directorships, criteria for independence, material interests in transaction or matters affecting the IIFS, and committee membership (including terms of reference and responsibilities, with particular reference to the Governance Committee or its equivalent, and the Shari’ah compliance function) and senior management (responsibilities, reporting lines, qualifications and experiences);

(ii) basic ownership structure – for example, major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management positions, shareholder meetings;

(iii) organizational structure – for example, general organizational chart, business lines, subsidiaries and affiliates, management committees;

(iv) information about the incentive structure of the IIFS – for example, remuneration policies, executive compensation, bonuses, stock options;

(v) the IIFS’s code or policy of business conduct and/or ethics (including any waivers, if applicable), as well as any applicable governance structures or policies (in particular, the content of any corporate governance code or policy and the process by which it is implemented, as well as a self-assessment by the Board of its performance relative to this code or policy);

(vi) where an IIFS is state-owned, an ownership policy that defines the overall objectives of state ownership, the state’s role in the corporate governance of the IIFS, and how it will implement its ownership policy; and

(vii) the IIFS’s policies related to conflict of interest, as well as the nature and extent of transactions with affiliates and related parties (which may be in aggregate form for routine financing facility to employees), including any IIFS matters for which members of the board or senior management may have material interests either directly, indirectly or on behalf of third parties.
RATIONALES AND OBJECTIVES OF THE GUIDING PRINCIPLES

Introduction

66. The Guiding Principles are designed to facilitate IIFS in establishing and implementing effective corporate governance practices. While Islamic mutual funds and Islamic insurance (takaful) institutions are excluded from the definition of IIFS, the Guiding Principles will be applicable to commercial banks, investment banks, finance houses and other fund-mobilizing institutions that offer only financial services and products complying with Islamic Sharīʿah rules and principles, as determined by the respective supervisory authorities.

67. The seven Guiding Principles of corporate governance here would have impacts on several aspects of corporate governance underlying the business practices of IIFS. They provide some examples of current practices, recognizing that these practices will and should change as markets change and as technology, financial engineering and improved coordination between supervisory authorities make other strategies available. However, the document does not detail every possible control procedure. The IFSB will keep these matters under review from time to time.

68. The Guiding Principles aim to complement the current corporate governance principles issued by the OECD, the BCBS and other international standard-setting bodies. The existing applicable international principles in respect of corporate governance have not been found to contravene or be incompatible, in general, with Islamic Sharīʿah rules and principles. Therefore, the IFSB considers it appropriate for these principles to be retained and their applicability expanded. However, the Guiding Principles primarily attempt to address specificities of IIFS which are not covered or given due consideration in other international standards.

69. The IFSB recognizes that the specific corporate governance practices of each IIFS will vary in scope and content depending on its activities. In certain countries, IIFS are exploring advanced corporate governance practices. The IFSB shares the opinion of the OECD that there is no single model for good governance, which is why the Guiding Principles do not set out detailed prescriptions in addressing all corporate governance issues. All supervisory authorities are encouraged to review their current recommendations, if any, in the light of the principles set out in the Guiding Principles.

70. Undeniably, different prudential regulations covering the aspects of capital adequacy, risk management, investor protection, transparency and market discipline, accounting practices, etc, would all have a corporate governance dimension with regard to the structure and business practices of IIFS. In this regard, the IIFS are expected to view compliance with these regulations from a holistic perspective.
Part 1: General Governance Approach of IIFS

Principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS’s accountabilities to various stakeholders.

Rationale

71. While the notion of “corporate governance” could be considered as a modern creation, the norms and values that are attached to this notion are already synonymous with Islam. Within its comprehensively prescribed way of life, Islam has always promoted good ethics, strong morals, unshakeable integrity and honesty of the highest order. The concern of the proponents of good governance that the separation of ownership and management of a firm may lead to an agency problem has long been addressed in the Qur’ān, which enshrines the importance of ethics not only in contracts and residual contracts but, ultimately, in accountability to God. The code of ethics that has been clearly set out in the Qur’ān includes:
   (i) honest fulfilment of all contracts –
       “O ye who believe! Fulfil (all) obligations.” (Al-Māidah: 1);
   (ii) prohibition of betraying any trust –
       “O ye who believe! Betray not the trust of Allah and the apostle, nor misappropriate knowingly things entrusted to you.” (Al-Anfāl: 27);
   (iii) prohibition of deriving income from cheating, price manipulation, dishonesty or fraud –
       “O ye who believe! Eat not up your property among yourselves in vanities. But let there be amongst you traffic and trade by mutual goodwill, nor kill (or destroy) yourselves; for verily Allah hath been to you Most Merciful!” (An-Nisā: 29);
   (iv) prohibition of bribery to derive undue advantage –
       “And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people’s property.” (Al-Baqarah: 188); as well as
   (v) a concern for minimizing problems arising from information asymmetry between contracting parties –
       “… Disdain not to reduce to writing (your contract) for a future period, whether it be small or big; it is juster in the sight of Allah, more suitable as evidence, and more convenient to prevent doubts among yourselves …” (Al-Baqarah: 282).

72. Accordingly, it is clear that an IIFS, as a corporate body governed by the principles laid out in Islam, must strictly fulfil its obligations to all stakeholders insofar as it operates within the confines of the Islamic Sharī‘ah.

73. In recent times, institutions which have no specific interest in the development of the Islamic financial services industry have taken forward initiatives in the development and propagation of corporate governance frameworks and best practices. However, if we can agree on a broad definition of “corporate governance” as “a set of organisational arrangements whereby the actions of the management of a corporation are aligned as far as possible with the interests of its stakeholders”,

16 S. Archer, “Corporate Governance of Islamic Banks”, a public lecture delivered at International Islamic University Malaysia on 14 April 2004.
difference could be that the Islamic approach has religious values and requirements of
the *Sharī‘ah* entrenched in it.\(^\text{17}\)

74. Therefore, in order to avoid “reinventing the wheel” in developing a set of corporate
governance best practices for IIFS, the OECD Principles and the BCBS Paper are among
the leading references that can provide useful guidelines. These documents have already
been the main source of references in many jurisdictions developing their own codes of
corporate governance.

75. The IFSB shares the governance philosophies subscribed to by the OECD and BCBS, as
they can easily accommodate the needs and requirements of different national
environments. In respect of investor protection, the OECD Principles lay down some
compelling viewpoints:

(i) *There is no single model of good corporate governance.* However, during the
development of the OECD Principles, some common elements that underlie
good corporate governance have been identified and the OECD Principles were
built on those elements and formulated to embrace the different models that
exist.\(^\text{18}\)

(ii) *The OECD Principles are non-binding and do not aim to provide detailed
prescriptions for national legislation.* Rather, they seek to identify objectives and
suggest various means for achieving them. Their purpose is to serve as a
reference point. They can be used by policy-makers, as they examine and
develop their legal and regulatory frameworks for corporate governance that
reflect their own economic, social, legal and cultural circumstances, and by
market participants as they develop their own practices.

(iii) *The OECD Principles are evolutionary in nature and should be reviewed in light
of significant changes in circumstances.* To remain competitive in a changing
world, corporations must innovate and adapt their corporate governance
practices so that they can meet new demands and grasp new opportunities.
Similarly, governments have an important responsibility for shaping an effective
regulatory framework that provides for sufficient flexibility to allow markets to
function effectively and to respond to expectations of shareholders and other
stakeholders. It is up to governments and market participants to decide how to
apply the OECD Principles in developing their own frameworks for corporate
governance, taking into account the costs and benefits of regulation.

76. While the BCBS Paper, like the OECD Principles, concedes that no single model can fit
into the various governance structures of banking organizations, it does highlight four
important forms of oversight that should be included in the organizational structure of any
bank in order to ensure the appropriate checks and balances. These are:

(i) oversight by the BOD or supervisory board;

(ii) oversight by individuals not involved in the day-to-day running of the various
business areas;

(iii) direct line supervision of different business areas; and

(iv) independent oversight of risk management and internal audit functions.

\(^{17}\) For some discussion on the definitions of corporate governance, see U. Chapra and H. Ahmed, “Corporate Governance in
Islamic Financial Institutions”, *Occasional Paper no. 6* (Islamic Research and Training Institute – Islamic Development
Bank, Jeddah, 2002).

\(^{18}\) For example, they do not advocate any particular BOD structure, and the term “board” as used in the OECD Principles
is meant to embrace the different national models of BOD structures found in OECD and non-OECD countries. In the
typical two-tier system, found in some countries, “board” as used in the OECD Principles refers to the “supervisory board”,
while “key executives” refers to the “management board”. In systems where there is a unitary BOD with oversight by an
internal audit body, the principles applicable to the BOD are also, *mutatis mutandis*, applicable to the internal audit body.
The terms “corporation” and “company” are used interchangeably in the text.
In addition, it reiterates the importance of having key personnel fit and proper for their jobs. It notes that government ownership of a bank has the potential to alter the strategies and objectives of the bank as well as the internal structure of governance. Consequently, the general principles of sound corporate governance are particularly beneficial to government-owned banks.

The recommendation for IIFS to have a Governance Committee whose functions are distinctly different from a conventional Audit Committee is made particularly because IIFS operate investment accounts which are not in the form of debt contract (as in the case of conventional fixed deposits), thus raising governance issues which have so far been overlooked. Conceptually, Muḍārib in the investment account contract comprises both the IIFS’s management and shareholders, not management alone. Consequently, an IIFS as a whole (that is, inclusive of both its management and shareholders) bears a fiduciary duty to the IAH. The significance of investment accounts as a source of funds for IIFS, and the unique fiduciary duties that come with them under the principle of Muḍārabah, certainly merits the establishment of a special organ of governance such as the Governance Committee.

**Objectives**

The IFSB assumes that IIFS have the best knowledge in terms of their own business model and corporate governance concerns. They should work out for themselves how improvements of various aspects of governance can facilitate the achievement of their strategic objectives. In order to remain competitive, IIFS need to ensure that their corporate governance policies and practices are benchmarked against internationally recognized corporate governance best practices and standards.

By having a comprehensive corporate governance policy framework, IIFS would be able to identify effectively the strategic roles and functions of each organ of governance and mechanisms for balancing their accountabilities to various stakeholders. The corporate governance policy framework should be effective, as it would have also taken into consideration the various elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are prevalent within a given country’s business environment, reflecting its needs and culture.

The process of developing such a comprehensive corporate governance policy framework could be a useful learning process for the IIFS, not just in improving their governance structure but also in increasing the technical expertise and in-depth knowledge of the IIFS with respect to their own business operations.

By having a tailor-made corporate governance policy framework, IIFS will help to inculcate a culture of transparency and accountability within their organizations. Even those IIFS which are not publicly listed entities must learn to expose themselves to reasonable public scrutiny as part of their duties and responsibilities in ensuring the stability of the financial system.

Adherence to a policy framework benchmarked against international best practices would also allow IIFS and other supporting institutions such as rating agencies to rate or rank their compliance with locally or internationally recognized corporate governance codes in a comparable manner.

Bearing in mind the importance of compliance with good governance principles to the health of IIFS, they must continue to strive towards improving their corporate governance and should not hesitate to exceed public expectations in order to achieve effective competitiveness and a strong reputation. In the context of systemic stability of the financial system, good governance of IIFS plays an important role in maintaining public
confidence in them, just like other financial institutions, as any action (or inaction) which indicates poor governance could trigger a run that can eventually affect the stability of the whole system.

**Principle 1.2:** IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Sharī‘ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.

**Rationale**

85. Amongst the most important lessons that can be derived from various corporate governance scandals around the world is that transparency and accountability should be embedded in the corporate culture of any corporation. In this respect, the IFSB recognizes that international accounting standard-setting organizations, as well as self-regulating professional bodies, have made tremendous efforts towards improving accounting best practices in response to corporate governance challenges, particularly in enhancing transparency and accountability.

86. With the advent of globalization, many countries are also ensuring that their financial and non-financial reporting standards are in line with internationally recognized accounting standards.\(^19\) As the Islamic financial services industry continues to grow within the global financial framework, the financial and non-financial reports of IIFS should also meet the globally recognized reporting standards.

**Objectives**

87. Through high-quality and transparent financial and non-financial reporting practices, IIFS would earn more credibility. The importance of such credibility for IIFS can hardly be overstated if the Islamic financial services industry is to avoid marginalization and to be well integrated into the global financial framework.

88. The adoption of IFRS or other international accounting and auditing standards depends largely on their recognition by the supervisory authorities, as well as by the relevant professional bodies in the respective jurisdictions. Hence, the IFSB urges such bodies to take a leading role in ensuring that the local accounting and auditing practices do not fall short of the international standards. If necessary, intensive education and training programmes should be undertaken in order to equip IIFS with the necessary technical knowledge and capacity to apply these international standards.

89. IIFS should support all initiatives and respond to calls to improve their accounting and auditing practices. For this reason, the IFSB strongly recommends, as best practice, the establishment of an Audit Committee by IIFS. In a survey carried out by the IFSB, it was noted that most IIFS have established an Audit Committee. In this respect, IIFS should ensure that their Audit Committee functions efficiently and effectively in addressing all their financial reporting and auditing concerns. For example, adequate written rules governing the overall audit functions – that is, for the Audit Committee and both external audit and internal audit – should be established and followed. The Audit Committee must also work very closely with the internal and external auditors in their routine review of the IIFS’s risk exposures and accounting procedures.

\(^{19}\) For example, the widespread adoption of the International Financial Reporting Standards (IFRS), including by the European Union, certainly indicates a strong trend towards harmonization of local accounting and auditing standards with the international standards.
Part 2: Rights of Investment Account Holders (IAHs)

Principle 2.1: IIFS shall acknowledge IAHs’ right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.

Rationale

90. A survey carried out by the IFSB revealed that there are more IIFS operating only unrestricted investment accounts than there are IIFS offering only restricted investment accounts or both types of investment accounts (restricted and unrestricted). The survey also indicated that none of the IIFS offering restricted investment accounts would allow an IAH to restrict his investment mandate in accordance with his individual risk appetite – that is, they offer "off the peg" investment funds, not funds “tailor-made” according to the preferences of the IAH. Although, understandably, investment accounts are often offered as “off the shelf” products without accommodating the specific risk appetites of potential IAHs, the issue of the fairness and transparency of the IIFS in managing the investment accounts gives cause for concern.

91. By providing IAHs with the right to monitor the performance of their investments and the associated risks, an IIFS is giving due recognition to the IAHs' interest and ownership of the funds (as 

Rationale

94. Adopting a sound investment strategy is a basic risk management tool that would not only mitigate any potential investment risks borne by an IIFS, but would also provide
opportunities for IIFS to tap a larger resource of funds from the public who have confidence in the investment strategy adopted by it.

95. The literature has highlighted the benefits and drawbacks of the practice of “smoothing the returns” by IIFS in the operation of the investment accounts by creating a PER. The main argument for such a practice is that it helps IIFS to remain competitive against the relatively stable rates of return offered by conventional banks. This argument could be valid, especially if IIFS consider themselves as merely offering a product which is perceived as a Shari’ah-compliant substitute for conventional deposits. However, its validity could be questioned if IIFS consider Shari’ah-compliant investment accounts as not just a substitute for conventional deposits but a truly different type of investment product. This fact has to be duly recognized, as in principle, IAH must bear the risk of losing their capital in accordance with the Shari’ah rules and principles of Mu’darabah (even if this risk is minimal because of sound investment management and an appropriate asset allocation strategy).

96. In addition to smoothing the returns to investment accounts, additional reserves have been built up to provide for the mitigation of unexpected losses. In some countries, IIFS have been specifically required to set up IRR to cater for this objective. 20

97. However, some have questioned the necessity of these practices when these concerns can be addressed by ensuring appropriate asset allocation. 21 Furthermore, as noted in paragraph 39 above, whereas in principle shareholders have some controls over an IIFS’s dividend policy and use of reserves (which have to be approved by them in the annual general meeting), IAH have no control over the use of reserves such as the PER and IRR.

98. In a survey carried out by the IFSB, it was found that only a small percentage of IIFS confirmed that they had practised smoothing of returns for the investment accounts. However, the IFSB are more concerned with the finding that some of the IIFS which operate PER and/or IRR have not informed their IAH that part of their share of profits from the investment accounts will be set aside into these reserve accounts. In fact, the results of our survey showed that none of the IIFS allows its IAH to choose not to have their returns “smoothed” via the PER.

99. Some of the IIFS that operate a PER for smoothing the returns to IAH admit to having used the reserves every year during the past five years to smooth the returns to the IAH. While this could indicate the importance of the PER in allowing IIFS to give returns to their accountholders that are very comparable to those paid by conventional financial institutions, it also raises the uncomfortable issue of whether such a reliance on reserves leads to a misconception on the part of IAH as to the actual performance of their investments.

100. The IFSB survey also revealed that no supervisory authority has issued specific guidelines or rules for the practice of smoothing the returns. In the absence of such guidance, some IIFS may want to refer to the relevant international financial reporting standards in respect of disclosures relating to investment accounts. However, it would be helpful if supervisory authorities could carry out a study of the practice of smoothing the returns within their respective jurisdictions and set out adequate guidelines or rules in this area.

20 For example, refer to Article 55 of the Banking Law of Jordan (Law No. 28/2000).
21 Archer, op. cit.
Objectives

101. By focusing on an efficient asset allocation strategy appropriate to the risk appetite of their IAH, IIFS would be practising good governance by aligning their actions with the interests of the IAH. They should not fail to ascertain and take account of the risk and return expectations of IAH even for unrestricted investment accounts, because that could amount to negligence, and IIFS are responsible for indemnifying IAH for losses if the losses are the result of their negligence.

102. Furthermore, reserves in the form of PER and IRR raise serious “intergenerational” problems between different time-cohorts of IAH, which raise further questions regarding the transparency and accountability of the IIFS. The issue of “ownership” of IAH funds is blurred by the operation of the PER and IRR. While the PER and IRR certainly work for the benefit of IIFS in terms of competitiveness and mitigating systemic risks, the benefits to the IAH are questionable. Obviously, the mechanics of PER and IRR strengthen the hand of those in control (that is, manager or Muḍārib) compared to those who mainly own the reserves (that is, IAH as Rabb al-Māl) and from a corporate governance point of view, this is a recipe for potential abuse.

103. Adequate and appropriate disclosures regarding the asset allocation and investment strategies of IIFS in respect of investment accounts and the utilization of PER and IRR would allow organs of governance such as the Governance Committee, Audit Committee and SSB to check and monitor the performance of IIFS as managers of the investment accounts. Similarly, such disclosure would enable other information intermediaries for consumers such as financial analysts and the media to play a more effective role in promoting market discipline.
Part 3: Compliance with *Sharī‘ah* Rules and Principles

**Principle 3.1:** IIFS shall have in place an appropriate mechanism for obtaining rulings from *Sharī‘ah* scholars, applying *fatāwā* and monitoring *Sharī‘ah* compliance in all aspects of their products, operations and activities.

**Rationale**

104. The establishment of a panel of *Sharī‘ah* scholars as advisers to the IIFS, commonly known as SSB, is the usual step taken by IIFS in putting in place appropriate *Sharī‘ah* advisory and monitoring functions to guide their business operations. According to a survey conducted by the IFSB, the majority of the IIFS have SSB either in the form of a panel comprising several members or an individual adviser.

105. Considering that the foundation of every IIFS is the offering of financial services in strict compliance with the requirements of Islamic *Sharī‘ah*, it would not be acceptable if any IIFS functioned without *Sharī‘ah* supervision of any sort. An IIFS bank without any access to *Sharī‘ah* scholars may not be able to distinguish itself as an institution that offers Islamic financial services and will not be able to attract investors and entrepreneurs who wish to invest their funds according to *Sharī‘ah* precepts. Hence, it is of primary importance for IIFS to understand that, only when they establish appropriate *Sharī‘ah* monitoring mechanisms would customers be convinced that the IIFS offer only *Sharī‘ah*-compliant financial products and the customers will become involved only in transactions that comply with the rules and principles of Islamic *Sharī‘ah*.

106. A particular aspect of *Sharī‘ah* compliance, which still appears to be generally lacking amongst IIFS is the conduct of external *ex-post* *Sharī‘ah* compliance reviews. In its survey, the IFSB found that only a small minority of the IIFS have external *ex-post* *Sharī‘ah* compliance reviews, even then mostly carried out by their governing central banks. The Audit Committee of IIFS should use their best efforts in ensuring that the external auditors are capable of accommodating *ex-post* *Sharī‘ah* compliance reviews (relying – where appropriate – on work carried out by internal auditors/*Sharī‘ah* reviewers) within their terms of reference. Where possible, the Audit Committee and the internal auditor/*Sharī‘ah* reviewer shall work closely with the external auditors to enhance the external auditors’ capabilities for conducting such *Sharī‘ah* compliance reviews as part of their audits.

107. The IFSB survey also indicates that a majority of the IIFS do have internal *Sharī‘ah* compliance reviews. Most IIFS have their internal auditor/*Sharī‘ah* reviewer carry out this review, while some have their SSB or *Sharī‘ah* compliance review function conduct it. This function may be carried out by an Audit Committee or Executive Committee, or by an internal set-up such as the Risk Management Department, Compliance Department, Investment Department, or *Fatāwā* and Research Department. In order to ensure that *Sharī‘ah* compliance reviews are conducted by competent and adequately trained professionals, the internal auditors/*Sharī‘ah* reviewers will be expected to carry out this task with the necessary competence.

**Objectives**

108. The rapid development of the Islamic financial services industry has created a need for specialization among *Sharī‘ah* compliance professionals. *Takaful* operations, for example, while based on many of the same principles, are nonetheless quite different from banking operations. The operations of commercial banks differ considerably from those of savings banks and investment banks. The Islamic financial services industry can
expect that in the future, there will be more specialized Shari'ah compliance monitoring or supervision, geared towards specific sectors within the industry, as it grows in size and sophistication.

109. By promoting a more professional approach in the provision of Shari'ah rulings, application of fatāwā and monitoring of Shari'ah compliance, the credibility and integrity of Shari'ah scholars as advocates and promoters of good governance can further be developed.

110. Although inevitably nowadays a small number of Shari'ah scholars have been providing their services globally, the current practice is considered far from professional because of some serious inadequacies, whereby in most jurisdictions:
(i) the criteria for recognizing a person as a qualified Shari'ah scholar is still vague; and
(ii) the means of checking the legality, credibility and validity of a Shari'ah ruling are still uncertain.
Considering the juristic nature of Shari'ah rulings and the legal implications they would have for the validity of contracts entered into by IIFS, the ultimate test for their legitimacy should be the admission of such rulings into a credible court of law. The IFSB notices that, for some IIFS, the fatāwā have legal force by virtue of the IIFS's constitution or statutes. However, in other cases, they do not; thus, from a legal point of view, the IIFS are not bound to follow the fatāwā. Accordingly, an IIFS must not enter into a contract which is not Shari'ah compliant.

111. Certain countries have a central SSB, recognized by the regulatory and supervisory bodies, to issue binding fatāwā. Nevertheless, so far, there is little evidence of the adoption of Shari'ah rulings by a credible court of law in resolving Islamic finance disputes. Even if there are some instances, more records of these are needed to ensure that the system is running smoothly and with reliable credibility.

112. We cannot set aside the idea that, in order to propel the Shari'ah compliance framework of IIFS to a higher level, it may be preferable to have a professional organization or an industry association that will set professional standards for Shari'ah scholars serving the Islamic financial services industry. Such a professional association might look after the interests of membership, and promote understanding and exchange through publications and regular forums. It could also establish relationships with relevant academic, commercial and professional bodies. The Islamic financial services industry appears to have matured to the point where such an association, which lay down a transparent and accountable structure for Shari'ah advisory services, would be of great value to everyone involved, whether as industry players or as consumers.

**Principle 3.2: IIFS shall comply with the Shari'ah rules and principles as expressed in the rulings of the IIFS's Shari'ah scholars. The IIFS shall make these rulings available to the public.**

**Rationale**

113. Modern Islamic financial services have evolved in many ways compared to practices during the early days of Islam. They continue to require fresh and innovative applications of Islamic Shari'ah rules and principles. Some Shari'ah scholars acting in advisory or monitoring roles to IIFS need to use their best knowledge and efforts in order to facilitate the development of the industry and not to hamper it, since too many restrictions and

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22 For example, refer to Article 58(a) of the Banking Law of Jordan (Law No. 28/2000).
23 For example, IIFS in Malaysia licensed under the Islamic Banking Act 1983 are required under section 13A of the Act to follow the rulings made by the Syariah Advisory Council established under section 16B(1) of the Central Bank of Malaysia Act 1958. Indonesia and Sudan also have a central fatwā-making authority for their Islamic financial services industry.
prohibitions may lead customers to the only other alternative – that is, a conventional financial institution. In this respect, those Sharī’ah scholars are expected to consider carefully the many schools of thought and diverse branches of opinions that can be relied on while issuing fatāwā. Just like any other professional advisers, such as lawyers and accountants, Sharī’ah scholars must strive to deal with the Sharī’ah compliance issues faced by IIFS to the best of their capability without neglecting the ethics of their profession and with due consideration for accountability to God as well as to the public.

114. Compared to their treatment of advice given by lawyers and accountants, IIFS must show a higher degree of respect to the opinions given by their Sharī’ah scholars. This is because the latter are entrusted to interpret Islamic Sharī’ah rules and principles and not man-made laws. Therefore, while it is acknowledged that genuine difference of opinions in interpreting Islamic Sharī’ah rules and principles is a blessing for the Islamic financial services industry, cynical “fatwā shopping” or “fishing for fatwās” – that is, asking Sharī’ah opinions from a variety of Sharī’ah scholars and then picking the most convenient opinion – cannot be considered an acceptable practice.

115. IIFS should realize that there is a reputational risk to be considered when they opt to follow certain Sharī’ah opinions at the expense of others. Hence, IIFS should be managing such risk carefully. Accordingly, they should consult the Sharī’ah scholars in preparing the relevant explanation to the public whenever they decide to adopt certain fatwās.

116. The potential abuse in such a practice might be aggravated by the presence of unqualified Sharī’ah scholars who falsely claim to have the necessary credentials, experience or knowledge to issue fatwās. Therefore, to enhance public confidence in them, it is appropriate that IIFS publish in their annual reports and on their websites details of the qualifications of Sharī’ah scholars who made the fatwās, how they were arrived at, and conditions for their applicability. This would not only cultivate cultures of transparency and accountability in IIFS but also among the Sharī’ah scholars, in line with the recommended best practices under Principle 3.1 which promotes a more professional approach in the provision of Sharī’ah-compliant advisory and monitoring services.

Objectives

117. An assurance by IIFS that they will uphold the Sharī’ah opinions of their chosen Sharī’ah scholars in the first place would enhance the reputation, honour and ethical reliability of Islamic financial services, in line with the Islamic teaching of honesty and integrity.

118. To safeguard the credibility and integrity of the Islamic financial services industry at large, and the IIFS in particular, the professionalism and independence of the Sharī’ah scholars must be upheld with the highest respect. Adequate and appropriate disclosure by IIFS allows organs of governance, such as the Governance Committee, and information intermediaries for consumers, such as financial analysts and the media, to check and monitor an IIFS’s compliance with Sharī’ah rulings issued by its Sharī’ah scholars.
Part 4: Transparency of Financial Reporting in respect of Investment Accounts

Principle 4: IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Rationale

119. The demand for transparency arises from a problem of asymmetric information. Transparency is “the opposite of secrecy”, as rooted in its connotations of honesty and clarity. In the context of good governance practices, transparency encompasses “self-disclosure” or “regulation by revelation” as a mechanism that facilitates the release of information about policies, capabilities and preferences.

120. In the capital markets, transparency tackles the issue of “opacity costs” that arises when a lack of information impairs market efficiency. The lower the level of transparency in information available to the market, the higher the transaction costs. Hence, a lack of transparency increases the cost of capital. Applying this scenario to investment accounts managed by IIFS (that is, a poor information environment), the lack of transparency could prevent potential customers from opening an investment account with an IIFS, thus reducing the IIFS’s capability to mobilize more funds.

121. Transparency contributes to the efficient allocation of resources by ensuring that IAH have sufficient information to identify risks and distinguish one IIFS from another. Most importantly, transparency helps to inform the IAH about what to expect from an investment account, thereby creating credibility and accountability.

122. Transparency completely fits into the requirement of Islamic Shari‘ah, as the Qur‘ān has specifically forbidden the concealing of evidence: “… Conceal not evidence; for whoever conceals it, his heart is tainted with sin. And Allah knoweth all that ye do.” (Al-Baqarah: 283).

This effectively means prohibition of the use of information asymmetry to gain unfair advantage in a transaction. Adequate and timely disclosure by IIFS to supervisory authorities, IAH and the public, of information on profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that they manage, manifests the willingness of IIFS to be accountable for their investment policies and decisions as Rabb al-Māl.

Objectives

123. By being transparent to supervisory authorities, IAH and the public on every aspect of the investment accounts that they manage, IIFS would help to educate IAH and the public on the risk and return profiles of investment accounts managed by them. This would duly distinguish the nature of investment accounts from conventional deposits. Ultimately, it would inculcate a culture of transparency and discipline among IIFS, and promote a good information environment, which would encourage efficient use of capital and reduce its cost.

124. Transparency also facilitates monitoring of compliance with obligations under the respective contractual and regulatory requirements of IIFS, thus helping to avoid disputes. Further, transparency is an important tool to foster fair and equitable competition in the Islamic financial services industry through allowing equal availability and access to vital information. All potential IAH should have the same access to information on IIFS offering investment accounts so as to have a level playing field in finding investment accounts which suit their risk appetite.
**DEFINITIONS**

The following definitions are intended to give readers a general understanding of the terms used in this document. It is by no means an exhaustive list.

<table>
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<th>Term</th>
<th>Definition</th>
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| Corporate governance                      | A defined set of relationships between a company’s management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which:  
  (i) the objectives of the company are set; and  
  (ii) the means of attaining those objectives and monitoring performance are determined.  
In the context of IIFS, good corporate governance should encompass:  
(i) a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders;  
(ii) provision of proper incentives for the organs of governance such as the Board of Directors, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and  
(iii) compliance with Islamic Sharī`ah rules and principles. |
| Investment risk reserves (IRR)            | IRR is the amount appropriated by the IIFS out of the income of IAH, after allocating the Muḍārib’s share, in order to cushion against future investment losses for IAH. |
| Muḍārabah                                 | A Muḍārabah is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed by the entrepreneur as the Muḍārib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Muḍārabah agreement, whilst losses are to be borne solely by the capital provider unless they are due to the Muḍārib’s misconduct, negligence or breach of contracted terms. |
| Profit equalization reserves (PER)        | PER is the amount appropriated by the IIFS out of the Muḍārabah income, before allocating the Muḍārib’s share, in order to maintain a certain level of return on investment for IAH and to increase owners’ equity. |
| Restricted investment accounts            | The accountholders authorize the IIFS to invest their funds based on Muḍārabah or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested. |
| Stakeholders                              | Those with vested interest in the well-being of IIFS, including:  
  (i) employees;  
  (ii) customers (including IAH and normal depositors);  
  (iii) suppliers;  
  (iv) the community (particularly the Muslim ummah); and  
  (v) supervisors and governments, based on the unique role of IIFS in national and local economies and financial systems. |
| Unrestricted investment accounts           | The accountholders authorize the IIFS to invest their funds based on Muḍārabah or Wakālah (agency) contracts without laying any restriction. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio. |