

FAQs on IFSB-3:

Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)

Q1. How many parts of the Guiding Principles are set in the Standard?

Answer: The Guiding Principles are divided into four parts:

- Part 1: General governance approach of IIFS;
- Part 2: Rights of investment account holders (IAH);
- Part 3: Compliance with Islamic Sharī'ah rules and principles; and
- Part 4: Transparency of financial reporting in respect of investment accounts.

Q2. What are the objectives of these guiding principles?

Answer: 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.

Q3. In complying with the Guiding Principles, how IIFS shall ensure that all relevant disclosures made to the supervisory authorities or to the public?

Answer: It comprises the following two components:

- 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;
- 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.

Q4. How IIFS shall establish a comprehensive governance policy framework which will guide them in cultivating a good governance culture?

Answer: In its governance policy framework, the IIFS should be able to set out:

- The strategic roles and functions of each organ of governance, including the Board of Directors (BOD),⁵ its committees, the executive management, the Sharī'ah Supervisory Board (SSB), the internal and external auditors, etc; and
- The mechanisms of balancing the accountabilities of each of the organs of governance to various stakeholders.

Q5. What is the recommended best practices for the Governance Committee in the IIFS?

Answer: This Governance Committee may comprise the following:

- Member of the Audit Committee;
- Sharī'ah scholar (possibly from the IIFS's SSB); and
- 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.

Q6. What is the recommended best practices for the mandate of the Audit Committee?

Answer: The Audit Committee shall be mandated to:

- Review and monitor the entire accounting process of the IIFS through close cooperation with the internal and external auditors; and
- 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.

Q7. What is the importance of the fiduciary duty for the rights of the Investment Account Holders (IAH) protection?

Answer: 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.

Q8. Based on recommended best practices, how is the relationship between IAH and IIFS?

Answer: 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:

- 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);
- Bear the risk of losing the capital of their investment; and

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.

Q9. What is the recommended best practices for the IIFS internal guideline in managing the IAH?

Answer: The Guiding Principles therefore require that IIFS shall have an internal guideline that sets out:

- The eligibility of the IIFS employees who are responsible for managing investment accounts operated by the IIFS;
- The adequate protection of the IAH investments, including the case where the unrestricted IAHs’ funds are commingled with shareholders’ funds;
- The disclosure of relevant and material information to the IAH; and
- A proper and disclosed basis for profit allocation and investment policies to be based on the risk expectations of the IAH.

Q10. How is the IIFS “smoothing the returns” paid to IAH?

Answer: IFS can adopt 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:

- 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

- 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.

Q11. What is the function of Investment Risk Reserve (IRR)?

Answer: This another special type of reserve used by IIFS as a cushion against the losses when the profit rate below the market rate.

Q12. What is the recommended best practices of strategy for IIFS to manage the risk and return expectations of IAH?

Answer: Three identified strategies for managing the risk and return expectations of IAH:

- Having an appropriate and systematic know-your-customer mechanism which can effectively reflect the different risk–return profiles of restricted and unrestricted IAH;
- Employing qualified investment managers who fully understand the needs and expectations of IAH; and
- Keeping the Governance Committee fully informed of the investment strategy adopted by IIFS, where appropriate.

Q13. What is the recommended best practices of the mechanism for obtaining rulings from Sharī`ah scholars, applying fatāwā and monitoring Sharī`ah compliance?

Answer: The mechanism shall cover:

- 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
- Operations of the IIFS, including aspects such as Sharī`ah compliance review, investment policies, disposal of non-Sharī`ah-compliant income, charitable activities, etc.

Q14. How the IIFS should behave in facing differing Sharī`ah opinions or fatāwā that are provided by the Sharī`ah scholars?

Answer: The IIFS shall not change their allegiance and obedience to fatāwā to suit their convenience. Such a practice could impair the independence of Sharī`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 Sharī`ah rules and principles issued by the IIFS's Sharī`ah scholars.

Q15. What is the recommended best practices for the IIFS to disclose the profit distribution for the IAH?

Answer: 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 Muḍārabah 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.

Q16. What is the recommended best practices for the IIFS to disclose the information in their annual report?

Answer: 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:

- 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 Sharī'ah compliance function) and senior management (responsibilities, reporting lines, qualifications and experiences);
- 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;
- Organizational structure – for example, general organizational chart, business lines, subsidiaries and affiliates, management committees;
- Information about the incentive structure of the IIFS – for example, remuneration policies, executive compensation, bonuses, stock options;
- 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);
- 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
- 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.

Q17. What is the scope of this IFSB Corporate Governance Guiding Principles?

Answer: 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 Sharī'ah rules and principles, as determined by the respective supervisory authorities.

Q18. How this IFSB Standard complements international best practices Standard such as Basel Committee of Banking Supervision (BCBS) and The Organisation for Economic Co-operation and Development (OECD)?

Answer: 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 Sharī'ah 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.