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ABOUT CIBAFI

The General Council for Islamic Banks and Financial Institutions (CIBAFI) is an international organisation established in 2001 and headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC).

CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives.

With over 120 members from more than 32 jurisdictions, representing market players, international and intergovernmental organizations, professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.

In its mission to support the Islamic financial services industry, CIBAFI is the leading industry voice advocating regulatory, financial, and economic policies that are in the broad interest of our members to foster the development of the Islamic financial services industry and sound industry practice. CIBAFI is guided by its Strategic Objectives, which are: 1) Policy, Regulatory Advocacy, 2) Research and Publications, 3) Awareness and Information Sharing and 4) Professional Development.

ABOUT THE WORLD BANK

The World Bank Group comprises five institutions which share a commitment to reducing poverty, increasing shared prosperity, and promoting sustainable development. The five institutions are: the World Bank, including the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA); the International Finance Corporation (IFC); the Multilateral Investment Guarantee Agency (MIGA); and the International Centre for Settlement and Investment Disputes (ICSID).

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ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
CEO	Chief Executive Officer
CGI	Corporate Governance Index
CIBAFI	General Council for Islamic Banks And Financial Institutions
CRO	Chief Risk Officer
EA&P	East Asia and Pacific
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
IAH	Investment Account Holders
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
MENA	Middle East and North Africa
OECD	Organisation for Economic Co-operation and Development
ROSCs	Reports on the Observance of Standards and Codes

Note: All dollar amounts are in U.S. dollars.

FOREWORD

The General Council for Islamic Banks and Financial Institutions (CIBAFI) and The World Bank are proud to present this report on Corporate Governance Practices in Islamic Banks. CIBAFI and The World Bank have been working closely together to develop the Islamic finance industry under a Memorandum of Understanding (MoU) signed in July 2015. One of the first outcomes of the MoU was a joint conference organized in Amman, Jordan in September 2015, titled "Corporate Governance for Islamic Financial Institutions: Lessons from Recent Global Developments."

In March 2016, CIBAFI published a Briefing Note on Corporate Governance that drew attention to important developments in the field in recent years, and the need to update standards on corporate governance for Islamic banks to take account of those developments.

CIBAFI and The World Bank agreed that there was a need for a robust analysis of current corporate governance practices within the Islamic banking industry. Such an analysis would serve as the basis for further work in the field of corporate governance by generating policy recommendations that would then prompt practical steps to strengthen areas of governance that are currently weak.

The study underlying this report breaks new ground in the field of corporate governance for Islamic banks. Its methodology is academically rigorous. Its findings and conclusions are easily accessible, and they have clear implications for the day-to-day governance of Islamic banks.

The report will also serve as a benchmark for future work, enabling the industry to track its progress, particularly in the areas that have been identified as those most in need of improvement.

We hope that this report will be read widely within the Islamic financial industry, by individual institutions seeking to improve their own governance practices and by regulators who are looking to strengthen the financial systems that they oversee. But we also hope that it will be read widely outside the Islamic financial industry. As Islamic banks become an increasingly important sector within the global banking community, it is important that conventional financial institutions, and their regulators, policymakers, and stakeholders are able to understand the strengths and weaknesses of the Islamic banking sector, and also to see the progress that it is making.

The publication of this report is not the end of a journey, but a beginning. It is a starting point for new policy initiatives and practical actions that will see Islamic banks strengthen their corporate governance practices, leading, in time, to strengthening financial systems and economies.

Sincerely,

Abdelilah Belatik
Secretary General
CIBAFI

Alfonso Garcia Mora
Director, Finance and Markets Global Practice
The World Bank

ACKNOWLEDGMENTS

Corporate Governance Practices in Islamic Banks is a collaborative study of the General Council for Islamic Banks and Financial Institutions (CIBAFI) and The World Bank.

We are grateful to those who have contributed to making the publication a success. In this regard, we would like to extend our special thanks to Dr. Abdurrahman Yazici, Aziza Yarlaeva, Dr. Mahmoud Al Homsi and Syed Siddiq Ahmed of the CIBAFI Secretariat; Abayomi A. Alawode, Head of Islamic Finance, Finance & Markets Global Practice, Abdulaziz Alsaiari, Financial Sector Specialist, Ayse Nur Aydin, Financial Analyst, Zamir Iqbal, Lead Financial Sector Specialist, and Fatih Kazan, Financial Sector Specialist with the Finance and Markets Global Practice at The World Bank; members of the CIBAFI Members Consultative Group; and Andrew Cunningham, Prof. Habib Ahmed and Peter Casey, CIBAFI-The World Bank consultants, for their contributions and reviews throughout the various stages of this publication.

This publication also benefited from the deep review and comments of Dr. Adam Ng, of the International Centre for Education in Islamic Finance; Abdulkareem Sukkari of the Islamic International Arab Bank PLC; Dr. Mohammed Burhan Arbouna of Al-Salam Bank-Bahrain; and Dr. Ahmet Faruk Aysan of the Central Bank of Turkey.

CIBAFI and The World Bank would also like to express their appreciation to the Centre for Excellence in Islamic Finance in the Institute for Business Administration, Karachi, Pakistan, and the Centre for Islamic Finance at Lahore University of Management Sciences, Lahore, Pakistan, both of which provided research support for the project.

It is hoped that this report will provide a clear picture to bank directors, senior management, and other stakeholders in the global Islamic finance industry with respect to various issues, challenges, and opportunities facing Islamic banks across jurisdictions to encourage the advancement of the Islamic financial industry.

Sincerely,

CIBAFI and The World Bank

EXECUTIVE SUMMARY

The General Council for Islamic Banks and Financial Institutions (CIBAFI) and The World Bank have collaborated to produce this report on Corporate Governance Practices in Islamic Banks.

It is well established that good corporate governance strengthens institutions and financial sectors, and in so doing contributes to building strong economies and economic growth.

Deficiencies in corporate governance were among the factors that contributed to the global financial crisis (GFC) of 2007–08. As a result, global standard setters such as the Basel Committee on Banking Supervision (BCBS) and the Organisation for Economic Co-operation and Development (OECD) have been updating and strengthening their guidelines on good governance practices.

The Islamic Financial Services Board (IFSB), which sets standards for Islamic financial institutions, published its Guiding Principles on Corporate Governance in 2006 as its standard IFSB-3. The Principles address, within the context of corporate governance, the distinct features of Islamic banks, such as the different relationship that they have with some of their stakeholders.

METHODOLOGY OF THE REPORT

Corporate governance issues for Islamic banks include those that are common to Islamic and conventional banks, and those that are unique to Islamic banks. After reviewing the literature related to corporate governance in general and Islamic banks in particular, this study focused on six themes within corporate governance: the Board of Directors; Board Committees; Internal Control and External Audit; Risk Governance; Shariah Governance; and Transparency and Disclosure.

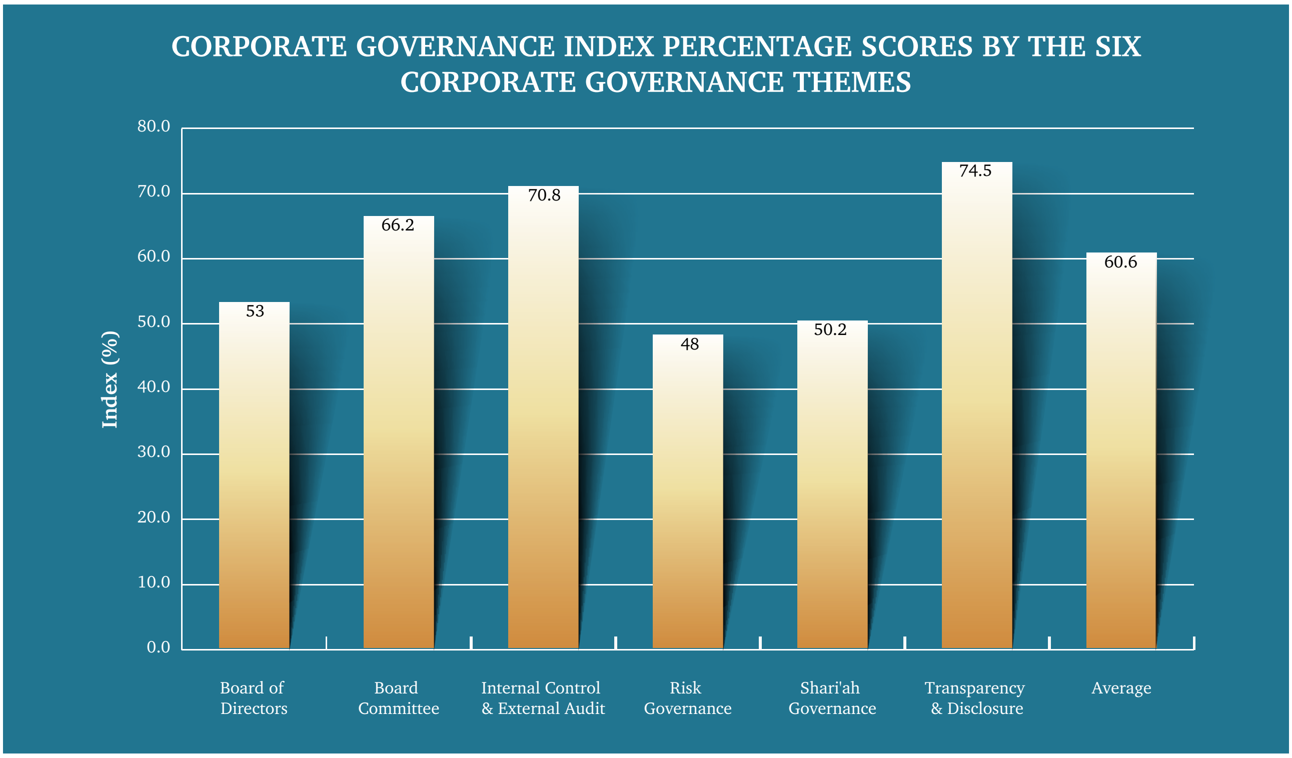
Within each of the six themes, six individual items were identified for evaluation. For example, the Board of Directors theme includes such items as “Qualification and experience of directors,” “Number/proportion of independent directors,” and “Number of board meetings per year.” Based on these themes and items, a Corporate Governance Index (CGI) was compiled using publicly available information published by 77 Islamic banks around the world. Details on the methodology and criteria used to compile the CGI are presented in Appendix A.

Results are presented in aggregate, for each of the six themes separately, and for each of the six items within each theme. The study also subdivides banks from four different perspectives: the region in which they are based; the legal system under which they operate; the quality of the broader regulatory system under which they operate; and their asset size.

KEY FINDINGS OF THE REPORT

The average score for all 77 banks was 21.8 out of the maximum score of 36 (60.6 percent). Of the six themes, the highest score was for Transparency and Disclosure at 74.5 percent, followed by Internal Control and External Audit. The lowest score was in Risk Governance (48.0 percent), and the second lowest was in Shariah Governance (50.2 percent). Figure E.1 shows the percentage value of the CGI for each of the six themes:

Figure E.1. Corporate Governance Index Percentage Scores by the Six Corporate Governance Themes



Source: CIBAFI and The World Bank.

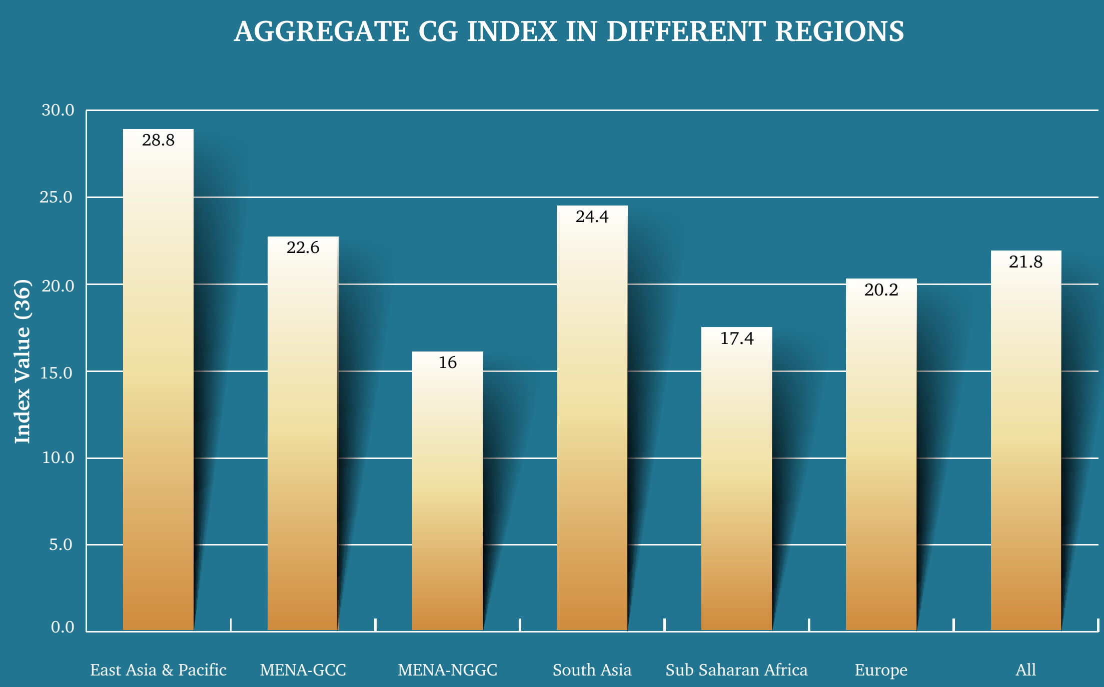
When these thematic scores are analysed in further detail, by item, a recurring pattern appears to be a lack of independent board directors, and of involvement by independents in key areas such as Audit Committee and Risk Committee. In addition, Boards and Board Committees (including Shariah Boards) are not meeting as frequently as might be expected given the responsibilities they should be carrying. There thus seems to be a weakness in the level of challenge offered to banks' executive teams.

The area where Islamic banks are most in need of improvement is Risk Governance. This is understandable since it is only in the last few years that the importance of Risk Governance has been fully recognized. The specific area that most urgently needs addressing is the status of the Chief Risk Officer (CRO). Very few of the banks, said that their CROs were members of their Executive Management Committee, implying that the CRO lacks high status within the bank. The lack of independent directors on Board Risk Committees has already been mentioned.

Shariah governance is the other area that receives low scores on the CGI. Here the big issues are the lack of diverse experience of the members on the Shariah Board and the infrequency of Shariah Board meetings.

Looking at the scores by region, banks in the East Asia and the Pacific region scored higher than any other region, with South Asian banks second. The lowest scoring regions were Middle East and North Africa excluding the Gulf Cooperation Council (MENA–Non-GCC), and Sub-Saharan Africa.

Figure E.2. Corporate Governance Index Scores by Region



Source: CIBAFI and The World Bank.
Note: CGI = Corporate Governance Index GCC = Gulf Cooperation Council; MENA-GCC = Middle East and North Africa-GCC countries; MENA-NGCC = MENA- Middle East and North Africa-Non-GCC countries.

Among the other findings of the study are that banks that operate in predominantly common law or civil law jurisdictions score more highly than those that operate under parallel jurisdictions (Islamic law and common or civil law); that those in a stronger regulatory environment score more highly than those in weaker environments; and, perhaps surprisingly, that there is no correlation between asset size and strong (or weak) corporate governance.

POLICY RECOMMENDATIONS

Finally, the study presents policy recommendations arising from the findings. The recommendations stress the need to create the right external environment to reinforce good corporate governance.

Specifically, the report recommends work to implement international corporate governance standards, including those that have been published by IFSB. It also recommends the development of a new or revised standard for corporate governance in Islamic banks, bringing together the thinking that has been done in the post-crisis period by the BCBS, the IFSB and others into a single standard which can be directly implemented by Islamic banks or incorporated within national regulatory frameworks.

The report also recommends strengthening corporate governance frameworks at the national level, drawing on international standards and the experience of jurisdictions that have already done so, and recognising the specific features of Islamic banks. The standard-setters, multilateral institutions, and other stakeholders can help to support this process.

The report recommends that more initiatives should be taken to enhance awareness of the principles of good corporate governance and of the benefits that can be gained by implementing them. Establishing local institutes that are focussed on corporate governance (such as the institutes of corporate governance in Jordan and Pakistan) are often more effective ways of delivering training (and increasing awareness) than relying on nonspecialized training bodies. Such institutes can not only enhance awareness but through training raise the quality of board members and others in key governance positions.

The report identifies other specific areas for improvement.

The independence and competencies of the Board of Directors need to be enhanced, through the involvement of more independent directors. This may well require regulatory action to require a minimum number or proportion of independent directors, who should have appropriate knowledge and expertise, including expertise in Islamic banking. There should also be more female directors. Many boards need to meet more frequently, and to establish a stronger system of committees covering, for example, Governance and Ethics, and with stronger involvement from independent members, especially in areas such as the Audit and Risk Committees.

Risk governance is a primary area for improvement, drawing on the post-crisis thinking of the international standard-setters. It would be a key element in any new standard for corporate governance in Islamic banks. Besides strengthening their Risk Committees, banks need to enhance the status of the Chief Risk Officer, which often falls short of what the importance of the function justifies.

Shariah governance is another area of relative weakness, partly reflecting the fact that not all jurisdictions have implemented provisions at national level; those that have not should do so. These should mandate appropriate Shariah governance at individual bank level, including matters like the avoidance of conflicts of interest within Shariah Boards. In addition, at bank level, the skill sets of Shariah Boards should be diversified, and it is likely that many Shariah Boards should meet more frequently.

Although Transparency and Disclosure emerged as a strong theme, even here there is room for improvement. Key recommendations include enhancing disclosure on matters related to internal audit and internal controls, and on Shariah-related matters.

1. INTRODUCTION

Corporate governance can be defined as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (G20 and OECD 2015).

Numerous studies have identified weak governance within financial institutions as a factor that contributed to the global financial crisis of 2007–08. Conversely, studies also indicate that well-governed institutions perform better, have increased access to finance, and have a lower risk profile than poorly governed institutions.

The benefits of good governance extend beyond individual institutions to the broader economy, reducing economic instability and enhancing the prospects for long-term growth.

International bodies such as the OECD have developed principles for good corporate governance that are applicable across economic sectors and in economies and regions at different stages of development. The BCBS has published corporate governance guidelines for banks. The BCBS guidelines were updated in 2015.

These international governance standards are applicable to Islamic financial institutions, but there are governance issues that are particular to these institutions that are not covered in the international standards. Examples include the treatment of investment account holders (a class of investors that does not exist in conventional banking) and the organization of Shariah governance.

Standard setters such as the IFSB have published guidance on corporate governance and related issues (such as risk management) in Islamic financial institutions.

Recognizing the importance that corporate governance has to individual financial institutions, and to the broader economies in which they operate, CIBAFI and The World Bank have undertaken this joint project to identify the extent to which Islamic financial institutions in the banking sector are complying with standards for good corporate governance, and to identify some policy priorities which, if implemented, will enhance the quality of governance within Islamic financial institutions.

This report is based on the results of research conducted on 77 Islamic banks in 22 countries. Twenty-eight of these banks are based in the Gulf Cooperation Council

(GCC) and another thirteen are based in the non-GCC Middle East and North Africa. Twelve banks are based in South Asia, and ten are in the East Asia and the Pacific region. Eight banks are based in Sub-Saharan Africa and six are in Europe. (Table A. 8, in Appendix A, gives fuller details.)

A Corporate Governance Index was constructed by identifying six different themes of corporate governance (such as Board of Directors or Risk Governance), and within each theme six individual criteria were formulated based on international standards and other authoritative documents. Each bank was assessed against the items making up the CGI based on content analysis of its annual report and website. A bank could score a maximum of 36 points if it met the criteria on all 36 individual items. The results from the CGI were then analysed at an aggregate level and at the level of each theme and item. They were also analysed with a view to identifying any patterns based on bank size, regional differences, or other external factors such as the legal system in which a bank operates and the quality of the regulatory environment. The methodology of the study is set out in detail in Appendix A.

The banks included free-standing Islamic banks, subsidiaries and Islamic windows, depending in each case on data availability. Those entities that are parts of larger banks or groups may rely on their parents for some aspects of governance (e.g. internal audit). It has not been possible to assess how far this may have affected the results.

The study covered Islamic banks only. It is possible that the patterns and issues identified may in many cases also be present in conventional banks in the countries from which the sample is taken. However, it is not possible to draw conclusions on this point from the data available.

The rest of the report is organized as follows. Chapter 2 presents key results of the study and, in particular, identifies the areas of governance where Islamic banks are strongest and weakest. Chapter 3 presents policy recommendations for banks, financial regulators, and policy setters, based on the analysis in chapter 2. Appendix A explains the methodology, including the choice of themes, some relevant international standards, how the evaluation criteria were selected, and the selection of the sample banks.

2. STRENGTHS AND WEAKNESSES OF CORPORATE GOVERNANCE IN ISLAMIC BANKS IDENTIFIED BY THE CORPORATE GOVERNANCE INDEX

This chapter presents the results of the CGI and identifies the strengths (prospects) and weaknesses (challenges) of Islamic banks against the CGI themes and items so that appropriate recommendations can be made to strengthen their corporate governance.

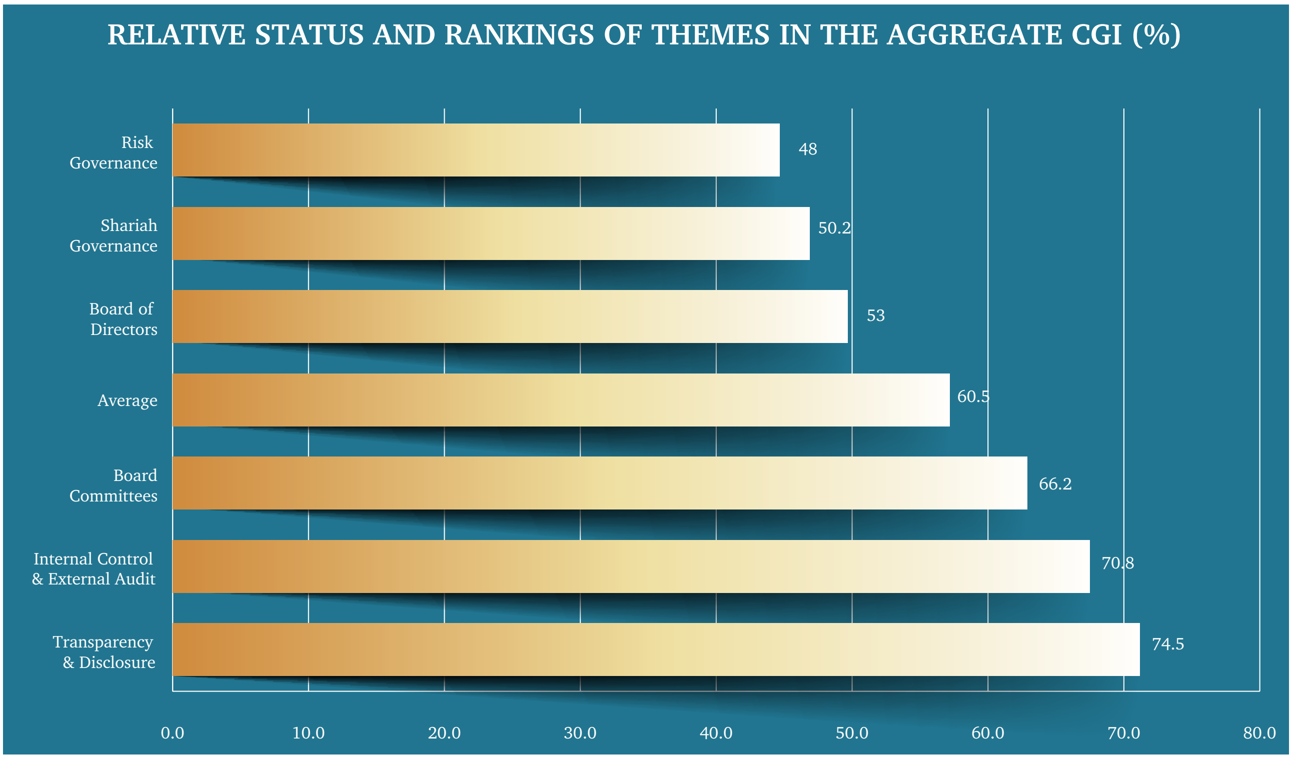
The index has six themes and each theme has six items. CGI values can therefore be presented in three ways: the aggregate value, including all 36 items, aggregating all items under all themes; thematic values on their own, each with their six items; and each of the 36 individual items on their own. However, when the sample is broken down to analyse patterns from different perspectives some of the samples become relatively small, and these analyses are therefore presented only at the level of the overall CGI.[1]

2.1 GLOBAL AVERAGES FOR THE SIX THEMES

The average aggregate CGI for the 77 banks in the sample is 21.8 out of a possible 36; in percentage terms, this amounts to 60.5 percent. The standard deviation of the score is 7.1. Figure 2.1 shows the percentage value of the CGI for each of the six corporate governance themes.

1. For consistency, CGI scores and percentages in this report are generally presented to one decimal place. In the more detailed analyses of individual items within themes, however, data are given to two significant figures. In both cases, however, care should be taken in interpreting these figures, given the limitations of sample sizes.

Figure 2.1. Relative Status and Rankings of Themes in the Aggregate CGI (%)



Source: CIBAFI and The World Bank.

The results indicate that the strongest corporate governance theme for Islamic banks in the sample is Transparency and Disclosure, followed by Internal Controls and External Audit. At the other extreme, the weakest corporate governance theme is Risk Governance, followed by Shariah Governance and the Board of Directors.

The low score of the Risk Governance theme (average score of 2.9, amounting to 48.0 percent) can partly be explained by the fact that it is a relatively new theme that has come to prominence since the global financial crisis. The regulatory focus on governance and risk has been enhanced by Pillar 2 of Basel III and was addressed in detail by the Financial Stability Board in 2013.

The BCBS addressed risk governance in the 2012 revision of its Core Principles (BCBS 2012), through a much-enhanced version of the Principle on Risk Management, and the associated assessment criteria.[2]The IFSB's Core Principles for Islamic Finance Regulation (Banking Segment) (IFSB-17) are based on the Basel Core Principles (BCPs), and the IFSB Principle on Risk Management covers the same ground as its BCP counterpart, with enhancements for the specificities of Islamic banks.

Neither body has produced a detailed standard on risk management in the post-crisis period.[3] However, the low score of risk governance in the CGI implies that there may be a lag in implementing existing risk governance standards in Islamic banks in countries from which the sample was drawn. Even here, though, there are some notable strengths; for example, boards of directors appear to be setting risk appetite and profile, and the Transparency and Disclosure theme reveals a high level of disclosure on risk management.

Shariah governance is the second weakest theme in Islamic banks, with an average score of 3.0 (50.2 percent) for the whole sample. Different factors may account for this, but one key determinant is likely to be whether there are regulatory standards governing Shariah governance, and supervisory oversight of them.

2. These Core Principles and assessment criteria are used in the Financial Sector Assessment Program conducted by the International Monetary Fund and The World Bank. See IMF (2016) for an example of an assessment against them.

3. The IFSB published the standard IFSB-1: Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services (IIFS) in 2005, but has not updated them, although the standard IFSB-14: Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes) does include some key issues related to risk governance.

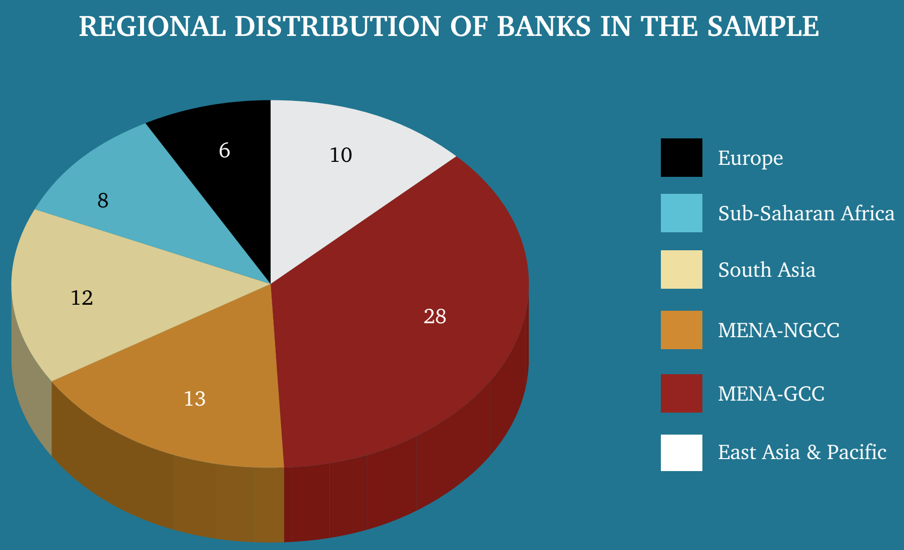
Currently, a few countries (such as Bahrain and Sudan) require Islamic banks to use Shariah standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and some countries (such as Indonesia, Malaysia, and Pakistan) have a regulatory framework and guidance on Shariah governance. This may or may not include a central Shariah council at national level. In countries that do not have regulatory requirements, Shariah governance issues are left in the hands of banks, which then determine its nature and status within their institutions.

The third weakest component of corporate governance in Islamic banks is the status and role of the Board of Directors, with an average score of 3.2 (53.0 percent), though again there are some notable strengths, for example the separation of the Chairman and Chief Executive roles. Many of the factors that can make a board effective derive from laws and regulations, including local corporate governance codes, but part of the board's functions is determined by a bank's own Articles of Association. The functions and operations of boards may also depend on ownership patterns. It is often believed that in banks that have a few large shareholders or that are owned by families, the board will be less effective. However, because information on ownership of the banks in the sample was not available, the relationship between ownership and corporate governance cannot be assessed.

2.2 RESULTS BY REGION

There are differences in the challenges that Islamic banks face in different regions. The number of banks included from different regions is shown in figure 2.2.[4] Within the Middle East and North Africa (MENA) region, a distinction is made between GCC countries (MENA-GCC) and non-GCC countries (MENA-NGCC). While the MENA-GCC region has the largest number of banks (28), the European region has the least (6 banks).

Figure 2.2. Regional Distribution of Banks in the Sample



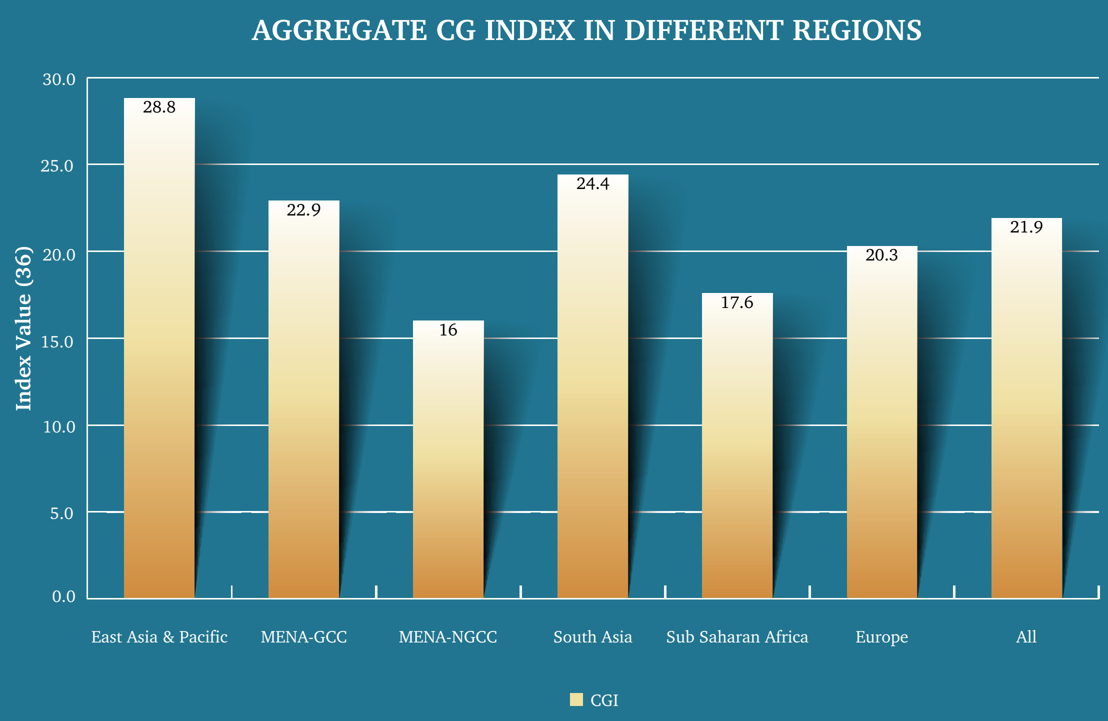
Source: CIBAFI and The World Bank.
Note: GCC = Gulf Cooperation Council; MENA-GCC = Middle East and North Africa—GCC countries; MENA-NGCC = Middle East and North Africa—Non-GCC countries.

4 The regions are identified using The World Bank criteria.

Figure 2.3 shows the aggregate CGI both as values and percentages for different regions. On average, the East Asia and Pacific region has the highest score, with a CGI score of 28.8 (equivalent to 80.0 percent), followed by the South Asian region with a CGI score of 24.4 (67.8 percent).

By contrast, Sub-Saharan Africa (with a score of 17.4, or 48.3 percent) and MENA-NGCC (with a score of 16.0, or 44.4 percent), have CGI values that are materially below the global.

Figure 2.3. Aggregate Corporate Governance Index by Region



Source: CIBAFI and The World Bank.

Table 2.1 presents a more detailed break-down by theme. Colours are used to show strengths and weaknesses relative to the average for that particular theme. However, the data can also be read to show patterns of strength and weakness in absolute terms.

Table 2.1. Relative Status and Rankings of Themes across Regions (each score out of 6)

CGI themes	Average	EA&P	MENA-GCC	MENA-NGCC	SA	SSA	EUR
Board of Directors	3.2	5.2	3.1	2.2	3.6	2.3	2.9
Board Committees	4.0	3.5	4.5	3.2	3.8	3.8	4.7
Internal Control and External Audit	4.3	5.5	4.5	3.2	5.0	2.8	4.1
Risk Governance	2.9	4.4	3.0	2.4	3.2	1.6	2.8
Shariah Governance	3.0	4.4	3.2	2.0	3.4	3.3	1.5
Transparency and Disclosure	4.5	5.8	4.6	3.0	5.4	3.8	4.3
Total	**21.9**	**28.8**	**22.9**	**16**	**24.4**	**17.6**	**20.3**

Source: CIBAFI and The World Bank.
Note: EA&P = East Asia and Pacific; EUR = Europe; GCC = Gulf Cooperation Council; MENA-GCC = Middle East and North Africa—GCC countries; MENA-NGCC = Middle East and North Africa—Non-GCC countries; SA = South Asia; SSA = Sub-Saharan Africa.

Given these regional differences, the varied corporate governance challenges facing Islamic banks in different regions need to be addressed accordingly.

2.3 RELATIVE STATUS AND RANKINGS OF ITEMS IN THE SIX THEMES

This section examines individual items within each of the six themes.

Board of Directors

Figure 2.4 shows the average scores of the individual items within the Board of Directors theme. In this case the chart shows the proportion of banks scoring positively on the particular item.

The BCBS (2015) says that the Board has, "the ultimate responsibility for the bank's business strategy and financial soundness, key personnel decisions, internal organisation and governance structure and practices, and risk management and compliance obligations."

The OECD Principles on Corporate Governance recommend that the positions of chair and chief executive should be separated, as doing so can strengthen the board's independence and objectivity. The chair of the board plays an important role by providing leadership and ensuring the proper functioning of the board. The chair should be an independent or non-executive Board member and ensure appropriate checks and balances. In almost all the Islamic banks, the chief executive officer (CEO) and the chair are different people (item A3).

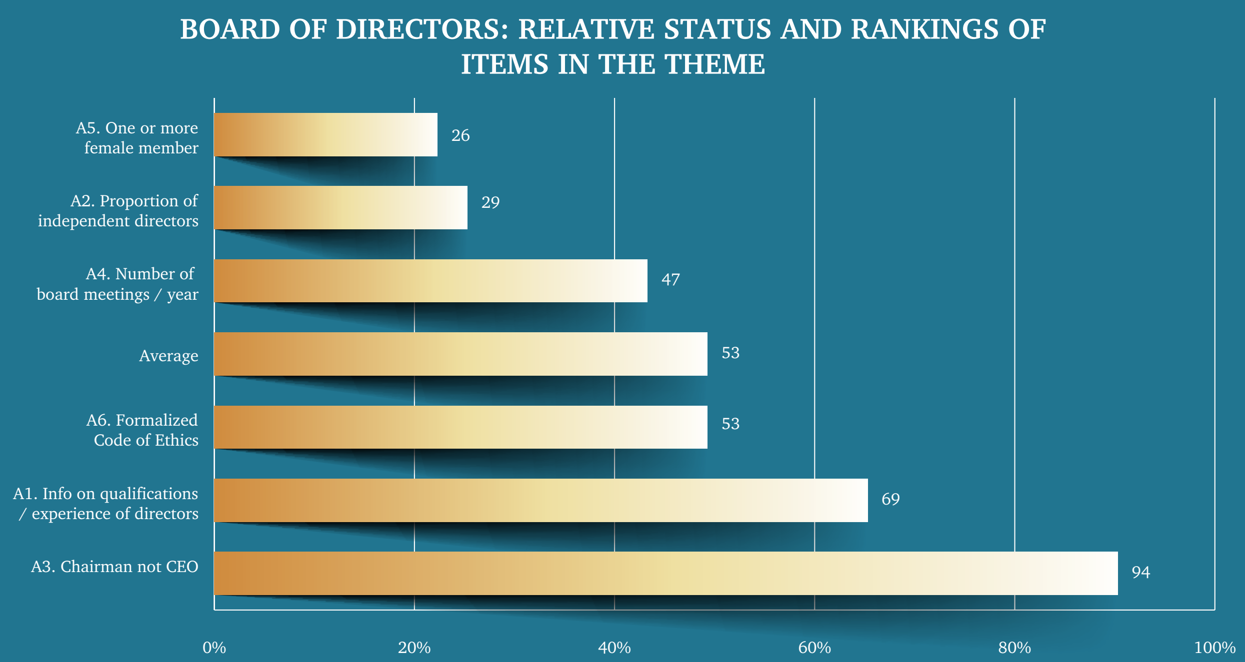
The item related to relevant information on qualifications/experience of directors (item A1) has the second highest score. BCBS (2015) recommends that the directors should collectively have the qualifications, background, knowledge, skills, and expertise to understand the risks and complexities of the bank and to guide the bank in a sound and prudent manner.

Separating the positions of chair of the board and CEO, and ensuring that board members are qualified, are two areas that are expected to enhance the objectivity and independence of the board.

The lowest scores for items in the Board of Directors theme are for diversity (item A5), and for independent directors (item A2). Most banks do not have one or more female board members, though the International Finance Corporation (IFC) and Hawkamah (2008) identify having at least one female member as an indicator of good board practices. BCBS also says (2015) that "the board should be comprised of a sufficient number of independent directors." Not having adequate independent directors on the board can reduce effective oversight and governance in banks.

Furthermore, the number of meetings held by the board annually (A4) also appears to be inadequate. Although the score is only a little below the average, the implication is nevertheless that fewer than half of the banks in the sample hold 6 or more board meetings a year. Improving oversight of the banks would require increasing the frequency of meetings.

Figure 2.4. Board of Directors: Relative Status and Rankings of Items in the Theme



Source: CIBAFI and The World Bank.

Board Committees

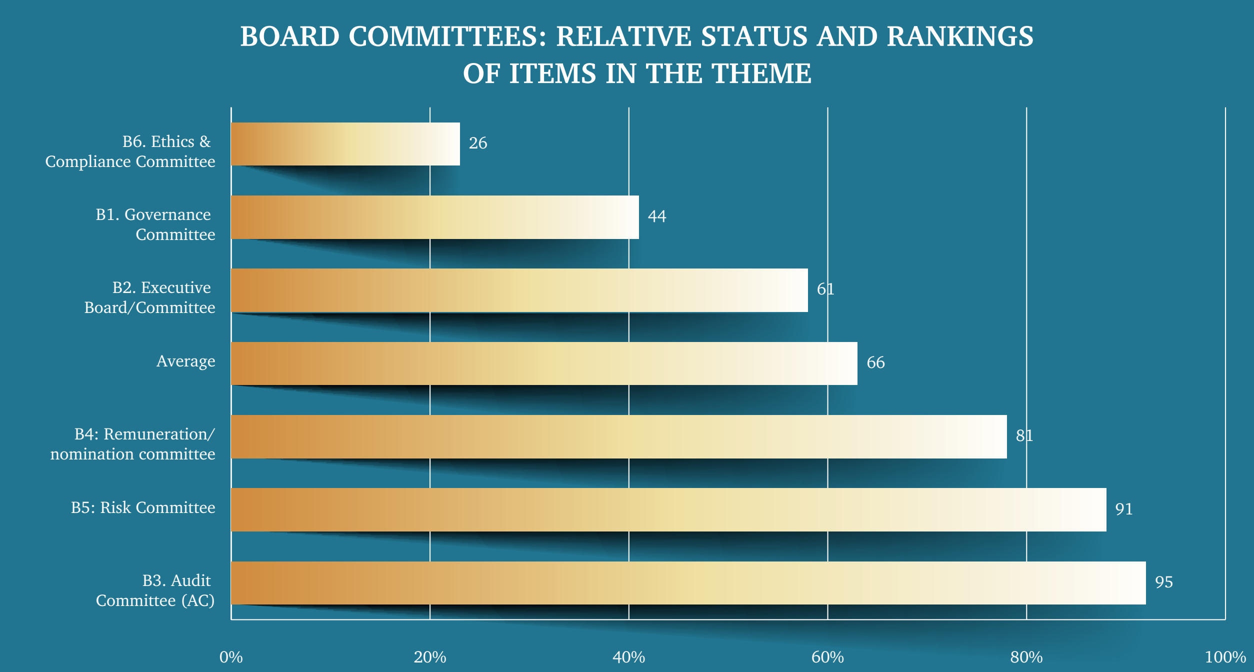
BCBS (2015) suggests that the board should establish different board committees so that specific issues can be dealt with in a focussed manner. Figure 2.5 presents scores of items in the Board Committees theme.

It is important to note that one of the determinants of having different types of board committees may be the size of the banks. As banks grow in size and their operations become more complex, there may be a need for more board level committees to have effective oversight of different aspects of the banks' operations.

Most of the banks in the sample have Audit Committees (B3), a Risk Committee (B5), and Remuneration/ Nomination Committee (B4). The responsibility of an Audit Committee is to frame policies and provide oversight on financial reporting and internal audit, and to interact with internal and external auditors. The role of the Risk Committee is to advise the board on the formulation of the bank's risk appetite and to oversee the implementation of the bank's risk management framework. The Remuneration/ Nomination Committee oversees the remuneration schemes of the bank to ensure that incentives and compensation are in line with the long-term business goals and risk appetite of the institution.

Most banks do not have Ethics/Compliance Committees (B6) and Governance Committees (B1). The responsibilities of the Governance Committee should include putting in place policies related to the responsibilities and conduct of directors, and nominations to the board and its committees. The IFSB standard IFSB-3: Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds) also recommends that in Islamic banks it should play a particular role in protecting the interests of investment account holders (IAH). The low score (44 percent) for the Governance Committee implies that in many Islamic banks governance-related issues, such as identifying the knowledge and skills required from new board members may not be handled systematically.

Figure 2.5. Board Committees: Relative Status and Rankings of Items in the Theme



Source: *CIBAFI and The World Bank.*

Internal Control and Audit

The bank's internal audit department and its external auditors play important roles in ensuring that the bank's internal controls are strong. Specifically, the internal audit department is responsible for carrying out risk-based and general audits and reviews in order to strengthen the overall governance and risk governance framework by ensuring that all policies and processes are applied consistently throughout the organization.

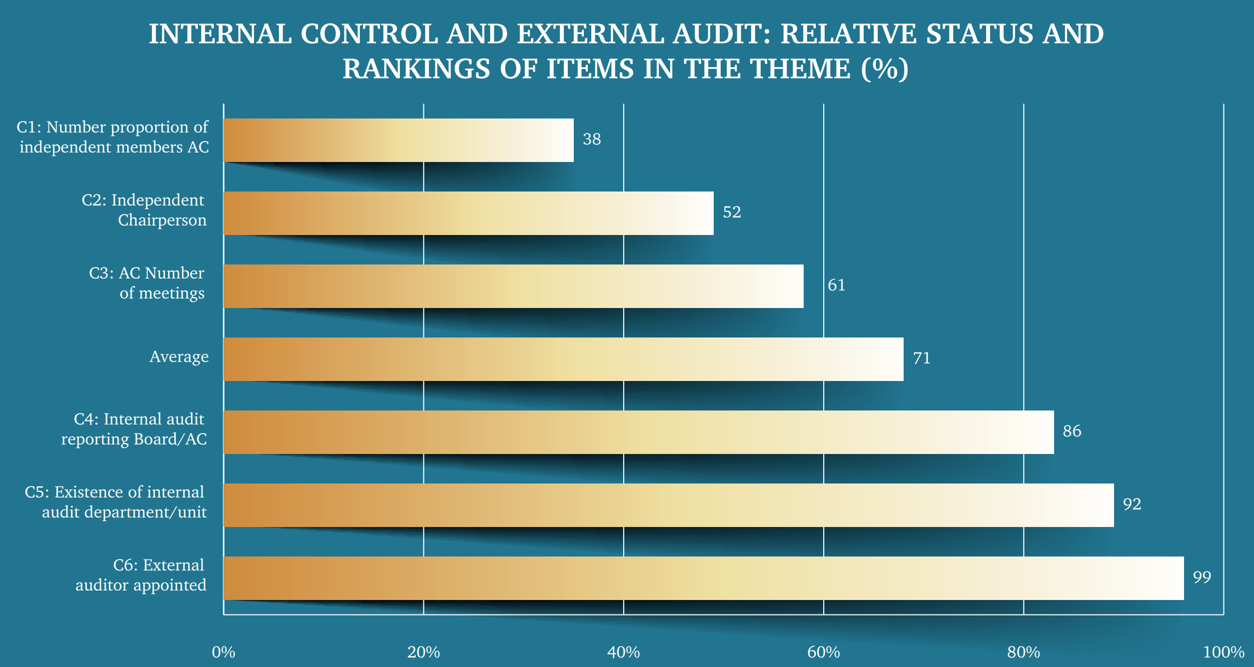
BCBS (2015) asserts that the internal audit function should provide "independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank."

As figure 2.6 shows, almost all banks appoint external auditors (C6) and have an internal audit department (C4). Furthermore, the Chief Internal Auditor reports to the board or its Audit Committee (C5) in most of the banks – a practice that is recommended by BCBS (2015). One reason these elements have high scores may be that they are required by the laws and regulations governing companies and banks.

The weaker items in this theme relate to the lack of independent members on the Audit Committee (C1) and the chair of the Audit Committee not being an independent director (C2). In order to maintain the effectiveness of the committee, it should be headed by an independent Board member, all other members should preferably be independent and non-executive, and there should be some members who have experience in auditing and financial reporting (BCBS 2015). Furthermore, as with the board of directors, in many cases the number of meetings held by the Audit Committee appears to be inadequate (C3).

These indicators reflect the problem that exists at the board of directors level where, as discussed, there is a lack of independent directors. Increasing the number of independent Board members will enable banks to have more independent members in the Audit Committee.

Figure 2.6. Internal Control and External Audit: Relative Status and Rankings of Items in the Theme



Source: CIBAFI and The World Bank.

Risk Governance

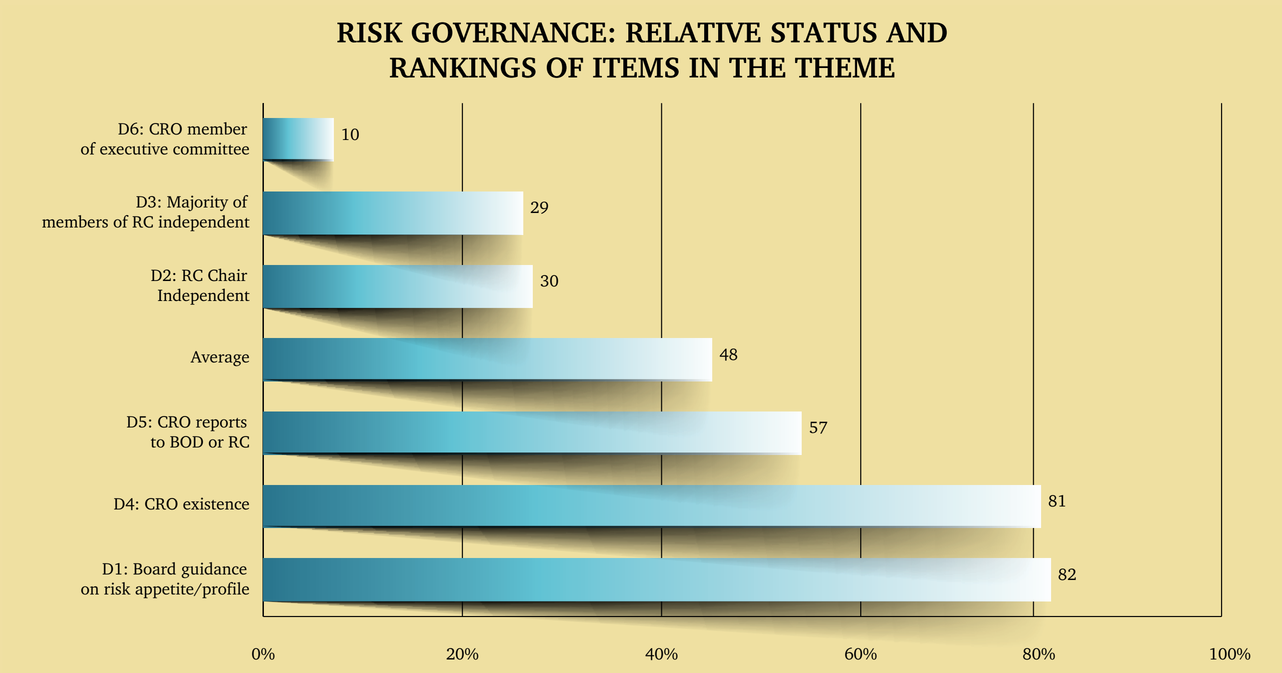
Risk governance is the weakest theme of the CGI, as shown in figure 2.7. Within this theme, the strongest item concerns risk appetite. In most banks in the sample, the board provides guidance on the risk appetite (D1). This is one of the responsibilities of the board of directors identified by the BCBS (2015).

Crucial to the success of risk management in any bank is a competent Chief Risk Officer, who needs to be a very senior executive within the firm. CROs are usually appointed by the Board and should have direct access to the Board or the Board Risk Committee. Although a CRO exists in most banks (D4), he/she is rarely a member of the Executive Committee (D6). Moreover, although the index value for the independence of the CRO, represented by D5 (CRO reports to board or Risk Committee), is above average, it is relatively low in absolute terms (57 percent).

It is necessary to have independent members on the Risk Committee in order to have an unbiased and objective overview of the overall risk management framework and culture in the bank. The Risk Committee should not only have a majority of independent members (D3) but should also have an independent chair (D2) (BCBS 2015). However, the results indicate that neither is the case in most banks, again reflecting the lack of independent directors noted earlier.

As discussed, risk governance is a relatively new phenomenon that has gained more prominence since the global financial crisis. International standard-setting bodies such as BCBS and IFSB have been developing relevant guidelines. It is important that these are incorporated into national regulatory standards and the banks' own risk governance frameworks.

Figure 2.7. Risk Governance: Relative Status and Rankings of Items in the Theme



Source: CIBAFI and The World Bank.
Note: CRO = Chief Risk Officer; RC = Risk Committee.

Shariah Governance

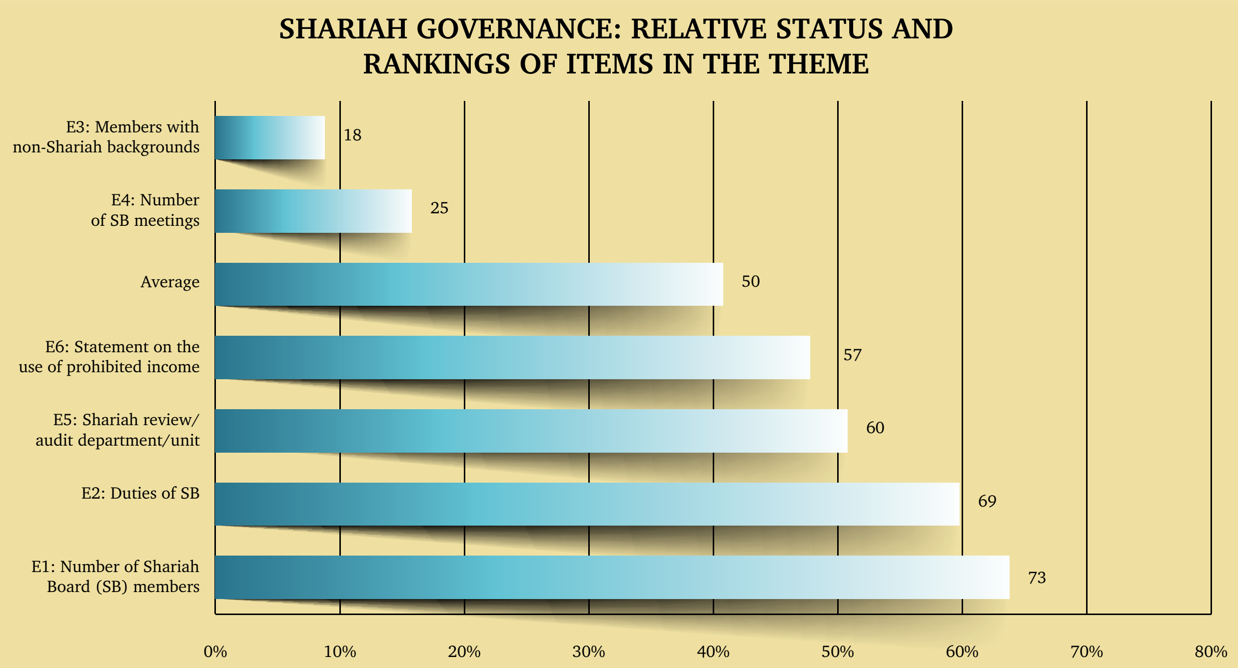
Sound Shariah governance involves instituting structures, controls, and processes to ensure that Shariah principles and requirements are fulfilled in all contractual, procedural, and operational aspects of an Islamic financial institution from the perspectives of different stakeholders. Figure 2.8 presents the index values of items in the Shariah Governance theme.

A key component of governance in an Islamic bank is Shariah supervision that ensures that Shariah requirements are fulfilled. IFSB-10: Guiding Principles on Sharīʼah Governance Systems for Institutions Offering Islamic Financial Services proposes four aspects that Shariah governance systems should have: issuance of Shariah pronouncements, ensuring day-to-day compliance with the Shariah, internal Shariah compliance review and audit, and annual Shariah compliance audits to ensure that internal Shariah compliance reviews have been properly carried out. To undertake these functions, the IFSB identifies different Shariah organs, which include an in-house Shariah compliance unit/department, an internal Shariah review/audit unit, and a Shariah Supervisory Board.

60 percent of the banks sampled have a Shariah review/audit department/unit (E5). In most cases, Shariah Boards have the recommended three or more members (E1). Many banks issue a statement on the use of prohibited income (E6). Furthermore, for most banks in the sample, the roles and duties of the Shariah Board are clearly specified (E2).

However, the Shariah Board is not diversified in most Islamic banks, as shown by the index value of 18 percent for E3. Furthermore, the number of meetings held by the Shariah Board appears to be fewer than 6 per year for most of the banks (E4). If the Shariah Board is involved not only with approving new products, but also with ensuring that these are implemented in accordance with what has been approved, and considering major transactions, there may be a need to have more meetings for review and oversight.

Figure 2.8. Shariah Governance: Relative Status and Rankings of Items in the Theme



Source: CIBAFI and The World Bank.
Note: SB = Shariah Board.

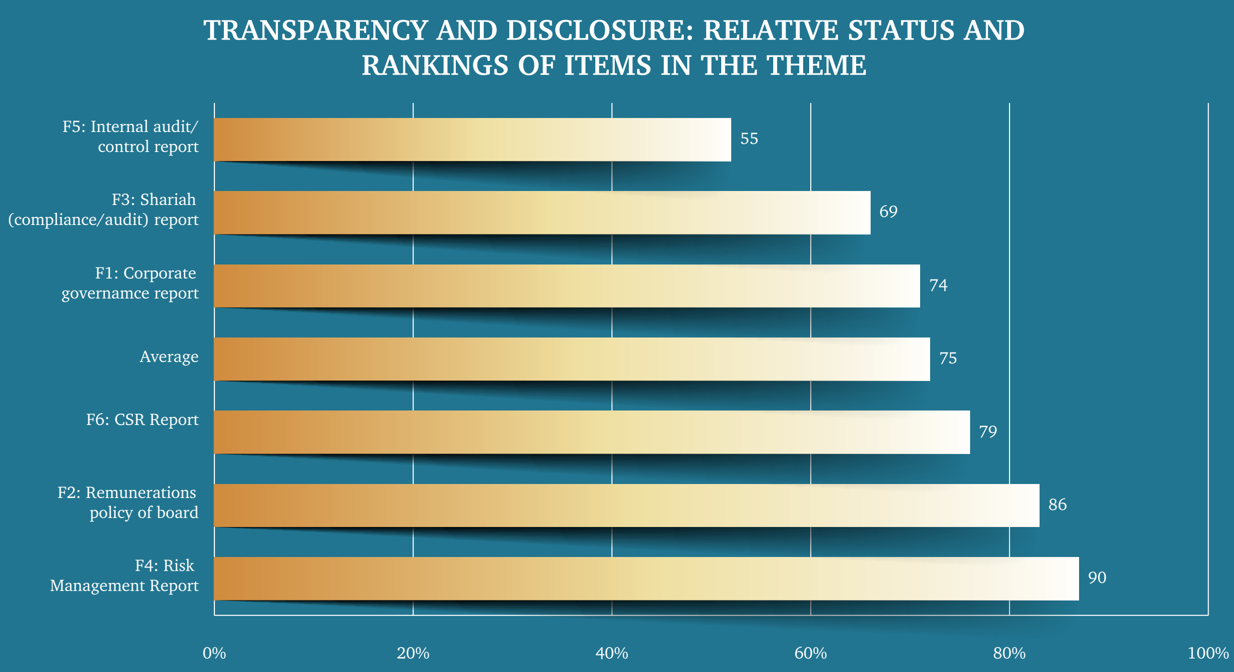
Transparency and Disclosure

Information disclosure enables market actors to monitor banks' activities. This is expected to lead to stronger governance through market discipline. BCP 12 (BCBS 2015) on disclosure and transparency recommends that banks should provide adequate and relevant information to their shareholders, depositors, market participants, and other stakeholders.

As figure 2.9 shows, the theme of Transparency and Disclosure is the strongest component of the CGI. A large majority of the banks in the sample disclose a risk management report (F4) and a remuneration policy (F2). However, fewer banks disclose an internal audit report (F5) and a Shariah report (F3), with scores of 55 percent and 69 percent, respectively.

IFSB-3 and IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services provide specific guidelines for transparency and disclosure in Islamic banks. For example, IFSB-4 provides details of the issues that need to be disclosed by Islamic financial institutions, including financial and risk disclosure principles, disclosures for investment account holders, and governance and Shariah governance disclosures.[5]

Figure 2.9. Transparency and Disclosure: Relative Status and Rankings of Items in the Theme



Source: CIBAFI and The World Bank.

5 This standard is currently being revised.

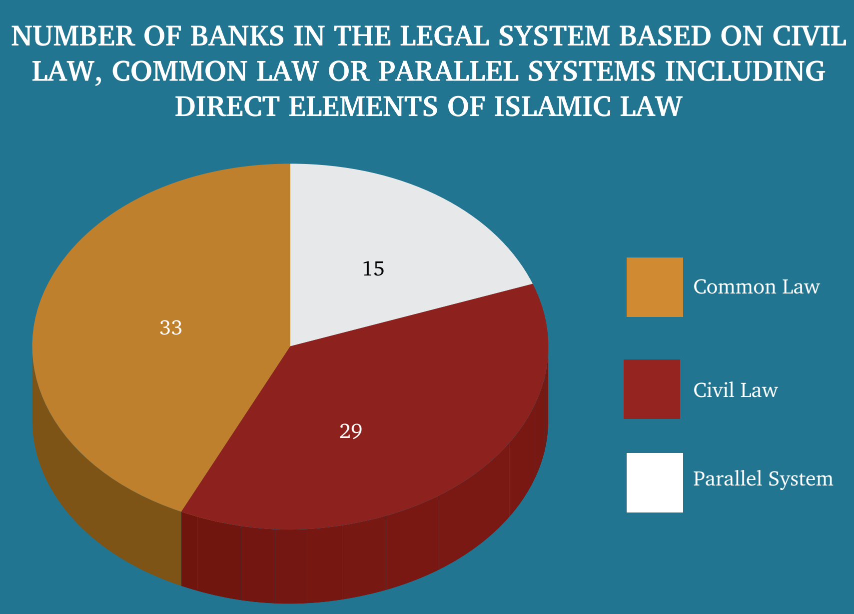
2.4. LEGAL SYSTEMS

Other than Islamic law, two broad categories of legal systems can be identified: common law and civil law. Each legal system shapes the legal rules that govern the financial markets and influence their development (La Porta et al. 1999). Because laws such as company laws and banking laws provide guidelines for corporate governance, legal systems are expected to influence the overall CGI.

Most Muslim countries have adopted some variant of Western legal systems, due either to colonization or imitation. Countries that are former British colonies have adopted the English common law framework, while the former French colonies have adopted the civil law regime. Most countries in the Arab world have adapted variants of the Egyptian legal system, which has a legal code based on French and European civil law.[6]

However, in some countries Islamic law plays a direct part in the legal system, alongside civil or common law.[7] These are referred to in this study as having "parallel" systems. The number of banks in the sample that belong to different legal systems is shown in figure 2.10.

Figure 2.10. Number of Banks in the Legal System based on Civil Law, Common Law or parallel systems including direct elements of Islamic Law

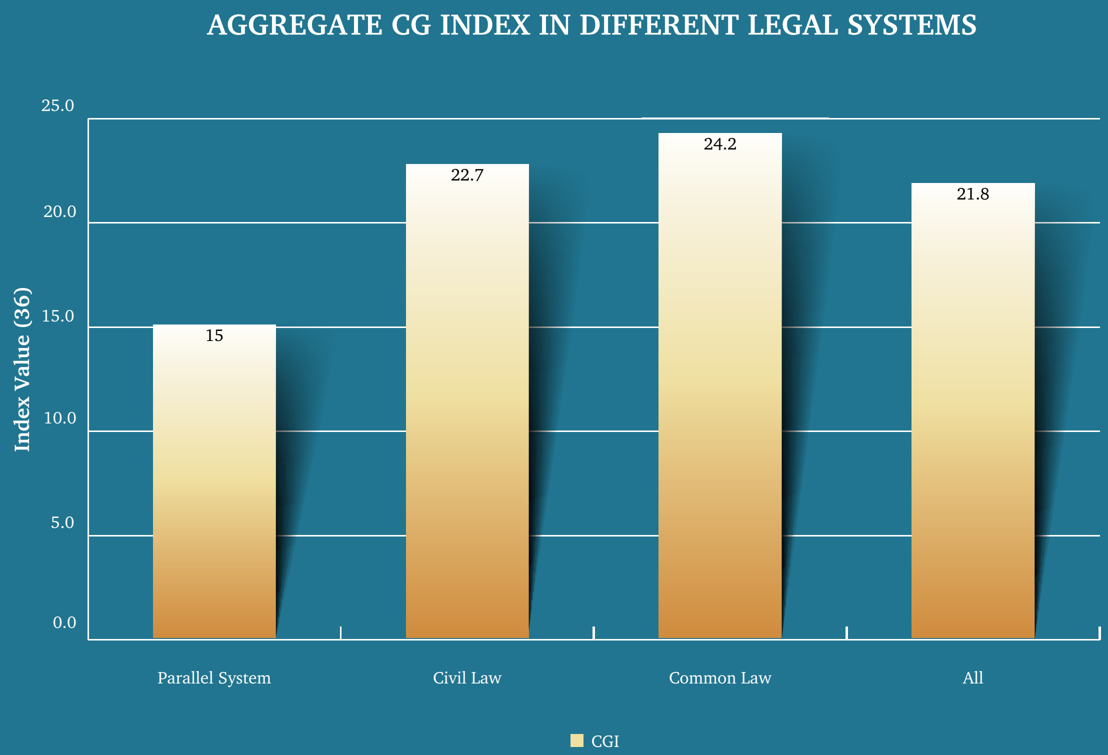


Source: CIBAFI and The World Bank, based on La Porta et al. 1999; The World Bank 2004.

6 See The World Bank (2004) for legal regimes adopted by different countries, including the Muslim countries.
7 Personal law in most Muslim countries is still Islamic, but the commercial laws are largely based on either common law or civil law. The constitutions of three countries identified as Islamic (Iran, Saudi Arabia, and Sudan) state Islamic law to be source of law and their judicial systems use Islamic law to adjudicate disputes in courts.

Figure 2.11 shows the aggregate CGI within the different legal systems. Banks operating in the common law system have the highest average CGI, with a value of 24.2 (67.1 percent) followed by banks in the civil law systems, which have an average CGI value of 22.7 (62.9 percent). The countries operating in parallel legal systems have the lowest aggregate CGI score of 15.0 (41.7 percent). Two of these countries also scored in the bottom decile of The World Bank regulatory quality index discussed below. However, it is not obvious that this is attributable to the choice of legal system; given the small number of countries involved, correlation may not imply causation.

Figure 2.11. Aggregate Corporate Governance Index in Legal Systems based on Islamic Law, Civil Law, or Common Law



Source: CIBAFI and The World Bank.
Note: CGI = Corporate Governance Index; CGI (percent) = percent of possible perfect score;

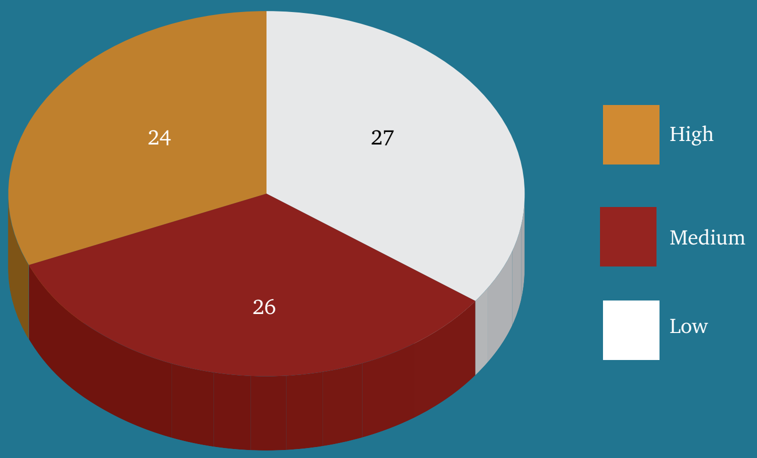
2.5. REGULATORY QUALITY

Another external factor that can affect corporate governance practices is the broader regulatory framework in which banks operate. For this report, data on regulatory quality were taken from the World Governance Indicators database of the World Bank.[8] "Regulatory quality" is a broad concept that attempts to capture the quality of the overall regulatory framework in different countries. According to the World Bank, it "captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development."

The World Bank reports the regulatory quality index in two ways. First, the index value varies from a minimum of -2.5 (weak) to a maximum of 2.5 (strong). Second, it is reported as percentile rank among all countries. For the purposes of this analysis, countries are grouped into three categories: regulatory quality is considered low for countries in the bottom tercile (1–33 percentiles); medium for countries in the middle tercile (34–66 percentiles); and high for countries in the highest tercile (67–100 percentiles). Figure 2.12 shows the number of banks that belong to countries with different regulatory qualities.

Figure 2.12. Number of Banks in Countries with Low-, Medium-, or High-Quality Regulatory Regimes

NUMBER OF BANKS IN COUNTRIES WITH LOW-, MEDIUM-, OR HIGH-QUALITY REGULATORY REGIMES



Source: CIBAFI and The World Bank.

8 http://info.worldbank.org/governance/wgi/index.aspx#doc.

Figure 2.13 reports the CGI for banks in countries with regulatory regimes of differing quality. Banks in countries that have high and medium regulatory qualities have aggregate CGI values that are higher than the overall average (24.0 and 23.7, respectively), while those in countries with low regulatory quality score lower (18.0). The results imply that the quality of business regulation generally does have an effect on the quality of banks' corporate governance.

Figure 2.13. Regulatory Quality and the Corporate Governance Index

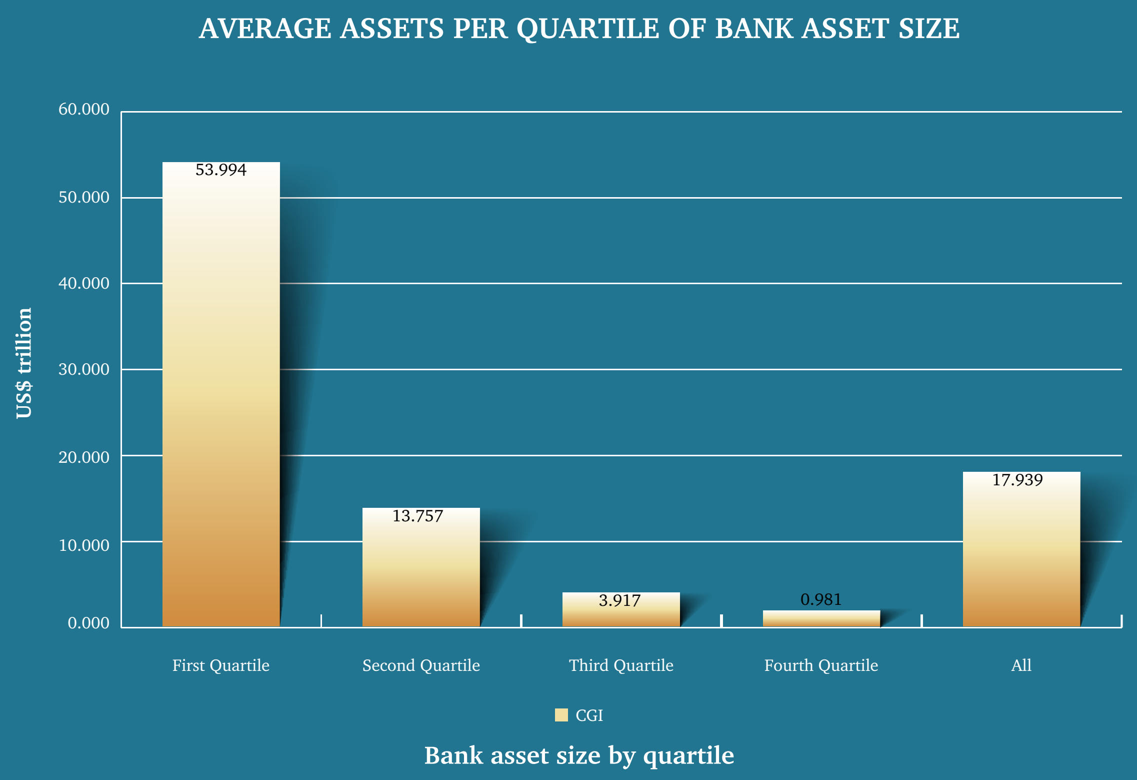
Source: *CIBAFI and The World Bank.*
Note: *CGI = Corporate Governance Index.*

2.6. BANK SIZE

To see whether the size of a bank has any impact on its CGI, the banks were divided into four quartiles based on their asset size, in descending order.

The average values of assets for the banks in each quartile are shown in figure 2.14. The average banking assets for all banks included in the sample is $17.939 billion. The average for banks in the first quartile is $53.994 billion. The remaining three quartiles have average bank sizes that are very much smaller: $13.757 billion for those in the second quartile, $3.917 billion for those in the third, and $981 million for the 20 banks in the lowest quartile.

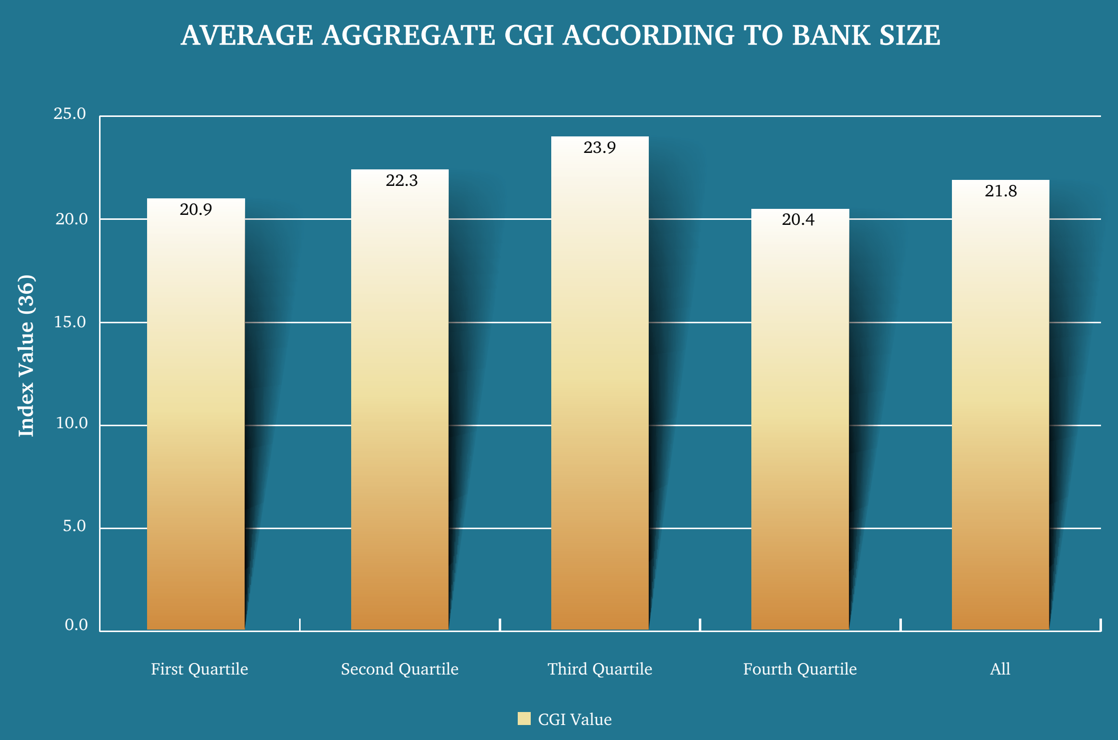
Figure 2.14. Average Assets per Quartile of Bank Asset Size



Source: CIBAFI and The World Bank.

Figure 2.15 shows the values and percentages for the aggregate CGI for banks in different asset size quartiles. The results do not show any trends that relate to bank size. The results thus appear to indicate that the bank size does not have any influence on the CGI, implying that the legal and regulatory environment is much more important.

Figure 2.15. Average Aggregate CGI by Quartile of Bank Asset Size



Source: *CIBAFI and The World Bank.*
Note: *CGI = Corporate Governance Index.*

2.7. SUMMARY OF THE CORPORATE GOVERNANCE INDEX RESULTS

The results presented in this chapter show the strengths and weaknesses in corporate governance practices in Islamic banks with respect to the CGI.

Overall, the analysis reveals that Islamic banks perform well in terms of their Transparency and Disclosure, Internal Control and Audit, and Board Committees. They face challenges in areas of Risk Governance, Shariah Governance, and the Board of Directors.

By examining the challenges across different themes, some important issues can be identified. First, not having enough independent directors appears to be a common challenge. Not only are there not enough independent directors on the board itself (A2) but, perhaps as a consequence, the Audit Committee and Risk Committee also do not have adequate independent directors (C1 and D3, respectively), nor are they headed by an independent chair (C2 and D2, respectively).

Second, in most banks, not enough meetings are being held by the Board (A4) or its committees (C4), which may result in less oversight. The number of meetings held by the Shariah board (E4) is also relatively low. Finally, both the board of directors and Shariah board lack diversity. The results show very few female members in the former (A5) and limited members with non-Shariah background in the latter (E3).

As the report did not attempt to find any causal relationship between external environment factors such as legal systems and regulatory quality and corporate governance, it is difficult to assess how these factors affect the status of corporate governance. However, the results do indicate that good corporate governance depends on the quality of the broader regulatory environment.

Given that corporate governance is a key factor driving better performance and stability in Islamic banks, it is important to tackle the challenges identified in this report. Moving forward, these challenges need to be addressed if the Islamic banking industry is to experience sound growth. Some of the ways of doing this are addressed in the next chapter.

3. POLICY RECOMMENDATIONS

Stronger corporate governance in the Islamic banking system will in turn contribute to healthier economies and stronger economic growth, benefitting Muslim communities, and others, worldwide. In this chapter, the policy recommendations to improve corporate governance in Islamic banks are presented based on the results found in the CGI and on relevant documents such as Reports on the Observance of Standards and Codes (ROSCs) on Corporate Governance published by The World Bank and International Monetary Fund (IMF) and national-level standards.[9]

3.1. CREATE THE RIGHT EXTERNAL SUPPORT SYSTEM TO REINFORCE GOOD CORPORATE GOVERNANCE

Implement International Corporate Governance Standards

Realizing the importance of governance in promoting good business practices and economic growth, various international bodies have developed standards and principles to strengthen corporate governance practices. The World Bank considers a strong corporate governance regime to be one of the key elements of sound financial architecture.[10] It uses the OECD Principles of Corporate Governance as standards to assess the overall status of corporate governance in different countries.[11] Some countries have not adopted all the recommendations of the OECD corporate governance principles. For example, The World Bank (2010) found that in Indonesia, 4 principles were fully observed, 25 were broadly observed, 34 principles were partially observed, and 2 were not observed.

Recognizing that weak governance was one of the causes of the global financial crisis, one of the key regulatory responses has been to improve corporate governance practices in banks. To this end, the BCBS updated its Corporate Governance Principles for Banks in 2015 to provide a framework for good governance principles for the banking sector. It also incorporated new material on corporate governance and risk management in its Core Principles (BCBS 2012). For Islamic financial institutions, the IFSB published its Guiding Principles

9 The World Bank and IMF prepare ROSCs, which evaluate the health of financial sector and financial architecture in different countries by assessing adherence to 12 core global best-practice standards. One of the financial architectural factors is corporate governance. A search of member countries of the Organization of Islamic Cooperation found that ROSCs on corporate governance had been prepared for only four countries (Bangladesh, Malaysia, Pakistan, and Saudi Arabia). However, corporate governance in banking specifically will have been one of the factors in any ROSC against the 2012 Basel Core Principles.
10 For the OECD (2004) Principles, see https://www.worldbank.org/ifa/rosc_cg.html).
11 The international Corporate Governance Principles (OECD 2004) were revised in 2015. See the G20/OECD Principles of Corporate Governance (http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf). Relevant assessments against the revised Principles are not yet available.

on Corporate Governance, IFSB-3, in 2006. The IFSB Principles provide a sound corporate governance framework for Islamic banks, but they do not consider developments in the global corporate governance thinking in the post-crisis era. A standard on Shariah Governance, IFSB-10, was published in 2009, and Core Principles based on those of the BCBS in 2015 (IFSB-17). Revised guidelines for bank supervisors published in 2014 (IFSB-16) discuss issues related to sound risk management practices in Islamic financial institutions.

However, although thinking on corporate governance in Islamic banks has progressed, it has not been brought together in a single document which, like the BCBS Corporate Governance Principles, can be directly implemented by Islamic banks, or incorporated essentially unchanged within a regulatory framework. This should be done, using either the 2015 Basel Principles or the earlier IFSB Guidelines as the base.

Nevertheless, if Islamic banks were to implement the existing standards, whether or not they are compelled to do so by their supervisors, this would go a long way to addressing the governance deficits that have been identified. It may of course be that some have now done so, especially since the BCBS Corporate Governance Principles are roughly contemporaneous with the reports analysed in the study. But any Islamic bank that has not explicitly reviewed its corporate governance framework against at least this standard should now do so.

Strengthen the National-Level Framework for Corporate Governance

Whereas the previous recommendation dealt with the actions that Islamic banks themselves should take, in practice banks are likely to give priority to conforming to the requirements set by national regulators and supervisors. At the national level, corporate governance issues are dealt with through different laws and regulations. Basic features of corporate governance are covered in the companies' laws and there are often additional governance requirements in securities market laws that apply to listed companies. Furthermore, banking regulations commonly have stipulations related to governance that are unique to the banking business.

In some countries, relevant laws such as companies laws12 are not updated and do not encompass the stipulations of new international principles and standards on corporate governance. For example, in assessing the corporate governance status in Bangladesh in 2009, The World Bank (2009a) suggested upgrading the Companies Act to include current thinking on matters such as duties and responsibilities of directors and improving shareholders' rights. Similarly, The World Bank (2012) recommended that the company law in Malaysia should be amended or replaced to protect shareholders, improve legal clarity, and ensure effective disclosure of ownership and control.

Banks are regulated by a diverse set of bodies. In fulfilling the role of protecting investors' rights and promoting the development of transparent and efficient capital markets, the securities regulator requires listed companies to adhere to certain corporate governance standards. For example, in Bangladesh, the Securities and Exchange Commission mandates listed companies to comply with or explain their lack of compliance with its Corporate Governance Code (The World Bank 2009a). Similarly, the Securities and Exchange Commission of Pakistan has issued a Code of Corporate Governance that is mandatory for listed companies. Adoption of the Malaysia Code on Corporate Governance (MCCG) issued by the Securities Commission in Malaysia in 2012 is voluntary, but companies are required to disclose the extent to which they comply with MCCG and reasons for any areas of noncompliance (The World Bank 2012). However, banks may not be listed, or be listed in one country but operate in others through branches or subsidiaries.

12 Exactly which provisions are set at the level of primary law, and which at the level of regulations, rules or guidelines set by a regulatory authority, varies from jurisdiction to jurisdiction. The words used in this section and elsewhere, though reflecting common practice, are not intended to imply a judgement for or against any particular approach to this issue.

Given the unique features of banks, banking regulators require compliance with another layer of governance standards or principles. As noted, BCBS (2015) has issued specific corporate governance guidelines that are relevant to banks, and its Core Principles (BCBS 2012) set expectations for the regulatory and supervisory framework that many supervisory bodies will wish to implement and which are assessed by The World Bank and IMF. Supervisors of Islamic banks will also commonly implement the IFSB standards. For example, in the most recent IFSB implementation survey, conducted in late 2016, 42% of respondents claimed to have implemented the IFSB Principles on Corporate Governance, and 35% to have implemented the standard on Shariah Governance (IFSB 2017).[13]

As these figures suggest, some authorities have recognised the need to include the special features and needs of Islamic banks in developing regulatory corporate governance guidelines for the banking sector. Bank Negara Malaysia issued corporate governance guidelines for financial institutions on August 3, 2016, and these have certain specific provisions that apply to Islamic banks and takaful companies. Similarly, Otoritas Jasa Keuangan, the regulatory body for the financial sector in Indonesia, published the Indonesia Corporate Governance Manual in 2014, which also applies to Islamic banks. It provides guidance on some specific issues that are unique to Islamic banking, such as establishing a Shariah Board in these institutions.

In countries where the laws and regulations do not have a sound framework for corporate governance, the gap can be filled by institutions or trade organizations. An example of a nongovernmental sector initiative is the Bangladesh Enterprise Institute, which has published Codes of Corporate Governance in Bangladesh that provide governance guidelines for corporations, state-owned enterprises, and nongovernmental organizations. While these codes are not mandatory, they provide information on good governance practices for institutions that seek guidance.

In conclusion, the status of corporate governance at a national level will depend to a significant extent on legal and regulatory regimes related to corporate governance. There is a need to have some specific provisions on governance for Islamic banks given the unique features that make them different from conventional banks. The international standards already cited provide a basis for this, and there are also examples from other jurisdictions which can be called upon.

Develop Initiatives to Enhance Awareness of and Improve Training in Corporate Governance

One of the reasons for weaker corporate governance practices in some countries is the lack of awareness of sound corporate governance standards and a lack of understanding of the benefits that they can bring. This is true for countries where corporations with dispersed shareholdings are relatively new and a small part of the corporate sector as a whole. For example, The World Bank (2009b)[14] recognized that lack of awareness on corporate governance issues was a problem in Saudi Arabia and suggested that campaigns such as organizing conferences, seminars, workshops, and media events should be used to increase the awareness of the principles and benefits of corporate governance.

Furthermore, initiatives should be taken to improve corporate governance practices within organizations by providing training to Board members. The training programmes should cover governance issues such as Board processes, oversight of internal controls, and the implementation of codes of ethics, and should be made mandatory for all Board members (The World Bank 2009b). Such initiatives can be undertaken by public training entities, but it is desirable to develop specialized agencies such as a Corporate Governance Institute or an Institute of Directors. A good example is the Pakistan Institute of Corporate Governance, which was established as a public-private partnership with the objective of training directors, raising awareness among market participants, and improving the culture of corporate governance. Another good example is the Jordanian Institute of Directors.

13 Since the respondents included some from jurisdictions where Islamic banking currently has only a negligible market share, and which have not implemented standards for it, it is likely that the proportion of the Islamic banking industry covered by those jurisdictions that have implemented the standards is in fact higher.

14 Here and elsewhere, references to reports on particular jurisdictions are intended simply to illustrate types of issue that may arise and, in some cases, possible ways of addressing them. They should not be taken to reflect the current situation in any country referred to, which may well have changed since the report in question.

Strengthen the Initiatives of International Stakeholders to Promote Better Corporate Governance

Various international multilateral organizations contribute to various facets of corporate governance framework for Islamic finance. The role of the IFSB in standards development has already been discussed, and a case made for development of a revised corporate governance standard. The accounting, auditing, and Shariah standard-setting body for the Islamic financial sector, AAOIFI, also plays an important role in improving the information infrastructure that is relevant for transparency and disclosure aspects of governance.

The need to implement corporate governance standards, especially those which recognise the specific needs of Islamic banks has also been discussed. One constraint that makes it difficult for countries to adopt international standards is weak regulatory capacity to improve corporate governance regimes. For example, The World Bank (2010) recommended that Indonesia should institute reforms to enhance regulatory capacity for better enforcement of corporate governance rules. While individual countries would have to take initiatives to improve governance, different international stakeholders such as CIBAFI, The World Bank, the IMF, the Islamic Development Bank, IFSB, AAOIFI, and others can also play an important role to facilitate this process. The Islamic financial industry can benefit from coordinated efforts of such international multilateral organizations to increase awareness, provide training to enhance the capacity of relevant national agencies, and provide more specific technical support for implementation of enhanced corporate governance frameworks.

3.2. SPECIFIC INITIATIVES TO ADDRESS THE SIX THEMES OF THE CGI

This section discusses policies that can strengthen the components of corporate governance that are included in the study and, in particular ways, to strengthen those items that the CGI identified as weak.

Strengthen Risk Governance Frameworks

The concept of risk governance was not well developed before the global financial crisis, either within conventional finance or Islamic finance. Islamic banks are not alone in needing to do more work in this area. One key change that has taken place in the corporate governance framework for the banking sector after the GFC is the enhanced role of risk governance. This is reflected in the Corporate Governance Principles issued by BCBS in 2015, in which three of the 13 Principles are directly related to risk (Risk management function; Risk identification, monitoring, and controlling; and Risk communication) and several other Principles highlight other roles of risk governance.[15] However, overall risk governance is the weakest theme in the Islamic banks' CGI. There is, therefore, a need to strengthen the risk governance component in the overall governance framework of Islamic banks. The specific items that are weakest in the risk governance theme include lack of independence of Risk Committee members and its chair, and the relatively low status of the Chief Risk Officer (implied in not being a member of the Executive Committee).

The risk governance theme of corporate governance needs to be strengthened in Islamic banks by updating the international standards and principles to reflect developments following the global financial crisis. While IFSB-1 and IFSB-3 discuss risk management issues, they do not incorporate the newer post-GFC risk governance framework that IFSB-16 identifies and that IFSB-17 deals with at high level (in Principle 17, Risk Management Process[16]).

15 These include identifying risk appetite, management, and control as one of the Board's overall responsibilities; the Risk Committee being a part of Board's own structure and practices; overseeing banks' compliance risk as part of Compliance; promoting the long-term soundness of the bank under Internal audit; and remuneration structure to support sound corporate governance and risk management under Compensation (BCBS 2015).

16 Other Principles dealing with specific risks also touch on their management.

This paper has already proposed that new guidelines on corporate governance should be prepared for Islamic banks. Specifically, as regards risk governance, they would upgrade the overall risk roles and responsibilities of governance functions and have the Board, Risk Committee, and CRO playing more prominent roles in dealing with risks in Islamic banks. These international guidelines on risk governance would then have to be adopted by different countries and implemented by Islamic banks.

Enhance the Independence and Competencies of the Board of Directors

The CGI results show that the Board of Directors is one of the weaker governance themes in Islamic banks. Strengthening boards is therefore an important step toward stronger governance. Some of the relevant laws discussed above outline the duties that directors are required to perform. For example, the Companies Act in Malaysia identifies a number of general and specific duties that directors are expected to perform.

The study reveals more specific weaknesses related to the board of directors, including not having enough Board meetings and a lack of independent directors. The latter may well have a knock-on effect elsewhere, since both Audit Committees and Risk Committees showed weaknesses in the involvement of independent directors. The effectiveness and professionalism of both the Board and its Committees can be enhanced by having more independent directors who are expected to be more objective and accountable to shareholders, and who can challenge and hold to account the senior management.

The reasons for the shortage of independent directors are unclear. The World Bank study of corporate governance in Pakistan (The World Bank 2005) noted that "The remuneration paid to directors has traditionally been token, because it was assumed that executive directors received their compensation through other means. The current compensation is inadequate to attract independent directors with the necessary knowledge and experience, especially for member who will serve on the audit committee, where financial and accounting expertise is required." Others have suggested that reasons may include relatively narrow, often family-dominated, patterns of ownership, and a reluctance by managements to be challenged by independent directors.

This issue needs to be addressed at the legal and regulatory levels, by requiring a minimum number or proportion of independent directors, with appropriate knowledge and expertise. Remuneration levels need to be set to attract such people. For Islamic banks, there is an additional need to attract people with the right knowledge and expertise in Islamic banking.

One way to improve the quality of board members is to require them to get training before they begin their work on the board. Given the complexities of the banking business, there may be a need for board members to undertake other training courses that are relevant to different aspects of banking operations. For Islamic banks these would include knowledge about Islamic banking principles, products, and operations. In Malaysia, all board members are required to attend a mandatory training program (Mandatory Accreditation Program). Furthermore, the listing rules of the Securities Commission require companies to disclose in their annual reports other training programs that directors attend.

One of the weaknesses that this study has revealed is the lack of diversity in terms of female board members in Islamic banks. While there is room for laws, regulations, and guidelines to impose diversity requirements related to gender, Islamic banks should take the initiative to encourage the participation of more qualified female members in their boards. This may make good business sense if Islamic banks want to increase the banking services they provide to women clients, who form a large percentage of their clientele.

Enhance the Role and Membership of Board Committees

Having different board committees enables better oversight and deeper focus on areas that are key to good governance. The number and nature of committees depends on the size of a bank, but there are certain board committees that always enhance overall governance quality. The CGI results show that most Islamic banks have an Audit Committee, Risk Committee, and Remuneration/Nomination Committee. However, many Islamic banks do not have a Governance Committee or an Ethics and Compliance Committee.

IFSB-3 recommends that the Boards of Islamic financial institutions should establish a Governance Committee of at least three members to coordinate and implement the governance policy framework of their organizations. The IFSB stipulates that one of the members of the Governance Committee should be a member of the Shariah Supervisory Board (SSB) to oversee the Shariah-related issues in the governance and operations of Islamic banks. IFSB-3 identifies protecting the rights of investment account holders (IAHs) as one of the key roles of the Governance Committee. The members of the Governance Committee should work with the management, the Audit Committee, and the Shariah Supervisory Board to oversee the implementation of the governance policy framework and to report the overall status of the governance practices to the Board. One of the key roles of the Governance Committee is to protect the rights of the stakeholders other than the shareholders. Given the fiduciary relationship of investment account holders and the fact that they share some of the bank's risks, mandating this role to the Governance Committee can be of supervisory interest.

An Ethics and Compliance Committee should "ensure that the bank has the appropriate means for promoting proper decision-making, due consideration of the risks to the bank's reputation, and compliance with laws, regulations and internal rules" (BCBS, 2015). Given that Islamic banking aims, if anything, at higher ethical standards than its conventional counterpart, one reason for not having Ethics Committee in most banks may be the existence of a Shariah Board. There is a perception that by being Shariah compliant, Islamic banking practices are inherently ethical. However, there are ethical and compliance issues which would not normally be dealt with by a Shariah Board, for example issues of sustainability or the bank's compliance with AML/CFT regulations. There is thus a need to have a committee that oversees these issues. The existence of such a committee should be included as a recommendation in any update of the IFSB's Governance Principles and in national codes.

Enhance the Effectiveness of Internal Control and External Audit

External audit is commonly a requirement in companies' law regimes. For listed companies, IOSCO (2017) requires the publication of audited financial statements, and sets requirements for the oversight of auditors.

Recognizing that one of the weaknesses of governance that led to the global financial crisis was the quality of external audits, BCBS (2014) published a document focussing on ways that external audit could be improved. Good quality audits, by auditors independent in both fact and appearance from those they audit, not only provide helpful input to supervisors, but also help to instil market confidence in financial statements and thereby contribute to financial stability. A bank's Audit Committee should have wide responsibilities for the appointment of the auditor and for monitoring and assessing the audit, and should have direct communication with the auditor.

There should also be strong internal control frameworks including "an independent, permanent and effective internal audit function" reporting to the Board or an Audit Committee (BCBS 2012).

The CGI results show that some elements of internal control are prevalent in Islamic banks. Internal control frameworks are strong, with internal auditors existing at nearly all banks and, crucially, the internal audit team usually reporting to the board or the board's Audit Committee.

The weaknesses revealed by the CGI in the theme of Internal Control and External Audit include the Audit Committee not having adequate independent members or an independent chair, and not meeting sufficiently frequently. The issues around independent board members have partly been addressed above. However, regulators could also directly require banks in general and Islamic banks in particular to have Audit Committees that have a majority of independent members and are headed by an independent chair. Regulatory guidelines on governance may also require that the Audit Committee meets at least quarterly, as is required in the Guidelines on Corporate Governance for Licensed Islamic Banks by Bank Negara Malaysia.[17]

Develop Robust Shariah Governance Frameworks

Shariah governance is a unique feature of Islamic financial institutions, but the CGI results show it to be among the weaker themes of corporate governance in Islamic banks. Although IFSB -10 provides guidelines for Shariah governance, these have not been universally adopted, though the IFSB's Islamic Financial Services Industry Stability Report 2017 shows material progress since the annual reports on which this study was based.

Some countries such as Malaysia and Pakistan have instituted good Shariah governance regimes, but in some countries the regulators neither provide centralised Shariah guidance nor impose effective governance at the level of individual banks. In these countries, Shariah governance is often driven by market considerations. Thus, the weaker status of the Shariah governance in the CGI is a reflection of the lack of Shariah governance regimes at the national level. One of the problems of implementing the IFSB's 2009 Guiding Principles is that they do not fit with the framework of largely conventional regulation (Casey 2015). However, as the experience of some countries has shown, providing a regulatory framework on Shariah governance instils discipline in Shariah matters and thereby reduces reputational risks.

Furthermore, as many customers of Islamic banks deal with Islamic banks due to their religious convictions, ensuring Shariah compliance is a matter of protecting consumer rights. Regulators should therefore have some guidelines to ensure that a sound Shariah governance framework is in place that ensures that banks have sound and effective Shariah controls and procedures that give a reasonable assurance that products and operations comply with Shariah principles and values. The CGI results show that specific items that can be improved include diversity and the frequency of meetings. Having members with different backgrounds is likely to improve the deliberations of Shariah Boards since issues will be discussed from different perspectives. Furthermore, as identified in IFSB-10, a robust Shariah governance regime has different organs within the organization that perform various operational and control functions. Instituting these in banks can be best done at the regulatory level.

There are some other Shariah governance issues that need regulatory attention. These include implementing a conflict of interest policy (regarding such matters as compensation, financing, and appointment of relatives) to ensure the independence of Shariah Committee members. IFSB-10 has identified how some of these issues can be resolved, and Appendix 3 of that standard, entitled "Basic Professional Ethics and Conduct for Members of the Shariah Board," can be adopted to enhance sound governance of Shariah Boards. Some jurisdictions have also chosen to limit the number of memberships that Shariah Board members can commit to, to reduce conflicts of interest and ensure that they can spend appropriate time on each.

17 See http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/17_Licensed_Islamic_Banks.pdf.

Improve Transparency and the Quantity and Quality of Disclosure

Providing relevant information to different stakeholders enables them to assess the performance and effectiveness of the Board and senior management in running the bank. Transparency and accurate disclosure of key information are therefore among the key indicators of good corporate practice and are included as a part of all international corporate governance guidelines and standards, such as the G20/OECD 2015 Principles, the Basel Committee on Banking Supervision 2015 Principles, and IFSB-3, as well as most national-level guidelines and laws.

The results on Islamic banks' corporate governance practices show that Islamic banks have much to be proud of. Transparency and Disclosure is generally good. Most banks publish reports on their risk management policies and procedures, and most have clear policies on the remuneration of Board members and senior executives. However, the areas in which disclosure can be improved further relate to the disclosure of information on internal audit/control, Shariah compliance, and the corporate governance framework. Disclosure of these nonfinancial areas would further enhance the transparency regimes of Islamic banks.

As sound corporate governance is a key regulatory issue, the status of the bank's compliance with the national corporate governance principles and standards should be disclosed to the stakeholders. For example, in Malaysia, companies are required to publish a Statement of Compliance with the Malaysia Code on Corporate Governance that shows the overall status of corporate governance of the organization. Such disclosures will in themselves create incentives to raise the standards of other aspects of corporate governance.

The disclosure of Shariah issues also warrants attention. Lack of disclosure of Shariah compliance is perhaps a reflection of weak regulatory Shariah governance regimes, as discussed. Various standards from both AAOIFI and IFSB mandate Shariah-related disclosures, not only on governance but on issues such as profit distribution to the investment account holders and the use of profit equalization and investment risk reserves (see, for example, IFSB-4. These standards should be implemented by regulators as they implement the more general disclosure regimes required by the Basel III standards).

APPENDIX A: SCOPE AND METHODOLOGY OF THE STUDY

The aims of the study are to assess the status of corporate governance in Islamic banks, review where it is strong and where it is weak, and suggest ways in which it can be improved.

The financial sector plays an important role in countries' economies and contributes to economic growth and development. Both theoretical and empirical studies suggest that proper corporate governance practices implemented by institutions facilitate access to finance, reduce perceived risk by investors and thereby the cost of capital, improve operational performance, and increase institutions' resilience against external shocks.

As a result, well-governed institutions not only benefit from better performance and soundness but they also promote overall economic development. While corporate governance affects the efficiency of companies and the overall economic performance at the national level, its status in banks and financial institutions also affects capital allocation in the economy. However, financial intermediation is inherently risky and the sector can generate negative externalities that can introduce instability in the economy if the risks are not well managed. An important aspect of bringing stability and efficiency to the banking sector is to require good governance practices and structures.

While almost all corporate governance principles developed by international organizations such as the OECD and the BCBS also apply to institutions providing Islamic financial services, there are some additional governance issues that arise in Islamic financial institutions. A key distinguishing feature of Islamic financial institutions that makes them different from their conventional counterparts is that they follow the principles and values of the Shariah. There is, therefore, a need to have governance mechanisms in place to ensure that there are adequate corporate governance controls that assist in ensuring operations and products of Islamic banks comply with the Shariah. There are also governance issues around the protection of investment account holders, whose interests are not identical with those of depositors in a conventional bank. Some of these issues have been addressed in standards developed specifically for the Islamic finance industry.

1. CORPORATE GOVERNANCE AND FINANCE: CONCEPTS AND LINKAGES

Corporate governance can be thought of as "a set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance."[18] Corporate governance can be strengthened by market discipline because market participants who have a stake in the institution will serve as monitors. Their ability to monitor will depend on the quality and quantity of information they receive, which in turn will depend on the quality of accounting standards and practices.

Though the primary responsibility for good governance rests with Boards of Directors, who represent the shareholders, and senior management, there are several external factors that have a direct influence on the governance of corporations in general and financial institutions in particular. The key external factors that affect corporate governance in financial institutions can be classified into three broad categories. First is the overall environment and the economic and financial systems under which financial institutions operate, including the financial laws and regulations and overall legal and accounting systems. The second group of factors that affect corporate governance includes the public institutions that directly or indirectly regulate, monitor, and supervise corporate governance practices. These would include the supervisors and in some cases trade associations. While both may set standards, it is supervisors who monitor the overall operations to ensure a stable and sound financial system. Finally, the key external players that have relevance to corporate governance in financial institutions are the bond holders (or sukuk holders), depositors, and external auditors. Key stakeholders in Islamic banks also include IAHs, who in principle share the risks on the investments made with their money (IFSB 2014). Because the Sukuk holders and depositors and IAHs can monitor the activities of the banks only indirectly, the external auditors play a critical role in evaluating the accuracy of the quality and quantity of information provided by the management.

Many studies have identified weak governance in financial institutions as a key factor that led to the global financial crisis. Thus, following the crisis, different stakeholders have paid considerable attention to sound governance and management of financial institutions. In this regard, Pillar II of Basel III has been strengthened with an Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning. One way this has been done is by adding supplementary requirements on governance and risk management. In 2012, the BCBS revised its Core Principles for Effective Banking Supervision, adding a new Core Principle on corporate governance, with associated assessment criteria (BCBS 2012), and in 2015 it updated and expanded its Corporate Governance Principles for Banks, which had first been published in 2006. The IFSB in 2015 published its Core Principles for Islamic Finance Regulation (Banking Segment) (IFSB-17), which includes a Core Principle on corporate governance based on the relevant BCBS Core Principles, but modified for the special circumstances of Islamic banks.

2. THEMES IN CORPORATE GOVERNANCE IN ISLAMIC BANKS

BCBS (2015) identifies the governance structure as being composed of the board of directors and senior management[19]. Given the distinct features of Islamic financial institutions arising from their commitment to the principles of the Shariah, corporate governance in these institutions encompasses certain additional stakeholders and issues that may not be found in conventional financial institutions. For example, in its third guiding principle on corporate governance, IFSB-3 identifies customers and communities as stakeholders with vested interests in the well-being of Islamic financial institutions. IFSB-3 emphasizes that Islamic banks should put in place adequate means to

18 BCBS (2015, 2); OECD (1999, 2).

19 Different jurisdictions have different structures of corporate governance, and the BCBS acknowledges that its terminology should be interpreted in accordance with the applicable law in each.

ensure that the IAH's rights such as the right to monitor their accounts and associated risks, are observed and exercised.

In general, the literature on corporate governance from an Islamic perspective has focused on issues relating to Shariah rulings and governance structures. These include studies related to controls on Shariah compliance, traditional concepts of governance, human character and decision making, investment account holders, Shariah Supervisory Boards, profiles of Shariah scholars, and Shariah review and audit. Only a few attempt to explore the implementation of corporate governance in Islamic financial institutions based on international standards of corporate governance (Hawkamah 2011) or indicators. In addition, the data used in these analyses are usually comprised of case studies and some small samples. As a result, there was a need for a much more robust study to investigate the status of corporate governance practices of Islamic banks, considering various dimensions of the corporate governance framework.

After scanning the literature on corporate governance in general and governance issues in Islamic finance in particular, this study considers the following six themes of corporate governance.

Board of Directors

By providing independent oversight of managers, the board of directors plays an important role in guiding banks and financial institutions toward sound management and operations.

The BCBS (2015) identifies the key responsibilities of the Board as the "bank's business strategy and financial soundness, key personnel decisions, internal organization and governance structure and practices, and risk management and compliance obligations." To have effective oversight, BCBS (2015) recommends that the board should have a sufficient number of independent directors and that the directors should collectively have the qualifications, background, knowledge, skills, and expertise to understand the risks and complexities of the bank and to guide the bank in a sound and prudent manner. The chair of the board plays an important role by providing leadership and ensuring the proper functioning of the board (BCBS 2015). The chair should be an independent or nonexecutive board member and ensure appropriate checks and balances. Although BCBS 2015 does not explicitly recommend that the position of chair and chief executive should be separated, it is generally considered good practice for this to happen (Ard and Berg 2010).

Board Committees

BCBS (2015) recommends that the board should establish different board committees so that specific issues can be dealt with in a focussed manner. The size and composition of the board committees will depend on factors such as bank and board size. Among others, the BCBS recommends establishing the following committees.

Audit Committee: The responsibility of an Audit Committee is to frame policies and provide oversight on and financial reporting and internal audit and to interact with internal and external auditors. In order to maintain the effectiveness of the committee, it should be headed by an independent board member. Preferably, all other members should be independent and non-executive and have experience in auditing and financial reporting.

Risk Committee: The role of the Risk Committee is to advise the board on the bank's risk appetite and oversee the implementation the bank's risk management framework in line with the risk appetite statement and in coordination with the Chief Risk Officer. The committee should be headed by an independent director.

Compensation Committee: The Compensation Committee's role is to oversee the remuneration schemes of the bank to ensure that incentives and compensation are in line with the long-term business goals and risk appetite of the institution. This entails examining the remuneration policy's effects on earnings, capital, liquidity, and risks (including how compensation schemes are likely to determine the way in which staff behave), and working closely with the Risk Committee.

Nomination/Governance Committee:
This committee studies the role and responsibilities of board members and identifies the knowledge and skills that are required from new board members. The Nomination/Governance Committee should include a sufficient number of independent members.

Ethics and Compliance Committee: This committee ensures that the institution complies with the external laws and regulations, on the one hand, and internal rules and ethical codes, on the other hand. Furthermore, achieving the Sustainable Development Goals launched by the United Nations in 2015 will require huge amounts of financing. The United Nations Environment Programme's Finance Initiative strongly encourages banks to consider sustainability issues in their operations, and this role would fall naturally to an ethics committee.

Internal Control and External Audit

A bank's risk profile can change quickly. In such situations, weak internal controls can lead to instability (Ard and Berg 2010). A bank's internal audit department and its external auditors play important (and different) roles in ensuring that a bank's internal controls are effective.

Principle 10 of BCBS (2015) relating to internal audit states: "The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank." The chief internal auditor should report to the board or its Audit Committee. The internal audit department is responsible for carrying out risk-based and general audits and reviews in order to strengthen the overall governance and risk governance framework by ensuring that all policies and processes are applied consistently throughout the organization. In order for the internal audit to function effectively and independently, it should be given access to all relevant information and records of the organization.

Realising that one of the weaknesses of governance that led to the GFC was the quality of external audits, BCBS (2014) published a document focusing on ways that external audit could be improved. Good quality audits identify weaknesses in financial reporting and internal controls so that remedial measures can be taken, provide helpful input to supervisors, and also help instil market confidence in financial statements. A bank's Audit Committee is responsible for ensuring that the financial statements are audited by an independent external auditor.

Risk Governance

The importance of risk management for financial institutions became particularly apparent during the GFC. Directors paid insufficient attention to risks and sometimes did not understand the risks that their banks were facing or how the risks had been changing.

Recognizing the weaknesses of risk management practices in financial institutions that led to the global financial crisis, the Corporate Governance Principles for Banks issued by BCBS (2015) put a lot of emphasis on risk governance. Of the 13 corporate governance principles identified by the BCBS, three specifically relate to risk management. Principle 6 concerns the risk management function, Principle 7 deals with risk identification, monitoring and control, and Principle 8 relates to risk communication. Other principles also refer to other aspects of risk management. For example, one of the responsibilities of the Board specified in Principle 1 is "risk appetite, management and control" and Principle 3, which deals with the Board's structure and practices, recommends establishing a Risk Committee.

Shariah Governance

Sound Shariah governance involves instituting structures, controls, and processes to ensure that Shariah principles and requirements are fulfilled in all contractual, procedural, and operational aspects of an Islamic financial institution from the perspectives of different stakeholders (Ahmed 2011). While an Islamic bank will have various organs and processes in the governance system, a key component of this system is Shariah supervision that ensures that Shariah requirements are fulfilled. In order to reduce Shariah compliance risks and ensure that the Islamic financial institutions fulfil their obligations of conducting business according to underpinning operational Shariah principles and licensing requirements, the regulatory bodies can also choose to provide Shariah governance frameworks and guidelines.

IFSB-10 proposes four aspects that Shariah governance systems should have at the level of IFS. These are: issuance of Shariah pronouncements, ensuring day-to-day compliance with the Shariah, internal Shariah compliance review and audit, and annual Shariah compliance audit to ensure that internal Shariah compliance review has been properly carried out. To undertake these functions, the IFSB identifies different Shariah organs. which include an in-house Shariah compliance unit/department, internal Shariah review/audit unit, and a Shariah Supervisory Board.

Transparency and Disclosure

Information disclosure enables market actors to monitor banks' activities, which can lead to stronger governance through market discipline (Mehran and Mollineaux 2012). Principle 12 of BCBS (2015) on disclosure and transparency recommends that banks should provide adequate and relevant information to their shareholders, depositors, market participants, and other stakeholders. It recommends applying the transparency section of the OECD Principles on Corporate Governance, it suggests publishing timely and periodic reports that provide comprehensive information on different aspects of corporate governance and risk exposure and management.

With regard to transparency and disclosures in Islamic banks, IFSB-3 and IFSB-4[20] provide specific guidelines. For example, IFSB-4 provides details of the issues that need to be disclosed by Islamic financial institutions, which include financial and risk disclosure principles, disclosures for investment account holders, and disclosures on general governance and Shariah governance. Similarly, Principle 4 of IFSB-3 states that Islamic financial institutions should make "timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage."

3. SCOPE AND FRAMEWORK OF THE STUDY

The study proceeded first by developing a conceptual framework for a Corporate Governance Index for Islamic financial institutions based on relevant theoretical and empirical literature and different standards on corporate governance. The empirical part of the study uses data collected from a sample of Islamic banks from different regions of the world. The framework of the CGI and the methods to collect and analyse data are presented below.

Although a key feature of the discussion on corporate governance relates to protecting shareholders' rights, this study focuses on the aspects of governance that can contribute to sound management and bring about healthy growth and stability in the financial sector. This is in line with the BCBS Corporate Governance Principles for Banks (BCBS 2015), which focus less on the rights of shareholders than on the need to achieve robust and transparent risk management and decision-making and, in doing so, uphold the safety and soundness of the banking system. The rights of shareholders are, however, a major feature of the G20/OECD Principles of Corporate Governance (G20/OECD 2015).

20 IFSB (2007) is currently being updated.

4. CORPORATE GOVERNANCE INDEX: THEMES AND FRAMEWORK

The elements that were used to develop the CGI were chosen to reflect regulatory perspectives identified in regulatory guidelines such as those cited above. In identifying the factors that would comprise the index, the study took into consideration that information used should be publicly available in reports or on websites.

The CGI can be viewed at three different levels: in the aggregate, by theme, and by individual items.

Table A. 1: Themes and Number of Items per Theme in the Corporate Governance Index

NO.	CORPORATE GOVERNANCE THEMES	ITEMS
1	Board of Directors	6
2	Board Committees	6
3	Internal Control and External Audit	6
4	Risk Governance	6
5	Shariah Governance	6
6	Transparency and Disclosure	6
	Aggregate CGI	36

The aggregate CGI comprises the six themes identified in Table A.1. Each theme in turn has six items that are identified from the literature and regulatory guidelines. The approach taken is similar to research that uses content analysis, whereby each item can take the value of 1 or 0 depending on whether or not it is present (Haniffa and Hudaib 2007). Given this framework, each theme can have a maximum score of 6. The highest value of the aggregate CGI can therefore be 36.

As data are collected by using content analysis of annual reports and webpages, the process requires identifying the key words and codes under different themes that are searched in texts and documents. Thus, the key words and elements representing each item and the scoring criteria need to be specified. Some elements of judgement were inevitably necessary in choosing which items to select from those in principle available, and also in translating some general statements of principle (for example on frequency of meetings) into specific objective criteria.

The items included in each theme, the relevant supporting literature, and the scoring criteria for different themes are summarized in Tables A.2–A.7.

Table A. 2: Board of Directors (A): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
--	Board size	Annual reports and/or bank websites	Noted only (this is not a component of the index)
A1	Qualifications/experience of directors	IFSB (2006); BCBS (2015)	If disclosed, 1; otherwise, 0
A2	Number/proportion of independent directors	(IFC and Hawkamah (2008), at least 2; Aebi, Sabato, and Schmid (2012); Klapper and Love (2002); BCBS (2015)	Majority, 1; otherwise, 0
A3	Chairman is not the CEO	IFC and Hawkamah (2008); Da Silva and Leal (2005)	Yes, 1; otherwise, 0
A4	Number of board meetings/ year	IFC and Hawkamah (2008); Klapper and Love (2002)	If more than 6, 1: otherwise, 0
A5	One or more female member	IFC and Hawkamah (2008)	Yes, 1; otherwise, 0
A6	Formalized Code of Ethics/Business Conduct	IFC and Hawkamah (2008); G20/OECD (2015)	Yes, 1; otherwise, 0
	Score		**6**

Table A. 3: Board Committees (B): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
B1	Governance Committee	BSBC (2015); IFSB (2006)	Yes, 1; otherwise, 0
B2	Executive Committee	Bader (2009)	Yes, 1; otherwise, 0
B3	Audit Committee	IFSB (2006); Klapper and Love (2002)	Yes, 1; otherwise, 0
B4	Remuneration/Nomination Committee	BCBS (2015); Klapper and Love (2002)	Yes, 1; otherwise, 0
B5	Risk Committee	BCBS (2015); FSB (2013)	Yes, 1; otherwise, 0
B6	Ethics and Compliance Committee	BCBS (2015)	Yes, 1; otherwise, 0
	Score		**6**

Table A. 4: Internal Control and External Audit (C): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
--	Audit Committee size		Noted only (this is not a component of the index)
C1	Number proportion of independent members Audit Committee	BCBS (2015); IFC and Hawkamah (2008)	Majority, 1; otherwise, 0
C2	Independent Chairperson of Audit Committee	BCBS (2015); James-Overheu and Cotter (2009)	Yes, 1; otherwise, 0
C3	Number of Audit Committee meetings		4 or more, 1; less than 4 or not disclosed, 0
C4	Existence of internal audit department/ unit	BCBS (2015)	Yes, 1; otherwise, 0
C5	Internal audit reporting to Board/Audit Committee	BCBS (2015)	Yes, 1; otherwise, 0
C6	External auditor appointed	BCBS (2015)	Yes, 1; otherwise, 0
	Score		**6**

Table A. 5: Risk Governance (D): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
D1	Board guidance on risk appetite/profile	BCBS (2105a); FSB (2013)	Yes, 1; otherwise, 0
D2	Risk Committee chair independent	BCBS (2015)	Yes, 1; otherwise, 0
D3	Majority of members of Risk Committee independent	FSB (2013)	Yes, 1; otherwise, 0
D4	Chief Risk Officer (CRO) exists	BSBC (2015); FSB (2013)	Yes, 1; otherwise, 0
D5	CRO reports to board of directors or Risk Committee	FSB (2013)	Yes, 1; otherwise, 0
D6	CRO member of Executive/Risk Committee	Aebi, Sabato, and Schmid (2012)	Yes, 1; otherwise, 0
	Score		**6**

Table A. 6: Shariah Governance (E): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
E1	Number of Shariah Board members	AAOIFI (2010)	3 or more, 1; otherwise 0
E2	Duties of Shariah Board	IFSB (2009)	Yes, 1; otherwise, 0
E3	Member (nonvoting) with non-Shariah background	IFSB (2009)	Yes, 1; otherwise, 0
E4	Number of Shariah Board meetings	IFSB (2009)	If more than 6, 1; otherwise, 0
E5	Shariah review/audit department/unit	AAOIFI (2010); IFSB (2009)	Disclosed, 1; otherwise, 0
E6	Statement on the use of prohibited income	AAOIFI (2010)	Yes, 1; otherwise, 0
	Score		**6**

Table A. 7: Transparency and Disclosure (F): Items, Sources and References, and Criteria

NO.	ITEMS	SOURCES AND REFERENCES	CRITERIA
F1	Corporate Governance Report	BCBS (2015); IFC (2014); G20/OECD (2015)	Yes, 1; otherwise, 0
F2	Remuneration policy of Board members and senior executives disclosed	BCBS (2015); G20/OECD (2015)	Yes, 1; otherwise, 0
F3	Shariah (Compliance/Audit) Report	AAOIFI (2010)	Disclosed, 1; otherwise, 0
F4	Risk Management Report	IFC (2014)	Yes, 1; otherwise, 0
F5	Internal Audit/Control Report	HKSA (2001); G20/OECD (2015)	Yes, 1; otherwise, 0
F6	Corporate Social Responsibility Report	UNEP (2011)	Yes, 1; otherwise, 0
	Score		**6**

5. RESEARCH METHODS: DATA COLLECTION

The population of the study consisted of all Islamic banks operating globally. The sample for the study was based on the following criteria. Countries where Islamic banking has a significant share of the banking sector were identified by using country-level information provided in the IFSB's Islamic Financial Services Industry Stability Report 2016 . To keep the workload manageable within the stipulated time, it was decided to take a sample of five largest banks from the 15 countries that have the highest Islamic banking share of the total banking assets. Thus the total sample would include 75 banks. However, searching for annual reports revealed that some countries had fewer than five Islamic banks and in other cases information was not available. Other countries such as Indonesia, Turkey, Kenya and Nigeria were deemed as important for the Islamic financial services industry and were therefore added to the sample. The sample of the study constitutes a total of 77 Islamic banks, including free-standing banks, subsidiaries and Islamic windows. Table A.8 shows the distribution of the banks in the sample across different regions.

Table A. 8: Islamic Banks in the Sample by Region and Country

REGION	BANKS FROM WHICH COUNTRIES	NUMBER OF BANKS IN THIS GROUP
East Asia and Pacific	Indonesia, Malaysia	10
Middle East and North Africa – Gulf Cooperation Council (GCC)	Bahrain, Kuwait, Qatar, Saudi Arabia, United Arab Emirates, Oman	28
Middle East and North Africa – Non-GCC	Egypt Arab Rep., Iran Islamic Rep., Jordan, Yemen Rep.	13
South Asia	Bangladesh, Maldives, Pakistan	12
Sub-Saharan Africa	Kenya, Nigeria, South Africa, Sudan	8
Europe	Bosnia, Turkey, United Kingdom	6
Total number of countries and banks	**22 countries**	**77 banks**

Source: CIBAFI and The World Bank.

The total assets of the banks used in the sample were \$1.381trillion. This amounts to 92.8 percent of the assets of the Islamic banking industry, which the IFSB (2016) put at \$1.496 trillion in 2015.

Data on Islamic banks were collected using two main sources. First, content analyses of the most recent available annual reports were carried out to search for the relevant corporate governance indicators identified above.[21] Second, information was sought from the webpages of relevant banks to gather additional information. To improve the reliability and consistency of the data, information on the same bank was collected by two researchers. The results were cross-checked to ensure not only that most of the relevant data had been captured, but also to arrive at the final consistent data that were to be used for analysis.

It should be noted that content analyses capture only the information that is revealed in the documents and webpages from where the data is collected. This method has the limitation of not capturing the actual practice when some elements of governance that are practiced are not revealed in these sources.

21 Most of the data were gathered from 2015 annual reports. In cases when those reports were not available, then 2014 annual reports were used.

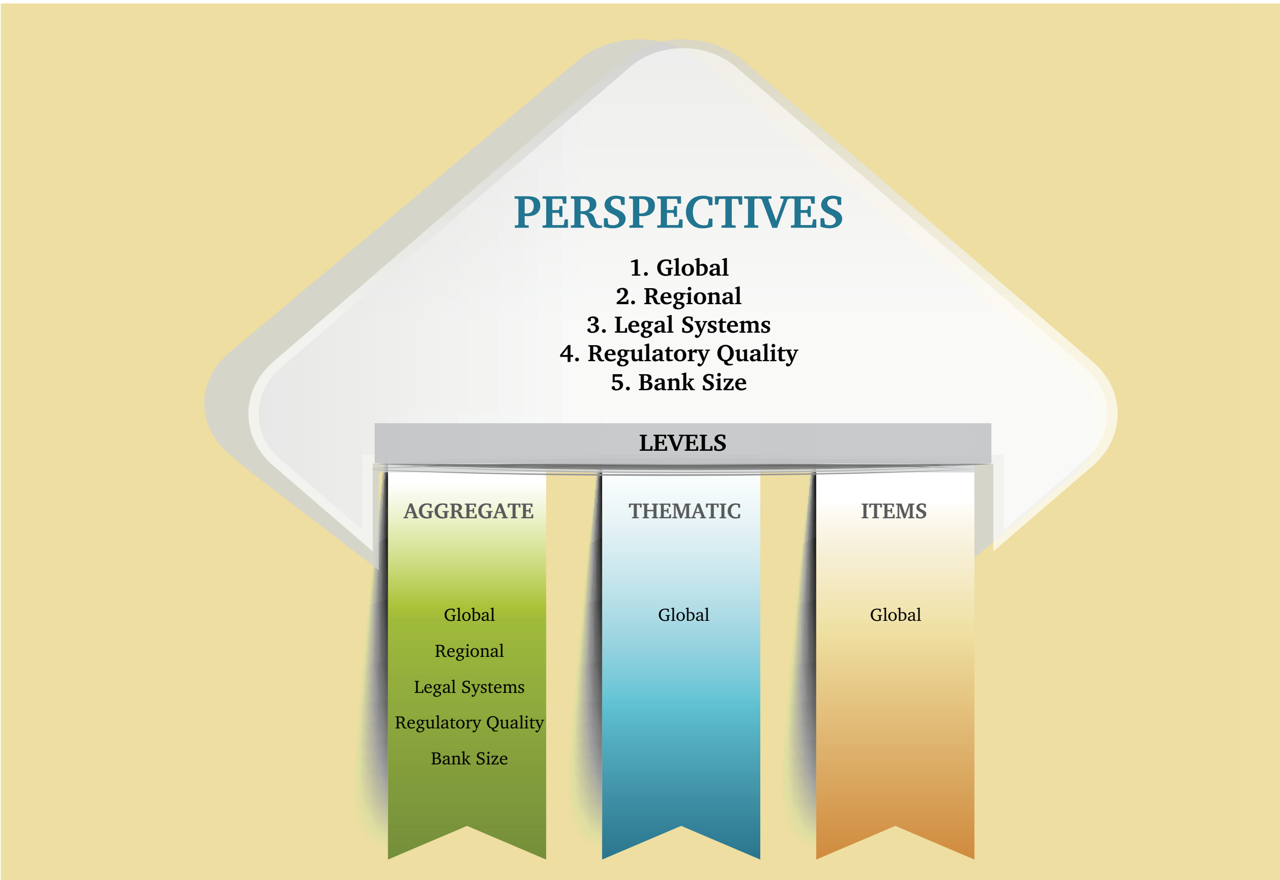
6. RESEARCH METHODS: DATA ANALYSIS

The analysis is carried out for different levels of the CGI (in aggregate, by theme, and by item) and provides comparative analyses from different perspectives. The results reveal information on the relative strengths and weaknesses of individual components of corporate governance for different financial institutions across different regions. Data are presented in numerical and graphic form.

Furthermore, the CGI is reported from five different perspectives to shed light on the factors that can affect corporate governance in Islamic banks.

The first perspective, the global perspective, includes all the banks in the sample, while the second, the regional perspective, provides results for different regional groupings. The third perspective focuses on the legal and regulatory systems of different countries, which have an impact on their corporate governance frameworks. The fourth perspective examines the CGI according to the regulatory quality index of The World Bank. The final perspective focuses on the banks' size to see if the CGI is related to total assets of different banks. A summary of the results reported across perspectives and levels of analysis is shown in table A. 9.

Table A. 9: CGI Results Reported across Perspectives and Levels of analysis



Source: CIBAFI and The World Bank.

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