

## Element of Corporate Governance in Islamic Banks vs Conventional Banks: A Case Study

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### Abstract

Corporate governance (CG) have gained a prominent place in the sustainability of any institution, be it a corporate or a bank. Individuals lack detailed knowledge on the applicability of CG and its aspects in Islamic Banks (IBs) in contrast to Conventional Banks (CBs). Thus, the objective of this study is to explore 'how' and 'why' IBs differ from CBs in terms of structure of CG and its elements mainly board responsibilities, legal and regulatory compliance, internal control environment and auditing from a fundamental perspective. The study adopts interpretative methodology and multiple case study strategy in selecting one bank to represent each banking systems. Further, primary and secondary data were collected through interviews, observations, reports and websites.–Major findings of the study concluded that IBs and CBs enclose differences as well as similarities pertaining to their CG and selected aspects. Major differences are driven connecting to the framework of IBs as they need to follow interest free paradigm, Profit and Loss Sharing paradigm and *Shariah* principles in performing the banking functions. Hence, these major principles have influenced for emergence of different CG structure in IBs.

**Keywords:** Islamic bank, Conventional bank, corporate governance, Profit and Loss Sharing paradigm, *Shariah* principals

### 1. Introduction

The financial institutions play a key role in the economy of any country as it facilitates the financial intermediation. As a result the sustainability of Financial Institutions (FIs) is a pre-request for the sustainability of economy as any crisis in FI would adversely affect a country's economy. Thus institutions need to take measures to govern its activities and process with an aim to achieve business objectives. Corporate governance (CG) plays a key role in this process. Good CG requires the governing bodies to manage all the aspects of a FI and thus important elements of good CG should also practiced in banks whether it would be a conventional bank (CB) or Islamic bank (IB). Islamic banking is a new concept that introduced specifically for committed Muslims to carry out banking transactions as per to their religious beliefs. IB performs financial intermediation by undertaking primary and secondary banking functions as conventional banks (CBs) but subject to interest free principle, profit and loss sharing paradigm along with Islam law. The Organization of Islamic Conference defined IB as "*a FI whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations.*" Thus IBs deem to be very unique than CBs since they reject interest and follow interest free framework while conforming to *Shariah* principles. However it can be observed that CG has been a popular research arena in the context of CBs. But there are very few studies that are undertaken on governance structure of IBs despite the unprecedented growth and expansion in last decades on world markets. With its growing awareness and success, IBs made its entry to the Sri Lankan banking industry in 2009, but still the bankers and individuals lack the detailed fundamental understanding on CG structure of IBs.

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Thus it would have been value adding to obtain a comprehensive understanding on new banking system as IB structure presents a radical departure from the CB due its unique and interesting features. Thus, this research would fill the knowledge and empirical gap in the Sri Lankan context. Hence the scope of the study is to understand about fundamental elements pertaining to CG, that are board responsibilities, legal and regulatory compliance, internal control environment and auditing as well as Risk Management (RM) specifically. Thus the study attempts to ascertain to what extent Islamic banks differ from conventional banks and its application of Shariah principles in Sri Lankan context with especial reference to the above aspects by selecting one bank to represent each CB and IB systems.

## **2. Adopted Research Methodology & Materials Used**

The purpose of the research is to gain a better understanding of the concept IB and its application in the Sri Lankan context as well as to identify how and to what extent it differs from CBs in the light of corporate governance. This is an exploratory study. Therefore, the qualitative nature of methodological approach has been used to go profound into the research area and to achieve the objectives. Interpretative methodology and multiple case study strategy have been employed to analyze the data. The study has selected two banks, IB1 and CB1 which represent IBs and CBs systems accordingly. Data are primarily collected by following in-depth focused interviews employing an interview guide. Further, within the scope of research, the current study has further used internet and observation as sources of data collection. The documentation was also used in order to supplement evidences from other sources. For example, data available in bank information materials as annual reports, articles and brochures were collected to acquire an overall view of the present situation of banks. Moreover the researcher obtained information and downloaded annual reports from the websites of two banks.

## **3. Analysis and Discussion of Findings**

It is known that CG is a mandatory requirement for any organization and as it enables a company to attain their objectives in a socially responsible manner by aligning with stakeholders' interest. Accordingly CG is a mandatory requirement for CB1 and they place a higher focus towards its CG framework to ensure a sustainable and a long-term value creation for shareholders. As emphasized by the informant of CB1, the bank does not perceive CG practices as only a matter for board, but perceive it as the heart of everything they do within bank. As a result, CB1 operates within a comprehensive governance framework for reviewing and improving its systems to provide transparency, accountability as well as to ensure that best practices are maintained according to the principles of CG and that they are in line with stipulated guidelines. Therefore it is emphasized that CB1 follows all prudential banking regulations and legal requirements to ensure legal as well as regulatory compliance. In this process, the BOD of CB1 is responsible for developing, reviewing and improving systems to ensure an effective CG framework within the bank. Further, BOD of CB1 should ensure that the best practices are maintained that are in line with legal and regulatory requirements of SL and international regulatory authorities which are applicable to industry.

In the case of IB1, though they practice interest free banking, they also place a higher importance in CG within the bank as IB believes that effective CG is vital to ensure legal and regulatory compliance as well as to ensure compliance with equitable principles of Shariah. As a result, IB1 carries out banking business within Shariah compliant framework and they too adhere to all the banking regulations as well as legislative enactments in SL as CB1 besides their Shariah regulations. Accordingly IB1 operates with a Shariah Supervisory Board (SSB) to ensure its compliance with Shariah principles in undertaking the banking activities. IB1 has a dedicated compliance department, which reports to the board to ensure legal and regulatory compliance. These findings emphasize that the board of CB1 is responsible for effective CG framework as well as for legal and regulatory compliance. In the case of IB1, they have a separate compliance department, which reports to the board to handle CG as well as legal and regulatory compliance of the bank. IB1 operates with SSB to handle Shariah compliance. Accordingly, the study validates that the board is responsible to handle CG framework in CB1 whilst the board and SSB, both handle CG in IB1. SSB of IB1 is responsible to give advices to the BOD on the matters relating to Shariah compliance. As indicted by the informant of IB1, this SSB comprises of experienced and eminent religious scholars who have exclusive knowledge about Shariah principles. SSB has the ultimate responsibility to reject any proposals, operations, products and services of IB1 when it violates Islam law and to accept them when it in line with Islam law. Thus, it is discovered that SSB of IB1 operates independently from BOD and that they have more power than its board.

This study emphasizes that IB1 operates with two boards, SSB and BODs. On the other CB1 operates only with BOD as they are not required to ensure Shariah compliance. IB1 has a different governance structure as they need to operate with SSB to ensure its compliance with Shariah principles. These findings of the study are consistent with the findings of Paino et al. (2011), Ghayad (2008), Zeti (2002) and Janahi (1995) as they have also discovered that the CG structure in IB is different from CB structure as, IBs follow a different set of rules, the Shariah principles, than CBs to enhance its social responsibility and to meet the expectations of Muslim community by offering Islamically acceptable products. It is found that SSB of IB1 has more power than its board as SSB has the sole authority to reject or accept the banks products and process based on its conformance with Islamic law. These results validate the findings of Paino et al. (2011) and Ghayad (2008) as they have also discovered that IBs operate with SSB in addition to BOD that comprises of eminent religious scholars, who are independent and have authority to reject any operations and products that deem to go against Islamic Law. Further it is expected that effective internal control systems are vital in maintaining a good CG framework. Similarly both banks, CB1 and IB1 have implemented a sound internal control system to ensure good CG framework by establishing a separate audit department and an audit committee to continuously review internal control issues as well as to conduct audits to ensure the banks adherence to these controls. In order to ensure an effective internal control system, CB1 conducts internal audit and external audit. Similarly IB1 also conducts internal audit and external audit. But additionally IB1 conducts internal and external Shariah audit to ensure that the bank, its practices and products are Shariah compliant. Therefore these results emphasize that IB1 conducts Shariah audits in addition to standard audits and that Shariah audits are conducted by the members of SSB. Accordingly the findings of the present study demonstrate that unlike CBs, IBs are subject to a Shariah audit in addition to the usual internal and external audit. Paino et al. (2011) have emphasized that as IBs operate with SSB they need to present disclosures relating to BOD as well as SSB. These findings are highly confirmed in this study by finding that as CB1, IB1 presents CG disclosures relating its BOD and that additionally IB1 presents disclosures relating to SSB in its annual reports.

When investigating the CG framework under legal and regulatory compliance of the two banking streams, all the national and international regulations that govern CB1 is also applicable to IB1. But all the regulations that govern IB1 are not applicable to CB1. IB1 is required to follow the directives and standards issued by the Central Bank Sri Lanka, Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) and Islamic Financial Service body (IFSB), whilst CB1 is only subject to follow the directives issued by Central Bank and they are not governed by AAOIFI or IFSB. This is due to the fact that AAOIFI and IFSB are international bodies that regulate only the Islamic FIs. Therefore, the research authenticates that all the national and international regulations that are applicable to CBs are also applicable to IBs. Unlike CBs, IBs are required to follow the regulations that are applicable to Islamic financial institutions. Further when analyzing the taxation regulations and its implications, CB1 is subject to corporate tax and other taxes that charged on a commercial bank. IB1 has a similar taxation treatment as CB1 as IB1 also subject to current tax, deferred tax, value added tax on financial services and economic service charge. Though IB1 subject to every tax implications as CB1, additionally they are charged with a tax called the *Zakat Tax*. The explanation for charging Zakat tax on IB1 is to ensure the equal distribution of wealth among the various groups in society. Further, IB1 has a separate fund called Zakat fund to accumulate the Zakat tax of the bank. IB1 distributes this fund to the poor in the society through religious institutions with an aim to achieve its motives of ensuring fairness and social justice to Islamic community. CB1 is only subject to corporate business tax and they are not entitled to Zakat tax as IB1. Findings suggest that IBs are also subject to the provision of tax legislation that are relevant to CB1 and thus additionally to Zakat tax.

It is very important for an institution to have effective RM system to ensure good CG. Hence it is required to understand the RM structure of each banking system. IB1 operates under the concept of risk sharing and partnership as IB1 follows the principle of profit-loss sharing paradigm. Mainly IB1 exists to share rewards and risk mutually with customers as they believe that both bank as well as customers should bear the risk of a venture as neither one is in control of the success or failure of the venture. Whereas CB1 does not share the risk with its customers instead they transfer whole risk to others. This is because they have a creditor-debtor relation with its customers and therefore they do not share the risk with them. As a result this study validates that though CBs tend to transfer whole risk to others, IBs share the risk with their customers, lenders and borrowers. When analyzing the RM framework in each banks, it is identified that as IB1 follows the Shariah rules in their banking operations, they are required to follow RM rules which are lay down in Islamic Shariah as well. Therefore IB1 operates in Shariah Integrated RM Framework.

As indicated by the informant of IB1, the bank considers RM as an important function in delivering higher shareholder value by striking a balance between risks and returns. Accordingly, they have appointed an independent risk officer and a separate department to assist risk functions within the bank. Their core RM function is segregated from other business and is centralized in the bank. The board of IB1 has the ultimate responsibility for understanding risk, approving overall bank's risk appetite, approving risk policies as well as strategies and monitoring the effectiveness RM function under the guidance of SSB. The Board Integrated RM Committee assists the board of IB1 in the RM function with the support of additional executive management committees. Further the board of IB1 operates with the guidance of SSB in their RM process. Hence, the board is subjected to control by SSB in RM process. On the other, CB1 also places a greater importance for RM in its business strategy in order to ensure its long term profitability and stability. Hence CB1 also operates within an integrated RM framework. According to the informant of CB1, they have set up an independent RM division with a chief executive risk officer to proactively assist the business in delivering a superior shareholder value. The board of CB1 actively participates in RM process as they have the responsibility to define risk appetite, approving risk parameter for the bank, approving strategies and policies to manage significant events that have potential impact on the banks' performance. The RM function of CB1 was designed by placing primary responsibility to its board and the board is assisted by the integrated RM committee with the support of additional executive management committees. When analyzing the risks faced by the two banks, IB1 faces credit risk, operational risk, market risks (rate risk, foreign currency risk, equity risk & commodity risk) and liquidity risk. However, IB1 is not subject to interest rate risk and thus it is further exposed to Shariah compliance risk, as they are required to ensure the compliance of its process with Shariah principles.

The informant further emphasized that IB1 places a major importance on ensuring a zero Shariah compliance risk. This is because, if IB1 deviates from Shariah principles, their total operations, process and profits are banned by SSB. In IB1 the Shariah compliance risk is considered under operational risk category and as it is crucial for the bank, operational risk is known to be vital to IB1. On the other hand, as to the informant of CB1, CB1 faces credit risk, liquidity risk, interest rate risk, operational risk, market risk (equity risk, foreign exchange risk & commodity risk) compliance risk and strategic/ reputational risk. From these risks, CB1 consider credit risk as the most important in RM. Therefore, the study confirms that IBs face same risks that are faced by CBs excluding interest rate risk. However, unlike to CBs, IBs face an additional risk of Shariah compliance risk as it is required for them to conform to Shariah principles. Unlike IB1, CB1 places a greater importance in managing credit risk, liquidity and interest rate risk, operational risk, market risk, compliance risk and reputational risk. While IB1 places major importance towards managing credit risk, operational risk, market risks, liquidity risk and Shariah compliance risk. Accordingly IB1 has not placed a greater importance in managing reputational risk. From all the risks, credit risk is known to be very important for CB1 and operational risk is vital for IB1 in RM. When analyzing the RM processes of two banking streams, the researcher has identified that both adopt different bank specified approaches as well as somewhat similar approaches in managing risks. Therefore it can be demonstrated that IB1 follows similar practices as of CB1 as well as customized approaches. Hence RM practices of IB1 are not completely unique than RM practices of CB1.

According to Khalid and Amjad (2012), a bank uses internal audit scores, risk and self assessment, risk indicators, loss event database, contingency planning and risk mapping as the main RM practices. They have further emphasized that CBs use internal audit scores, risk and self assessment, risk indicators, loss event database, contingency planning, whilst IBs use internal audit scores, risk and self assessment, risk indicators, loss event database, contingency planning and risk mapping. In an attempt to verify their findings, the current researcher has used the "*content analysis*". By adopting the content analysis, this study has categorized the RM practices of two banks based on the classification of Khalid and Amjad (2012). From the classification, the researcher has found out that CB1 and IB1 tend to use internal audit scores, risk and self assessment, risk indicators, loss event database and contingency planning in managing risks. But unlike IB1, CB1 does not use risk Mapping tool. Therefore, the present study highly confirms the results of Khalid and Amjad (2012). Further, this study is consistent with the findings of Khan and Ahamad (2001) that IBs tend to adopt RM practices that are used by CBs. Further, there are many new techniques that have been developed to measure and mitigate the risk with the development in firm-wide RM and that includes: Gap analysis; VaR; and Stress-testing.

When analyzing the usage of these techniques by two banks, IB1 as well as CB1 both use Gap analysis, VaR and Stress testing in managing risk. IB1 and CB1 adopt Gap analysis, VaR and Stress testing in managing market risk. Additionally CB1 uses VaR and Stress testing in managing credit risk too. It is identified that CB1 adopts stress testing and VaR extensively than IB1 in RM.

Hence the findings of this study confirm the results of Iqbal and Mirakhor (2007), Tafri et al. (2011) and Rosman (2009) as they also have discovered that IBs do not extensively use VaR and stress testing as compared to CBs in Malaysia. They further mentioned that IBs have an inadequate RM system when compared to CBs. The findings of the current study have highly confirmed this as the findings suggest that CB1 use more tools to manage the risks than IB1. Hence, they have more extensive and adequate RM system than IB1.

#### **4. Conclusion**

The findings of the study suggest that the both CBs and IBs enclose differences as well as similarities pertaining to the elements of CG, that are board responsibilities, legal and regulatory compliance, internal control environment and auditing along with Risk Management as follows. In CBs, BOD is responsible for an effective CG framework that ensures legal and regulatory compliance. While in IBs, two independent boards, BOD as well as SSB is responsible for the governance. Hence BOD ensures legal and regulatory compliance while SSB ensures Shariah compliance of the bank in IBs. It is identified that when CBs document CG disclosures relating to BOD, IBs have to present disclosures relating to BOD as well as SSB. It is further discovered that SSB of IBs have more power than BOD. On the other hand BOD has the ultimate responsibility and the power in CBs. Moreover IBs and CBs are observed to conduct internal and external audit. In addition IBs conduct a Shariah audit. IBs and CBs both follow all national and international regulations applicable to banking industry in SL. Additionally IBs follow national and international regulations that applicable to Islamic FIs too as they follow Islamic financial principles. Furthermore IBs have a similar taxation treatment as CBs, as they also subject to current tax, deferred tax, Value Added Tax on Financial Services and Economic Service Charge. However, additionally IBs are charged with Zakat tax as IBs required to ensure social justice among various group in a society.

When looking at the RM structure, IBs share risk and rewards with customers as they follow PLS paradigm while CBs transfer whole risk to others. IBs follow a Shariah integrated RM framework and its board has the ultimate responsibility for RM function under the guidance of SSB as well as with the support from RM division. While RM function of CBs is designed placing primary responsibility to the board of the bank and the board is only assisted by RM division. Moreover, IBs face same risks as CBs credit risk, liquidity risk, operational risk, market risk and compliance risk, but excluding interest rate risk. Additionally IBs face Shariah complaint risk and CBs are not exposed to this risk. From all risks, credit risk is very important for CBs and operational risk as well as Shariah compliance risk is vital for IBs. Unlike CBs, IBs tend to have a less concern towards managing reputational risk. Hence, CBs and IBs both tend to use the RM tools such as internal audit scores, risk and self assessment, risk indicators, loss event database and contingency planning in managing risks. But unlike CBs, IBs additionally adopt risk mapping tool. Further IBs and CBs both use new RM tools Gap analysis, VaR and Stress testing. However, CBs adopt stress testing and VaR extensively than IBs in managing risk in SL. Hence it is discovered that CBs have more extensive and adequate RM system than IBs in SL.

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