Study of the Constituents of Corporate Governance - Islamic Banks vs Conventional Banks.

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Abstract

The Corporate governance have gained a outstanding place in the sustainability of any organization, either corporate or bank. Individual short of comprehensive understanding on applicability of the corporate governance and its aspects in Islamic Banks and Conventional Banks. Thus, the objective of this study is to investigate 'how' and 'why' Islamic Banks differ from Conventional Banks in terms of configuration of Conventional Banks and its fundamentals mainly board responsibilities, lawful and authoritarian compliance, internal control environment and auditing from a fundamental point of view. The study adopts interpretative methodology and several case study strategies in selecting one bank to represent respective banking systems. Additional primary and secondary data were collected through interviews, observations, reports and websites. Key findings of the study concluded that Islamic Banks and Conventional Banks enfold distinctions as well as similarities pertaining to their corporate governance and selected aspects. Most important differences are determined connecting to the structure of Islamic Banks as they need to follow interest free pattern, Profit and Loss Sharing pattern and Shariah doctrine in performing the banking functions. Hence, these principles have influenced for coming out of different corporate governance structure in Islamic Banks

Keywords: Islamic bank, Conventional bank, corporate governance, Profit and Loss Sharing pattern, Shariah doctrine.

1. Introduction

The financial organizations play a very important role in the economy of any country as it facilitates the financial intermediation. As a result the sustainability of the financial organizations is a pre- requisite for the sustainability of economy as any crisis in financial organizations would negatively affect a country's economy. These organizations need to take actions to govern its activities and course with an aim to accomplish business objectives. Corporate governance plays a very important role in this course. Good Corporate governance requires the governing bodies to manage all the aspects of financial organization and thus important fundamentals of good corporate governance should also accomplished in banks whether it would be a conventional bank or Islamic bank. Islamic banking is a new thought that introduced exclusively for faithful Muslims to carry out banking transactions as per their religious beliefs. Islamic banks practices financial mean by undertaking primary and secondary banking functions as conventional banks but subject to interest free code, profit and loss sharing pattern along with Islam law. The Organization of Islamic Conference defined Islamic banking as "A Financial institutions whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and to the exclusion of the receipt and payment of interest on any of its operations. Thus Islamic banking consider to be very unique than Conventional bank since they refuse interest and follow interest free structure while conforming to Shariah doctrine. On the other hand it can be observed that corporate governance has been an admired research showground in the context of Conventional bank. However there are very few studies that are undertaken on governance structure of Islamic banking in spite of the unparalleled growth and expansion in last decades on global markets. With its mounting at a rapid pace with regard to its awareness and success, Islamic banking made its promising debut to the Indian region in the state of Kerala as banking industry in 2013 with RBI approval, but still the bankers and individuals are short of the detailed fundamental understanding on corporate governance structure of Islamic banking.

Therefore it would have been value adding to obtain a complete understanding on new banking system as Islamic banking structure nearby a radical departure from the Conventional bank due its matchless and fascinating features. Therefore, this research would fill the understanding and empirical break in the context of Indian region. Consequently the scope of the study is to understand about fundamental basics pertaining to corporate governance, i.e. board responsibilities, lawful and administrative compliance, internal control environment and auditing plus Risk Management particularly. Therefore the study attempts to discover up to what extent Islamic banks distinct from conventional banks and its application of Shariah doctrine in the context Indian region with special reference to the above aspects by selecting conventional banks and Islamic banks systems respectively.

2. Adopted Research Methodology & Materials Used

The intention of the research is to put on a better understanding of the concept Islamic banking system and its application in the context of Indian region in addition to recognize how and to what extent Islamic banking distinct from conventional banking with special reference to corporate governance. The study is an exploratory in nature. Thus, the qualitative nature of methodological approach used to go insight into the research area and to attain the objectives. Interpretative methodology and multiple case study strategy used to analyze the data. The study selected two banks, Islamic bank1 and conventional bank1 which represent Islamic banking and conventional banking systems. Data are primarily collected through in-depth focused interviews. Additional within the scope of research, this study has also used internet observation as a source of data collection. This documentation is used so as to supplement evidences from other sources. For instance, data available as annual reports, materials with regard to bank information, articles and leaflets were collected to acquire an overall view of the present scenario of banks. Further, the researcher gathered information and downloaded annual reports from the websites of the respective two banks.

3. Analysis and Discussion of Findings

The corporate governance is a mandatory requirement for any organization in the present scenario in order to sustain in the long run in market and as it enables a company to conquer their objectives in a socially responsible approach by support with stakeholders' interest. In view of that the corporate governance is a mandatory requirement for conventional bank1 and they play very important role in focusing towards its corporate governance structure to make sure a sustainable and a long-run value creation for shareholders. As highlighted by informant of the conventional bank1, the bank does not consider corporate governance practices as only a substance for board, but consider as the heart of the whole thing they do within bank. As a result, conventional bank1 run within comprehensive governance outline for examination and improving its systems to provide transparency, answerability plus to ensure that the best practices are maintained according to the main beliefs of the corporate governance and that they are in line with predetermined guidelines. Hence it is emphasized that conventional bank1 follows all prudential banking regulations and lawful requirements to ensure legal with regulatory compliance. In this context, the Board of Directors of conventional bank1 is answerable for developing, evaluating and improving the systems to ensure the effective corporate governance work line within the bank. Further, Board of Directors of conventional bank1 be supposed to ensure that the best practices are maintained that are in line with lawful and regulatory necessities.

In the context of Islamic bank1 although they practice interest free banking, they also consider crucial place in corporate governance within the bank as the Islamic banking believes that effective corporate governance is essential to ensure lawful and regulatory compliance with to ensure compliance with reasonable principles of Shariah. As a result, Islamic bank1 carries out banking activity within Shariah obedient framework and they too stick to all the banking regulations in addition to legislative enactments in India as conventional bank1 besides their Shariah regulations. Accordingly Islamic bank1 functions with a Shariah Supervisory Board to ensure its practices with Shariah principles in performing the banking activities. Islamic bank1 has a dedicated department, which reports to the board to ensure lawful and regulatory compliance. These findings gives emphasis to that board of conventional bank1 is answerable for effective corporate governance framework with legal and regulatory compliance. In the case of Islamic bank1, they are maintaining separate compliance department, which informs to the board to handle corporate governance as legal and regulatory compliance of the bank. Islamic bank1 runs with Shariah Supervisory Board to handle Shariah compliance. Hence the study authenticate that the board is responsible to handle corporate governance framework in conventional bank1 at the same time as the board and Shariah Supervisory Board, both handle corporate governance in Islamic bank1. Shariah Supervisory Board of Islamic bank1 is having the responsibilities to give advices to the Board of Directors on the subject relating to Shariah compliance. As charged by the informant of Islamic bank1, this Shariah Supervisory Board encompasses of knowledgeable and renowned religious scholars who have special knowledge about Shariah principles. Shariah Supervisory Board has the final responsibility to discard any proposals, operations, products and services of Islamic bank1 when it breach Islamic laws and to accept them when it is underlying within Islamic law. Therefore, it is discovered that Shariah Supervisory Board of Islamic bank1 operates independently from Board of Directors and that they have more power than its board.

This study stress that Islamic bank1 operates with two boards, Shariah Supervisory Board and from Board of Directors. On the other conventional bank1 operates only with Board of Directors as they are not required to ensure Shariah compliance. Islamic bank1 has a separate governance structure as they needs to run with Shariah Supervisory Board to make sure its compliance with Shariah doctrine. These findings of the study are steady with the findings of **Paino et al. (2011), Ghayad (2008), Zeti (2002) and Janahi (1995)** as they also revealed that the corporate governance composition in Islamic bank is different from conventional bank's structure as Islamic bank's follow a special set of rules, the Shariah principles, than conventional bank to develop its social responsibility and to meet up the opportunity of Muslim community by presenting Islamic acceptable inventions. It is found that the Shariah Supervisory Board of Islamic bank1 has more power than Shariah Supervisory Board which has the sole authority to refuse or admit the banks products and methods based on its conformance with Islamic law. These results authenticate the findings of **Paino et al. (2011)** and **Ghayad (2008**) as they also revealed that Islamic banks operate with Shariah Supervisory Board as well as Board of Directors that comprises of renowned religious scholars, who are independent and have authority to refuse any operations and products that deem to go against Islamic Law. Moreover it is expected that efficient internal control systems are very important in maintaining a good corporate governance structure. In the same way both banks, conventional bank1 and Islamic bank1 have put into practice a sound internal control system to make sure good corporate governance structure by set up a separate audit unit and an audit committee to constantly evaluate internal control issues in addition to conduct audits to ensure the banks observance to these controls. In order to make sure an effective internal control system, conventional bank1 conducts internal and external audit. In the same way Islamic bank1 also conducts internal and external audit. But furthermore Islamic bank1 conducts internal and external Shariah audit to make sure that the bank practices and products as per the Shariah compliant. The results highlight that Islamic bank1 conducts Shariah audits in addition to ordinary audits and that Shariah audits are conducted by the members of Shariah Supervisory Board. Hence the findings of this study reveal that the unlike different conventional banks, Islamic banks are subject matter to a Shariah audit over and above the usual internal audit and external audit.

Paino et al. (2011) have emphasized that as Islamic banks run with Shariah Supervisory Board they require to disclose relating to Board of Directors in addition to Shariah Supervisory Board. These findings are greatly confirmed in this study by finding that as conventional bank1, Islamic bank1 presents corporate governance discloses relating its Board of Directors and that furthermore Islamic bank1 discloses relating to Shariah Supervisory Board in its annual reports. When the scrutinizing is done of the corporate governance framework under lawful and regulatory compliance of the two banking stream, all national and the international regulations that preside over conventional bank1 is also applicable to Islamic bank1. But all the regulations that preside over Islamic bank1 are not applicable to conventional bank1. Islamic bank1 is compulsory to follow the directives and standards issued by the reserve bank of India, Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) and Islamic Financial Service body (IFSB), whilst conventional bank1 is only subject to follow the directives issued by the reserve bank and they are not governed by Accounting and Auditing Organizations for Islamic Financial Institutions or Islamic Financial Service body. This is due to the fact that Accounting and Auditing Organizations for Islamic Financial Institutions and Islamic Financial Service body are international bodies that regulate only the Islamic Financial institutions Thus, the research validates that all national and the international regulations that are applicable to conventional banks are also applicable to Islamic banks. Unlike conventional banks, Islamic bank are necessary to follow the regulations that are applicable to Islamic financial institutions. Additional to that when analyzing the taxation guidelines and its implications, conventional banks1 is subjected to corporate tax and other taxes that charged on a commercial bank. Islamic bank1 has a similar taxation treatment as conventional banks as Islamic bank1 also subject to current tax, deferred tax, VAT on financial services and economic service charges. Although Islamic bank1 subject to every tax inferences as conventional banks1, additionally they are charged with a tax called the Zakat. The explanation for charging Zakat on Islamic bank1 is to make sure that the equal allocation of wealth among the various groups in the society. Furthermore, Islamic bank1 has a separate fund namely Zakat fund to accumulate the Zakat of bank. Islamic bank1 allocates this fund to the poor people in the society through religious organization with an intention to achieve its motives of ensuring fairness and social justice to Islamic community. Conventional banks1 is only subject to corporate business tax and they are not entitled to pay the Zakat as Islamic bank1. Findings suggest that the Islamic banks are also subject to the provision of tax legislation that are relevant to conventional banks1 and thus in addition to Zakat. It is very significant for an institution to have effective system to ensure good corporate governance. Therefore, it is necessary to understand the RM structure of each banking system. Islamic bank1 operates under the concept of risk sharing and partnership as Islamic bank1 follows the principle of profit-loss sharing pattern. Mainly Islamic bank1 subsist to share rewards and risk mutually with customers as they believe that both bank plus customers should bear the risk of a speculation as neither one is in control of success or failure of the venture. While conventional banks1 does not share the risk with its customers in its place they transfer whole risk to others. This is because of the reason that they have a creditor-debtor relation with its customers and hence they do not share the risk with them. As a result this study authenticate that although conventional banks lean to transfer whole risk to others, Islamic banks share the risk with their customers, lenders and the borrowers. When examine the RM composition in each banks, it is identified that as Islamic bank1 follows the Shariah rules in their banking operations, they are need to follow RM regulations which are laid down in Islamic Shariah too. Hence Islamic bank1 runs in Shariah Integrated RM structure.

Wijethunga & Ekanayake As indicted by the informant of Islamic bank1, the bank with regard to RM they consider as a significant function in delivering higher shareholder value by signal the balance between risks and returns. Thus, they have employed an independent risk officer and a separate unit to assist risk functions within the bank. Their nucleus point of RM function is segregated from the other businesses and is centralized in the bank. The board of Islamic bank1 has the vital responsibility for understanding the risk, approving the overall bank's risk craving, approving risk policies in addition to strategies and monitoring the efficiency RM function under the guidance of Shariah Supervisory Board. The Board incorporated the RM Committee to assists the board of Islamic bank1 in the RM functions with the prop up of extra executive management committees. Further more the board of Islamic bank1 runs with the guidance of Shariah Supervisory Board in their RM course. Therefore, the board is subject to control by Shariah Supervisory Board in RM course. On the other side, conventional banks1 also consider a significant importance for RM in its business strategy in order to make sure its long term profitability and stability. Therefore conventional bank1 also works within an integrated RM structure. According to the informant of conventional bank1, they set up an independent RM section with a chief executive risk officer to positively assist the business in delivering the better shareholder value. The board of conventional bank1 actively participates in RM progression as they are the responsible to define risk appetite, approving risk factor for the bank, approving strategies and policies to manage important events that have possible impact on the banks' performance. The RM function of conventional bank1 designed by inserting primary responsibility to its board and the board is aided by the integrated RM committee with the hold up of extra executive management committees. When examining the risks faced by the two banks, Islamic bank1 holds credit risk, operational risk, market risks (rate risk, foreign currency risk, equity risk & commodity risk) and liquidity risk. However, Islamic bank1 is not subjected to the interest rate risk and hence it is additional exposed to Shariah compliance risk, as they are necessary to make sure that the compliance of its course with Shariah doctrine. The informant further highlights that the Islamic bank1 places a most important significance on ensuring a zero Shariah compliance risk. This is because, if Islamic bank1 turns from Shariah principles, their total operations, course and profits are banned by Shariah Supervisory Board. In Islamic bank1 the Shariah compliance risk is regarded as under operational risk category and as it is vital for the bank, operational risk is known to be very important to Islamic bank1. On the other hand, as to informant of the conventional bank1, conventional bank1 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. Since these risks, conventional bank1 believe credit risk as vital in RM course. Therefore, the study confirms that Islamic bank1 face same risks that are faced by conventional banks excluding interest rate risk. However, unlike to conventional banks, an Islamic bank faces an additional risk of Shariah compliance risk as it is need for them to obey the rules to Shariah principles. Unlike Islamic bank1, conventional bank1 places significant importance in managing credit risk, liquidity and interest rate risk, operational risk, market risk, compliance risk and reputational risk. While Islamic bank1 places significant importance towards managing credit risk, operational risk, market risks, liquidity risk and Shariah compliance risk. Hence Islamic bank1 has not placed significant importance in managing reputational risk. Since all the risks, credit risk is known to be significantly significant for conventional bank1 and operational risk is significantly important for Islamic bank1 in RM. When analyzing the RM courses of two banking streams, the researcher has acknowledged that both adopt different bank specified approaches in addition to somewhat similar come near in managing risks. Hence it can be confirmed that Islamic bank1 follows similar practices as of conventional bank1 in addition to customized approaches. Therefore, the RM practices of Islamic bank1 are not completely unique than the RM practices of conventional bank1.

Khalid and Amjad (2012), a bank uses internal audit scores, risk and self assessment, risk meter, loss event database, contingency planning and risk mapping as the key RM practices. They further emphasized that conventional banks exercise internal audit scores, risk and self assessment, risk meters, loss event database, contingency planning, whilst Islamic banks exercise internal audit scores, risk and self assessment, risk meters, loss event database, contingency planning and risk mapping. In attempt to validate their findings, the current researcher used the "content analysis". By take up the content analysis, the study is categorized the RM practices of two banks based on the classification of Khalid and Amjad (2012). From the classification, the researcher founded that conventional bank1 and Islamic bank1 lean to use internal audit scores, risk and self assessment, risk indicators, loss event database and contingency planning in managing risks. However Islamic bank1, conventional bank1 does not use risk mapping tool. Hence, this study highly confirms the results of Khalid and Amjad (2012).

Khan and Ahmad (2001) that the Islamic banks lean to adopt the RM practice so as to use by conventional banks. Furthermore, there are lots of new techniques that have been developed to determine and take the edge off the risk with the development in firm-wide RM and it includes: Gap analysis; VaR; and Stress-testing. **48 Journal of Islamic Banking and Finance, Vol. 3(1), June 2015** When examining the usage of these techniques by two banks Islamic bank1 and conventional bank1 both uses Gap analysis, VaR and Stress testing in managing risk. Islamic bank1 and conventional bank1 approve Gap analysis, VaR and Stress testing in managing the market risk. Furthermore, conventional bank1 uses VaR and Stress testing in managing credit risk too. It recognized that the conventional bank1 implement stress testing and VaR extensively than Islamic bank1 in RM. Therefore, the findings of this study confirm the results of **Iqbal and Mirakhor (2007)**, **Tafri et al. (2011)** and **Rosman (2009)** as they also discovered that Islamic banks do not extensively use VaR and stress testing as compared with conventional banks in Malaysia. They further mentioned that Islamic banks have not enough RM system when compared to conventional banks. The findings of this study encompasses highly confirmed this as the findings suggest that conventional bank1 use more tools to manage the risks than Islamic bank1. Hence, they have more extensive and adequate RM system than Islamic bank1.

4. Conclusion

The findings of this study recommend that the both conventional banks and Islamic banks enclose differences as well as similarities pertaining to the elements of corporate governance, in the areas of board responsibilities, lawful and regulatory compliance, internal control environment & auditing alongside with Risk Management. In conventional banks, Board of Directors is answerable for an effective corporate governance framework that makes sure lawful and regulatory compliance. While in Islamic banks, two independent boards, Board of Directors in addition to Shariah Supervisory Board is accountable for the governance. Therefore Board of Directors makes sure the lawful and regulatory compliance while Shariah Supervisory Board makes sure Shariah compliance of bank in Islamic banks. It is recognized that when conventional banks deed the corporate governance disclosures concerning to Board of Directors, Islamic banks have to present disclosures of the relating to Board of Directors and Shariah Supervisory Board. It further discovered that Shariah Supervisory Board of Islamic banks have more power than Board of Directors On the other side Board of Directors has the ultimate responsibility and the power in conventional banks. Furthermore, Islamic banks and the conventional banks are experiential to conduct internal and external audit. Additionally Islamic banks conduct the Shariah audit. Islamic banks and conventional banks they both follow all the national and international regulations applicable to the banking industry. Furthermore, Islamic banks pursue national and the international regulations that are applicable to Islamic Financial Institutions too as they follow Islamic financial principles. Moreover, Islamic banks have similar taxation treatment as the conventional banks, as they also subjected to the current tax, deferred tax, VAT on Financial Services and Economic Service Charge. On the other hand, Islamic banks are also charged with Zakat tax as Islamic banks required ensuring social justice among various groups in the society. When come across at the RM structure, Islamic banks share risk and rewards with customers as they follow PLS pattern while conventional banks transfer the whole risk to others. Islamic banks follow a Shariah integrated RM structure and its board has ultimate responsibility for the RM function under the guidance of Shariah Supervisory Board plus with support from the RM division. Although, RM function of the conventional banks is designed inserting primary responsibility to the board and the board is only aided by RM division. Furthermore, Islamic banks face the same risks as conventional banks i.e. credit risk, liquidity risk, operational risk, market risk and compliance risk, but excluding the interest rate risk. Moreover, Islamic banks face the Shariah complaint risk and conventional banks are not exposed to this. Since all risks, credit risk is very significant for the conventional banks and the operational risk with Shariah compliance risk is vital for Islamic banks. Contrasting conventional banks, Islamic banks lean to have a less distress towards managing reputational risk. Therefore, conventional banks and the Islamic banks both are lean to use RM tools such as the internal audit scores, risk and self assessment, risk indicators, loss event database and contingency planning in managing risks. However, unlike conventional banks, Islamic banks also adopt risk mapping tool. Additionally, Islamic banks and conventional banks both use the new RM tools i.e. Gap analysis, VaR and Stress testing. Though, conventional banks approve stress testing and VaR comprehensively than Islamic banks in managing risk. Therefore it is notice that the conventional banks have more extensive and adequate RM system than Islamic banks.

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