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The differences and the similarities between corporate governance principles in Islamic banks and Conventional banks

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Abstract

The purpose of this paper is to present the differences and similarities between corporate governance principles in Islamic banks and conventional banks by paradigmatic diversification. Corporate governance in Islamic banks is a social phenomenon in Islamic societies, the paper uses social theory paradigms (functionalist, interpretive, radical humanist and radical structuralist) to compare between corporate governance in Islamic banks and conventional banks. This paper shows that the existence of Islamic governance demonstrates that mainstream corporate governance is not a law of nature but a social construct.

Keywords: Corporate governance, Islamic banks, Conventional banks, Paradigms

1. Introduction

Corporate governance of banks has become an important area that needs to be given a further attention at global level, especially after the crisis of financial institutions in 2008 which influenced the stability of banks around the world (Haan and Vlahu ,2015), the financial institutions are highly interconnected due to the globalization and technological developments and policies of financial liberalization, which it inevitably triggers higher risks to the banking sector, in this regard the Basel Committee on Banking Supervision (2006) points out:[1] *´´effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole*''[1], the governance in the banking sector should be designed so as to align the manager with the interests of debt holders including depositors.

The corporate governance in Islamic banks is different from Conventional banks, it is unique and offers a particular structure guided by religious board which is Shariah supervisory Board (SSB), (Safieddine, 2009; Quttainah 2013), the Islamic Financial Services Board in Malaysia has defined the Shariah governance system in the following term *"Shariah Governance System refers to the set of institutional and organizational arrangements through which an Institutions offering Islamic financial services ensures that there is effective independent oversight of Shariah compliance"*[2] To analyze the similarities and differences between governance in Islamic banks and conventional banks, this paper use social theory through different paradigm (functionalist, interpretive, radical humanist and radical structuralist) to a deeper understanding of the nature and structure of corporate governance in Islamic banks and conventional banks.

The rest of the paper is organized as follows: After the introduction sections 2, presents the paradigms: functionalist, interpretive, radical humanist and radical structuralist, about the nature and role of Islamic corporate governance and Western corporate governance on banks. Finally section 3 concludes the paper.

[1] The Basel Committee on Banking Supervision (BCBS Enhancing corporate governance for banking organisations 2006 p.4).

[2] IFSB-10 (December 2009) Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services.

2. Paradigms

The paper analyse why Islamic corporate governance differs from western corporate governance of banks using different paradigms to provide a much broader and deeper understanding of this phenomenon.

2.1 The functionalist paradigm

This paradigm supposes that the society is a complex system and their parts work together to promote solidarity and stability. It seeks to provide rational explanations of social affairs and generates regulative sociology; researchers who use this paradigm in their research believe that corporate governance is a technical matter and focus on this aspect of the corporate finance. The most central point in the field of corporate governance is to solve potential agency problem which arises from separation from ownership and control in the corporation (Ardalan, 2007), each party in the corporation seeks to achieve its own benefit at the expense of the other party ,this the rationale of the existing corporate governance systems around the world (the Anglo-Saxon, the European and other models), each of every model has its own features and structure, all the models of corporate governance share the same goal of which is reducing the agency problem.

The corporate governance in Islamic banks are subject to a multi-level governance system where the religious elements play a considerable role in the governance structure, this religious board is distinguishing feature of Islamic business organizations. The corporate governance model in Islamic system seeks to protect the interest and rights of all stakeholders and reduce agency problem which is the share point with other corporate governance models (Quttainah 2013). There are three main reasons may lead to conflict between managers and stakeholders

1. The desire of managers to remain in the power: the managers in the firm seek to remain in control of the firm, even in those cases where the management team is not acting in the interest of stakeholders; here we have the conflict of interest between shareholders and managers.

2. The escape from the risk: while the mangers have the majority of their human capital invested in the firm, the shareholders hold a diversified portfolio such as only a small portion of his wealth is invested in a particular firm.

3. The profit of the firm: The proficts the firm is generating can end up increasing the free cash flow. The conflict arouse when the management and the shareholders disagree about the distribution of such free cash flow. Corporate governance mechanism that drives the firm toward its objectives while also satisfying stakeholders' needs and reduce agency effect, there are differences and similarities between corporate governance mechanism between Islamic banks and conventional banks from different categories, internal mechanism, external mechanism, independent audit.

The internal mechanism determines the sets of controls that a corporation uses to control and monitor the progress and activities of the corporation. The internal mechanisms include the structure of the board of directors, ownership structure, the oversight of management and the debt structure of the corporation. In Islamic banks, the structures of the board of directors of Islamic banks are different from conventional banks due to the presence of the religious board. The role of this board can be divided between the macro and the micro levels. In some countries such as Malaysia, the Shariah Supervisory board take place at the central bank or regulatory authority level (Hamza, 2013), the Shariah boards at macro level play significant roles in the aspect of harmonization standardization of fatwa (legal opinion) and act as the highest Shariah authority of Islamic Financial Institutions (Figure 1).

At the micro level, the board should define appropriate governance structures and practices for its own work and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness. However in Islamic banks there are additional functions of board of directors related to the introduction of comprehensive policies, processes and infrastructure to ensure Shariah compliance in all aspects of the Islamic bank’s operations, products and activities and establish an appropriate Shariah governance framework.

Within the western banks there are at least two governance models (Figure 2). The one tier and the two tier boards. In the one tier board there is a shareholder-managers relation whereas in the two tier boards the relation is between stakeholders and managers (Iqbal and Mirakhor, 2004 and Hasan, 2009).

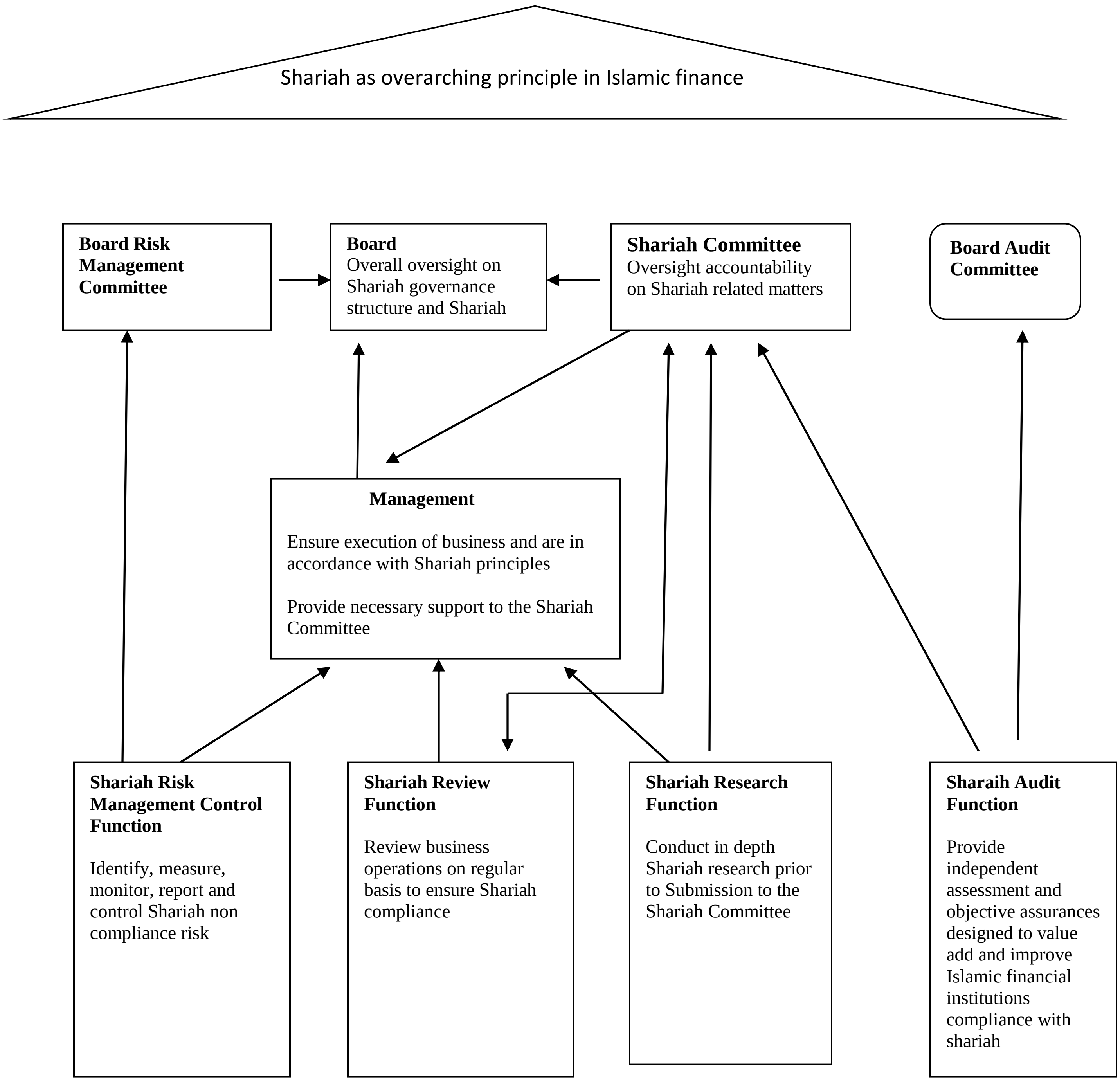

Figure1: Shariah governance structure

Source: Bank Negara Malaysia (Shariah Governance Framework for Islamic Financial Institutions.

In two- tier system boards, the board of directors separate in two boards, the management board and supervisory board (Cernat, 2004). The supervisory board supervises the Board of directors of the firm, in this model employees in many cases, have the right to appoint or recommend several members to the supervisory board. (Figure 3).

Islamic corporate governance model is completely different from either the one or two tier boards. Thus, the functional roles of the banks are applied via the Shariah rules. Then, the Shariah board play important role in the firm to ensure that all firm's activities are in line with Shariah principles. At the same time, the shareholders play important role as active participants and conscious stakeholders in the process of decision making and policy framework by considering the interest of all stakeholders rather than maximize their profit alone, all the parties (Board of directors, Shariah board, shareholders and stakeholders) in the firm act as one group under the Shura system (consulting system) in Islam (Hasan, 2009, Cernat, 2004).

Among the external corporate governance mechanism, there are different finance resources for Islamic banks: current account, namely investment accounts and issuing shares of common equity. In current accounts there is limited duration and holders can withdraw their funds under certain conditions. On the other hand, the Investment accounts are in most cases based on a profit-sharing and loss-bearing (Mudarabah contract). In this type of contract the bank manages the funds on behalf of their holders (Karim and Archer 2012), where the profits are shared between the bank and the investment account holders (IAH). In the case of a loss the IAH will bear it, the contracts don't give the Investment account holders the right to manage the funds (Aggarawal and Yosef, 2000 and Saffieddine 2009). There are two types of investment account holders, the first one is Restricted investment account (RIA) in this type of investment the investors determine specific investment and the period of this investment, they mandate the bank to invest in specific asset classes and economic sector within Mudarabah contract. The Islamic bank invests the funds of Restricted Investment Account Holders (RIAH) in asset pool which separated from bank's own funds. RIA holders don't have the right to interfere in the management of their funds, this is one of the conditions in Mudarabah contract and violation of this condition can nullify the contract, there is another agent which is appointed by Shareholders to manage and monitor their funds (Grais and Pellegrini, 2006).

The second type of investment account holders is unrestricted investment account (URIA). The investment account holders in this type of investment authorize the bank to invest the account holder's funds on the Mudarabah contract in a manner which the bank deems appropriate without any restrictions as to where, how and for what purpose the funds should be invested, Under this arrangement the bank can commingle the IAH funds with its own funds (owner's equity) and with other funds with prior permission from the investors. The bank has the right to use current accounts or any other funds which the bank does not receive from the of Mudarabah contract).

The ownership concentrates on inside restricted investment account holders as they, contribute to the bulk of the bank's capital and bear the bulk of the loss (Safieddine, 2009). In other corporate governance model, the ownership concentrates on inside shareholders in agreement to its contribution to the capital of the bank who are also the major decision makers in the firms, in this case, the large shareholder who has the high ratio of the capital has right to collect information and monitor managers (John et al. 2016).

The internal audit function provides independent assurance to the board and supports board and senior management in promoting an effective governance process and the long-term soundness of the bank. The internal audit function should have clear permission, be accountable to the board, be independent of audited activities and have sufficient standing, skills, resources and authority within the bank. The board and senior management should take into their account that independent and qualified internal audit function plays a vital role to effective governance process. An effective internal audit function provides to the board and senior management on the quality and effectiveness of bank's internal control, risk management and governance system and processes, this will lead to help BoD and senior management to protect the banks and its reputations.

The internal audit function should be accountable to the BoD on all matters; it must be independent of audited activities and have sufficient standing, authority, and resources within the bank. In Islamic bank, there is an additional department which is Internal Shariah compliance audit unit (ISCU) that it is an independent department for verifying that Shariah compliance has been satisfied during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified.

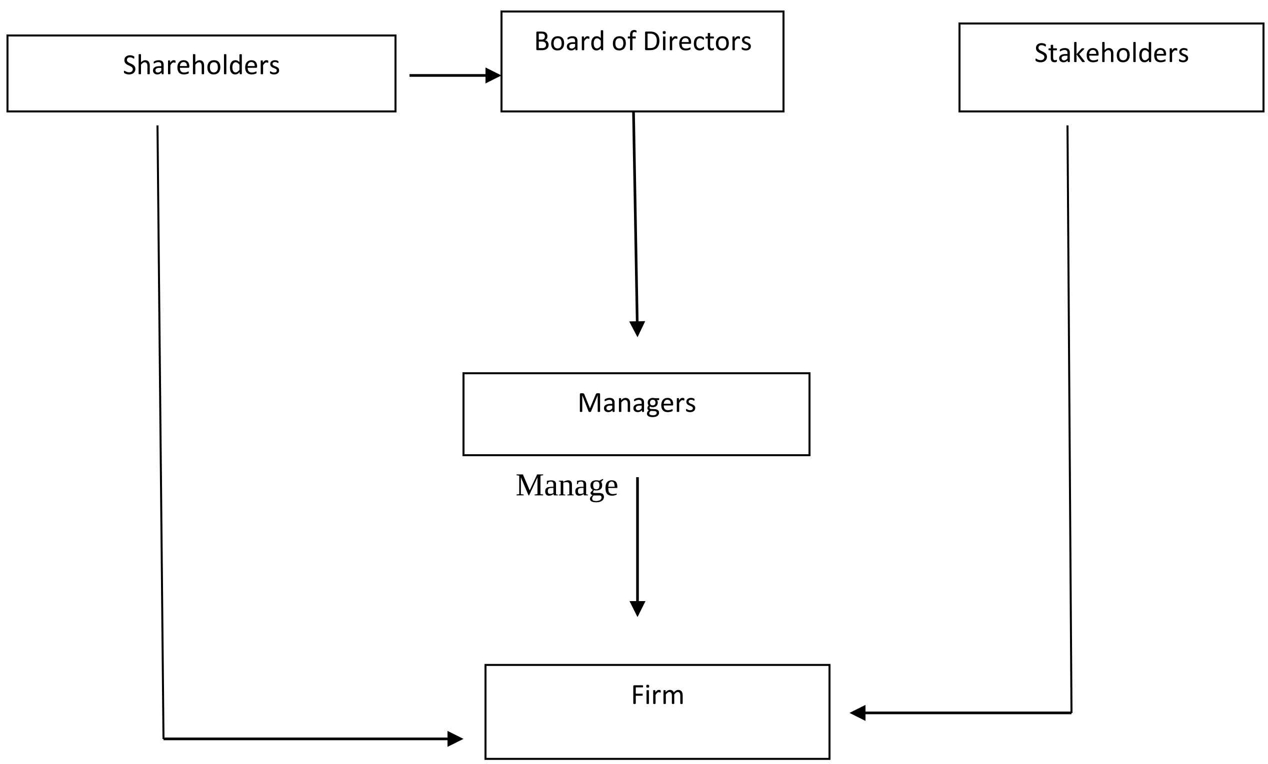

Figure 2: Western model

Source (Cernat, 2004)

2.2 The interpretive paradigm

Corporate governance is a social process affected by social and economic conditions; it is not isolated from the social and economic environment and there is no universal model of corporate governance in line with different cultures and societies. The interpretive paradigm assumes that individuals contribute to the creation of the social world; Researchers who abide by this paradigm in their research believe that corporate governance is socially constructed. The finance view of corporate governance focuses on agency problem and the solutions to solve it and ignore the social process of corporate governance (Ardalan, 2007).

The Islamic economic seek to social discipline in response to this environment in Islamic countries, it characterized by social commitments ethical norms which are based on moral framework of the Shariah which originated from the bible for Muslims (the Holy Quran) and the actions of the prophet Mohammed (Sunnah). In Islamic society the Muslims are permitted to conduct their business activities as guided by the Shariah code of conduct , this code encourage the people to be honest, fair and just in their business activities (Ahmed,1984, Khalifa, 2003),

All stakeholders in the bank are given full rights and responsibility to participate and convey their ideas in reforming better corporate governance under the Shura principle (consulting principle) which enhance the role of the individual in the society (Hasan 2009).

According to the Principle 3 of CG in Islamic Financial services Board in Malaysia: "*Institutions offering Islamic financial services shall have in place an appropriate mechanism for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance in all aspects of their products, operations, and activities*"[3]. The Shariah Supervisory Board monitors and controls the Board of Directors and executive managers to ensure that they only execute the ex-

[3] IFSB-3 (December 2006) Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services

ante approved products and services conforming to Islamic law and to help the employees in Islamic Financial Institutions to adhere the morality principles rather than personal interests and greed, Collective action is required of all stakeholders to improve the Bank's reputation and to benefit all parties.

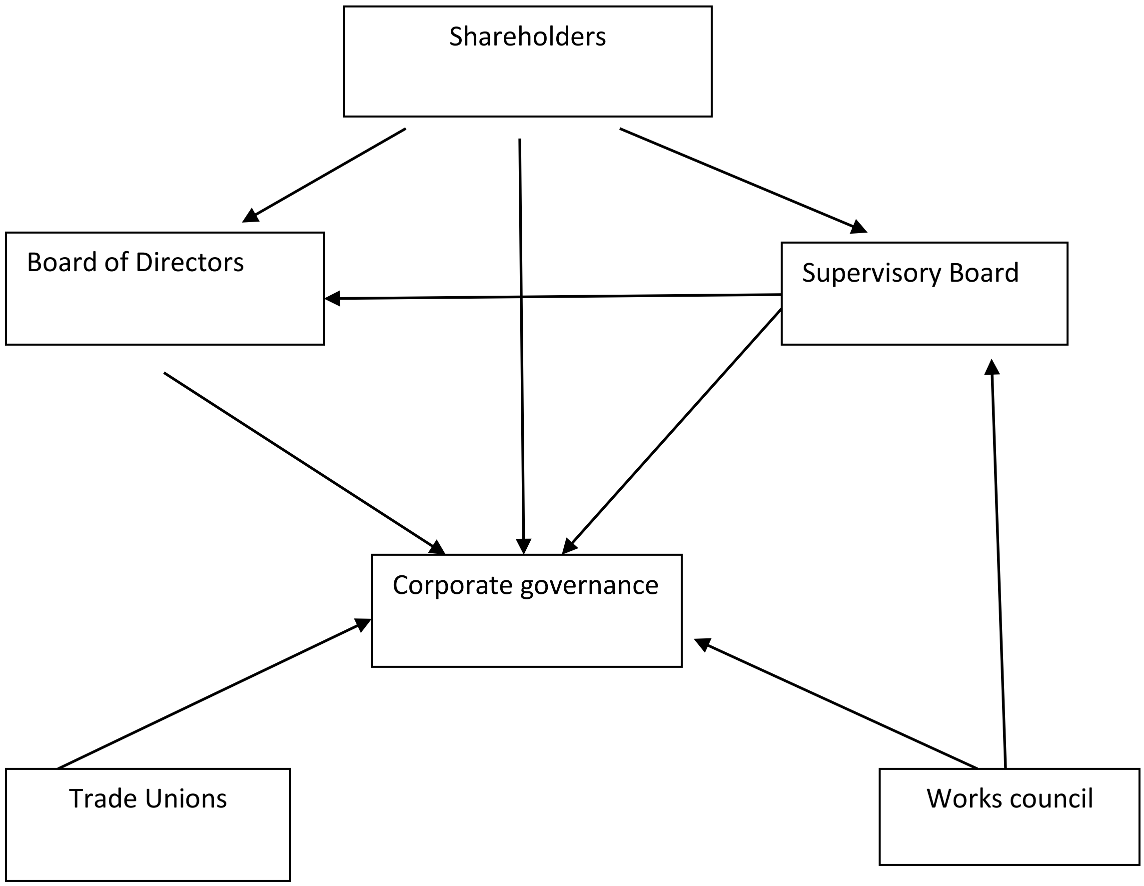

Figure 3: European model of corporate governance

Source: (Carent, 2004)

All parties are accountable to God, responsibility from an Islamic perspective means that every person is accountable to God and must abide by his work and mastered to the fullest extent. Islamic banks seek from the principle of profit and lose sharing to perform the role of redistributing wealth and achieving the principle of social justice that contribute to the improvement and well-being of society and strive to achieve a balance between providing sufficient returns to their shareholders and depositors with not neglecting their social responsibilities and commitments to their various stakeholders (Farook, 2008, Ahmad, 2000).

2.3 The radical humanist paradigm

The concept of this paradigm is that everything must be understood as a whole; the researchers explain corporate governance from this paradigm as socially and politically constructed. Thus they consider social, political context and political domination in their researches, from truly democratic process the populations has opportunity choose what it seems to be the most appropriate form of corporate governance, the corporate models chosen through a fair and democratic process, the views of corporate governance from this paradigm is a truly democratic standpoint.

The corporate governance from Islamic perspective depends on the principle of consultation (Shura principle) between all stakeholders in which is confirmed by the holy Quran 1400 years ago. The holy Quran adhere the consultation between Muslims to spend their needs and to address problems and treatment. “Those who hearken to their Lord, and establish regular Prayer; who (conduct) their affairs by mutual Consultation” (Holy Quran, Surah, Alshura: verse 38), The interpretation of the verse and those who responded to God when he called them to unite and obey him, and set up the prayer in a good way and if they want to spend an order consulted with each other and cooperated to accomplish in a good way, the decision making in Islamic ethics is not limited to managers only but is a process that contributes to different parties shareholders, clients, financiers, suppliers, customers, employees because the stakeholders in Islamic concept are the society as whole (Baydoun et al. 1999).

In order to achieve social justice, Islamic banks establish charity boxes (Zakat boxes) and at the end of each financial year to deduct a percentage of the profits and distribute them to the poor and needy people. The difference between the Islamic models and the Western model in corporate governance is that the Islamic society as a whole contributes to the development of the institution or bank and has the right to decision making and has the right to object in case the bank or the institution deals with interest, while in the one tier western model are the Shareholders who directly influence on decision-making. Finally in the two-tier western model the stakeholders who directly affect decision-making (Figure 3).

3 The radical structuralist paradigm

This paradigm is based on several central notions. Firstly, radical change, they call for radical reform of institutions to change. Secondly, structural conflict, which emphasis on configuration of social relationships. Thirdly, methods of domination, contradiction and deprivation. Fourthly crisis, Contradictions that cannot be contained and which are the cause of economic and political crises and which are a turning point in order to move to change and reform. Researchers who stick to this paradigm believe that corporate governance has its base in social classes. The view of corporate governance from this paradigm that corporate governance was found to meet the needs of the social classes, the social classes is that social groups enter into relations with each other to produce; they enter into production relations (Ardalan, 2007).

The administrative work in Islam has its constituent elements based on the Islamic faith, which defines the relationship of managers to employees in the institution and their relationship to society as a whole on the basis of cooperation and exchange of views and respect for the opinions of others. The nature of the work of Islamic banks differs from the nature of conventional banks. Islamic banks have a set of principles that have made them distinctive (the principle of participation in profit and loss, the principle of trade on the basis of ownership and the principle of Prohibition of dealing with interests), while the conventional institutions are based on fixed interests, The structure of corporate governance in conventional banks consists of the board of directors, executive managers, shareholders and other stakeholders.

In Islamic banks, there is an additional component, which is Shariah board; this board has come as a requirement of Islamic banks to supervise banking operations and prevent interest-bearing transactions, the prohibition of dealing with the interests (riba in Islamic perspective) is the focal point that created the idea of Islamic banks and the application of the principle of Islamic law and creates a structure of corporate governance commensurate with the nature of its work, Islamic institutions have a sensitive nature in Islamic societies and the trust of people is the basis for the success of these institutions (Grais and Pellegrini, 2006, Abu- Tapanjeh, 2007).

4 Conclusion

This paper analyses bank corporate governance under different paradigms either for Islamic bank or western banks. The functionalist paradigm views that all models in corporate governance seek to reduce the agency problem, the Islamic corporate governance model demonstrates that the governance of Islamic banks is multi-level governance system where the religious elements play a considerable role in the governance structure; this religious board is the distinguishing feature of Islamic business organizations. The interpretive paradigm demonstrates that corporate governance is social constructed. Thus according to this paradigm demonstrates the corporate governance in Islamic banks is characterized by social commitments ethical norms that are based on the moral framework of the Islamic religion.

Corporate governance from the radical humanist paradigm considers that corporate governance models are chosen through a fair and democratic process. In this paradigm view of the Islamic corporate governance depends on the principle of consultation (Shura principle) between all stakeholders in the bank.

Finally, the radical structuralist paradigm demonstrates that corporate governance has its base in social classes. Thus, the reason for the existence of governance in Islamic banks is a turning point for the unwillingness of people in Islamic society to deal with banking interests which are forbidden in the Islamic religion.

The paper showes that Islamic governance demonstrates that mainstream corporate governance is not a law of nature but a social construct. It is thus evident that there is no unified governance model that covers all societies, all cultures, and all companies; each society has its own social structure and culture, through which the principles of governance are shaped.

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