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Corporate Governance System and Its Role in Activating Islamic Bank's Management and Supervision

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Abstract: This paper examines corporate governance (CG) characteristics and relates them to earnings management (EM) behaviours in the context of a large emerging sector, Islamic banking industry. Main differences are found with regard to philosophical aspects, including objectives of the bank, natures of contract involved, key players in theCG practice as well as the relationships between the players. We verified that these aspects provide strong justification for an additional layer in the CG of an Islamic bank being the Shari'ah Supervisory Board (SSB). The mechanism and tools for the effective implementation of CG are relatively the same as the conventional system.

Keywords: Corporate Governance, Islamic Bank, Management and Supervision

1. Introduction

Banking activities tend to be more diversified and complicated due to the globalization of financial services, which affects the risk profile, both quantitatively or qualitatively; banking active management can be achieved through the contribution of:

- Good governance;
- High degree of transparency;
- Disclosure of information;
- Having a minimum level of risk-based capital requirements.

All these factors contribute to active risk management as a neseccery, even if not adequate for any financial system to strengthen the public's confidence in it, achieve its stability and, at the end, to find general standards for good governance to realize integration in the international financial system.

The International Standards of Banking Supervision, issued by Basel Committee in the first and second version, has not taken into account Islamic banks, but the Islamic Financial Services Board (IFSB) in Malaysia -which is considered a reference framework institution that most Arab central banks ratify the standards and instructions it issues regarding Islamic Banks- develops special standards for Islamic Banks in the field of good governance rules, capital adequacy and transparency. That was because Basel Committee had not done that, especially that the IFSB is exerting prompt and significant efforts to set general rules and standards concerning the safety and stability of Islamic Banks under the rapidly increasing Islamic financial services.

The IFSB achieved the capital adequacy standard for financial institutions (except for insurance institutions) that provide only Islamic financial services. This standard has filled a very important gap in the field of risk management and capital adequacy for Islamic Banks.

The primary version of good governance rules has been completed. Work is going on to achieve the supervisory review according to the second pillar of Basel 2, and for transparency and market control according to the third pillar of Revised Basel Framework for risk-based capital adequacy. It is worth mentioning that Basel Committee is concerned with developing a comprehensive conception of effective banking supervision for across borders financial operations as a priority due to the risks they contain. Basel Committee abides by enhancing cooperation with states that are not members in the Committee, and with the institutions which have similar concerns to Basel's topics, on top of it which is the IFSB, with which there's serious cooperation that's expected to be fruitful in the different fields of mutual concern by Basel Committee and the IFSB:

- The good and sound governance which plays an

important role in achieving the safety factor at the level of banks and the financial stability as a whole.
- Basel capital framework contribution to achieving the good governance in the banking sector.
- Basel's achievement in setting the good governance standards.

2. Analysis and Findings

2.1. Good Governance for Banks and Banking Supervision

The absence of good governance in banks will result in a high degree of failure as it happened in large international corporations such as Enron, Parmlat, and Cadbury in the foregoing years. Each crisis had its unique story, and till now the surrounding circumstances of these crises have not been revealed, because not all the facts have been disclosed. Nevertheless, we can, in general, attribute a great deal of these collapses to the management failure and failure to fulfill the good governance principals which would guarantee security and safety for the institution. The major failure factors are:

- The board of directors' failure to understand and evaluate the risks assumed by the institution when practicing its job, and failure to apply accountability to the CEO and the staff.
- Conflict of interests and the members of the board, as well as the executive management are not independent so that decisions in favor of persons are passed on the account of others.
- Internal auditing is either weak or does not exist; if it appears to be sufficient, it will be only on paper without any actual implementation.
- Failure of internal and external auditing to uncover embezzlement, and even supporting and encouraging it sometimes.
- Improper organizational structure; deals are designed in a way that lacks transparency and prevent market parties from making a clear image of the institution's status.
- Moreover, the governance culture in institutions collapsed as they adopted unethical behavior and thwarted any problem-solving attempts in the institution.

2.2. Institutional Governance in Islamic Banks Supervision and Management

The success, advancement and prosperity of the Islamic banking sector does not mean that it is immune against financial crises, which hit international institutions including traditional banks making them fail to continue and get out of the market; Islamic banks affect and are affected by what happens in international banking arena. The Gulf crisis, for example, led to a decrease in all banks' deposits; the storm reached the biggest banks including Islamic ones with good capital solvency and strong reputation in the Islamic banking arena; the breakdown of the Credit and Commerce Bank led to vast losses in a number of Islamic banks that managed to tolerate and absorb them because of their great assets, huge capitals and profits; they announced specifying allocations to cover the losses.

This crisis proved the importance of having sufficient risk-based capital according to the requirements of Revised Basel Framework for capital adequacy, on one hand, and the necessity to apply corporate governance in Islamic banks management and supervision, on the other hand.

The institutional governance system is a wide range of principals, ethics, systems, procedures and policies, through which the institution is controlled and guided and its path is identified, so that to reflect the nature of the relationship based on the theory of deputization between three major stakeholders in the institution: shareholders, board of directors, and the executive management, where the CEO, according to the theory of deputization, deputizes the owners represented by the board of directors to manage the institution in accordance with the interests of the depositors and shareholders based on the following principals:

- Transparency,
- Disclosure.
- Accountability

The institutional governance system includes appropriate incentives for the board of directors and top management to urge them to achieve the goals in favor of the company and its shareholders and to continuously follow up and encourage the institution to achieve the optimum use of resources.

The governance concept is relatively new, although it is an important element to enable banks to manage the risks they face when performing their job. A bank, basically, invests the shareholders', depositors' and investment accountholder’s money, which implies many risks and requires a competent management that can face the potential risks to avoid the bank their consequent losses, especially that the failure of any bank will lead to negative consequences on the stability of the banking system, the financial sector and economy as a whole, because the banking sector is one of the most sensitive and vulnerable sectors to the extent that monetary literatures considers it the concrete basis and the safety and security valve for economy as a whole.

The Islamic banks dependency on principals that are deeply-rooted in the Islamic economy and built on doctrine, the ethical factor and real basis, does not devalue the importance of institutional governance in the management of risks that are higher than those of traditional banks due to subjective reasons which lay in the nature of Islamic investment instruments, and to objective reasons because the institutional, legal and regulatory environment of Islamic banks has not completed yet. Here, we do not underestimate the role of the Sharia Control Board in the bank as one of the most important and prominent self-management instruments used to judge the safety of bank's operations and the staff performance efficiency, and their abidance by banking policies and administrative procedures.

Striving for accuracy makes us look at the Islamic banks experience, which is a big success story not only in the Islamic world, but in the entire world, as an experience that still needs a further practice to complete its real picture. There are still a lot of controversial and undetermined points in the Islamic banks' work. The most important ones are:

Interests: which some jurisprudences legitimate and some illegitimate. Islamic banks consider interests off-balance sheet items (illegitimated gains) that are to be used as donations, for example, upon the recommendations of the bank' Sharia Control Board.

Earmarked investment accounts: they are accepted by the bank from the costumer after identifying the investment's type and nature, where the investor takes the profit and assumes the loss, according to the Sharia's rule: the loss vs. the profit. The bank gets a share from the raised profits for being the costumer's agent without assuming any losses or risks for the investment. It is worth mentioning that investment accounts constitute about 30% of the money that is available to Islamic banks. Though investment accountholders have better luck than others (deposit accountholders) in profit making arena, theyare subject to a wider range of risks:

A chance for bank's management (insider dealing) to get information concerning a bad loan causing losses to investment accounts.

An investment account gets the return on the maturity date. If returns are transferred to profit equalization accounts to reduce the return's fluctuation impact, it may cause profits or losses to investment accounts at the expense of the past or future investment account, these risks can be included within the securities and mutual fund industries. It is worth mentioning that these risks are well-known to market players, especially to the investment accountholders. This does not imply any violation to market rules, instructions and laws, but the Islamic banks themselves should, based on their awareness of these risks, adopt internal policies to deal with them.

A bank's concern to implement the proper institutional governance principals in its management, may only protect the investment accountholders, provided that the risks to be dealt with are known and perceived at the level of the board of directors so that it can develop a clear detailed framework to tackle them.

In this context, and in accordance with the existence of effective and good institutional governance structure, we believe that it is necessary to have an independent member in the board or directors to protect the rights of the investment accountholders.

Identifying in advance the realised profit rate for investment accounts can be a solution to clinch the dispute concerning finding a way to protect these accountholders. But this is approved by some parties and rejected by others. The Assembly of Islamic Researches legitimates investing money in banks at a specified return justifying that by the idea that banks' investment of individuals' money against an in advance return is legitimated, and falls under the concept of agency; it, also, protects the money from corruption which may lead to losing the invested money's profits. It became a custom at some Islamic banks to give a small rate to investment accountholders regardless of the investment result, and the rest goes to the bank. Here the good institutional governance system should be put into effect to set an internal supervisory framework (internal and external audit) to avoid causing harm to investment accountholders, which is expected to be big if this group is not effectively represented in the board of directors.

2.3. The Relationship Between Internal Auditing and Institutional Governance in Islamic Banks

Internal auditors are concerned with monitoring the degree of respecting the Sharia. Considering that external auditors are not experts in the Islamic Sharia, the supervisory boards usually insist on reviewing and assuring the competence of internal auditor, and evaluating him/her based on:

- To which limit the external auditor depends on the outputs of the internal auditor.
- The quality of internal auditor's reports, and how their outputs are used by the executive management and the board of directors.
- The internal auditor's work must be risk-based not inspection-based. The internal auditor is asked to review the bank's internal evaluation systems annually at least, in order to monitor and update them if necessary. The auditor also evaluates the institutions with which the bank deals in the context of the bank's risk management and assessment, and not risk pricing as that is prohibited in Islamic banks.
- Internal auditor's independency.

2.3.1. An Internal Auditor Is Required to Report Annually and Biannuallyon

- The bank's safety and transparency standards.
- The appropriateness of the policies and procedures.
- The quality the bank's management.
- The historical database in place.
- We highlight here the necessity to distinguish between auditing and inspection, which is involved in:
- Evaluating the qualitative factors in the procedures of administrative practices.
- Future horizons (the effect of present decisions on the bank's future status)
- Understanding the risks that the bank is subject to.

2.3.2. Rationales for Applying Good Institutional Governance Principles in Islamic Banks

- The absence of a unified body that is a reference framework for all Islamic banks in the world; there are deep disagreements (in both opinion and jurisprudence) stemming from the fact that there're different jurisprudential schools which hinders clinching many disputes in the work of Islamic banks.
- The Islamic banks' philosophy of prohibiting in-advance specification of return and the principal of dividing profit and loss necessitate the provisions of a good institutional governance system to ensure that the management and the owners will not harm the

depositors, investment accountholders and other stakeholders of the Islamic finance channels.

- The absence of Islamic accounting standards until this moment though the Accounting and Auditing Organisation for Islamic Financial Institutions is taking confident steps in achieving a package of Sharia accounting standards. However, the rapid growth of banking sector (four times the traditional ones) and the development of Islamic finance and investment instruments leave a wide space for jurisprudence and the consequent disagreements among Sharia auditors and states.
- Completing an appropriate organizational structure is difficult due to the rapid growth of Islamic banks that is not accompanied with similar growth in human resources that are qualified and experienced in Islamic investment.
- The human nature which tends to prioritizing self-interest, especially that not all Islamic banks' members of staff have enough religious commitment.

2.3.3. Challenges Faced by Islamic Banks in the Context of Applying Institutional Governance System

- Ensuring the requirements of rapid growth of Islamic banks which attracted very huge capitals that have been out of the banking framework; their owners kept them in their safes and wallets, i.e. Islamic banks' work is similar to land reclamation.
- Replacing the traditional banking instruments by other instruments that are consistent with the provisions of the Sharia, because the traditional banking market preceded the Islamic one by many years; which makes difficult for the public to get used to them; it needs deepened awareness of the social impact and the economic return of Islamic investment, as well as the religious dimension at the same time.
- Competition of traditional banks, especially that some groups, even educated ones, have a deeply rooted idea that there is no difference between dealing through interest and dealing through murabaha; some even prefer to borrow through interest, which makes it very important and pressing for Islamic bank to launch creative and innovative awareness campaigns.
- No complete understanding of the Islamic banking system's dynamics, which need continuously modernization and amendment of procedures and practices to reduce the risks that are deeply-rooted in the Islamic banking system, outweighing those of the traditional banks.
- Achieving integration between the good institutional governance system and the central bank's supervision on the Islamic banks according to the central bank's laws, the law of banks and the detailed regulations and instructions issued by virtue of them, along with internal and external auditing and the Sharia supervision.
- Ensuring the necessary training in the context of qualifying the staff as a precondition to apply the good institutional governance system in the bank.
- Planting commitment in Islamic banks' employees, starting from the similarities between them and traditional banks.
- Achieving transparency and disclosure of Islamic bank's operations.
- Removing the gaps in some of the Islamic investment instruments, from which some breaches, favoring and realizing the interests of some accountholders on the account of other accountholders.

3. Conclusion

Putting the good institutional governance into effect is one of the main ingredients, not only for Islamic banks, but also for political and economic reform as a whole. The absence of good governance in any institution threatens its existence and survival, which requires promoting the thought and culture of good institutional governance in the Islamic banking sector; this culture has positive reflections on the work of banks and ingraining the good governance mechanisms through developing their policies and directions in the administrative field, and enhancing the accountability, transparency and disclosure values in their work.

Banks are the locomotive of the economic growth process. They, basically, invests the depositors' money, which implies many risks and requires a competent management that can face the potential risks to avoid the bank their consequences, and not only the bank because a bank failure affects the banking system as a whole.

Engraining the concept of good institutional governance and good governance is a collective responsibility lays on the entire society. The bank's surrounding environment plays an important role in disseminating this culture, which requires cooperation from all stakeholders: government, private sector, media, companies, and the public. Those stakeholders should undertake their responsibilities in this essential and important topic.

I should emphasize here on the necessity to practice clear, transparent and sound banking supervision rules and laws, and the importance of providing the required training and qualification to human resources according to the international banking rules and standards.

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