

## Corporate Governance Practices in Bangladesh: A Comparative Analysis between Conventional Banks and Islamic Banks

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### ABSTRACT:

Corporate governance (CG) is an important effort to ensure accountability and responsibility and is a set of principles, which should be incorporated into every part of the organization. This study focused on the state of Corporate Governance (CG) in two categories of the banking industries: Conventional Banks and Islamic Banks. As Conventional Banks and Islamic Banks differ a great deal in their rules, regulations and operating procedures, the corporate governance (CG) practice of these two banking sectors is also different from each other. Here, in this paper it is tried to represent a clear comparative study about corporate governance (CG) practice of these two banking sectors. For this purpose it has been selected ten commercial banks of which five are renowned Conventional Banks and the same number of Islamic Banks in Bangladesh. After exploring the scores of each indicators it has been noticed that in average the grand score of Islamic Banks is less than the grand score of Conventional Banks to the extent of 0.07 (0.60-0.53). And in 2012 the grand score of Islamic Banks is less than the grand score of Conventional Banks to the extent of 0.05 (0.83-0.78). But Islamic Banks signify a higher overall improvement score than Conventional Banks that is 0.02 (0.25-0.23). Both Conventional Banks and Islamic Banks are being imperative in practicing corporate governance (CG) as both the banking sectors are facing significant improvement in practicing CG. But in comparison to Conventional Banks, Islamic Banks are bit lacked behind in corporate governance (CG) practices.

**Keywords:** *Corporate governance, Comparison, Indicators, Bangladesh bank guidelines*

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### INTRODUCTION

Given the important financial intermediation role of banks in an economy, their high degree of sensitivity to potential difficulties arising from ineffective corporate governance and the need to safeguard depositors' funds, corporate governance for banking organizations is of great importance to the merits targeted supervisory guidance. So, undoubtedly effective corporate governance (CG) is a burning question for each and every bank. Banking companies have their unique role in the blood circulation of the economy. Conventional Banks and Islamic

Banks are two major sectors of banking industry in Bangladesh. This paper focused on the corporate governance (CG) practices by the Conventional Banks and Islamic Banks and represents a comparison between them.

#### **Introduction to Corporate Governance (CG)**

Corporate governance (CG) is an important effort to ensure accountability and responsibility and is a set of principles, which should be incorporated into every part of the organization. Though it is viewed as a recent issue, there is,

infact, nothing new about the concept. Because it has been in existence as long as the corporation itself-as long as there has been large – scale trade, reflecting the need for responsibility in the handling money and the conduct of commercial activities. Fundamental concern of corporate governance (CG) is to ensure the conditions whereby a firm's directors and managers are held accountable, ensure better and effective protection to all stakeholders. It is argued that the framework of corporate governance should be based on four “pillars” – of Responsibility, Accountability, Fairness and Transparency (RAFT).

Sir Adrian Cadbury in 'Global Corporate Governance Forum', defined Corporate Governance as: "Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society" (Cadbury, 2000)

#### **Concept of Conventional Bank and Islamic Bank**

In a developing economy like Bangladesh the banking systems as a whole play a vital role in the progress of country development. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Islamic Banking is an integral part of Islamic Economics and thereby an Islamic way of life. Islamic Banking is a special nature of financial intermediary which has not involve in any way with interest. The introduction of interest-free and equity-based financing by the Islamic Banking systems based on the principles of Islamic economics. On the other hand, Conventional Banking is essentially based on the debtor-creditor relationship between the depositors and the bank on one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.

#### **Literature Review**

One school of thought describe corporate governance as a “system” by which companies are directed and controlled (Cadbury and

Greenbury Report, CFACG 1992); another school views corporate governance as “structures and processes for decision making, accountability, control and behavior at the governing body” (Public accounts and Estimates Committee, 2002); to others corporate governance is about “finding ways” to ensure effective decision making (Pound 1995).

Kocourek (2003) believes that to counter the accounting, leadership, and governance scandals, organizations are rushing to institutionalize corporate governance, which may be even be counterproductive. The drive to more tightly regulate the membership and functions of corporate boards is already encouraging organizations as well as commercial banks to view governance as a legal challenge rather than a way to improve performance. By reducing the critically important issue of corporate governance to what amounts to box-checking exercise, corporate directors and senior executives are addressing the symptoms, not the root cause, of the governance crisis. Kocourek states that governance begins at home – inside the boardroom, among the directors. It is embedded in *how, when, and why* they gather, interact, and work with one another and with management in other words, the “soft” stuff. But qualitative reforms to the behaviors, relationships, and objectives of the directors and CEO are meaningless unless they are subject to the “hard” mechanisms of performance criteria, processes, and measurement. According to Kocourek, this combination of soft and hard solutions can turn corporate governance from vague concept into a means to deliver organizational resilience, robustness, and continuously improved performance.

The purpose of corporate governance in Islamic financial institution is different from the purpose of corporate governance of other firms. Habib and Chapra (2002) consider the corporate governance of Islamic financial institutions as a mechanism who allows ensuring fairness to all stakeholders through greater transparency and accountability towards Islamic principle. According to Ibrahim (2006), the corporate governance of Sharia compliant business would first look at the transactional structure to see whether the transaction involves elements that invalidate gains or profits, since Sharia is concerned not only with the substance but also

with the form of the business. In effect, corporate governance for Islamic financial institutions stems from two principle elements: faith based approach that mandates conduct of the business in harmony with Islamic law and profit-motive that recognizes business and investment transactions and maximization of shareholder's wealth etc. (Akhtar, 2006). According to Arif (1988), Conventional Banking and Islamic Banking differs in that while the Conventional Banking follows conventional interest-based principle, the Islamic Banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries. According to Archer et al. (1998), in comparison to Conventional Banking, Islamic Banking needs more corporate governance to omit the weaknesses of the past and to increase the transparency by monitoring the financial activities (Archer et al., 1998). Here, it has been found that a large number of research papers already published in the various context of corporate governance over the world but it is also noticed that a very few papers published in Bangladesh relating with Conventional Banks and Islamic Banks on CG. So, in this paper it attempts to know the status of corporate governance of Conventional and Islamic Banks in Bangladesh.

## **RESEARCH METHOD**

**Guidelines followed in:** The state and nature of corporate governance (CG) in Bangladesh are guided by several factors: a) company law, b) Bangladesh Bank's (BB) guidelines, c) SEC requirements, and d) pressure from buyers or peer pressure. The cumulative impact of these factors results in a corporate behavior which is followed differently by Islamic Banks and Conventional Banks in Bangladesh. This paper has been prepared based on the Securities and Exchange Commission's (SECs) guidelines and Bangladesh Bank (BB) guidelines.

**Time Frame:** In 2003, after providing the Bangladesh Bank's guidelines toward CG, SEC developed a code of corporate governance in 2006. So, it could be well assumed that starting point of practicing CG based on established benchmark or code is the year of 2006-2007. So,

it is quite reasonable to choose the time frame from 2006 to 2011.

**Average:** For the sake of calculation, here it has taken the average of the compliances from the year 2006 to 2011.

**Banks selection:** 5 Conventional Banks (i.e. United Commercial Bank Ltd., Eastern Bank Ltd., IFIC Bank, NCCB and City Bank Limited) and 5 Islamic Banks (i.e. Islamic Bank, Exim Bank Ltd., Bangladesh Islamic Bank, ICB Islamic Bank Ltd., and Al-Arafah Islamic Bank Ltd) were randomly selected for the purpose of preparing this paper.

**Data Collection:** Data have been collected from the annual report of the banks. The annual reports of the selected banks were explored in order to gather information. 5 broad indicators and other sub-indicators were taken from the SEC guidelines and BB guidelines of the banks.

**Explanation of Indicators:** To measure the status of corporate governance (CG) in Conventional Banking and Islamic Banking sector and to make comparison between these two on the basis of 5 broad indicators. These are as follows:

**Nature of Compliance:** This indicator is used to get the idea about the priority concern of banks towards practicing CG.

**Independent Directors (ID):** This indicator focuses on the appointment of independent director and other matters related to independent directors.

**BOD and Functionalities of Board:** It focuses on the functional measures of board and board size.

**Audit committee:** This indicator is used to aware of the worthiness of the functions of audit.

**Transparency and disclosure:** This indicator indicates about the state of disclosure in various information and their availability through annual reports.

**Analysis:** Considering the timeframe from 2006 to 2011, it has been well analyzed whether the

different banks comply with different indicators as well as sub indicators or not. On the basis of compliance and non-compliance it has given score 1 and 0 respectively.

**Comparison:** Firstly, it has analyzed the state of corporate governance (CG) practice of selected Islamic Banks and Conventional Banks. Then a comparison has been made between them.

#### Objectives of the Study

The broad objective of the research is to understand the overall state of corporate governance (CG) in the Conventional and Islamic Banking sector of Bangladesh. Besides, from this research it is expected to know the followings:

- ✓ How far the current practice of corporate governance (CG) in Islamic and Conventional Banking sector passes the test of fairness.
- ✓ Whether the corporate culture of Islamic Banks is different from the Conventional Banks or not.
- ✓ To highlight a clear comparison of CG practices between Conventional Banks and Islamic Banks.

## RESULTS AND DISCUSSION

### Results

Inclusion of independent director is increasing with an improvement score 0.27. But it has found that banks are not interested enough to appoint Independent Director. From the table 1 it has been noticed that in 2012 only 3 banks (out of 5) are appointing independent directors. Another indicator "Audit committee" has an improvement with a score of 0.22. Again it is found that the banks are not voluntarily including independent directors in the audit committee.

From the table 2 it is found that in average among the five indicators "Nature of compliance" the first indicator scores 0.8, but in 2012 it has scored to its highest extent that means 1. This has happened because of SEC guideline which has developed in 2006 and now it has become a bench mark to measure the

status of CG, so banks are required to comply with that.

After having a closer look to the four other indicators (Independent director, BOD and functionalities of board, Audit committee, and Transparency and disclosure), from this table it is also found that the four other indicators' scores are 0.33 (average), 0.60 (2012), 0.66 (average), 0.80 (2012), 0.53 (average), 0.75(2012), 0.66 (average), 1(2012) respectively.

The largest extent of improvement is found in case of the indicator "Transparency and disclosure" and the score of improvement is 0.34. This is happened as the banks are becoming imperative in transparency and they are disclosing their risk management systems in the annual reports of the banks. Disclosing of risk management system in Annual Report is very essential considering taking investment related decisions. Bangladesh Bank imposed compulsion on commercial banks to comply with Basel-2 as a result risk management mechanism is disclosed in annual report of banks.

The lowest score of improvement is noticed for the indicator "BOD and functionalities of the board" and the score is 0.14. This just because the banks have not sufficiently scored in holding adequate number of board meetings and attendance by the directors, fairness of financial statement, soundness of internal control, board size, compliance with accounting standards, separate chairmanship from the CEO etc. So, in this regard banks need to pay more attention.

From table 3 it can be found that in 2012 only one bank out of five appointed independent director in the audit committee. The highest extent of improvement has been noticed for the indicator "Nature of Compliance" which has an improvement with a score of 0.40.

From table 4 it is found that in average among the five indicators "Nature of Compliance" the first indicator scores 0.60, but in 2012 it has been scored to its highest extent that is 1. As banks have been started practicing CG from 2006, day to day Islamic Banking sectors are complying with SEC guidelines and BB guidelines.

**Table 1: Average compliance of five conventional banks during the period from 2006 to 2011 along with the average of year 2012**

SL	Indicators	Average	2012
1.0	Nature of compliance	-	-
1.1	Having any code of CG	4	5
2.0	Independent directors	-	-
2.1	Having any independent directors	2.2	3
2.2	Appointment of independent directors by elected directors	1.6	3
2.3	Independent directors at least 1/10 of the total	1.2	3
3.0	BOD and functionalities of board	-	-
3.1	BOD	-	-
3.1(i)	Board size	3.4	5
3.1(ii)	Whether chairmanship of board is separated from the CEO of the bank	2.8	3
3.2	Functionalities of board	-	-
3.2(i)	Holding any board meeting and attendance of directors	3.8	3
3.2(ii)	Compliance with international accounting standard	3.4	4
3.2(iii)	Observance of Bangladesh accounting standard	1.6	3
3.2(iv)	Fairness of financial statement	3.6	5
3.2(v)	Soundness of internal control system	3.8	5
3.2(vi)	Deviations in operating results from last year	4	4
4.0	Audit committee	-	-
4.1	Audit size	2.2	3
4.2	Inclusion of independent directors in the audit committee	1.8	2
4.3	Filling the casual vacancy in the audit committee	1.6	5
4.4	Having significant person (CFO, company secretary, head of internal audit)	5	5
5.0	Transparency and disclosure	-	-
5.1	Compliance with accounting standard, fairness of financial statement, maintenance of proper books of account	4.4	5
5.2	Disclosing of risk management system in annual report	2.2	5

**Table 2: The score on each indicator and overall performance in the conventional banking sector of practicing CG**

Indicators	Score- average	Score-2012	Improvement
Nature of compliance	0.80	1.00	0.20
Independent director	0.33	0.60	0.27
BOD and functionalities of board	0.66	0.80	0.14
Audit committee	0.53	0.75	0.22
Transparency and disclosure	0.66	1.00	0.34
Grand score	0.60	0.83	0.23

**Table 3: Average compliance of five Islamic banks during the period from 2006 to 2011 along with the average of year 2012**

SL	Indicators	Average	2012
1.0	Nature of compliance	-	-
1.1	Having any code of CG	3	5
2.0	Independent directors	-	-
2.1	Having any independent directors	2.4	4
2.2	Appointment of independent directors by elected directors	0.60	2
2.3	Independent directors at least 1/10 of the total	0.60	2
3.0	BOD and functionalities of board	-	-
3.1	BOD	-	-
3.1(i)	Board size	2	4
3.1(ii)	Whether chairmanship of board is separated from the CEO of the bank	1.8	2
3.2	Functionalities of board	-	-
3.2(i)	Holding any board meeting and attendance of directors	4.4	5
3.2(ii)	Compliance with international accounting standard	3.6	5
3.2(iii)	Observance of Bangladesh accounting standard	1.4	2
3.2(iv)	Fairness of financial statement	4.2	5
3.2(v)	Soundness of internal control system	4.4	5
3.2(vi)	Deviations in operating results from last year	2.6	5
4.0	Audit committee	-	-
4.1	Audit size	4.8	5
4.2	Inclusion of independent directors in the audit committee	0.60	1
4.3	Filling the casual vacancy in the audit committee	3	4
4.4	Having significant person (CFO, company secretary, head of internal audit)	4.2	5
5.0	Transparency and disclosure	-	-
5.1	Compliance with accounting standard, fairness of financial statement, maintenance of proper books of account	4.4	5
5.2	Disclosing of risk management system in annual report	1.2	3

**Table 4: The score on each indicator and overall performance in the Islamic banking sector of practicing CG**

Indicators	Score-average	Score-2012	Improvement
Nature of compliance	0.60	1	0.40
Independent director	0.25	0.53	0.28
BOD and functionalities of board	0.61	0.83	0.22
Audit committee	0.63	0.75	0.12
Transparency and disclosure	0.56	0.80	0.24
Grand score	0.53	0.78	0.25

For Islamic Banking sector the second indicator “Independent Director” has not a satisfactory score (0.25) in average. Although this score has been developed in 2012 having an improvement score of 0.28, Islamic Banks need to pay more attention with regard to appointment of independent directors.

From this table it is found that the three other indicators’ (BOD and functionalities of board, Audit committee, Transparency and Disclosure) scores are 0.61 (average), 0.83 (2012), 0.63 (average), 0.75 (2012), 0.56 (average), and 0.80(2012) respectively. In 2012 almost satisfactory results have been found in case of both the indicators “BOD and functionalities of board” (0.83) and “Transparency and disclosure” (0.80).The lowest score of improvement has been noticed for the indicator “Audit committee” which scored only 0.12. This has been happened because Islamic Banks have been faced a poor score in the sub-indicator “Inclusion of Independent Director in Audit committee”.

After having a closer look on table 5 it is found that in comparison to Islamic Banks, Conventional Banks are bit imperative in the

overall practices of Corporate Governance(CG).

After exploring the scores of each indicators we have noticed that in average the grand score of Islamic Banks is less than the grand score of Conventional Banks to the extent of 0.07 (0.60-0.53). And in 2012 the grand score of Islamic Banks is less than the grand score of Conventional Banks to the extent of 0.05 (0.83-0.78). But Islamic Banks signify a higher overall improvement score than Conventional Banks that is 0.02 (0.25-0.23).

#### Discussion

Both Conventional Banks and Islamic Banks are being imperative in practicing corporate governance (CG) as both the banking sectors are facing significant improvements in practicing CG. But in comparison to Conventional Banks, Islamic Banks are bit lacked behind in corporate governance (CG) practices. Moreover, we can further notice that these differences are not so much significant although the operating procedures of these two banking sectors are quite different from each other.

Table 5: Comparative analysis of practicing cg between conventional banks and Islamic banks

Indicators	Score average		Score-2012		Improvement Score	
	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks
Nature of compliance	0.80	0.60	1	1	0.20	0.40
Independent director	0.33	0.25	0.60	0.53	0.27	0.28
BOD and functionalities of board	0.66	0.61	0.80	0.83	0.14	0.22
Audit committee	0.53	0.63	0.75	0.75	0.22	0.12
Transparency and disclosure	0.66	0.56	1	0.80	0.34	0.24
Grand score	0.60	0.53	0.83	0.78	0.23	0.25

## CONCLUSION AND RECOMMENDATION

Both for Conventional Banks and Islamic Banks, after comparing the average and the year 2012 in general conclusion it may be focused that Conventional Banks as well as Islamic Banks have progressed to implement Corporate Governance (CG). But there are some issues which are needed to be focused. These are (a) Shareholders' Rights, (b) Public Disclosures of Information, (c) Effectiveness of the Board, (d) Inclusion of Independent Director, (e) Effectiveness of Audit Committee. In fact, these issues are convenient to the proper practice of CG.

Active participations of the independent directors in the board meetings, and inclusion of independent directors in the audit committee is so much imperative of having good practice of CG. But unfortunately both banking sectors (Islamic and Conventional) are showing less concern regarding the appointment of independent directors. Moreover, although audit committees are present in both the banking sectors (Islamic and Conventional), their effectiveness are questionable. This may cause hindrance in the way of smooth running of CG. So, audit committee shall have to be effective as prescribed by manners.

Especially, Islamic Banks need to pay much attention with regard to public disclosure of information. Public disclosure in an important element of governance in the corporate world because it builds trust, and ensures smooth functioning of the capital markets and excels the banks' growth. It is, therefore, a requirement in our SEC's code of conduct.

If the mentioned issues are sufficiently focused, Responsibilities, Accountability, Fairness and Transparency (RAFT) will be properly ensured.

Given the above discussion and findings, it is fair to conclude that although CG practices are gradually improving in both banking sectors; corporate culture in banking sector of Bangladesh is still in a state of infancy. While we have created legal requirements for good corporate governance, rushing to institutionalize the culture of governance through legal and regulatory requirements or through external pressures will do more harm than good to the culture. Under such circumstances, the spirit of

the good governance will be lost and rather perfunctory structure will take place. The objective of practicing good governance is to help the corporation as well as the society and the nation. It promotes a mechanism to use the capital market to enhance the growth of the corporations and for this it is important that corporate sector are educated to understand the benefits from good corporate governance. It is under such a scenario, the state of governance in our corporations will mature.

## Notes

CG=Corporate Governance

BOD=Board of Directors

SEC=Securities and Exchange Commission

BB=Bangladesh Bank

CEO=Chief Executive Officer

CFO=Chief Financial Officer

ID=Independent Director

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