The Impact of the Application of Corporate Governance in the Banking Sector

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Introduction
Governance in banks has gained a prominent position in the light of the importance in financial services offered by banks, and it exposes those services greatly to difficulties and potential risks, and to the need of protecting the interests of depositors and the money of shareholders in addition to protecting the interests of other related parties such as workers and dealers with the bank. In 1999, the Basel Committee for banks supervision has issued instructions related to the adoption of best bank practices.

Adding to that, the decisions or guidance of Basel 2 of the year 2005 and reviewed in February 2006 in addition to 8 principles related to governance and banking discipline of the banks’ boards of directors members, followed by the formation of Basel 3 stating the necessity of diversification of the sources of income, in order to create other sources of income different than the banking activities, where the new rules demand banks to keep a high quality capital amounting 7% of its high risk assets instead of the previous rate which was 2%, and this new agreement includes a transition period or a grace period until 2019 to implement, it also demand a mechanism to deal with the high risk financial derivatives which was the most important reason of the financial crisis in the second half of 2008, in addition to the off records accounting transactions.

Research importance
The importance of this research comes from highlighting the role of governance in enhancing the banking business efficiency and providing trust, safety, and the effective and healthy transparency of banking operations which leads to improving, developing and increasing the effectiveness and efficiency of the banking system.

In addition to that, its importance comes from ensuring the necessity of expanding the application of the banking governance concept in the economic environment, where we intend through this paper to know the advantages and benefits of banking governance and the way of utilizing it in practicing the banking services.

The importance of this study also is taken from the importance of the right application of the standards and principles of banking governance in order to avoid the financial and economic crises.

Without a doubt, this paper is considered to be a source for people interested in the banking system and its development, especially the banking regulators, unions and banks itself.

Research problem
Governance is considered to be more complicated in the banking sector compared to other sectors, considering that the banks include elements that do not exist in other sectors such as deposits insurance, regulatory risk management, quality, evaluating the capital specialized to borrowers and the internal
control systems in addition to the capital structure that generally consists of debts and small percentages of private cash, in addition to that, the source of money in the bank is mostly in the form of deposits on the condition that it will be available at the demand of depositors, whereas the assets of the bank are mostly long term loans.

As such, control is usually stricter on the level of banks compared to other entities, where it is characterized by conflict of interest between the different parties in a complicated way, where the research problem is represented in indicating the level of incorporation of governance in the banking sector and in the clarification rights and duties of all the related parties, and the problem is divided into different sub problems as follows:

1. To what extent is there an interest in governance?
2. Is there available professional and educational experience within the board of directors which enables them to take reasonable decisions related to shareholders and depositors?
3. Do specialized board of directors’ regulators work on their role which is protecting the rights of investors and depositors?

Objectives of the research

1. Identifying the concept of the governance of the bank sector and its determinants.
2. Identifying the standards and goals of the banking sector governance.
3. Identifying the rules and advantages of the governance of the banking sector.
4. Offering suggestions and recommendations appropriate to the field.

Definition of the banking governance and its components

Governance means system, which is regulations defining the relations between the primary elements that affect performance, which include the elements of enhancing the company in the long term and defining responsible parties and their responsibilities.

First: The concept of banking governance

Governance in the banking sector is related to the control of the board of directors and higher management of the bank, and protecting the rights of investors and depositors, in addition to the interest in the relations of those external parties, defined by the organizational framework and the regulatory authorities, and this governance in applied in the banking sector on general, private and common banks.

The main categories in the governance are represented in two main categories as follows:

1. The first category represents internal parties, such as stockholders, board of directors, executive management and internal reviewers and regulators.
2. The second category represents external parties, such as depositors, deposits insurance, media and the legal, regulatory framework.

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Second: The governance concept from an Islamic perspective (Governance in the Islamic bank)

Dr. Muhsin Khudri says that: “The managerial work in Islam is based on certain doctrinal foundations built on the Islamic doctrines which set the boundaries and determinants on it, and draws a way controlling the behavior of the managers, the managerial organization, and personnel working in it, whether in their relations to each other, or the relations between them and their society, and then the Islamic management becomes of a comprehensive message to all religions and ethics in a complete framework where it is impossible to separate one of its elements from the other.”

The Islamic banks experiences was characterized by several imbalances in committing to the doctrines of the Islamic laws and regulations dictated by the first theoreticians, until criticized by many writers, researchers and experts, saying that it is only based on stimulating the traditional banks operations trying to find ways to justify it illegal processes putting it under the Islamic umbrella on the surface with plenty of usury in reality, in addition, filing the gaps between what should happen and what is happening in the Islamic banking is connected to some serious arrangements that are considered as a main priority endangered by the quantitative proliferation that does not express the commitment of those banks in their theoretical principals.

The importance of governance in the banking sector

The need to governance has emerged in many advanced and developing economical sectors in the past few decades, especially after the economic collapse and economic crises that took place in eastern Asia and Latin America and Russia in the nineteenth of the 20th century. In addition to what the American economy witnessed lately of accounting and financial collapses in 2002.

The importance of governance has increased as a result of the orientation of many countries to transfer to the capitalism economic systems that depends hugely on the private companies to achieve high and continues rates of economic growth, and the expansion of those products has lead to the separation of the possession from the management, and those projects have began looking for financing sources which are less expensive than the banking sources, and as a result they got oriented to the monetary markets, which was supported by the liberation of those markets, where the transfer of capital increased between borders in an unprecedented way, in addition to the expansion of the size of the companies and separation of possession from ownership caused the weakening of the control on managers behaviors, and many other problems in companies such as the crisis of “Enron and World Com” in 2001, which lead the world interest in governance.

The importance of good governance in banks is summarized as follows

1. Corporate governance is considered to be a system that orients and controls operational processes in banks.

2. Good corporate governance represents a main element in improving the economic efficiency whereas the bad governance can affect the stability of the financial and economic situation, and the best proof on that, is what happened in the Asian crisis.
Objectives of governance in the Banking Sector
The rules and determinants of governance aim to achieving transparency and justice, and granting the right of the accountability of the company’s management, as such, achieving investors protection and bonds carriers, taking into consideration the interests of work and workers, and limiting authorities abusing in ways other than the common interest, leading to developing and encouraging investments, increasing savings and profitability and making new work opportunities. In addition, these rules enforces the importance of committing to the law, and working on ensuring the review of the financial performance, and the existence of managerial structures that enables judging the management in front of the shareholders, and forming a committee of non executives that has certain specialties and tasks and multiple authorities to achieve independent control on execution.

Advantages of governance in the Banking Sector
1. Achieving economic efficiency.
2. Achieving efficiency in reaching set goals.
3. Reserving the rights of the concerned parties.
4. Limiting corruption and its negative effects.
5. Developing economic growth.

Determinants of governance in the banking sector

1. External determinants:

It indicates to the general investment environment in the nation, which includes for example: the laws organizing the economic activities (such as financial market activities and organizing competition and prohibiting monopoly practices and bankruptcy), the efficiency of the monetary market (banks and financial institutions) in providing necessary financing to projects, the level of competition of products and production elements markets, the efficiency of regulatory and control systems (the stock market committees) in controlling companies, in addition to some self organized institutions that guarantees the efficiency of the markets’ work (such as labor unions which sets its workers ethics charters like accountants, lawyers and stock market companies), and private professional services companies such as law, audit and financial and investment consulting firms. The importance of these determinants comes from the fact that its existence forces the execution of laws and regulations that guarantees the good management of companies, minimizing the conflict between the social and the private income.

2. Internal determinants:

It indicates to the rules and basis determining the way of taking decisions and distributing of authorities inside the company between the general assembly, the board of directors and executive managers, where its existence and application leads to reducing the conflict between the interests of those three parties.
In addition, governance eventually leads to the increase of trust in the national economy, deepening the role of financial market, increasing the rates of investment, and preserving the rights of the minorities, and on the other hand, governance encourages developing the private sector, enforces the competition, and helps projects to win financing and gaining, and finally creating jobs opportunities.

**Standards of governance in the banking sector:**

Given the increase in the concept of governance, many institutions worked on studying, analyzing this concept and setting specific standards to apply it. One of those institutions is the Bank of International Settlements represented by the Basel Committee, and the international financing institute under the World Bank, CASSP authority.

**Basel Committee standards for international banking control:**

The Basel Committee has issued a statement related to enhancing governance in 1999, and then an edited copy in 2005, and in February 2006; it issued an updated copy titled “Enhancing corporate governance for banking organizations” which includes the principles of banking governance as follows:

**First principle**

The board of directors of a bank must be completely qualified to fill their positions, and must have complete knowledge in governance and the ability to manage banking operations; the members of this board are fully responsible for the performance of the bank and its financial position, in addition to putting a strategy for the work in the bank and its risk policies, and they have to exclude themselves from making decisions in a conflict of interest situation which makes them incapable of performing their duties fully towards the bank, in addition to restructuring the board which increases efficiency.

Figure (1): Internal and external determinants of governance.
The duties of this board include choosing and hiring executive managers to guarantee the existence of competencies necessary to manage the bank, and they have to be fully aware of the principles and basis of the bank operations.

The board shall form supporting committees including an executive committee, and an internal audit committee which with is formed by the support of the auditors, receiving their reports, and taking corrective decisions in the right time to determine the weaknesses of control and inconsistencies with the policies, laws and regulations.

Adding to that, the board forms a risk management committee setting principles related to the higher managements regarding risk management, market, liquidity, operations, reputation and other risks, and wages committees that sets wages and executives hiring criteria parallel to the bank strategies and goals.

**Second principle**

The board of director must approve and control the strategic goals of the bank, and its values and work policy, taking into consideration the stakeholders, shareholders and depositors interests, and those strategies must be applied in the bank, and the board has to ascertain that the executive management applies the strategic policies and prohibits the activities, relations and situations that weakens governance, such as conflict of interest, for example lending employees or managers or shareholders or giving competitive advantages to related parties, and the board and high management must provide necessary security for employees preparing reports related to corruption or unethical personnel.

**Third principle**

The board of directors must set clear boundaries related to responsibilities and the self accountability of the managers and works and putting a managerial structure that encourages accountability and sets responsibilities.

**Forth principle**

The board of directors must make sure that the principles and concepts of management is aligned with the policy of the board and that the bank’s executives own the necessary skills to manage the bank’s operations and that those operations are done according to the policies and systems set by the same board based on the internal controls.

**Fifth principle**

The board of directors must confirm the independence of the auditors and the internal controls (including the tasks of commitment and legality) considering it as a foundation to bank’s governance in order to accomplish the control tasks through testing and validating information that are obtained from the management regarding the operations and the performance of the bank, and the higher management of the bank shall confirm as well the importance of audit and efficient internal and external controls for the safety of the bank in the long run.

The board of directors and the higher management of the bank must ascertain that the financial statements represent the financial situation of it in all aspects, that is through validating that the work of auditors is done based on the applied standards and that they participate in the internal control process by disclosing the financial statements. It is also appropriate that the internal control committee issues reports directly to the board of directors.
Sixth principle
The board of directors must make sure that the wages policy is parallel with the culture, goals and strategies of the bank in the long run and that the higher management and executive management incentives are related to the bank’s goals in the long run.

Seventh principle
Transparency is considered to be essential for effective and healthy governance, and according to the Basil committee regarding transparency in banks it hard for shareholders and stakeholders and other contributors in the market to monitor efficiently and correctly the performance of the banks management in lack of transparency situations, and this happens if shareholders and stockholders did not obtain enough information about the bank’s ownership structure and its goals, as a result, appropriate full disclosure is considered to be important especially in banks for banks registered in the stock exchange committee to accomplish discipline in the market, timely and accurate disclosure is disclosed in the banks website and the periodic and annual reports, and it shall be parallel to the size and the complexity of the bank’s ownership and risk exposure and whether the banks is registered in the stock exchange committee and a part of to the information that must be disclosed the information related to financial statements, tax exposure, subjects related to the internal audit and bank governance such as the qualifications of the banks management and committees and the employees’ wages policies.

Eighth principle
The board of directors must understand the bank operations and legislation environment that it works through and may expose the bank to legal risks indirectly when doing services on behalf of its clients that use the services provided by the banks to undergo illegal activates that endangers the reputation of the bank.

Standards of the International Financing Institution
The international financing institution that is related to the International Bank has set in the year 2003 regulations and general standards that are considered essential to support the corporate governance at its diversity, whether financial or non financial, at the following four levels:

1. Acceptable practices of good judgment.
2. Additional steps to guarantee the good new judgment.
3. Basic contributions to improve the domestic good judgment.
4. Leadership.

Cash authority standards
The cash authority has worked on developing a complete guide and the new governance standards in banks, and this guides in categorized under the efforts of the cash authorities aiming to setting the best rules in applying the governance in banks, and to enhance and develop the banks’ performance in alignment with the international practices, this is the reason that the cash authorities have developed this guide to fulfill the following goals:
1. Enhancing the awareness of the banks about the good judgment subject and creating awareness about the importance of applying it to accomplish the hoped benefits.

2. Setting an organizational framework to bank governance to complete the legal requirements stated in the related laws.

3. Providing guidance to banks related to the ways of accomplishing better commitment to the standards and the best international practices to bank’s management.

This guide is not considered to be a substitute of developing internal codes to governance in banks, shaping the mechanisms and standards of the healthy governance requirements stated in this guide and any other extra standards where the bank forecasts application possibilities, not conflicting with the valid laws in the country and the bank contains basic principles to organize the following sides:

1. Board of director’s membership.
2. The role of the board and its formation.
3. Internal and external audit.
4. Risk management.
5. Transparency and disclosure.
6. Wages and remunerations.
7. Role and rights of shareholders.
8. The role and rights of the other related parties.
9. Work ethics and practices.

**The structure and contents of the guide**

When developing this guide, best corporate governance international rules, regulations, standards and practices where relied upon especially those stated by the OECD with the help of a number of international organizations such as the international cash fund and the international bank, in addition to the principles issued by the Basel committee for banks control that took over the task of wording the standards of banks governance, where the standards contained in this guide are flexible allowing its application on working banks in the country in its different sizes, structure and activities.

The guide was structured to contain mandatory requirements representing the binding statements to working banks, and those requirements are considered to be obligatory in application. In addition, the cash authority aims to providing those instructions to directing the attention of banks to those areas especially that it is expected that those instructions will turn to binding rules in the future, according to what the interest of the banking services needs.
Rules related to the governance system and ethical conduct

Good application of governance needs preserving the rules and standards related to enhancing the level of accuracy and transparency of the financial reports and focusing on the importance of applying the standards related to the ethics of the organization.

The goals of the ethical conduct of banks contains setting standards to the good banking practices, and increasing the level of transparency and openness, in addition to developing the confidence level, supporting health competition basis, guaranteeing the rights of clients and shareholders, and confirming the importance of the right ethical practices of employees that should free of personal interests.

The impact of applying governance in the banking sector

Applying governance in banks leads to many positive consequences such as increasing the financing opportunities, reducing the investment cost, stability of the monetary market and limiting corruption, in addition, banks commitment to applying the governance standards leads to encouraging the companies to lend from it by applying these rules that mainly are disclosure, transparency, wise management and applying the governance principles leads to reducing the risk level when dealing with the banks.

Difference between governance in Islamic banks and traditional governance

Islamic banks are different in form and in content than traditional banks, where the first depends on a group of principles that cannot be waived or the bank will lose its Islamite, and those principles are:

1. The principle of participation in gain or loss.
2. The principle of trade on the base of ownership and on the religion basis.
3. The principle of the banks’ commitment to working under the Islamic laws.

Whereas the second depends on the base of fixed interest and it does not requires the legality of the financed projects.

Accordingly, we find that the contracts based on the participation principle in gain or loss are distinguished by a high level of risk compared to the contracts based on predetermined interest, which requires that fair management and efficient control and clear transparency that clarifies the rights and obligations of each party.

In addition, the commitment to the Islamic doctrine is not looked at only from the perspective of not financing “Haram” projects, but also is seen as a commitment of the banks management in the Islamic doctrines principles in practices and behavior.

Adding to that, through the combination of basic principles of governance, the traditional banks contain four basic elements represented in shareholders, board of directors, management and stakeholders, where one element is added to those in the Islamic banks which is the Islamic advisory committee that concentrates on the level of agreement of the banks practices with the Islamic laws, which makes the system of the governance system in Islamic banks different than that in traditional ones.
Results and Recommendations

First: Results

1. Identifying the importance and influence of banking governance in the favor of the concerned parties whether internal or external in many economic and legal aspects.

2. In the latest years, the interest in the concept of corporate governance increased greatly and clearly, which became a primary foundation of the banking sector.

3. Applying banking governance is the effective solution to guarantee the right of stakeholders especially shareholders and depositors.

Second: Recommendations

1. Issuing governance laws that are more detailed on each country level.
2. Urging the organizational parties in the banking sector to developing wise governance practices and issuing specific instructions to evaluate the banks’ performance.
3. Urging the organizers of the banking sector on specifying the inputs of the banks applications of wise governance practices.
4. Putting the responsibilities of the board of directors’ members and identifying their duties in prioritizing the banking sector policy.
5. Developing the skills of the board of directors through training programs that covers the ethical and professional requirements that are imposed by the banking sector practices.
6. The regulatory parties must be precise in determining the items of full disclosure of banks.

Conclusion

As a result, we can say that the importance of governance is clarified by its goals that are represented in fulfilling transparency, justice, and accountability rights, as a result, accomplishing protection of the shareholders and bond carriers taking into consideration the interest of work and employees and limiting authority abuse in situations not related to the general interest which leads to developing investment, savings and profitability, and the existence of an efficient system capable of granting trust and anti-corruption in banks will pay more success, and will support operations expansion, which requires the support of the management’s governance related processes inside the banks such as commitment management and internal control and legislations in its internal and external qualities.

In addition, the application of banks governance is a inevitable necessity which comes through detailing the contracts and setting its conditions precisely from the religious and organizational aspects.

Adding to that, the Islamic banks is more efficient if the managers succeeded in accomplishing both goals simultaneously, the first is financial to fulfill the investors and shareholders needs and the second is religious to validate the doctrinal sides of operations.
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