

# Economics and Business Review

Volume 10 (1) 2024

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# Corporate governance and risk management: An evaluation of board responsibilities in western and Islamic banks

 Bchr Alatassi<sup>1</sup>

 Rekha Pillai<sup>2</sup>

## Abstract

This research aims to explore the role of the board in corporate governance (CG) and risk management within the context of Islamic banking. Given the global reach of financial institutions, it is important to compare and evaluate the unique position of Shari’ah committees or Shari’ah Supervisory Board (SSB) in addressing the unique risks of Islamic banks. Using a comparative analysis, this study evaluated risk management guidelines in the CG codes of the United Kingdom, Germany, Saudi Arabia, and Malaysia. It found that board were ultimately responsible for risk management, regardless of the governance structure, and Shari’ah-related risks fell under the board’s purview. An innovative blend of Western CG frameworks and Islamic principles enhanced governance robustness through the strategic collaboration between board and SSBs.

## Keywords

- corporate governance
- Islamic banking
- risk management
- Shari’ah
- governance codes

**JEL codes:** G30, G39, G34, G21

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## Introduction

In recent years, corporate governance (CG) has evolved from its presumption of fair standards and its view of stakeholder responsibilities, board competence, and corporate sustainability as mere tick-box activities (Wadsworth, 2020). Nonetheless, the definition of 'good governance' is a controversial topic. Many shareholder-focused theorists argue that the board of directors' primary responsibility is to maximise shareholders' wealth (Friedman, 2007), and that the CG mechanism should logically aim to fulfil this purpose. In contrast, stakeholder theorists, such as Freeman (2010), claim that shareholders are only one of many stakeholders that corporations ought to be accountable to, and good CG must be designed to serve this broader range of stakeholders. Despite the range of concepts of CG, there are certain fundamentals that 'good' CG will consider, including creating sustainable and retainable businesses, achieving corporate objectives, ensuring efficiency and resource allocation, defining roles and responsibilities, balancing companies' economic and social benefits, and ensuring an efficient risk management strategy is in place (Crowther & Seifi, 2010). These fundamentals are logical, given that CG started to garner attention with the onset of three major events over past decades, namely, the Asian financial crisis in 1998, the wave of corporate scandals in 2001, and the start of the global financial crisis in 2007, all of which reflected diminished risk management standards and practices (Gennaro & Nietlispach, 2021). Effective risk management strategies are capable of mitigating financial dilemmas, ensuring sustainable investments, and enhancing diligent decision-making (Gouiaa, 2018). With the recent COVID-19 pandemic, it is arguably even more critical now to form active board that are capable of taking the leading role in CG strategy and implementing a resilience plan to ensure smooth and effective operations in the financial services sector (Haben, 2020). This is because financial markets are subjected to stiff competition and rapid innovation and are vulnerable to political, economic, institutional, financial, and environmental risks, which have led to tighter profit margins and increased capital adequacy requirements (Permatasari & Yuliyanto, 2016). Lam (2014) suggests that interactions with the aforementioned risks can be mitigated through efficient governance and board. The board of directors plays a vital role in determining the appropriate levels of risk appetite, reducing information asymmetry, managing and controlling risks and strategies, and thereby increasing shareholder wealth (Gelter & Puaschunder, 2021; Gouiaa, 2018). These claims align with Geeta and Prasanna's (2016) argument that risk management effectiveness is dependent on variations in a board's structure, operating procedures, and characteristics. Nevertheless,

research on CG systems, board and risk management practices is at the embryonic stage, and thus warrants further study. For example, Gouiaa (2018, p. 14) asserts that ‘the risk oversight function of the board of directors, as a central corporate governance mechanism, has never been more critical and challenging than it is today’.

To address the evident gap in the risk governance literature, this paper provides a comparative analysis of the latest CG reports in leading organisations in both Islamic and Western countries to investigate what constitutes good CG when it comes to risk management and board responsibilities in financial institutions. Previously, Alatassi and Letza (2018) explored the idea of fusing Western CG elements with Islamic principles to create an evolved CG structure led by effective board, who are able to cope with the constant challenges and risks in the contemporary world. Prior research has evinced agency problems and risk-taking behaviour in the Middle East and North Africa-based Islamic banks (IBs) (Fayed & Ezzat, 2017), identified the CG–risk management nexus in conventional banks (Permatasari, 2020), or unveiled risk management in a CG framework (Rehman et al., 2020). However, there is a dearth of empirical research related to conventional and Shari’ah governance and their relationship with risk management. This evident gap motivated this study—the first that we know of—to examine how a fusion of conventional and Shari’ah-based CG can be applied to risk management practices, particularly considering the board’s contribution and responsibilities towards risk management. Furthermore, (Alatassi & Letza, 2018) has previously highlighted the unique position of CG in IBs and proposed a model for further development combining the fundamental philosophical principles of Islam with the theories and practical structures, codes, and systems developed in the West.

Through a comparative analysis, this paper sought to achieve three objectives: first, to examine the risk management policies in the United Kingdom (UK), Germany, Saudi Arabia, and Malaysia; second, to assess the role of board in leading the risk management strategy; and third, to evaluate the role of IBs’ board of directors and Shari’ah Supervisory Board (SSB) in accommodating the unique requirements associated with the Islamic finance industry and traditional risks. The study makes several contributions to the CG literature. First, the paper aids Islamic financial policymakers in identifying the gaps in the current CG structure and influencing smooth operations in the global markets. Second, it guides regulators, especially in the Islamic finance industry, to optimise the guidelines and aim to achieve good CG practises. Third, by examining the differences and similarities in governance structures, risk exposures, and regulatory frameworks, this study provides valuable insights into the effectiveness of these practices in maintaining financial stability and resilience in IBs in the face of economic turbulence. Furthermore, this paper offers possible solutions to bridge the research gap by suggesting potential improvements to governance structures and risk management practices in

both Western and Islamic banks. These include identifying best practices, enhancing board oversight, and fostering a culture of effective risk management.

The rest of the paper is structured as follows: Section 1 reviews the existing literature, while Section 2 highlights the methods and materials of the study. Section 3 reflects the key findings, and the conclusions provide recommendations for future research.

## **1. Literature review**

### **1.1. Theoretical overview**

Following a series of corporate scandals and increasing socio-economic and political upheaval, the board of financial institutions have been assigned the principal responsibility for overseeing impending and existing risk management processes (Gupta & Leech, 2014) to avoid substantial institutional risk management failures. In terms of the theoretical approaches, Udayasankar (2008, p. 2) states that 'despite the proliferation of multiple theories of CG, including resource dependency, stakeholder, and institutional theories, the epistemological basis of this domain remains the agency theory'. The economic theory of agency conflict argues that both principals (owners) and agents (managers and board members) prefer to maximise utility, but there is a difference in the objectives behind each maximisation. 'Agency problems arise because, under the behavioural assumption of self-interest, agents do not invest their best effort unless such investment is consistent with maximising their own welfare' (Barnea et al., 1985, p. 26). As far as financial organisations are concerned, the managers (board members) are assumed to exhibit self-interest, thereby showing a misalignment with shareholders' interests; indeed, managers may display risk aversion due to their incapacity to diversify risk because they are heavily dependent on the firm (Squires & Elnahla, 2020).

Furthermore, agency theorists argue that the separation between the corporation's ownership (principal) and its management (agent) creates what is known as 'agency cost'. Agency theory aims to reduce this cost caused by the 'homo-economics' model of people, where directors are self-serving and seek to maximise their wealth at the principal's expense (Jensen & Meckling, 2019). Although agency theory has played a role in forming CG roles and regulations, it is restricted in scope and unable to explain the more complicated, non-economic factors in the organisation. In contrast, the stakeholder theory extends the directors' responsibility towards the shareholders and the broader constituencies that influence corporations, such as employees,

customers, suppliers, and society (Letza et al., 2004; Mallin, 2016). Letza and Sun (2004) and Alatassi and Letza (2018) argue that the clear-cut, stable boundaries between stakeholder and agency theorists only exist in theory, and that real-world events indicate that directors should take a more dynamic approach based on the actual situation, including a mixed approach, where both shareholder and stakeholder values are taken into consideration. Another school of thought argues for the new concept of stewardship theory, where agents can be viewed as stewards trying to pursue a higher need than self-serving or value creation (Alatassi & Letza, 2018; Bhatti & Bhatti, 2010; Donaldson & Davis, 1991).

There is no single 'best fit' theory for all countries and corporations. Each state will adopt an approach that can respond to the state's cultural and economic demands (Alatassi & Letza, 2018). For example, the UK and US models of CG (the so-called Anglo-Saxon approach) focus on maximising shareholders' wealth, therefore, requiring a more agent-theory-based course. Other countries, such as Germany, follow the broader stakeholder approach, which empowers other groups in the organisation, such as employees. In Islamic financial institutions, there is a more ethical approach, by which the banks' stakeholders have a higher, more spiritual need to fulfil. Thus, the internal stakeholders of the bank ought to act as stewards.

While the stakeholder theory discussed earlier acts as the CG underpinnings for their operationalization, the Islamic governance model upholds Aqidah belief, Shari'ah, and ethics, which are derived from the Islamic maxims of free will, unity, equilibrium, and responsibility. These all act as cornerstones for IBs' operational standards. Apart from the ethical doctrines advocated in the Holy Quran and Sunnah, al-Kahtani (2014) proposes secondary sources such as *Ijmā* (consensus of opinions) and *qiyās* (analogical deduction) as vital foundations on which to base governance under Islamic jurisprudence (as cited in Al-Malkawi & Pillai, 2018, p. 606). Furthermore, an in-depth study by Zein et al. (2008) alludes to *Amanah* (trust), *Adalah* (justice), and *Shura* (consultations) from the Tawhid and the Quranic verses to bring out the essence of the principal-agent relationship. Here, it is presumed that managers are entrusted with *Amanah* by the shareholders, and its fulfilment would bring *Adalah* to the recipients. All this can be performed through *Shura*, or mutual decision-making. Additionally, Aljifri and Khandelwal (2013) address the specific features of Islamic financing, such as mandatory compliance with Shari'ah principles, the generation of fair returns to the investor, the ethical values of curtailing self-interest, and the avoidance of excessive risk-taking, as mitigators of agency-theory problems compared with their conventional counterparts, where the sole objective is profit generation without any embedded values. Alam et al. (2020) also highlight that it is anticipated that the moral responsibility and ethical sense in IBs will reduce agency-led implications, such as lowering necessary risk-taking actions (Alam et al., 2020).



## 1.2. Risk management

### 1.2.1. Introduction

Corporate failures and scandals have often been attributed to individuals like board members and executives. However, Power (2009) argues that the system itself also bears responsibility. Risk management, as a social construct, is influenced by its surrounding environment (Bhimani, 2009). It involves identifying, assessing, and prioritising risks, followed by the efficient application of resources to minimise and control their impacts (Hubbard, 2020). Enterprise risk management represents a comprehensive approach to managing risks across an organisation, although a universally accepted definition remains elusive.

This paper focuses on the overarching risk management aspects in the context of Islamic banking. It recognises the similarities and differences between risk management and enterprise resource management while emphasising the importance of effective CG in addressing the various risks faced by financial institutions. The concept of risk management in Islamic banking is inherently interconnected with its governance structure and principles (Archer & Karim, 2007). Islamic banks are subject to unique risks that stem from their adherence to Shari'ah principles, such as the prohibition of interest (*Riba*) and excessive speculation (*Gharar*) and the requirement to engage in ethical transactions (Iqbal & Mirakhor, 2011). This necessitates the development of tailored risk management approaches that accommodate the distinctive characteristics of Islamic financial institutions (Abdul Rahman, 2010). In this regard, one such approach is the application of Shari'ah-compliant risk mitigation instruments, such as profit and loss sharing contracts, which allocate risks and returns more equitably between the parties involved (Iqbal & Mirakhor, 2011). Moreover, IBs are required to establish SSBs, which oversee and monitor compliance with Shari'ah principles, acting as an additional layer of governance (Al-Suwailem, 2008). Risk management in Islamic banking also emphasises the importance of ethical considerations and social responsibility. The Maqasid al-Shari'ah (objectives of Shari'ah) framework guides institutions in achieving overall well-being and an equitable distribution of resources in society (Chapra et al., 2008). As such, IBs are expected to engage in socially responsible investments and avoid financing activities that may harm society or the environment (Hasan & Dridi, 2010).

In summary, effective risk management in Islamic banking is a multifaceted endeavour that involves addressing both conventional financial risks and those unique to Islamic finance. This necessitates a holistic approach that integrates governance, compliance with Shari'ah principles and ethical considerations, while drawing on insights from the broader field of risk management (Archer & Karim, 2007; Iqbal & Mirakhor, 2011).

### **1.2.2. Risk in banking**

The strength of the banking systems, regardless of whether they are conventional or Islamic, lies in their ability to identify and manage risk levels and interest-rate spreads whilst maintaining strong liquidity, credible depositor bases and lucrative loan portfolios (Winterbottom, 2014). Monitoring, identifying, managing and measuring different kinds of banking risks such as credit risk, operational risk and currency risk are amongst the main missions of risk management to prevent such risks from occurring. On this note, Brunnermeier and Yogo (2009) argue that various types of bank risks may result in a liquidity risk, which then generates a spiralling effect and impacts the bank's reputation and overall performance. Thereby, liquidity risk acts as a contributory factor in the collapse of the overall financial system in the country, or even exacerbates contagion (Adalsteinsson, 2014).

Currently, liquidity risk has emerged as the most important element in an enterprise-wide risk management framework. Liquidity risk refers to the present and future risks arising from the bank's inability to meet its financial obligations. It stems from myriad factors such as unexpected cash outflows, large credit disbursements, unexpected market movements, the crystallisation of contingent obligations (see Winterbottom, 2014), external shocks and inter-bank rivalry issues. Liquidity risk can be divided into two main types: funding/cashflow liquidity risk and market / asset liquidity risk. The former relates to the capacity of a firm to fund its liabilities and the latter refers to the degree to which it will be difficult to dispose of an asset fast enough to avoid potential losses. As the foundation of IB relies more on participation than mere financial intermediation, the scope and intensity of risks are likely to be greater due to the various roles played by IBs as partners, investors, buyers, and sellers in comparison with the customary lender status in traditional banking.

Banks have evolved from traditional practices solely based on receipts of deposits and generating loans, with new instruments being launched, such as trading in financial markets and income generation through fees (Archer & Karim, 2007). Van Greuning and Bratanovic (2020) argue that this evolution of the banking system exposes banks to higher and more variable risks associated with the newly developed instruments. Also, banks must adapt quickly and develop risk management capabilities to survive in competitive financial markets and build consumer trust (Doğan & Ekşi, 2020). Van Greuning and Bratanovic (2020) divide banking risk into three main categories: First, financial risks, including traditional risks such as credit, balance sheet, solvency, and income statement structure; second, environmental risks, including but not limited to macroeconomic and policy concerns and legal and regulatory factors; and third, operational risks including compliance, internal control, technology and IT security, fraud and business continuity concerns. In addition to the academic literature, similar risk classifications have been presented

by other guidelines, such as those of the ACCA and the UK Code of Corporate Governance (FRC, 2018; McNulty et al., 2012).

Sundararajan (2007) argues that Islamic financial institutions (IFI) had seen a growth in the global markets due to globalisation and regulatory environment changes, which necessitated a more robust risk management system that enabled them to compete in financial markets. He also emphasises that IFIs were susceptible to more complex risks than their conventional counterparts, including contractual risk based on Islamic instruments that comply with Shari'ah principles, legal risk and governance risk. Finally, one of the main unique risks for Islamic banking, as discussed in the existing literature (Grassa & Matoussi, 2014), is the reputational risk caused by non-compliance with Shari'ah rules, which is also part of the business risk identified by Archer and Karim (2007). The current paper focuses on analysing risk management according to the main three categories determined by Archer and Karim (2007) and Van Greuning and Bratanovic (2020), namely, financial, business/environment and operational risk.

### **1.2.3. Corporate governance and risk management**

Prior research attests to the inter-relationship between the risk management–CG nexus (Bhimani, 2009; Muhammad et al., 2023; Woods, 2009). It argues that both subjects strongly influence public policy debates and corporate control. Bhimani (2009) states that management's CG and risk management concepts can only be actionable if they are construed within three primary dimensions—technical, analytical and calculable—as well as continuously reassessing and developing risk management to adapt to the world's ongoing economic fluctuations. Woods (2009) discusses risk management as a dimension of CG and argues that although the principles of risk management are globally applicable, the industry's constant challenges require unique contingencies that can be generalized and adopted by enterprises later on. More recently, Muhammad et al. (2023) emphasise the relevance of board characteristics in influencing firms' systematic and unsystematic risk.

Therefore, it is essential to understand the definition of CG and its correlation with the board's function and risk management. The 1990s were considered the tipping point in the contemporary CG system. This was influenced by a myriad of reasons, such as the reform of the governance structure in both the USA and Germany, the response to the collapse of the 1990s global stock markets, and the shift towards a more enhanced shareholder model of CG (Cioffi, 2006). The publication of the first Cadbury report in 1992 (Committee on the Financial Aspects, 1992) was considered the pinnacle of the UK code of corporate governance and was arguably one of the most influential factors in policy and practice worldwide. However, the Islamic Financial Services

Board (IFSB, 2006) argued that all the core principles that helped form the modern norm of CG have existed in Islam since its establishment more than 1400 years ago. Therefore, CG as a set of values and standards is well known to all Muslims and Islamic institutions. Moreover, IFSB (2006) argues that there are more similarities than differences between Islamic institutions and their Western counterparts when it comes to good governance and ensuring fairness, transparency, and accountability. The sole element differentiating Islamic institutions from their more conventional peers is the religious factor and the Shari'ah roots in IFIs.

Delving into the plethora of CG benefits, Charny (1998) highlighted the role that CG plays in three main areas, namely, (a) reducing agency costs by monitoring executives and ensuring that all activities maximise shareholders' value; (b) establishing a good relationship between the corporation and its stakeholders, including employees, directors, creditors, and shareholders; and (c) achieving the state's socio-political and economic goals such as shareholder primacy in the UK and US or codetermination in Germany. In addition, the chain of uncertainties looming in the economy has undermined investor trust, thereby requiring a system to document environmental, social, and corporate governance (ESG) issues as well as to recognise and manage risks (Pillai et al., 2021).

On the above basis, this paper argues that CG in Islamic banking is still at the embryonic and formation stage and requires on-going reformation and development to reach the revolutionary stage that modern capitalism urgently needs. Therefore, a fusion between Western guidelines and Islamic principles might benefit the global banking sector by achieving a more robust CG system.

#### **1.2.4. Corporate governance and risk in conventional and Islamic banks**

Banks are the backbone of any economy, due to their significant role in people's lives and in organisational development. Therefore, CG in the banking sector is a primary focus for government guidelines and policymakers (OECD, 2010). The existing CG literature shows an orientation towards the banking sector, especially since 2007–2008 (Adams & Mehran, 2003; Alatassi & Letza, 2018; De Andres & Vallelado, 2008; Doğan & Ekşi, 2020). De Andres and Vallelado (2008) argue that CG is crucial for any country's economy because it provides financial institutions with appropriate rules and regulations to manage and participate in economic development. Islamic banking differs from its conventional counterparts by sharing profit and loss, prohibiting speculation and gambling, limiting non-performing loans (Chapra et al., 2008) and, most importantly, banning fixed interests (Frag et al., 2018). Moreover, all IBs' activities should comply with Shari'ah principles and be based on real

investment, which adds new stakeholders and unique players to the banks' structure. Thus, the CG structures of IBs differ from their western counterparts and require special attention (Frag et al., 2018; Safieddine, 2009). Godlewski et al. (2014) also question the pertinence of standardization in the Shari'ah governance practices embedded in Islamic finance activities. With respect to risk, Zarrouk et al. (2016) emphasise the high degree of financial risks inherent in IBs due to the mismatch between the undertaking of risky financial operations and returns guaranteed to customers.

Two prominent and unique stakeholders differentiate IBs' structure from that of conventional banks and add risk layers that do not exist in traditional banking. Investment account holders are the first category that is considered one of the unique stakeholders in Islamic banking. They provide the banks with funds via equity-based contracts called Mudaraba and Musharaka. While depositors in conventional banks receive a fixed interest on their deposits, investment account holders in IBs share profit and loss, including losses caused by their Shari'ah compliance investments, creating an extra unique risk assessment requirement to mitigate the additional risk. In this regard, Yanikkaya et al.'s (2018) findings related to incorporation of more non-murahabah assets as a financing structure to mitigate risks in IBs offer valuable insights.

Safieddine (2009) and Frag et al. (2018) argue that the unique nature and characteristics of the Islamic banking industry cause a specific and more complex agency problem compared with the typical agency dilemma. This dilemma is attributed to the separation between management and control. In Islamic banking, all stakeholders, including shareholders, policymakers, and investors, add a layer of agency caused by the separation between depositors' and investors' rights. Therefore, the managerial decisions should not only aim to maximise shareholders' wealth but also investment account holders' return on their investment. The second category of stakeholders, namely, the SSBs, are key players in the Shari'ah governance system, which the Islamic Financial Board defined as 'the structures and processes adopted by stakeholders in an institution offering Islamic Financial Services to ensure compliance with Shari'ah rules and principles' (IFSB, 2009). The Shari'ah board's role is to assure all stakeholders that the IBs' investment and activities comply with Islamic laws and avoid any non-compliance risk (Alnasser & Muhammed, 2012).

### **1.2.5. The role of the board in corporate governance**

The board of directors is arguably the central pillar of the CG mechanism in all economies and plays a fundamental role in enhancing CG practices by taking on the responsibilities of monitoring and supervising the available re-

sources (Doğan & Eksi, 2020; Fernandes et al., 2017). One of the main differentiators between CG models worldwide is that the board structure is affected by many factors, including social, cultural, and financial factors (Grassa & Matoussi, 2014). Therefore, the board's role might vary from one country to another based on the structure (single or dual), rules, regulations, and cultures. However, there are certain fundamentals that most CG guidelines in the world have in common.

The board's role within the governance structure is not only limited to internal processes but also encompasses external and internal duties. According to Heracleous (1999), the board of directors' duties formally include monitoring the C-level in the organisation and participating in their strategic directions. Heracleous (1999) also add that while the normative expectation from the board of directors was high, they have not delivered in the last few years, which has increased the demand for different frameworks and policies designed to support the board and boost their performance. Therefore, directors have been under pressure from their primary stakeholders, such as institutional investors, politicians, and society, driven by disquiet and discomfort (Heracelous, 1999). Shareholders in the Anglo-Saxon countries led by the USA and UK, and in the majority of the EU members, use a single board of directors, who take responsibility for all corporations' activities. They hold this board accountable for maximising the value of the companies' shares. In contrast, countries such as Germany, Denmark, and the Netherlands adopt a dual board structure model, where shareholders elect the supervisory board members. It is the supervisory board's responsibility to appoint the executive management board, who are then responsible for running the business. In the dual structure, employees might be represented on the supervisory board (Mallin, 2016). There are pros and cons of each model (Frag et al., 2018). For example, a unitary board structure might benefit from characteristics such as a faster decision process, higher meeting frequency, and having both executives and non-executives engaged in the decision-making unit. However, a single-tier board lacks any actual separation between managerial and supervisory activities. A dual-board structure allows for a broader stakeholder representation to achieve better performance. Researchers such as Farag et al. (2018) argue that IBs' governance structure is based on a unique dual board structure: the board of directors and SSB. Nonetheless, Alatassi and Letza (2018) argue that the role of the SSB fluctuates between advisory and supervisory, depending on the policies and regulations in the countries of operation.

Adding to the former, Grais and Pellegrini (2006) report that the current role of the SSBs was limited to the Shari'ah compliance process, where SSBs approve and certify all financial instruments in IBs before launching them in the market. Moreover, it is the SSBs' responsibility to monitor the banks' activities and ensure all transactions comply with Shari'ah principles.

Furthermore, the IFSB (2006) states that SSBs should consist of at least three independent non-executive members, while Farag et al. (2018) contend that policymakers should allow room for reform in IBs' governance structure by enhancing the independence of SSBs, because shareholders currently hold the board of directors responsible for appointing the members of SSBs (IFSB, 2006). Furthermore, Farag et al. (2018) argue that policymakers for Islamic financial institutions should reform the design of the current CG structure in place and, instead of holding the board of directors in IBs responsible for appointing the SSB, the members of the SSBs should be given more independence to avoid any pressure from the board members. They also state that the regulators should reconsider the role that the SSB plays, changing it from a supervisory and consultative body to being mandatorily present in organisational affairs.

### **1.2.6. The role of the board in risk management**

A bank's board is more critical for governance aspects than its non-bank counterparts for various reasons, which Doğan and Ekşi (2020) mainly attribute to the bank's ultimate responsibility towards both regulators and shareholders. Moreover, banks arguably face a high insolvency risk due to increased leverage, which also requires a premium to be paid to depositors as compensation. Thus, risk control is a vital responsibility of the board, and regardless of its composition (unitary, dual, Islamic, or conventional), a board must develop and enhance management activities to create precise risk management mechanisms (Deloitte, 2018). Van Greuning and Bratanovic (2009) mention that the quality of bank risk management, especially the risk management frameworks, is a critical concern in guaranteeing both individual banks' security and soundness and the overall financial framework. Furthermore, the ultimate responsibility for conducting a bank's business lies with the board of directors and the supervisory board, particularly where a dual board applies. The board also has to set strategic plans, appoint managers, establish operational policies, and, most importantly, take responsibility for ensuring a bank's reliability towards risks.

Research by Deloitte (2018) discusses in depth the roles and responsibilities of risk oversight in a dynamic and turbulent business environment, where risk is constantly evolving and requires the board to provide the same level of flexibility. It is the board's responsibility to monitor and guide management's activities regarding all risk activities, including, but not limited to, identifying, assessing, and monitoring risks. Nevertheless, Deloitte (2018) argues that all board should clearly define the risks that they will review regularly, and properly delegate the rest to the appropriate board committees, mainly the audit committee.

The SSB in IBs plays a pivotal role in managing the Shari'ah non-compliance risk, which is a unique and significant risk type specific to Islamic financial institutions (Hassan & Lewis, 2007). Shari'ah non-compliance risk arises when a financial transaction or product fails to comply with Islamic jurisprudence or Shari'ah principles, leading to the potential invalidation of contracts and financial losses (Karim & Archer, 2002). This risk is distinct from conventional banking risks such as liquidity or credit risk, which are typically overseen by the main board of the bank. The SSB's expertise in Islamic jurisprudence is crucial for ensuring that all banking activities align with Shari'ah principles, including the prohibition of *Riba* (interest), *Gharar* (excessive uncertainty), and *Maysir* (gambling). This is only achieved by closely collaborating with the main board, because the SSB helps in structuring products and auditing transactions to avoid any form of non-compliance (El-Hawary et al., 2007). Their role extends to ongoing monitoring and reviewing of bank operations to ensure adherence to Shari'ah laws, thus safeguarding the bank against the reputational and financial risks associated with Shari'ah non-compliance (Sundararajan & Errico, 2002). The SSB's guidance is indispensable for IBs, because Shari'ah non-compliance not only affects the legality of transactions but also impacts customer trust and the bank's reputation in the market (Khan & Bhatti, 2008). Therefore, their strategic collaboration with the main board is essential for mitigating this unique risk and ensuring the overall sustainability and growth of Islamic banking institutions.

### 1.3. Summary

The research gap identified in the literature pertains to the lack of comprehensive and comparative studies on the role of board structures and risk management practices in conventional and Islamic banking systems (Grassa & Matoussi, 2014). Although previous literature has acknowledged the unique dual-board structure in IBs (Farag et al., 2018) and offer some insights into risk management frameworks (Deloitte, 2018; IFSB, 2006), there is still a dearth of knowledge for understanding the comparative effectiveness of these practices in both banking systems and how they may affect financial stability and resilience. A few initiatives, such as the guidelines provided by the Islamic Financial Services Board (IFSB, 2006), have made progress in addressing the research gap by outlining the roles and responsibilities of the board and risk oversight in IBs. However, these efforts do not provide an up-to-date and comprehensive understanding of the interaction between board structures, risk management practices, and the impact on overall financial stability in both Western and Islamic banks—a gap that warrants further investigation.



## 2. Methodology

This section outlines the methodology used to conduct a comparative analysis of risk management guidelines in the CG codes of four countries, namely, the UK, Germany, Saudi Arabia, and Malaysia, in both Western and Islamic banking systems. The core of this methodology is a document analysis approach, tailored in order to scrutinize the roles and responsibilities outlined in the CG codes regarding risk management.

The methodology, set out in detail by Bowen (2009), facilitates an in-depth exploration of textual data to unearth themes, patterns and insights relevant to board responsibilities in both Western and Islamic financial institutions. Following a structured approach, documents including CG codes, regulatory guidelines and Shari'ah governance frameworks were systematically reviewed and analysed. This enabled a comparative analysis of risk management policies, the role of board in directing risk management strategies and the unique position of Shari'ah committees in IBs. The approach is similar to the study by Aguilera and Cuervo-Cazurra (2004), and others who have highlighted the global diffusion of governance codes and their implications on firm performance and governance practices. The document analysis approach, which is rooted in qualitative research traditions, supports the synthesis of empirical evidence on the alignment of risk management practices with Shari'ah principles, contributing novel insights into the governance structures that bolster the resilience of IBs within the global financial ecosystem.

The philosophical basis for the comparative analysis approach can be traced back to the works of several social science scholars and philosophers, most notably Emile Durkheim (1982). Comparative analysis is rooted in the belief that understanding complex social phenomena can be effectively achieved by comparing and contrasting different cases or instances. The underlying philosophy of comparative analysis is grounded in the positivist and interpretivist paradigms (Bryman, 2001). On the one hand, positivism emphasises the use of empirical, systematic and objective methods to study social phenomena, while interpretivism, on the other hand, focuses on understanding the meanings that individuals and groups ascribe to their experiences. In comparative analysis, researchers seek to identify similarities and differences between the cases being studied, as well as uncover patterns, relationships, and underlying mechanisms that can help explain the phenomena being observed (Ragin, 2014). By analysing multiple cases, comparative analysis allows for a deeper understanding of the social, political, economic and cultural contexts that shape the phenomena under investigation. Consequently, this approach helps researchers to test theories, identify factors that influence outcomes, and generate new hypotheses for future research (Bryman, 2001).

## **2.1. Data collection**

The data for this study were obtained from secondary sources, including the latest versions of the CG codes of the UK, Germany, Saudi Arabia, and Malaysia, as well as relevant guidelines, regulations, and frameworks published by the respective authorities. The data collection process entailed searching and reviewing various academic and professional databases, such as Google Scholar, ProQuest, and EBSCOhost, using a combination of keywords like 'corporate governance', 'risk management', 'UK Code of Corporate Governance', 'German Code of Corporate Governance', 'Saudi Corporate Governance Code', 'Malaysian Corporate Governance Code', 'Shari'ah governance' and 'Islamic banking systems'. To ensure a comprehensive analysis, the paper focuses on the application and adoption of risk management guidelines in each report, as well as the roles of the board and its committees. To compare and contrast the risk management guidelines across multiple countries and banking systems, this paper uses a comparative analysis approach. Specifically, the study analyses the 2018 UK Code of CG and the 2020 German Code of CG to assess the board' roles and responsibilities in risk management. In addition, the paper analyses the 2017 Saudi CG Code and the 2021 Malaysian CG Code, which are leading countries in Islamic banking, to provide a similar analysis. To further consider the unique requirements of Islamic finance, the study analyses the Shari'ah governance guidelines published by the Saudi Monetary Authority (SAMA, 2020) and the 2010 Central Bank of Malaysia Shari'ah Governance Framework for IFIs (Central Bank of Malaysia, 2010).

The rationale for selecting the four countries in this study was based on their unique approaches to CG and Islamic banking and their prominence in the global economy (OECD, 2014a). The UK and Germany are well-known for their strong CG systems, while Saudi Arabia and Malaysia are leading countries in the Islamic banking system. The UK is a world leader in CG and employs a single board structure, while Germany follows a dual board structure. The importance of CG and Islamic banking systems in these four countries cannot be overstated because the effectiveness of these systems can significantly impact each country's economic and business conditions. For example, the 2008 global financial crisis highlighted the importance of effective risk management in CG, while the growth of Islamic finance has led to the development of new financial products and services in Saudi Arabia and Malaysia.

## 2.2. Analysis process

The document analysis methodology employed in this study was organized to scrutinize CG reports across the UK, Germany, Saudi Arabia, and Malaysia, with an emphasis on understanding risk management frameworks within conventional and Islamic banking systems. The process commenced with the identification of essential keywords, including 'corporate governance,' 'risk management,' 'Risk,' 'Committee,' 'Shari'ah governance,' 'Shari'ah Board', thus facilitating a targeted search for the most recent CG codes and related documents.

This preparatory step was instrumental in assembling a comprehensive database for analysis. Subsequently, a comparative document analysis was conducted, examining each CG code to delineate the roles and responsibilities attributed to board in the realm of risk management, paying special attention to the incorporation of Shari'ah governance principles in Islamic financial institutions. This analysis was pivotal in extracting and synthesizing critical information, thereby enabling a structured evaluation of the alignment between CG codes and risk management practices. Special attention was given to analysing Shari'ah governance guidelines to assess their integration into the broader CG frameworks. This methodological approach offered insights into the governance mechanisms underpinning risk management strategies, highlighting both the commonalities and disparities across different banking systems and underscoring the unique compliance with Shari'ah principles within Islamic banking.

This study built on the OECD's Risk Management and CG report (2014b), which applied similar methodology covering 27 jurisdictions, including the UK and Germany, and provided valuable insights for policymakers, regulatory bodies, and financial institutions on how to improve risk management practices. The comparative analysis of the CG and Islamic banking systems in the four countries studied provided insights into their approaches to risk management, board structures, and Shari'ah governance. This highlighted the importance of learning from the unique features of each system, which can lead to improvements in risk management practices, ultimately driving economic growth. The data analysis process involved reviewing the collected documents, extracting key information, and comparing and contrasting the risk management guidelines across the four countries. The paper focuses on specific aspects of risk management in CG codes, including application and adoption, board roles in risk management, committees and responsibilities, and Shari'ah governance.

### 3. Results and findings

#### 3.1. Risk management guidelines in countries

Table 1 presents a comparative analysis to assess the risk management guidelines in the CG codes of four countries - the UK, Germany, Saudi Arabia, and Malaysia. The board’ roles and responsibilities towards risk management were examined by focusing on the 2018 UK Code of CG, the 2020 German Code of CG, the 2017 Saudi CG Code, and the 2021 Malaysian CG Code. The unique requirements of Islamic finance were addressed by analysing the Shari’ah governance guidelines for Saudi Arabia and Malaysia.

In the UK, the ‘comply or explain’ approach struck a balance between flexibility and accountability within CG frameworks, allowing companies to adapt

**Table 1. Comparison of risk management in CG codes in the UK, Germany, Saudi Arabia, and Malaysia**

<b>Country</b> <b>Criteria</b>	<b>United Kingdom</b>	<b>Germany</b>	<b>Saudi Arabia</b>	<b>Malaysia</b>
<b>Application &amp; adoption of the codes</b>	comply or explain	mandatory (law enforcement)	mandatory with some guidance	mandatory (Islamic Financial Services Act)
<b>Board’s role in risk management</b>	strategic planning, risk monitoring, and internal control	strategic decision-making, risk supervision, and compliance	comprehensive strategy, risk culture development, risk management instruments	overall governance structure and compliance, Shari’ah-related matters
<b>Committees &amp; responsibilities</b>	audit committee: risk management systems, internal control, and financial reporting	supervisory board: oversight of management board, risk management, and compliance	advisory risk committee: risk plans, risk assessment, acceptable risk levels	Shari’ah Committee: Shari’ah governance, risk implication, oversight of internal audit, risk management, and compliance
<b>Shari’ah Governance (if applicable)</b>	N/A	N/A	Shari’ah Governance Framework	BNM Shari’ah governance

Note: Table 1 is a summary of the key aspects of risk management in CG codes in the UK, Germany, Saudi Arabia, and Malaysia. The full text is available at <https://www.ecgi.global/content/codes>.

Source: own work.

to dynamic market conditions while maintaining transparency. Therefore, integral to this structure was the Audit Committee, whose oversight was vital for upholding financial integrity and managing risk, ensuring that organizations adhered to high standards of financial reporting and control.

In Germany, CG was characterized by stringent legal requirements that mandated robust risk governance. The supervisory board was central to this system, functioning independently of the management board. It was tasked with compliance oversight, reinforcing the division between strategic supervision and operational management. This demarcation underlined the German model's emphasis on checks and balances.

In contrast, Saudi Arabia embedded risk management within its strategic framework, with a pronounced emphasis on fostering a risk-aware culture across corporate entities. This approach was supplemented by the Shari'ah Governance Framework, which imposed a unique set of compliance standards that ensured corporate practices were in line with Islamic principles, thereby integrating ethical considerations into the core of business operations.

Finally, in Malaysia, the CG landscape was similarly influenced by Islamic principles, as enforced by the Islamic Financial Services Act. The Shari'ah Committee was pivotal in this context, ensuring that all financial practices complied with Shari'ah law. This compliance was not just a legal formality but a defining trait of the Malaysian financial sector, distinguishing its governance model on the global stage.

Each of these countries demonstrated a unique confluence of regulatory compliance, cultural ethos, and governance mechanisms, illustrating the diversity of approaches to corporate governance in different legal and cultural settings.

### **3.1.1. The board's role in risk management**

The UK and German codes both placed the responsibility for risk management on the board, with a focus on strategic planning, risk monitoring and internal control in the UK and strategic decision-making, risk supervision and compliance in Germany. The Saudi code placed an emphasis on setting a comprehensive strategy, developing a risk culture, and providing risk management instruments, while the Malaysian Shari'ah Governance Guidelines held the board accountable for the overall governance structure and compliance, including Shari'ah-related matters.

### **3.1.2. Committees and responsibilities**

All four countries had designated committees responsible for specific aspects of risk management. The UK and German codes highlighted the role of the Audit Committee in overseeing risk management systems, internal con-

trol and financial reporting. The Saudi Code required companies to form an Advisory Risk Committee with duties including setting risk plans, assessing risk-taking abilities and determining acceptable risk levels. The Malaysian Shari'ah Governance Guidelines assigned the Shari'ah Committee responsibilities such as Shari'ah governance, risk implication, and oversight of internal audits, risk management, and compliance.

### **3.1.3. Shari'ah governance**

Shari'ah governance played a significant role in the risk management guidelines of Saudi Arabia and Malaysia. The Saudi Shari'ah Governance Framework focused on setting roles and responsibilities, ensuring the integration of Shari'ah principles in finance, and reinforcing the competence of internal control and risk management committees. The Malaysian BNM Shari'ah Governance Guidelines stressed the importance of identifying, measuring, monitoring, and reporting Shari'ah non-compliance risks and emphasised the management of reputational risks associated with Shari'ah non-compliance. The UK and German codes did not directly address Shari'ah governance because it was not applicable to their banking systems.

This critical comparative analysis highlighted the similarities and differences in the risk management guidelines within the CG codes of the UK, Germany, Saudi Arabia, and Malaysia. All four countries placed significant emphasis on the board' roles and responsibilities in risk management, but they adopted different approaches in application and enforcement. The Shari'ah governance aspect played a crucial role in the Islamic banking systems of Saudi Arabia and Malaysia. While Western and Islamic banking systems differed significantly in their governance structures, there were shared principles that transcended cultural and religious boundaries. For instance, the importance of risk management, transparency and accountability were universally recognised as crucial components of a robust CG framework. Ultimately, understanding these shared principles and learning from the unique features of each system can lead to better governance practices worldwide.

## **3.2. Similarities and differences between the CG and risk management guidelines in the four countries**

Table 2 highlights the key differences and similarities between the CG and risk management guidelines in UK, Germany, Saudi Arabia, and Malaysia. The table establishes a comparative analysis of the countries studied and identifies areas where each country's guidelines could benefit from the experience of the others.

**Table 2. Key differences and similarities in risk management guidelines**

Country Criteria	UK	Germany	Saudi Arabia	Malaysia
<b>Application &amp; adaption</b>	comply or explain	obligation	mandatory	comply or explain
<b>Board structure</b>	single board system	dual board system	single board system	single board system
<b>Risk management role</b>	board of directors	management board	board of directors	board of directors
<b>Risk reporting</b>	to stakeholders	supervisory board	to stakeholders	to stakeholders
<b>Shari'ah governance</b>	not applicable	not applicable	applicable	applicable
<b>Board composition</b>	no specific requirement	no specific requirement	encourages inclusion of Shari'ah committee member	encourages inclusion of Shari'ah committee member

Source: own work.

On the basis of the comparison, it was evident that while all four countries placed significant emphasis on the board' roles and responsibilities in risk management, they adopted different approaches in application and enforcement. The UK and Malaysian codes followed a 'comply or explain' approach, allowing for flexibility in the application of the core principles. In contrast, the German and Saudi codes leaned more towards obligatory enforcement. The German code also featured a unique dual board structure, with a management board and a supervisory board, which differed from the single-board systems adopted in the UK, Saudi Arabia and Malaysia.

The Shari'ah governance aspect constituted a crucial difference between the Islamic and Western banking systems. Both Saudi Arabia and Malaysia had specific guidelines addressing Shari'ah risk management and the roles of the board of directors in overseeing compliance with Shari'ah principles. However, it should be noted that even within the Islamic banking systems, differences exist in the application and adaptation of their CG codes, with Saudi Arabia adopting a more stringent, mandatory approach and Malaysia following a 'comply or explain' policy.

In all four countries, the board of directors had a direct relationship with the risk management and audit committees. In Germany, the management board reported to the supervisory board, which then had a relationship with the audit committee. In Saudi Arabia and Malaysia, the board of directors also had a direct relationship with the Shari'ah committee and the compliance committee. Additionally, both Saudi Arabia and Malaysia had a unique

relationship, where the board of directors was responsible for the Shari’ah governance framework.

### 3.3. Board-committee relationships

Finally, the structure and governance of corporate board and their associated committees played a pivotal role in the effective oversight and accountability of organisations. Table 3 offers a comprehensive perspective on the intricate relationship between the board and its committees across four distinct nations: the UK, Germany, Saudi Arabia, and Malaysia.

**Table 3. Board-committee relationship**

BoD’s Relationship	UK	Germany	Saudi Arabia	Malaysia
Board of Directors -> Risk Management Committee	direct	via management board	direct	direct
Board of Directors -> Audit Committee	direct	via supervisory board	direct	direct
Board of Directors -> Shari’ah Committee	N/A	N/A	direct	direct
Board of Directors -> Compliance Committee	direct	via supervisory board	direct	direct
Board of Directors -> Shari’ah Governance Framework	N/A	N/A	direct	direct

Source: own work.

In the UK, the relationship between the Board of Directors and the Risk Management Committee was direct, suggesting a streamlined approach to risk management that benefited from immediate oversight from the board. However, Germany’s board structure was notably distinct, embracing a dual-board system. This system bifurcated the board into a management board and a supervisory board, where the former assumed direct responsibility for the Risk Management Committee, while the latter provided oversight for the Audit Committee. This tiered structure, inherent to Germany’s corporate landscape, strove to strike a balance between executive decision-making and supervisory control, even though it could introduce potential communication challenges. Both Saudi Arabia and Malaysia depicted analogous governance structures. Their Board of Directors maintained a direct relationship with the Risk Management Committee, Audit Committee, and, more uniquely, the Shari’ah Committee. The emphasis on the Shari’ah Committee and the ac-



companying Shari'ah Governance Framework underscored the profound significance of compliance with Islamic principles in Islamic banking operations. Furthermore, this commitment to Islamic principles resonates with the growing global acknowledgment of the importance of Islamic finance. Moreover, the inclusion of a compliance committee in their governance structure boosted the emphasis on rigorous adherence to both the regulatory framework and religious guidelines. In essence, while countries like the UK and Germany mould their governance structures to suit their distinct economic and regulatory environments, nations such as Saudi Arabia and Malaysia embed Islamic principles within their governance paradigms. Therefore, this analysis emphasises the importance for corporations, especially those operating across various jurisdictions, to possess a deep understanding of these diverse board and committee relationships.

In summary, the paper's findings align with those reported in the literature (Bhimani, 2009; Muhammed et al., 2023; Woods, 2009), namely, that both CG and risk management are interrelated. Moreover, results also evince that the board of directors is ultimately responsible for managing the risk regardless of the CG structure, single or dual system. Finally, the ultimate responsibility for Shari'ah risks lies with the directors and not the committees, because it is the board's responsibility to adhere to the recommendations of the SSB, also known as the Shari'ah committee.

## Conclusions

The paper outlines a comparative analysis of CG and risk management guidelines in four countries, namely, the UK, Germany, Saudi Arabia, and Malaysia. It focuses on the relationship between the board of directors, committees, and various aspects of risk management in both Western and Islamic banking systems. The research aimed to compare and contrast risk management policies across the countries studied, assess the board's roles in leading risk management strategies, and review the Shari'ah committee or SSB's position in accommodating the unique risks of IBs.

The analysis found that each country's codes and guidelines aimed to boost stakeholders' confidence, increase CG effectiveness, and support institutions in managing various types of risks. Moreover, the application and adoption of these codes varied, with Western countries such as the UK adopting a more flexible approach with a 'comply or explain' policy, while Germany took a more rigid stance using terms like 'obligation' to emphasise law enforcement. In the Islamic banking sector, Malaysia followed the UK's 'comply or explain' approach, whereas Saudi Arabia's code application was mandatory.

In terms of the board's role in managing risk, all codes in both Western and Islamic countries held the board of directors ultimately responsible for risk management, establishing strategies, and forming committees. However, there were some unique requirements depending on the country and board structure. For example, Germany's dual-board structure held the management board responsible for adhering to the law, reporting to the supervisory board on strategic matters, overseeing risk operations and establishing committees.

Regarding Shari'ah risk management, Malaysia and Saudi Arabia held the board of directors ultimately responsible, while encouraging a comprehensive risk management approach that included Shari'ah aspects, with the SSB being an additional layer board. In contrast, leading Western countries such as UK and Germany neglected the Shari'ah aspect, despite the significant share of Islamic finance in their economies.

These findings align with previous research by Alatassi and Letza (2018), which explores the idea of fusing Western corporate governance elements with Islamic principles to create a more robust governance structure, including risk management. This study can assist policymakers, regulatory bodies and financial institutions in improving risk management practices by learning from the unique features of each system.

However, the paper is not free from limitations due to its focus on CG codes in only four major Western and Eastern nations and the qualitative analysis performed. Future research could explore a broader spectrum of countries in Islamic finance, perform an empirical study and analyse banks' publications and annual reports to assess compliance with best practice codes. It would also be useful to investigate the extent to which the SSB influences risk management strategies and the ethical behaviour of the board. Moreover, studies can explore the possibility of highlighting the board's responsibility to Shari'ah activities in Western countries where Islamic finance being adopted.

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