The Role of Board Committees in Monitoring the Performance of Jordanian Listed Banks

A Thesis
Submitted to the School of Law- University of Western Sydney in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

By:
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August 2014
Statement of Authentication

The work presented in this thesis is, to the best of my knowledge and belief, original except as acknowledged in the text. I hereby declare that I have not submitted this material, either in whole or in part, for a degree at this or any other institution.

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Signature

Asem T. Tahtamouni
University of Western Sydney
Dedication

This thesis is dedicated to my father Dr. Taleb and my mother Ghosoon. I would like to thank them for their love and support. Also, my thanks go to my brothers, sisters and all my friends in Jordan and Australia for their encouragement. Last and not least, my special thanks go to my life partner Rawan Snunu for her love and support.
ABSTRACT

Bank failure gives rise to a systemic risk that can affect the whole of the banking system not just an insolvent bank. Because of this systemic risk, it is recognised that special regulatory provisions are required to ensure bank security. The Global Financial Crisis (GFC) in 2008 motivated governments around the world to re-evaluate their financial regulatory systems and to consider new measures to avoid a future banking crisis.

This thesis considers the role that bank Board Committees should perform in ensuring bank security. It draws on international literature and experience to examine the importance of Board Committees (Audit Committee, Risk Management Committee, Remuneration Committee and Appointments Committee) and their role in improving the monitoring of the performance of directors and overall performance in Jordanian listed banks. The focus is bank governance in Jordan because in Jordan the financial market is underdeveloped and banks are typically the most important source of finance giving rise to the problems of systemic risk and catastrophic collapse of the financial system.

The thesis argues that the Board Committees and their independence are important in monitoring the performance of directors in Jordanian listed banks as well as providing stability and integrity of the banking system in Jordan in facing any financial crisis. It argues that, in relation to banks, Board Committees should provide objective oversight of the banks operations, be independent and mandatory as a response to agency problems and the serious risks to investors, depositors and the economy from risk taking by bank management.
Acknowledgements

I would like to thank my supervisors, Prof. Razeen Sappideen and Prof. Carolyn Sappideen for their sound advice, careful guidance, insightful criticisms, and patient encouragement which aided the writing of this thesis in innumerable ways.

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List of Abbreviations

AASB: Australian Accounting Standards Board.
ACCC: Australian Competition and Consumer Commission.
ADIs: Authorised Deposit-taking Institutions.
AGM: Annual General Meeting.
ANZ: the Australia and New Zealand Banking Group.
APRA: Australian Prudential Regulation Authority.
ASX CGC: Australian Stock Exchange-Corporate Governance Council.
ASX: Australian Stock Exchange.
ASIC: Australian Securities and Investments Commission.
AU$: Australian Dollar.
BCBS: the Basel Committee on Banking Supervision.
BCCI: The Bank of Credit and Commerce International.
CBA: Commonwealth Bank of Australia.
CBJ: Central Bank of Jordan.
CAR: Capital Adequacy Ratio.
CBI: Confederation of British Industry.
CCP: Central Counterparty.
CDO: Collateralised Debt Obligation.
CDS: Credit Default Swap.
CEO: Chief Executive Officer.
CLERP: Corporate Law Economic Reform Program.
CLF: Committed Liquidity Facility.
COINS: the Combined Online Information System.
FCA: Financial Conduct Authority.
FSA: Financial Services Authority.
GDP: Gross Domestic Product.
GFC: Global Financial Crisis.
G10: Group of Ten.
HIH: Heath International Holdings.
ICAAPs: Internal Capital Adequacy and Assessment Processes.
IMF: The International Monetary Fund.
IOSCO: the International Organization of Securities Commissions.
JD: Jordanian Dinar.
JSC: Jordan Securities Commission.
LCR: Liquidity Coverage Ratio.
MBS: Mortgage-Backed Security.
NAB: National Australia Bank.
NOHCs: Non-Operating Holding Companies.
NSFR: Net Stable Funding Ratio.
OECD: Organisation for Economic Co-operation and Development.
OTC: Over-The Counter.
PCR: Prudential Capital Ratio.
PRA: Prudential Regulation Authority.
RBA: Reserve Bank of Australia.
RWAs: Risk Weighted Assets.
SDC: Securities Depository Centre.
SIFIs: Systemically Important Financial Institutions.
UBS: Union Bank of Switzerland.
UK: United Kingdom.
USA: United States of America.
USD: American Dollar.
VaR: Value-at-Risk.
WBC: Westpac Banking Corporation.
£: UK Pound.
CHAPTER 1

INTRODUCTION

The banking sector is central to the financial activities and financial stability of all countries. Banks’ activities include the provision of payments, settlement, and custodial services; underwriting debt and equity securities offerings; providing asset management services; serving as dealers in foreign exchange, securities, and derivatives markets; and the taking of deposits and making loans to persons and corporations. However, because banks have shareholders, banks have to be profitable and competitive. Because margins, and profits, are modest in relation to retail banking, banks may engage in higher risk, higher profit activities and use financial instruments which may include non-recourse financing activities (e.g. project financing and syndicated loans). This exposes banks to greater risk and at the same time the potential for greater profits for the bank and its shareholders but at the potential expense of depositors and other creditors. As the GFC demonstrated, high risk strategies may lead to bank failure.

Bank failure gives rise to a systemic risk that can affect the whole of the banking system not just an insolvent bank. Because of this systemic risk, it is recognised that special regulatory provisions are required to ensure bank security. Bank failure was a key element in the Global Financial Crisis (GFC) in 2008.¹

¹ Chapter 3 details the problems relating to excessive risk undertaking by Banks in the period leading up to the 2008 GFC. Also the effect of the GFC is discussed further in chapter 3.
of directors. Still another concerns remuneration incentives that became such a clear part of the business model drivers, with bonuses linked to up-front revenue and the current share price.²

The thesis argues that more rigorous control exercised by Board Committees might have helped reduce excessive risk taking.³ The focus is on Jordanian banks listed on the Amman Stock Exchange (ASE).⁴ There has been no previous examination on the role of Board Committees in monitoring the performance of directors in Jordanian listed banks in Jordan. This investigation will draw on international literature and experience to examine the importance of the independence of Board Committees. It discusses the importance of independent Board Committees in improving the performance of directors, overall performance of Jordanian listed banks, and in particular their importance to the stability and integrity of the banking system in Jordan.

This thesis reviews and analyses the literature relating to the need for independent Committees. It illustrates the issues by reference to the UK and Australian experience. This will inform the arguments concerning the importance of independence of Board Committees in banks. The thesis will argue that circumstances in Jordan present a special case for mandating Board Committees and their independence. As will be seen in chapter 7, the special features warranting this are the predominance of family control in listed banks, the political volatility in the Middle East and lack of secondary market mechanisms to act as constraints on management.


³ This chapter points out the Agency Problems that inhibit effective monitoring and governance of Banks, see chapter 2 [2.2.2].

⁴ Chapter 7 examines all 15 listed Banks in Jordan to assess whether they comply with the requirements of the Central Bank of Jordan Code for the year ended 2010, see chapter 7.
This thesis is organised as follows:

Chapter 2 sets the background for the thesis. It will review the principles of good governance and their application to Jordan. Illustrations will be taken from the approaches in the UK and Australia.

Chapter 3 examines special requirements relating to the governance of banks. It focuses on the importance of banks, special risks for banks (e.g. systemic risk) and the importance of banks regulation in avoiding these risks.

Chapter 4 examines the international experience relating to the governance of banks. It will take as an illustration bank governance in the UK. It will discuss the problems of ensuring proper governance, the risks, failures and solutions adopted in the UK. This will provide a comparator for discussion of the position in Jordan in chapter 6.

Chapter 5 discusses the governance of banks in Australia. It focuses on the financial regulation in Australia (Twin Peaks model) and how far this regulation has provided security and stability for the Australian banking system. This will provide a comparator to the discussion on the Jordanian regulation of the banking system.

Chapter 6 turns to examine in detail bank governance in Jordan. It investigates the development, role and importance of the regulatory structure of Jordanian banks. It discusses the main external supervision monitoring system, in particular, the regulatory system of the Central Bank of Jordan (CBJ).

Chapter 7 discusses the internal monitoring system in the Jordanian banking system. In particular, it examines the role of Board Committees in achieving effective bank
governance in the Jordanian banking sector and assesses how far Jordanian listed banks complied with governance Codes.

Chapter 8 is the concluding chapter. It summarises the discussions in the earlier chapters and sets out a list of recommendations for the Jordanian banking sector.
CHAPTER 2
GOVERNANCE OF THE MODERN CORPORATION

2.1. Introduction

This chapter sets the background for the thesis. It reviews the principles of good governance. It does this in the context of the issues associated with ensuring financial stability through the proper functioning and independence of Boards and their Committees. Illustrations will be taken from the approaches in the UK and Australia. The chapter also examines the difficulties and problems in ensuring independent Board Committees. As will be seen in chapter 7, the proper functioning of Board Committees is particularly important for the financial stability of Jordanian banks and the Jordanian economy.

This chapter is divided into five sections. Section 2.1 is introductory. Section 2.2 discusses the principal theories relating to corporate governance, the stakeholder and shareholder theories. This is important because corporate governance must start by examining the purposes of the institution. Otherwise there is no standard against which corporate governance can be assessed. This section then turns to examine agency theory. This is important because corporate governance sets out principles to respond to the conflicts created by the agency problem. Section 2.3 explores how principles of good corporate governance have sought to deal with agency problems. It discusses the importance of the main internal governance mechanisms: the Board of

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1 The term ‘institutions’ will be used throughout the thesis to denote all types of organisations including all types of Banks.
Directors, Non-Executive Directors, separating the role of Chairman and the Chief Executive Officer (CEO) and the importance of Board Committees and their independence in monitoring the performance of the bank and senior management. Section 2.4 discusses the main barriers to good corporate governance in Jordan. Section 2.5 concludes.

2.2. The Principal Theories

2.2.1. Stakeholder and Shareholder Theories

The Organisation for Economic Co-operation and Development (OECD) in 1998 issued a report titled “Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets” (OECD Report). Its focus was the Board of Directors and accountability. The OECD Principles for Corporate Governance discussed below, expanded the focus of the earlier Cadbury Report to recognise that management’s duties are not limited to duties to shareholders but extend to its stakeholders. The OECD principles aim to protect the rights of shareholders and other stakeholders and ensure equitable treatment of these groups. The next section examines the duty of management towards its stakeholders.

Stakeholder Theory

Stakeholders include: customers, employees, suppliers, financiers, political groups, governmental bodies, trade unions, trade associations and communities. Stakeholder

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3 See the discussion below at [2.3.1] for further discussion concerning the Cadbury Report.


6
theory emphasises that managers have a duty to the shareholders as well as to all “individuals and constituencies that contribute, either voluntarily or involuntarily, to [a company’s] wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers.” The theory states that managers are agents to all stakeholders and have responsibilities in making decisions to take into account the interests of stakeholders.

The main goal of corporate governance according to stakeholder theorists is to balance the maximisation of profit with a long term sustainability capacity of the institution. Communitarians such as Etzioni go even further and argue that stakeholders should have the ability to get timely and regular relevant data from the Board of Directors through the general meetings similar to shareholders; this would assist stakeholders to be informed about the real performance of their institutions as well as giving stakeholders an opportunity to present their opinions and concerns about unethical or illegal activities to the Board of Directors. The OECD recommends proactive and timely disclosure of financial and other important data to both shareholders and stakeholders. This includes the institution’s financial situation,

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9 The failure of directors to recognise the entitlements of potential litigants was the subject of the James Hardie case. The James Hardie Industries Ltd. is an industrial building materials corporation headquartered in Ireland and listed on the Australian Stock Exchange (ASX). In May 2012 the High Court of Australia found 7 Non-Executive Directors as well as 3 senior executives breached their statutory obligations to act with diligence and care in performing their responsibilities. This occurred in 2001 when 2 subsidiaries with significant asbestos-related liabilities were separated from the group as well as the Medical Research and Compensation Foundation was issued to finance damages claims made against the separated institutions by individuals injured by their asbestos products. On 15th of February 2001, the Hardie’s Board of Directors confirmed the separation. The next day, Hardie sent
ownership, Board membership, key executives, executive remuneration and appointments and processes, performance and governance as well as the material foreseeable risk factors.\textsuperscript{10}

In most jurisdictions, Corporate Governance Codes endorse the stakeholder view. There is some positive evidence that corporations do take into account stakeholder interests and benefit from this.\textsuperscript{11}

In many nations, corporations go well beyond legal requirements in providing health care and retirement benefits, encouraging diversity of race and gender in employment and promotion practices, financially supporting education, and formulating and adopting environmentally friendly technologies. Similarly, many companies strive to avoid activities perceived to be socially undesirable even where not prohibited.\textsuperscript{12}

This is the theoretical position but the reality may be that stakeholder interests are not given priority. For example, shareholders might prefer the institution to take on high risk, high profit investments in which risks to stakeholders such as creditors and

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\textsuperscript{12} Holly J Gregory and Marsha E Simms, 'Corporate Governance: What it is and why it is Matters?' (Paper presented at 9th International Anti-Corruption Conference, Durban, South Africa, 10-15 October 1999) 10.
employees, and in the case of banks the problem of depositors funds, are regarded as less significant. The dominating principle in practice is shareholder theory.

**Shareholder Theory**

Shareholder theorists, of which agency theorists are the best known, take the view that shareholders being the owners of the corporation, the managers owe obligations primarily, if not exclusively, to the shareholders. To them, an essential goal of corporate governance is to protect this property right and to assure procedures for ownership, registration and free convertibility of shares.

The shareholder theory is more than 200 years old. It has its roots in Adam Smith’s 1776 Book *The Wealth of Nations*. At that time, it was not called Agency Theory (Agency Theory is discussed below) the term only came into vogue in the mid-1970s when Jensen and Meckling published their seminal paper called ‘Theory of The Firm: Managerial Behaviour, Agency Cost and Ownership Structure.’

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15 The OECD observed that the corporate governance system needs to ensure the equitable treatment of all shareholders, considering minority and foreign shareholders. Ibid 31.

16 The theory is sometimes called the “stockholder” theory, but the term “shareholder” is used here for consistency with the usual usage.


The theory is grounded in the view that the main goal of business lies in making profits and increasing the wealth of shareholders. Shareholders advance capital to the institution’s managers, who should spend corporate funds only in accordance with the recommendations of the shareholders. This advances three main goals: maximising the available profits for distribution to shareholders, increasing the wealth of investors by increasing the value of shares and increasing earnings per share. The duty of the Board of Directors is to act on their behalf in achieving these goals with the Board being accountable to the shareholders who appoint/elect them to manage the business of the entity.

Shareholder theory has its emphasis on generating shareholder wealth rather than broader social justice goals. On this approach social and ethical obligations are outside the remit of corporations and are best left to government and other bodies. This is because when institutions become involved in social issues wealth is diverted to matters outside the core managers’ principal mandate.

The shareholder and stakeholder theories deal with the question of whether a company’s only duty is to its shareholders. Independently of this, there is the further problem created by corporations. It is that there is a division between management who controls the business and the owners of the business, the shareholders. The

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19 Michael D. Pfarrer, ‘What is the Purpose of the Firm?: Shareholder and Stakeholder Theories’ in James O’Toole and Don Mayer (eds), Good Business: Exercising Effective and Ethical Leadership (Rutledge UK, 2010), Chapter 7, 87.

20 Ibid 87-88.

21 In Jordan, the shareholders shall have the right to examine the documents and data related to their companies as well as they can be invited to attend the AGM. See the Jordanian Companies Law 1997 Article 144. See also chapter 7.

potential for conflict between the various interest groups within the corporation, particularly between managers and shareholders, is the subject of Agency Theory.

2.2.2. Agency Theory

Agency Theory concentrates on the relationship between shareholders and managers, and how best to align the competing interests of the two groups to increase the value of the institution. It is also relevant to the problems created by the dominating role of large shareholding interests.23

The agency problem created by the separation of control and ownership of assets was referred to as far back as in the 18th century by Adam Smith in his book *Wealth of Nations*, and later on by Berle and Means in 1932.24 Adam Smith commented:

> The directors of such companies however being the managers rather of other people’s money than of their own, it cannot well expected that they should watch over it with the same anxious vigilance which the partners in private copartnery frequently watch over their own … Negligence and profusion, therefore, must always prevail, more or less; in the management of the affairs of such a company.25

The separation of the institution’s executive (agents) management and shareholders (principals) are the main concern of agency theory:

> Owners delegate authority to managers to make decisions that affect the value of the financial institution and, thus, the wealth of the owners. Because owners and managers have different interests and operate under conditions of information asymmetry, owners


are vulnerable to managers who serve their non-economic self-interests at the expense of owners’ economic interests.\(^\text{26}\)

This assumes that managers will always be motivated by self interest and put management’s self interest ahead of the interests of shareholders. However, they also suppose that “individuals are rational and capable of forming unbiased expectations regarding the impact of agency problems and the associated future value of their wealth.”\(^\text{27}\) This self interest must be taken into account by devising strategies to manage conflicts of interest.

Jensen and Meckling identified the agency relationship as an agreement under which a principal can engage another agent to achieve some service on their behalf which includes delegating some resolution making authority to the agent. The principal may limit divergence from its interests through establishing appropriate motivations for the agent, as well as monitoring.\(^\text{28}\)

The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities, of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs)\(^\text{29}\) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions.\(^\text{30}\)


\(^{29}\) Bonding costs are costs of mitigating the agency problem.

It is unrealistic to expect that there will be zero costs to guarantee that the agent will act optimally from the principal’s viewpoint. In most agency connections, there are likely to be positive bonding and monitoring costs and some level of divergence between the principal and the agent’s interests. “The dollar equivalent of the reduction in welfare experienced by the principal as a result of this divergence is also a cost of the agency relationship” or in other words, this latter cost is residual loss. Agency costs are the total of the bonding and monitoring expenditures, and the residual loss.

The nature of the agency problem is illustrated by Jensen and Meckling in comparing management behaviour in two different company structures: the first is where the company is wholly owned by an individual, and the second where the owner decides to sell a part interest in it to another. In the first situation, the owner will act to maximise the value and welfare of the company as the benefits accrue to him as sole owner. But when he sells an interest in it to another, e.g. a 20% equity stake, agency problems would set in because of the divergence in interests between the two owners. For example, since the interest of the original owner has decreased to 80 percent, he will want more effort expended into the business as he will tend to benefit in the proportion of 80:20. On the other, if the 20% owner was to be entrusted with the task of managing the affairs of the business altogether, he would view it differently as his efforts would only yield him a return in the proportion of 20:80. Such shirking by the

31 Ibid.
32 Ibid.
33 Ibid. There are agency costs in providing rewards intended to incentivise executives. There may be a lack of data about the activities of agents upon which to base performance review, costs of monitoring and analysing managerial performance as well as costs for specifying and enforcing policies. There are also costs in setting up incentive and bonus schemes, see Ibid 309.
34 Ibid 312.
20% holder entrusted with the running of the business (the agent in this scenario) may be reduced but not removed through the principals incurring monitoring costs.\textsuperscript{35}

Shleifer and Vishny found that self-motivated management behaviour involves direct expropriation of funds by the agent, remuneration of excessive perquisites, shirking and suboptimal investment. Although there will inevitably be residual agency costs, this behaviour may be limited by bonding and monitoring.\textsuperscript{36} The agent’s taste for non monetary benefits as well as the replacing the agent’ cost will make the real size and the affect of this self-seeking behaviour vary across institution and country.\textsuperscript{37}

A 2000 study measured the agency costs. The study evaluates whether there is a difference in the cost of running of the institution and in the utilisation of the institution’s assets; between the institution facing zero equity agency costs (owner-managed); and institutions where there is a separation between management and ownership. For the owner-manager institution, there is no separation of control and ownership and the interests of agent and equity holders are totally aligned. Therefore, the owner-managed institution gives the base case for equity agency costs comparisons. As owner-manager equity ownership falls under 100%, the agent has a reduced residual claim on the institution. When there is a relatively dispersed equity ownership, the agent has higher incentives for shirking or obtaining excessive compensation. Although the value of the institution is reduced by management non monetary usage or shirking, the agent only bears a proportion of the expenses related to their ownership stake. A lower managerial equity holding gives rise to a reduced

\textsuperscript{35} Ibid 313.


incentive to exert effort in their work and find profitable investments. Therefore, the agency costs vary inversely to the agent’s ownership stake.\textsuperscript{38}

Jensen and Meckling conclude that agency costs are unavoidable when there is a separation between control and ownership. The issues related with the separation of control and ownership and the overall agency problem is therefore a consequence of the diffuse ownership of the company. These costs are “inefficiencies” which are unavoidable even if in the “ideal world” the interests of shareholders and managers can be aligned so that agency costs will be zero.\textsuperscript{39}

One of the key problems for agency theory is how to align management and shareholder interests. Alignment of interests is often sought to be achieved through the medium of remuneration packages. Jensen and Meckling found that the companies might achieve efficiencies through aligning corporate and managerial interests by using stock as part of the remuneration package for executives.\textsuperscript{40} When executives “have skin in the game” they are more likely to promote the interests of shareholders including themselves.

In theory a perfectly tailored compensation package (the optimal contracting view) neutralises agency problems. There are, however, a number of factors affecting its ability to operate as an effective mechanism to reduce agency costs. First, the nature of the compensation may distort incentives. There is some evidence that remuneration in the form of cash rather than equity increases agency costs and that restricted stocks


\textsuperscript{40} Ibid 309.
and stock options appear to reduce agency costs. Conversely there is evidence that executives engage in the manipulation of share-price and disclosures in order to enhance share price for their own benefit.

A 1997 study analysed the timing of CEO stock option awards, as a way of investigating the influence of corporate managers over the terms of their own remuneration. It used a sample of 620 stock options provided to the CEOs of the Fortune 500 corporations between 1992 and 1994. The study found evidence suggesting that agents time stock options grants prior to release of favourable company news. The study found that agents who become aware of impending improvement in corporate performance might influence their Remuneration Committees to achieve better performance-based pay, as a low-risk way of capitalising on the expected investor response to news of the improvement in corporate prospects.

There may be high levels of influence by CEOs on Boards and their Remuneration Committees, in setting remuneration packages. There is evidence that CEO

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influence results in higher agency costs\textsuperscript{46} and the ability of management to extract more advantageous remuneration packages. Higher executive pay suggests diminished effectiveness of Board governance.\textsuperscript{47} As will be discussed later in this chapter, Boards (and Remuneration Committees) have largely not been effective in moderating executive remuneration.

There is the problem of information asymmetry between the agent and the principal. This impacts the ability of Boards and the Remuneration Committee to effectively monitor executive management. Again there is evidence that reduced information asymmetry results in lower agency costs.\textsuperscript{48} Furthermore, large shareholders may be relevant to reducing agency costs on the assumption that it is in their interest to actively monitor management to ensure better returns.\textsuperscript{49} But as discussed below, large shareholders may themselves pose agency problems. These various factors suggest great difficulties in ensuring appropriate alignment between shareholder and management interests. In chapter 7, it will be argued that some of these problems might be diminished by mandating Board Committees for Jordanian banks and requiring direct reporting to shareholders by Board Committees.

Agency problems also arise when there are conflicts of interest between controlling shareholders and minority shareholders. There is a risk that controlling shareholders,

\textsuperscript{45} A 2003 study found that executives have substantial effect over their own pay. See Lucian A Bebchuk and Jesse M Fried, ‘Executive Compensation as an Agency Problem’ 17 (3) (2003) \textit{Journal of Economic Perspectives} 71, 75.


\textsuperscript{47} Ibid 3.

\textsuperscript{48} Ibid 3-4.

\textsuperscript{49} Ibid.
much like controlling executive managers, may seek to have the company act in their interests rather than shareholders as a whole. So, for example, controlling shareholders might be more interested in long term capital growth rather than short term cash flow and dividends. In this context, there are two types of agency problems. Agency Problem-Type I occurs when majority shareholding holds intensive equity positions in their institutions so they are able to exercise control over managers. This common problem leads to risk that the business is directed to the benefit of those shareholding interests rather than shareholders generally. Agency Problem-Type II involves conflicts between controlling and non-controlling shareholders. This occurs when the majority shareholding has control which brings with it seats on Boards and power to monitor the Board in the light of their interests. It can give rise to conflict of interests where the majority shareholding’s interests are in increasing earnings, domination of management positions and favourable deals with related parties.

Good corporate governance deals with many of these agency problems by setting out principles which attempt to minimise agency conflicts. The Board of Directors and

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50 For controlling shareholders, private benefits might be transfers or profits to other institutions in which the controlling shareholders have significant interests. On the other hand, managers may get excessive benefits without adequate performance or take decisions such as ignoring decisions of important restructuring to avoid any face-off with unions, employees or the media. See Ralph P Heinrich, Complementarities in Corporate Governance (Springer-Verlag Berlin, 2002) 4-8. Note the restrictions under the UK Companies Act 2006(UK) s 190 which requires transfer of substantial non cash assets by or to Directors or related parties to be approved by shareholders. There are limited exceptions. See also Companies Act 2006 (UK) ss197-214 in relation to loans to Directors and similar types of dealing.


52 Such as the family controlled companies. See the discussion below at [2.4.1]. In the UK amendments to the Corporate Governance Code 2012 allow a veto by minority shareholders where transactions are entered into between the company and the controlling shareholder, see Financial Reporting Council, Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes (December 2013), 9 <https: // frc. org. uk/ Our- Work/ Publications/ Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>

Board Committees are critical components for avoiding agency problems by implementing control systems to make the executives accountable.\(^{54}\) Independent Non-Executive Directors are an important component of Board oversight to ensure that managers act in the best interests of the company and shareholders.\(^{55}\) The next section discusses the importance of corporate governance, the Board of Directors (particularly the role of Non-Executive Directors) and the independence of Board Committees.

2.3. Principles of Good Corporate Governance

2.3.1. Introduction

The importance of good corporate governance to economic growth is captured in the following quote:

Without efficient companies or business enterprises, the country will not create wealth or employment. Without investment, companies will stagnate and collapse. If business enterprises do not prosper, there will be no economic growth, no employment, no taxes paid and invariably the country will not develop. The country needs well-governed and managed business enterprises that can attract investments, create jobs and wealth and remain viable, sustainable and competitive in the global market place. Good corporate governance, therefore, becomes a prerequisite for national economic development.\(^{56}\)

There has been renewed interest in the corporate governance practices of modern corporations as a consequence of international corporate collapses which occurred in

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2001 such as Enron\textsuperscript{57} in the United States (USA) and HIH\textsuperscript{58} in Australia. It has become particularly important as a consequence of the 2008 Global Financial Crisis (GFC) which caused many corporate collapses including banks such as Lehman Brothers bank\textsuperscript{59} in USA and Northern Rock\textsuperscript{60} in the UK.

Corporate governance has been defined in different ways. A useful definition is that of the OECD:

One key element in improving economic efficiency is corporate governance, which involves a set of relationships between a company’s management, its Board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Furthermore, the corporate governance framework also depends on the legal, regulatory and institutional environment. In addition, factors such as business ethics and corporate awareness of the

\textsuperscript{57} In 1985 Enron was listed as the 7th largest company in USA. It traded in Internet, Electricity, Gas, and many other products. It collapsed in 2001. Factors which led to the collapse were the provision of misleading financial reports, involvement in high risk dealing, conflict of interest, high executive remuneration not matched by performance, see George J Benston, ‘The Quality of Corporate Financial Statements and their Auditors Before and After Enron’ [2003] Policy Analysis No. 497, Goizueta Business School, Emory University, 1.

\textsuperscript{58} HIH Insurance Group was Australia’s second largest insurance company in 2001. Investigations into the reasons for failure led to conviction and prison of the majority of members of HIH management. Following the HIH collapsed in 2001, the HIH Royal Commission reported the causes of collapse in April 2003 and identified them failure of the Board, Board Committees, conflicts of interests and remuneration. The Report found that the HIH had poor management and lack of integrity and faith. The Report found that the Board of Directors didn’t work effectively; the Board didn’t understand the company policies and agendas which were controlled by the CEO and executive management. Moreover, the HIH auditor (Arthur Andersen) lacked independence. Three former partners of the company used to be on the HIH Board of Directors. Moreover, the HIH Board of Directors didn’t have independent Non-Executive Directors. Of its four Non-Executive Directors, there were two members former partners of Andersen as well as two were included in giving legal services to the group. The HIH had only one independent director on the Audit Committee. The Boards did not regularly meet and evaluate the effectiveness of the company’s corporate governance system nor did it regularly and fairly disclose the company performance in the annual report, the Report concluded that the company was lack of integrity and accountability in its processes. See HIH Royal Commission, The failure of HIH Insurance: Final Report, Volume I: A Corporate Collapse and Its Lessons (2003), Commonwealth of Australia, 51-61 <http://www.hihroyalcom.gov.au/finalreport/index.htm>.

\textsuperscript{59} Lehman Brothers Holdings Inc was the fourth largest investment Bank in the USA. The collapse of Lehman Brothers in 2008 was the largest collapse in the business history of the USA, see chapter 3 [3.4] for further discussion concerning the collapse of this Bank.

\textsuperscript{60} Northern Rock was one of the top five mortgage lenders in the UK. See discussion in chapter 3 for further discussion concerning its failure.
environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long-term success of a company.\textsuperscript{61}

This OECD definition provides a useful basis for the discussion following. This section discusses the importance of the Board’s functions; the role of Non-Executive Directors; the importance of separating the role of Chair and the CEO; and the importance of Board Committees and their independence in monitoring the performance of executive management.

Corporate Governance principles have been developed over a significant period of time and typically in response to serious corporate collapses. In 1991,\textsuperscript{62} a committee chaired by Sir Adrian Cadbury was established to review the reasons for recent collapses and provide recommendations to improve the regulation for banks and all UK financial institutions. The Cadbury Committee reporting in 1992\textsuperscript{63} concluded that the reason for financial institution failures was not the need to enhance accounting and auditing principles but poor and ineffective internal control systems in UK financial institutions. The Committee identified many defects with the current system of corporate governance, these included Board members without appropriate experience,\textsuperscript{64} institutions run in the executive directors’ interests, unreliable and

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\textsuperscript{64} Appropriate experience generally means the person who has extensive knowledge and experience from fields such as accounting, finance, business or any related field so as to be able to provide expert advice and monitoring. In the Banking system, for example, members who work in banking sector
\end{flushleft}
misleading financial reporting, lack of independent auditors and inadequate risk management.⁶⁵

The Cadbury Report’s recommendations aimed to enhance the effectiveness of the Board members who have a monitoring role and are responsible for ensuring an effective control system over all the institution’s activities.⁶⁶ As noted above, this is not limited to shareholder interests. There must be clarity about the responsibilities and duties of Boards and their members. This in turn requires disclosure of business goals and standards.⁶⁷ The Report recommended that the Board members

Must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.⁶⁸

It added that:

…smaller listed companies may initially have difficulty in complying with some aspects of the Code and we have given careful consideration to the responses to the draft report which addressed this point. The boards of smatter listed companies who cannot, for the time being, comply with parts of the Code should note that they may instead give their reasons for non-compliance. We believe, however, that full compliance will bring benefits to the boards of such companies and it should be their objective to ensure that the benefits are achieved. In particular, the appointment of appropriate non-executive

need to have formal banking experience gained through long term experience and work in the fields of finance and banking business which enables them to effectively understand and evaluate all the intricacies of the banking processes, procedures and requirements. For example, one of the main reasons for the collapse of the US Lehman Brothers Bank during the 2008 GFC was due to lack of appropriate banking expertise by Board members who were unable to exercise sufficient disciplinary control over management as the Banks had only one financial expert member among the other members. See Thomas Clarke, Corporate Governance and the Global Financial Crisis: The Regulatory Responses (UTS, Press Research, 2010) 75. For further discussion concerning this Bank, see chapter 3 [3.4].


⁶⁶ Ibid para, 1.8, 10.

⁶⁷ Ibid paras, 4.1-4.6, 19-20.

⁶⁸ Ibid para, 1.1, 10.
directors should make a positive contribution to the development of their businesses. Any practical issues which may arise in respect of smatter listed companies will be thoroughly reviewed by the Committee and its successor.

Integral to the proper functioning of the Board is its monitoring and supervisory role. The Board must be able to act independently if it is to exercise effective supervision. In relation to this function, the Cadbury committee recommended the separation of the role of the CEO and the Chairman, discussed below. Recommendations were also made in relation to Non-Executive Directors, discussed below. The Committee also recognised the crucial importance of financial control through the role of auditors and the establishment of a mandatory Audit Committee of the Board. Many of the Cadbury recommendations were not new and reflected international best practice:

Audit Committees and Non-Executive Directors were not new; the Cadbury Report itself was picking up the provisions from the New York Stock Exchange listing rules. Separation of CEO and Chairman of the Board, however, was a more European than American approach, harkening to the German governance structures of the dual Board, where the Supervisory Board provides oversight (with no overlap) to the management Board. So there were no radically new propositions in the Code of Best Practice of the Cadbury Report. The propositions, though, were stated simply and clearly articulated. Variations on these propositions have proliferated over time.

Other reports published recommendations and principles as best practices for a range of issues some of which were covered by the 1992 Cadbury Report. In particular, the

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69 Ibid para, 3. 15, 18.

70 See the discussion below at [2.3.2.4] for further discussion concerning the main reason of separation the role of Chairman and CEO.

71 See the discussion below at [2.3.2.3] for further discussion concerning the importance of Non-Executive Directors.


Greenbury Report in 1995 addressed the issue of excessive remuneration. This Report was the product of a committee established by the UK Confederation of Business and Industry on Corporate Governance. It was created in response to concerns of shareholders and the public about the level of remuneration of the executive management. The Greenbury Report suggested extensive disclosure in Annual Reports on remuneration and recommended the establishment of a Remuneration Committee comprised of Non-Executive Directors. The majority of the recommendations were endorsed by the listing rules of the London Stock Exchange. The main goal of the report’s recommendations was to ensure that there was a balance between the executive performance and remuneration. As discussed below, the problems related to excessive remuneration continues.

The Cadbury Report principles of corporate governance were adopted by the London Stock Exchange. These were not mandatory requirements but rather adopted a ‘comply or explain’ approach. The only commitment on listed companies was to publish how far there had been compliance with the report’s principles and to explain the reasons of non-compliance.

The London Stock Exchange intend to require all listed companies registered in the United Kingdom, as a continuing obligation of listing, to state whether they are complying with the Code and to give reasons for any areas of non-compliance. This requirement will enable shareholders to know where the companies in which they have

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75 Ibid.

76 See the discussion below at [2.3.2.5, IV] for further discussion concerning the importance of the remuneration system and its independence and how the level of director’s remuneration tends to make them less independent.

77 The London Stock Exchange, which is part of the London Stock Exchange Group, is a stock exchange of the UK located in London City. It was founded in 1801. In December 2011, the Exchange had a market capitalisation of about US$3.266 trillion which made it the fourth largest exchange in the world. See <http://www.londonstockexchange.com/home/homepage.htm>.
invested stand in relation to the Code. The obligation will be enforced in the same way as all other listing obligations. This may include, in appropriate cases, the publication of a formal statement of censure.\footnote{78 Committee on the Financial Aspects of Corporate Governance, \textit{Financial Aspects of Corporate Governance} (1992) United Kingdom (‘Cadbury Report’), para. 1.3, 10 <http://www.ecgi.org/codes/documents/cadbury.pdf>.


80 See David Seidl, Paul Sanderson and John Roberts, ‘Applying ‘Comply-or-Explain’: Conformation with Codes of Corporate Governance in the UK and Germany’ [2009] \textit{Centre for Business Research Working Paper No. 389, University of Cambridge}, 1, 5-7.}

In Europe, including UK, the practices of corporate governance are, to a large extent, founded upon the ‘comply or explain’ approach. This approach provides flexibility to companies in deciding how it should implement governance standards.\footnote{79} In theory, it promotes innovation because it allows companies to implement rules that reflect their needs and operations and learn from the experience of others. It permits corporations to adopt different measures to achieve similar outcomes or not to adopt because, in the individual circumstances, it results in high costs without commensurate benefits. Institutions are encouraged to think about the objective of the clause rather than just 'tick the box', so that the underpinning principles of corporate governance become part of the companies own internal standards of governance. The comply and explain approach responds to the view that the corporate governance system is about human behaviour and its goals will be more efficiently achieved when institutions act out of their own will, rather than being pushed to change through processes and structures.\footnote{80}

This approach may be seen as giving market-based solutions that are worked out between shareholders and their institutions without requiring regulatory intervention. The institution that does not comply with Code provisions needs to explain how its
practices are consistent with the relevant principle and promote good governance and 
the achievement of the institution’s goals. The European Commission states that:

It seems appropriate to have a closer look at the way in which companies comply with 
the recommendations of the applicable code. In particular, it does not seem sufficient to 
rely on simple compliance rates. When applying the principle of ‘Comply-or explain’ 
more emphasis needs to be put on the quality of the explanations for deviations from the 
code as a meaningful explanation can fully justify non-compliance. The potential 
responsibility inherent to a statement of compliance should also be examined.

A study by Seidl, Sanderson and Roberts analysed the corporate governance reports 
and the compliance statements of the largest listed corporations in both UK and 
Germany (overall 257 corporations). It evaluated the effectiveness of the two 
countries corporate governance codes to determine whether the codes have any 
influence on corporate practices. Explanations for failure to comply might be given in 
writing, orally at the Annual General Meeting (AGM) or by private meetings with 
shareholders. For the purposes of the study, written explanations were used as 
indicators of broader communication to wider audiences. The study examined the 
distribution of various forms of explanation across different types of corporations. It 
compared the statements of corporations in UK and Germany in the light of different 
capital market structures, legal cultures and experiences of regulatory codes.

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81 Ibid.
83 David Seidl, Paul Sanderson and John Roberts, ‘Applying ‘Comply-or-Explain’: Conformation with Codes of Corporate Governance in the UK and Germany’ [2009] *Centre for Business Research* Working Paper No. 389, University of Cambridge, 1, 4-5.
84 Ibid.
The study found that of the 129 UK corporations examined, 67 corporations (51.94%) were fully compliant with the Combined Code UK. In Germany, of the 128 German corporations examined, 18 corporations (14.06%) were fully compliant with the recommendations of the German Cromme Code. In both countries the level of compliance diminished with size. In the UK, in relation to the top 130 corporations, less than 30% of the small institutions, (30 of them), were fully compliant, about 2% of similar institutions were fully compliant in Germany. The study suggested a number of reasons to explain this deviation; the first relates to stock exchange listing requirements.

In the UK transitional justifications from new entrants to the London Stock Exchange were also fairly frequent, reflecting the relative importance of the exchange - it is the third largest in the world, and around twice the size of its counterpart in Frankfurt. This, combined with the longstanding importance of the UK as a financial centre, makes it an attractive place for companies from outside the UK to obtain a primary listing.

The second explanation relates to the size of the Corporation and Board. The average size of the German corporations may be considerably smaller that their UK counterparts and this may account for lower level of compliance.

Unsurprisingly size was more often offered as an explanation for deviation by the smallest 30 companies than the largest. But perhaps of greater interest, industry-specific reasons were only rarely cited. A few companies did refer to the specific characteristics of their industry as a reason for deviating but such deviations were relatively unimportant. The small number of explicit justifications drawing on industry specificities also indicates that in this respect one size can indeed fit all.

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85 The UK Combined Code had 48 clauses covering different areas for good corporate governance such as accountability. See now the 2014 UK Corporate Governance Code which is extracted in Appendix [E].

86 The German Cromme Code introduced in February 2002 has 82 clauses many of which are similar to the UK governance Codes, see David Seidl, Paul Sanderson and John Roberts, ‘Applying ‘Comply-or-Explain’: Conformation with Codes of Corporate Governance in the UK and Germany’ [2009] Centre for Business Research Working Paper No. 389, University of Cambridge, 1, 17.

87 Ibid 25.

88 Ibid 25.
The study also pointed to the number of provisions in each code; 48 in the German Cromme Code compared to 82 in UK Combined Code. Most of the UK Combined Code provisions have been used for more than a decade while the Cromme Code is relatively new to German companies applying from 2002.\(^8^9\) The study concluded that:

Levels of both full compliance and fully justified non-conformance are higher in the UK than in Germany. (This is not to say that individual companies in the UK and in Germany might not be very similar in terms of board members’ attitudes to comply-or-explain.)

The differences in behaviours can be explained by differences in the structure of capital markets in both countries.\(^9^0\)

In designing the original code the Cadbury Committee took into account UK corporate practice and the structure of the UK capital market where, although share ownership is dispersed, large outsider financial institutions exercise considerable influence on boards. These institutions have both the interest and the resources to monitor and enforce the code provisions. This contrasts sharply with the German context where companies are more likely to be controlled by insider blockholders with networks of cross-shareholdings. There is therefore less pressure to justify publicly deviations from the Cromme Code.\(^9^1\)

The study also found that differences in the legal processes and structures in both the UK and Germany, help explain the different levels of compliance in those countries and that these differences may diminish over time.\(^9^2\) In the most recent survey of compliance, it has been found that there are very high levels of compliance with the Corporate Governance Code 2012 by UK FTSE 350 corporations (many large UK banks would be in this group) with smaller companies also achieving high levels of compliance.\(^9^3\)

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\(^8^9\) Ibid 24.

\(^9^0\) Ibid 27.

\(^9^1\) Ibid.

\(^9^2\) Ibid 28.
The ‘comply or explain’ approach is a market mechanism which provides alternative approaches for compliance with the best practices for their institutions. Explanations for non compliance might be justified on a variety of grounds. It might not be reasonable, for example, for very small companies to comply with corporate governance codes and this is the experience in UK and Germany. It is the market and shareholders that make the judgment whether the explanation for non compliance is satisfactory. Large institutional shareholders may exert influence in this regard. Where the explanation is unsatisfactory and the stability and effectiveness of the company or its shareholders is threatened, this may be reflected in a fall in share price or impact on decisions to buy or sell. It has been suggested that investors may be prepared to pay a premium of up to 14% for well governed corporations in Europe and United Kingdom. Consequently, the market can effectively discipline companies who do not satisfactorily explain lack of compliance with governance codes. The market itself will mitigate the problem of self-interest as well as lead to more effective corporate governance clauses for a given institution.

Where the structure of the market is such that there are not large institutional shareholders or a critical financial press able to exert influence on the Board, such as


95 Ibid 27.

96 Ibid 6-7.

97 Ibid.

98 Ibid 28.
seems to be the case in Jordan, this makes the role of Board Committees extremely important to monitoring code compliance and ensures that there is adequate disclosure to shareholders and the market. Board Committees are therefore important in providing an independent internal control to ensure that the Board justifies non compliance on reasonable grounds.  

The Cadbury Report has been influential in most countries as providing the desirable approach to good corporate governance. It reflects the preference for “light touch” regulation rather than mandatory standards. What is clear is that despite high levels of compliance, the Cadbury principles did not prevent wholesale corporate collapses during the GFC. It begs the question why those principles had not been effective. As will be discussed in later sections, Boards and Committees failed in their roles to ensure proper monitoring and control of executive management. A significant part of the problem was lack of expertise by Boards and Committees, lack of independence and particularly failure to reign in excessive risk taking by management in pursuit of personal profit, (see below).

This section continues with a discussion of the key structural components of good corporate governance.

2.3.2. The Internal Governance Mechanisms

2.3.2.1. Introduction

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99 For further discussion concerning the role of Board Committees, see section [2.3.2.5] below.

100 Ibid 31.

101 Such as Enron collapse in 2001 in USA and HIH in 2001 in Australia.

102 See the discussion below at [2.4].

103 See the discussion below at [2.3.2. 3 & 5].
The principles of good corporate governance respond to agency problems by establishing internal governance mechanisms. The Board of Directors is a key mechanism. The Board comprises Executive Directors drawn from management and Non-Executive (outside) Directors. The executive directors provide their inside knowledge and experience. The Non-Executive Directors provide their expertise, knowledge, and, in theory, independent judgment.\textsuperscript{104} The purpose of Non-Executive Directors is to monitor and supervise the performance of the executive.\textsuperscript{105} The ultimate control as to the composition of the Board of Directors rests with the shareholders, who can appoint/elect and dismiss them. In the UK, FTSE 350 companies under the Corporate Governance Code should have an annual election for all directors.\textsuperscript{106} This is an important step in empowering shareholders to call to account directors and Board Committee members in their supervision of the company.

What is apparent is that code reforms target areas of weakness in corporate governance. Reforms are strategic in that the emphasis is on the very large corporations which would include the largest banks and financial institutions where the risks are highest. These reforms are directed to strengthening the Board and its Committees so that they are able to act independently and objectively in monitoring the performance of the institution and its senior management.

\textsuperscript{104} An Executive Director or Inside Director is a member who works full time and involved in the day-to-day processes and gets a salary.

\textsuperscript{105} Non-Executive Directors or Outside Directors are external to the institution, are not engaged in day-to-day management but may be involved in policy making and planning and monitoring executives. Non-Executive members can own shares in the institution and should be independent. See [2.3.2.3] for further discussion concerning the Non-Executive Directors and their independence.

\textsuperscript{106} The FRC reported that all but two FTSE 350 companies have complied with this Code requirement. See Financial Reporting Council, \textit{Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes} (December 2013), 12 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>.
The next section discusses the main functions of the Board of Directors and its role in ensuring good corporate governance.

2.3.2.2. Board Functions

Board members are appointed/elected by the shareholders and are accountable to shareholders and stakeholders for the institution’s progress and activities. The Board is the link between the shareholders and the managers in the institution.\textsuperscript{107}

The Board of Directors has the responsibility to promote the corporation by directing its affairs and promoting the interests of the shareholders. The Board has legal duties and obligations of good faith and loyalty.\textsuperscript{108} In order to fulfil these duties, the Board must ensure that accurate, complete and timely statements about the real performance of the company are disclosed to shareholders, stakeholders and other investors.

Board members should determine the goals and values of the institution and ensure that the institution complies with all relevant regulations, laws, accounting and auditing principles and governance practices. Board members have the responsibility to develop principles which include the ethics, values, and beliefs which can be used to lead the policy and behaviour of the institution.\textsuperscript{109} The Board must also set operational plans and provision for monitoring outcomes.


\textsuperscript{108} For example, the Australian \textit{Corporations Act 2001}, states that any director who fails to perform his/her duty: “May be guilty of a criminal offence with a penalty of $200,000 or imprisonment for up to 5 years, or both; may contravene a civil penalty provision (and the Court may order the person to pay to the Commonwealth an amount of up to $200,000); may be personally liable to compensate the company or others for any loss or damage they suffer; and may be prohibited from managing a company.” See \textit{Corporations Act 2001 ss} 5, 140.

\textsuperscript{109} Job K Kihumba, \textit{Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance} (1999) Private Sector Corporate Governance Trust, Brookside
The Board is responsible for the business strategy as well as establishing, implementing and supervising operational plans.\textsuperscript{110} The important question is whether Boards effectively perform these roles. The literature points to a number of factors that are important to assessing effectiveness. There is a link between Board size and good corporate governance.\textsuperscript{111} Large Boards are usually more effective than small Boards because management is less likely to influence large Boards in their decisions.\textsuperscript{112} However, large Boards may lead to problems of control, coordination, as well as conflicts of interest; there is greater capacity for members to provide different opinions leading to conflict on the Board in making decisions.\textsuperscript{113} U.S commentators argue that the size of Boards should be reduced:

\begin{quote}
[T]he size of a Board should be limited to a maximum of ten directors (indeed we would favor boards of eight or nine) with a ratio of at least two independent directors to any director who has a connection with the company.\textsuperscript{114}
\end{quote}

This is based on the view that with smaller Boards, Board members know each other and discussion is more productive. The optimum number is thought to be thirteen.\textsuperscript{115}


\textsuperscript{114} See Martin Lipton and Jay Lorsch, ‘A Modest Proposal for Improved Corporate Governance’ (1992) 48 (1) \textit{Business Lawyer} 59.

\textsuperscript{115} Walter Puckey, \textit{The Board Room} (London: Hutchinson, 1996) 86.
There is therefore a trade off between size and efficiency.116 But Boards also require sufficient numbers with a range of expertise to monitor and supervise the management’s performance.117 This expertise extends to improving procedures to ensure the stability in business, strategic planning, evaluating performance, and in the banking sector particularly monitoring compliance with regulatory requirements including managing liquidity.118 The US Lehman Brothers bank,119 for example, is illustrative of the problems that occur where the Board does not have sufficient expertise to exercise sufficient disciplinary control over management.

…during the critical years from 2006–2008…Lehman Brothers only had one financial expert on the Board. This suggests that the investment banks’ Boards involved were critically disabled in the effort to independently understand and monitor complex financial transactions.120

Relevant also to the effective operation of Boards are regular meetings to review their performance and discuss issues related with the overall performance of corporation.121

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117 The US Lehman Brothers Holdings Inc was the fourth largest investment Bank in the USA. Its collapse in 2008 was the largest collapse in the American history. The Bank had 11 directors, 10 of them Non-Executive Directors and 1 Executive Director who was also the chairman and CEO of the Bank. From these 10 Non-Executive Directors there was only 1 member who had recent experience. Many studies indicated that the Non-Executive Directors might have been appointed for reasons other than their expertise. See, eg. Dennis K Berman, ‘Where Was The Lehman Board?’ [2008] Wall Street Journal Blog, Deal Journal <http://blogs.Wsj.com/deals/2008/09/15/where-was-lehmans-board/>.


119 See the discussion in chapter 3 [3.4] for further discussion concerning this Bank.

Regular evaluation is also important in relation to Board members’ performance and whether these members have the required skills, knowledge and expertise.\textsuperscript{122} The importance of this has been recognised in the 2014 UK Corporate Governance Code which provides that FTSE 350 companies should have an external facilitator formally evaluate the Board and its membership every 3 years.\textsuperscript{123} This recognises the crucial role of the Board and its Committees and the need to ensure Board and Committee independence. It is also recognised in the UK code provision that FTSE 350 companies should have an annual election for all directors.\textsuperscript{124} This is an important step in empowering shareholders to call to account directors and Board Committee members in their supervision of the company. The Australian Stock Exchange (ASX)\textsuperscript{125} Corporate Governance Council (CGC) in 2013, recommended 8 general

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\begin{itemize}
\item \textsuperscript{121} For example, in Jordan, “the Bank’s Board meetings take place at least six times a year”. See Ibid chapter Ch 2, 12. Also see chapter 7 for further discussion.
\item \textsuperscript{122} As to the importance of the evaluation process, see Bob Tricker, \textit{Corporate Governance: Principles, Policies, and Practices} (Oxford University Press Inc, New York, 2009) 314. In Jordan, for example, the CBJ Code states that “at least annually assesses its own performance as a Board. There is a formal annual evaluation of the General Manager by the Board”. See Central Bank of Jordan, \textit{Corporate Governance Code for Banks in Jordan} (2007) (‘CBJ Code’), ch 2, G 14 <http://www.cbj.gov.jo>. See the discussion in chapter 7 for further discussion concerning the separate the role of the Chairman and CEO in Jordan.
\item \textsuperscript{124} The FRC reported for 2013 that all but two FTSE 350 companies have complied with this Code requirement, see Ibid.
\item \textsuperscript{125} The ASX was created by the merger of the Australian Stock Exchange and the Sydney Futures Exchange in July 2006. It is the primary stock exchange group in Australia. Moreover, underpinning ASX’s activities as a market operator is the quality of the monitoring and enforcement of compliance with its operating rules performed by its wholly owned subsidiary, ASX Compliance. By providing its systems, processes and services reliably and fairly, ASX seeks to promote confidence in the markets that depend on its infrastructure. This is integral to ASX’s long-term commercial success. Furthermore, ASX offers products and services including shares; futures, exchange traded options, warrants, contracts for difference, exchange traded funds, real estate investment trusts, listed investment companies and interest rate securities. See http://www.asx.com.au.
\end{itemize}
principles for good governance,\textsuperscript{126} (see Appendix [F]). In relation to Board of Directors, it recommended that there is in place:

The process for recruiting a new director, including evaluating the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, preparing a description of the role and capabilities required for a particular appointment.\textsuperscript{127}

The Board members need to evaluate their ability to work efficiently together in making decisions as well as identifying any problems.\textsuperscript{128}

An important point that emerged in the research interviews was that the formal annual Board evaluation is not the only opportunity for boards to assess themselves and implement improvements. In a good board, evaluation is a continuous process, problems are ironed out as and when they are recognised.\textsuperscript{129}

The effectiveness of Board members will be greatly improved if these members, Non-Executive Directors, in particular, have the opportunity to get together outside of formal Board meetings to discuss matters that could not fall within the formal agenda.\textsuperscript{130} Non-Executive Directors can provide a mix of expertise, knowledge, and independence of judgment to the institution. They are a mechanism for responding to agency issues. The next section deals with Non-Executive Directors.


\textsuperscript{127} See Ibid principle 2, recommendation 2.4, 17.

\textsuperscript{128} Alice Klettner and Thomas Clarke, ‘Board Performance Evaluation Post-Financial Crisis’ (2011) 63 (4) \textit{Keeping Good Companies} 200, 205.

\textsuperscript{129} Ibid 206.

\textsuperscript{130} Ibid.
2.3.2.3. Non-Executive Directors

Non-Executive Directors bring knowledge, experience and external expertise to the business. They are expected to provide independent review of strategies and processes as they have the “ability to engage with the outside environment in a dispassionate way.” The presence of Non-Executive Directors on Boards is now the standard in most countries. For example, in Australia in 2008, across the top 300 institutions (by market capitalisation), about 74% of directors were Non-Executive Directors, increasing to 80% for top 50 institutions. In the UK, in relation to FTSE 350 companies, the code provides that at least half the members of the Board should be independent Non-Executive Directors. The most recent UK Financial Reporting Council annual survey of code compliance with minimum requirements for independent Non-Executive Directors, reported 87% compliance by FTSE 350 companies and 99% compliance by smaller companies. In Jordan, the Central Bank of Jordan (CBJ) Code requires that “to foster an independent element within the

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133 Financial Reporting Council, The UK Corporate Governance Code (September 2014) B 1 <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>. Smaller companies should have at least two independent Non-Executive Directors on the Board, ibid. See also Appendix [E].

134 The 2013 UK report on code compliance shows high levels of compliance, see Financial Reporting Council reporting the annual survey of Grant, Thornton and Manifest – The Proxy Voting Agency, see Financial Reporting Council, Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes (December 2013), 11 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>. There are differing requirements for FTSE 350 companies and smaller companies. The Code requires FTSE 350 companies to have a majority of independent Non-Executive Directors on the Board; smaller companies require only 2 Non-Executive Directors, ibid. See also chapter 4.
Board, the Bank’s policy is that the Board should have at least three Non-Executive Directors and the majority independent members.”

The Board of Directors with a significant proportion of Non-Executive Directors are more efficient in monitoring executive managers. Consistently with this, a study by Byrd and Hickman, found a positive relationship between the institution’s performance and the number of Non-Executive Directors on the Board of Directors. This study found that Non-Executive Directors can contribute both objectivity and expertise in assessing and monitoring the decisions of the executive managers and consequently are a powerful governance mechanism.

Byrd and Hickman in their study also evaluated the relationship between Non-Executive Directors and the returns to shareholders of bidding corporations in tender offers. Non-Executive Directors can bring greater objectivity to assessing the benefits and costs of an acquisition for the company and shareholders, especially when there is executive self interest which conflicts with the interests of the shareholders.

Where independent Non-Executive Directors are the majority on the Board, they can effectively block unprofitable acquisitions. Even if independent members do not have the majority vote, they can affect the process of the acquisition by voicing their concerns which may persuade other Board members. The study by Byrd and Hickman  

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139 Ibid.
found a positive relationship between the ratio of independent Non-Executive Directors on the Board of Directors and acquisition profitability.\footnote{Ibid.}

However, the mere fact that there are Non-Executive Directors on the Board does not, of itself, guarantee effective monitoring of the company and management. In order to be effective Non-Executive Directors must be active, independent and committed to their duties on the Board. Part time, inexpert Non-Executive Directors may not be effective in achieving proper corporate governance. Non-Executive Directors may also lack the experience and knowledge of executive members. They may also not be willing to undertake a confrontational role which may sometimes be necessary to ensure that there is proper supervision. Furthermore, the CEOs have been able to use their power to influence Non-Executive Directors. As discussed above,\footnote{See section [2.2.2].} a 1997 study found that the CEOs of the Fortune 500 corporations between 1992-1994 had been able to influence their remuneration packages in advance of favourable results.\footnote{David Yermack, ‘Good Timing: CEO Stock Option Awards and Company News Announcements’ (1997) 52 (2) The Journal of Finance 449.} A later 2010 study found that one cause of the US Lehman Brothers collapse in 2008 was because the top five executives of Lehman Brothers cashed out large amounts of performance-based remuneration in the period 2000 to 2008; they received about $1 billion from cash bonuses and equity sales during this period.\footnote{See Lucian A Bebchuk , Alma Cohen and Holger Spamann, ‘The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008’ (2010) 27 (2) Yale Journal on Regulation 257. See chapter 3 [3.4] for further discussion concerning the Lehman collapse.}

The Board and its committees were not effective in preventing this self interested profit taking. Nor have Boards and their committees been a significant restraint on
risk taking by banks. In the UK, one of the reasons for the UK Northern Rock collapsed in 2008 was because:

…The Non-Executive members of the Board, and in particular the chairman of the Board, the chairman of the Risk Committee and the senior Non-Executive Director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.  

Therefore, the critical question is whether the evidence supports the view that Non-Executive Directors are in fact independent and in fact provide a monitoring role. Independent directors have an important role in controlling the performance of the executives and limiting executive self interest. A series of empirical studies suggest that where directors are independent this provides better control. Some of the older literature suggested that the institutions work better if Boards contain at least three Non-Executive Directors with a majority of independent members. Boards with a higher numbers of independent directors can increase the quality of control over management provided that they are “independent representatives of the shareholders’ interests.” In the UK, the 2013 statutory amendments provide for binding shareholder votes on directors’ remuneration, thus subjecting directors’

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147 Karen Pincus, Mark Rusbarsky and Jilnaught Wong, ‘Voluntary Formation of Corporate Audit Committees Among NASDAQ Firms’ (1989) 8 (4) *Journal of Accounting and Public Policy* 246, 239.

148 See the UK Enterprise and Regulatory Reform Act 2013. Note the Broad definition of ‘director’ in the UK Companies Act 2006, s.250 which can apply to Managing and Executive Directors. Note also
remuneration for scrutiny and evaluation by shareholders and reducing the risk that the CEO may seek to win favour by providing excessive benefits to directors. There is also provision requiring director’s service contracts which are for more than two years, (or maybe) to be approved by shareholders.  

In the banking sector, independent monitoring is especially important in managing risk. Chapter 3 refers to some of the key factors leading to the 2008 GFC. One of these factors was how remuneration structures encouraged risk taking by executive management. In this respect the Board, and particularly Non-Executive Directors, in theory, perform a crucial role. The Cadbury Report said on this issue:

An essential quality which Non-Executive Directors should bring to the Board’s deliberations is that of independence of judgement. We recommend that the majority of Non-Executives on a Board should be independent. This means that apart from their directors’ fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the Board to decide in particular cases whether this definition is met. Information about the relevant interests of directors should be disclosed in the directors’ report.

Although shareholders can’t directly check management behaviour, they can influence their behaviour by making managerial pay dependent on performance measures that the Board and shareholders are able to monitor. Effective monitoring by

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149 See The UK Companies Act 2006, ss188,189.

150 See chapter 3.

151 This was recognised by the Basel Committee. See Bank for International Settlements, Basel Committee on Banking Supervision: Principles for Enhancing Corporate Governance (October 2010), 10 <http://www.bis.org/publ/bcbs176.pdf>.

the Board, and particularly by Non-Executive Directors, reduces the power of management to use their power to influence their own remuneration packages.\textsuperscript{153}

A study by Fernandes examined the link between the structure of the Board of Directors, the company’s performance and executive remuneration. The study examined whether the structure of the company’s governance affects management remuneration. Particularly, the study considered the Non-Executive Directors role as mediators between the shareholders and management.\textsuperscript{154} The authors used as a sample 51 companies listed on the Portuguese Stock Exchange from 2002 to 2004. The study categorised these companies into three groups (large, medium and small) based on their market capitalisation.\textsuperscript{155} The study found that top executives have higher remuneration when the listed companies have more Non-Executive Directors suggesting that Non-Executive Directors did not have an effect on limiting executive remuneration. Companies which did not have Non-Executive Directors have fewer agency problems as well so achieving a better alignment of the interests of managers and shareholders. It concluded that in practice Non-Executive Directors do not play a large role in protecting shareholder interests.\textsuperscript{156} What is unknown is whether these findings translate into different legal, financial and cultural environments. It does suggest that it is crucial that Non-Executive Directors are truly independent and that steps should be taken to ensure this independence, (see the discussion below).


\textsuperscript{155} Ibid 32.

\textsuperscript{156} Ibid 43.
From the viewpoint of shareholders, Boards have failed to rein in excessive remuneration to executive management. On one level this might be seen to be a failure of Non-Executive Directors to bring some discipline to the Board. Some jurisdictions have responded to the failure of Boards to check excessive remuneration by vesting greater powers in the shareholder meetings. In Australia, for example, there is the Two Strike rule which allows a spill of the Board and the requirement of a new Board election. In UK, there is the Clawback provision which attempts to deal with the mismatch between remuneration and executive performance. The Two Strike rule and Clawback provisions are discussed below.\textsuperscript{157}

What is in question is the independence of Non-Executive Directors. If they have been captured by management, then any supervisory or monitoring role is compromised. The various Codes suggest criteria for determining independence. The ASX CGC deals with the issue of independence; there will not be the requisite independence if the director:

is, or has been, employed in an executive capacity by the entity or any of its related entities and there has not been a period of at least three years between ceasing such employment and serving on the board; is, or has within the last three years been, a partner, shareholder, director or senior employee of a professional adviser or consultant to the entity or any of its related entities; is, or has within the last three years been, a material supplier or customer of the entity or any of its related entities, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer; is a substantial shareholder of the entity or an officer of, or otherwise associated directly or indirectly with, a substantial shareholder of the entity; has a material contractual relationship with the entity or its related entities other than as a director; has close family ties with any person who falls within any of the categories described above; or has been a director of the entity for more than 9 years.\textsuperscript{158}

\textsuperscript{157} See the discussion at [2.3.2.5, IV].

The 2014 UK Corporate Governance Code also sets out criteria for independence, (see Appendix [E]). The UK Code goes further in requiring the Board to indicate its view in the Annual Report that the Non-Executive Director is independent and provide reasons for this assessment. In this way the Board takes responsibility for assessing independence of Non-Executive Directors. This is a powerful mechanisms for promoting an independent Board and membership of independent Non-Executive Directors.

In Jordan, the 2007 Central Bank of Jordan (CBJ) Code states that:

An independent Director, whether natural person or representing legal entity, is one whose directorship constitutes his only connection to the bank, and whose judgement is therefore unlikely to be influenced by external considerations.

These definitions of independence will cover the most obvious cases where objectivity may be compromised. But as the GFC and measures to deal with excessive remuneration suggest, these do not guarantee that Non-Executive Directors in fact exercise independent judgment and effectively monitor management.

The drive for independent Non-Executive Directors is not assisted by corporate governance Codes where there is no mandatory requirement that Non-Executive Directors are appointed or be independent. Nor are there any penalties for failure to ensure the independence of Non-Executive Directors. Chapter 8 will make recommendations for Jordan in this respect.


161 Ibid.
Principles of good corporate governance respond to the agency problems of aligning the interests of shareholders with that of management. Another principle which responds to the agency problem is the separation of the role of Chairman and CEO.

2.3.2.4. Separation of Chairman and CEO Roles

The Chairman is appointed by the Board of Directors and presides over the Board. The Chair’s duties include promoting a constructive relationship between the Board and executive management, and between the executive directors and Non-Executive Directors. The duties of the Chairman and the Board are interrelated. The Chair speaks on behalf of the Board and acts as its representative. The Chair does not have independent authority as the Chair’s authority is derived from the Board.162

The Board of Directors appoints the CEO. The CEO is accountable to the Board for the management of the institution. The CEO’s duties include providing leadership and management in running the institution, developing and monitoring, organizational strategies and ensuring effective internal controls are in place. The CEO can influence Board decisions concerning the new membership on the Boards and Board Committees, prescribing the agenda for the Board, control of the decisions made by the Boards as well as the directors’ compensation.163


163 See Melissa Middleton, 1987 ‘Nonprofit Boards of Directors: Beyond the Governance Function’ in Walter W Powell (eds), The Non-profit Sector: A Research Handbook (New Haven, CT: Yale University Press, 1987), Chapter 8, 141. In relation to Director’s remuneration, the UK requires shareholder approval, see the UK Enterprise and Regulatory Reform Act 2013. Note the Broad definition of ‘director’ in the UK Companies Act 2006, s.250 which can apply to Managing and Executive Directors. Note also further requirements relating to disclosure of remuneration in remuneration reports, The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.
The CEO’s power over the process of appointment of directors is considered a source of control by management. A 1989 survey of Fortune 500 directors reported that Boards usually do not have significant influence over the process of appointment of new directors but CEOs are a powerful force in getting the people they want on the Board and getting rid of less favoured directors. The CEO is able to exert this influence over Board by being able to persuade major shareholders to appoint particular Non-Executive Directors who are likely to be compliant with the CEO’s views. By identifying members who have similar views about management and strategy, CEOs can improve the support of the Boards for their decisions and decrease any conflicts.

One of the responses to the agency problem is to separate the role of Chairman of the Board from that of the CEO. The separation of the roles of Chair of the Board and the CEO is more likely to ensure that the Board effectively monitors and demands accountability for the performance of the institution and for the protection of shareholders and stakeholders interests. There appears to be an obvious conflict between the monitoring and supervisory role of the Board and a CEO as chair of the

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166 Ibid 77. In the UK, the Financial Reporting Council stated that there was no formal evidence that troublemakers were moved on, see Financial Reporting Council, Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes (December 2013), 13 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>. But this didn’t rule out defects in the appointments process.


The Board meeting represents the main assembly for directors to challenge the performance and decisions of the CEO. Where the CEO is also Chair of the Board this provides opportunities to restrict the agenda and limit discussion of issues.

There are also practical considerations:

...one logic of the separation of the roles of chairman and chief executive was simply the sheer scale of the task in a growing organisation; there is work for two at this level in a public company. But it is immediately obvious that the division of responsibilities for the Board and business does not and cannot in practice delineate respective domains of autonomous action for the individuals involved. Instead the separation of the roles has to be understood as the creation of a pivotal relationship between what are arguably the two most powerful figures in a company. The UK Cadbury Report (1992), although supporting the separation of roles, did not recommend that it should be mandatory.

Given the importance and particular nature of the Chairman’s role, it should in principle be separate from that of the Chief Executive. If the two roles are combined in one person, it represents a considerable concentration of power. We recommend, therefore, that there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the Board.

The separation of the roles of Chair of the Board and the CEO is more likely to ensure that the Board effectively monitors and demands accountability for the performance


of the institution and for the protection of shareholders and stakeholders interests. If the roles are not separated, other measures should be implemented to provide the necessary independence such as appointing an independent Board Committees to monitor their roles and mitigate any self interest. The recommended separation of roles has been followed in many jurisdictions. In Australia, in 2008, about 80% of all listed companies in ASX had separated the role of CEO and chairman. Because of the greater risks in relation to banks and financial institutions in Australia, amendment to the regulatory standards now require the position of CEO and Chair of the Board of Directors to be separated. In the UK there are high levels of compliance with this principle with 94% of FTSE 350 companies and 97% of smaller companies compliant. In Jordan according to a sample of the annual reports for the year ended 2010, 14 of the 15 listed banks separated the role of the chairman and CEO. This complies with the Central Bank of Jordan (CBJ) Code which provides:

The position of Chairman of the Board is separated from that of General Manager…The division of responsibilities between the Chairman and the General Manager has been set down in writing, is subject to review and revision from time to time as necessary, and is approved by the Board.

173 Such as in the case of the Australian American ‘Rupert Murdoch’ media magnate, where the father is the chairman and the son is the deputy chairman.


176 In the UK there are high levels of compliance with this provision, see Financial Reporting Council, Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes (December 2013), 11 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>.

177 See chapter 7 for further discussion.

It should, however, be remembered that it is the duty of the Board as a whole, not only that of the Non-Executive Directors, to make sure that the Chairman or CEO’s authority is exercised for the benefit of shareholders and the institution.\footnote{179}

The thesis’s specific emphasis is on the role of Board Committees in ensuring the good governance of banks. The next section examines Board Committees and their importance in ensuring the stability, efficiency and good governance of the corporation. Board Committees are also a measure to expand the expertise of the Board and also play an important role in mediating agency problems.

\section{2.3.2.5. Board Committees}

\section{I. Introduction}

The Board’s objectivity, independence, expertise and supervision of management can be improved by appointment of appropriate Sub-Committees such as Audit, Risk Management, Remuneration and Appointments Committees.\footnote{180} Board Committees are appointed by the Board of Directors and are responsible and accountable to the Board of Directors and shareholders.

Board Committees have very important duties. Committees are able to give more detailed and expert advice in relation to particular issues. They can also improve the Boards effectiveness by providing supervision of areas which give rise to special risks to the financial institution. Committees can require the institution to provide relevant


\footnote{180} Subject to their charter, Boards may appoint any other Committees they wish to handle particular areas of their duties such as a Corporate Governance Committee and a Compliance Committee. The thesis is concerned with the four main Committees.
information if needed and consult external consultants for financial, legal or technical advice.\textsuperscript{181}

One of the methods by which the independence, efficiency and expertise of the Board may be promoted is by establishing Board Committees. The duties of the Committees are to help the Board in their decision making.\textsuperscript{182} Board Committees assist the efficiency of the Board and make the work of the Board more manageable.\textsuperscript{183} Many countries recommend the establishment of Board Committees. In the UK, for example, institutions use four Committees, namely: the Audit Committee, the Risk Management Committee, the Remuneration Committee and the Appointments Committee. The usual rule is that only the Audit Committee is mandatory. The four Committees have also been recommended in Jordan. The 2007 Central Bank of Jordan (CBJ) Code states that:

\begin{quote}
The Board of Directors whether in listed or not listed banks shall form the following four Committees and appoint their members: Audit Committee, Risk Management Committee, Remuneration Committee and Appointment Committee. This accords with international practices.\textsuperscript{184}
\end{quote}

Although these Committees and their independence are important in monitoring the performance of executive management and Boards as well as mitigating any potential conflicts of interest between them, there is no mandatory requirement which requires the Committees to be independent, nor a mandatory requirement to have Board

\begin{footnotes}
\footnote{182}{Adrian Cadbury, \textit{Corporate Governance and Chairmanship: A Personal View} (Oxford University Press Inc., New York, 2002) 92-93.}
\footnote{183}{Ibid 93.}
\end{footnotes}
Committees, except the Audit Committee. In Australia, under the ASX Corporate Governance Code, it is not mandatory for Boards to appoint Board Committees except for S&P ASX 300 companies.\footnote{See ASX Corporate Governance Council, \textit{Corporate Governance Principles and Recommendations} (2013), 3\textsuperscript{rd} Ed, 21 <http://www.asx.com.au/documents/public-consultations/draft-cgc-3rd-edition.pdf>. Audit Committee (Principle 4, recommendation 4.1, 20); Remuneration Committee (Principle 8, recommendation 8.1, 29); Appointments Committee (Principle 2, recommendation 2.4, 16); and Risk Management Committee (Principle 7, recommendation 7.1, 26). Ibid. See also Appendix [F].} The ASX Listing requirements (mandatory for listed companies) Rules 12.7, 12.8 require S&P ASX 300 Listed companies to have Audit and Remuneration Committees\footnote{See APRA, \textit{Prudential Standards CPS 510 Governance}, 1 (January 2014) <http://www.apra.gov.au/CrossIndustry/Documents/Final-Prudential-Standard-CPS-510-Governance-(January-2014).pdf>. See also chapter 5.} and Remuneration Committees must have only Non-Executive Directors as members of the Committee.\footnote{Ibid, Rule 12.8.} But the importance of these Committees to the stability of the bank and its operations has been recognised in Australia by imposing additional formal mandatory requirements on regulated financial institutions, including banks; they are required to have audit and Remuneration Committees and from 2015 to have a Risk Management Committee,\footnote{See Eugene F Fama and Michael C Jensen, ‘Separation of Ownership and Control’ (1983) 26 (2) \textit{Journal of Law and Economics} 301, 317-318.} (see chapter 5).

In order to be effective, Committees members are required to meet and evaluate their performance regularly and they should have the necessary independence and expertise to be able to contribute to decision making and the control of management of the financial institutions.\footnote{See ASX, \textit{On-Going Requirements} (December 2013). Chapter 12, Rules 12.7 & 12.8, 1203 <http://www.asx.com.au/documents/rules/Chapter12.pdf>. Three of the four major Australian Banks are in the ASX 300 list, Commonwealth Bank of Australia, National Australia Bank, Westpac Bank, the ANZ Bank is not within that list.} It has also been recommended that the Committee...
membership be disclosed in the financial institution’s annual report together with the terms of reference and relevant arrangements for the Committee.\textsuperscript{190}

The Corporate Governance Codes referred to above generally do not make the appointment of Committees (other than the Audit Committee) compulsory nor are the meetings and evaluations compulsory, or that the Committees must be independent of management and other vested interests. Australia is the exception with the requirement that regulated financial institutions, including banks, are required to have Audit, Remuneration (and from 2015) Risk Management Committees.\textsuperscript{191} The final chapter will make recommendations relating to this issue. This section now turns to examine more closely the four Board Committees.

II. The Audit Committee

Many corporate collapses have been exacerbated by lack of independent auditors. Especially in relation to banks, an Audit Committee performs a critical role in reviewing auditor’s reports, monitoring the stability of the bank and protecting shareholders and depositors. As will be seen in chapter 3, there are special risks in the banking sector.

The Audit Committee is responsible for internal and external audit systems to provide oversight and independent review of the financial stability of the company. The Audit Committee’s role includes monitoring the internal control system as well as audit management. Best practice also requires that the Committee evaluates its performance as well as the performance of its members and the Chair of the Committee. This

\textsuperscript{190} Chapter 7 discusses the level of compliance with corporate governance rules by Jordanian Banks.

Committee is the only Committee that is normally mandated under the various corporate governance Codes. Although its members must be able to exercise independent judgment and have the relevant expertise to assess the financial position of the institution,\textsuperscript{192} there is no requirement that Committee members be independent. For example, in relation to the Enron collapse in 2001, the Auditor had a conflict of interest as it earned large consulting fees from Enron and had not appropriately advised the Board or Audit Committee of concerns about Enron's internal contracts over the related-party processes.\textsuperscript{193} In the UK, the FTSE 350 listed companies (which includes the larger UK banks) have additional code provisions. FTSE 350 companies need to put out to tender the contract for external audit at least every 10 years.\textsuperscript{194} This provision gives greater assurance of an independent audit particularly where accounting firms performed dual roles of auditor and advisor to companies.

Not all jurisdictions make Audit Committees mandatory. In relation to corporations generally, in Australia only the top 300 listed companies are required by the ASX to appoint Audit Committees.\textsuperscript{195} But regulated financial institutions, including banks, are required to have an Audit Committee under the Prudential Regulatory


\textsuperscript{195} Lois Munro and Sherrena Buckby, ‘Audit Committee Regulation in Australia: How far Have We Come?’ (2008) 18 (4) \textit{Australian Accounting Review} 310.
Standards. In Jordan, for example, all institutions are required to have Audit Committees under the law but there is no requirement that they be independent. The second Board Committee is the Risk Management Committee.

III. The Risk Management Committee

The Board appoints this Committee from its members. The Committee usually comprises directors and may also include executive management. In Australia, the Risk Management Committee should comprise least three members, at least two of whom must be independent Non-Executive Directors. The Board of Directors appoint the Chair of this Committee. Members must have appropriate experience and knowledge of the financial as well as operational and legal issues. Similarly, in Jordan, the Boards of Directors appoint the Risk Management Committee. The generally accepted practice is not to make this Committee mandatory. Australia has


199 Ibid

however mandated the establishment of this Committee for regulated financial institutions from 2015.\textsuperscript{201}

The Risk Management Committee is responsible for assuring responsible business behaviour in the light of the business risk exposure and promoting transparency and accountability in the controlling of risk.\textsuperscript{202} In Australia the Australian Stock Exchange Council states that the Risk Management Committee has a duty in checking the disclosure system and promoting balanced disclosure of all material matters concerning the institution to give fair and accurate financial results to investors and shareholders.\textsuperscript{203} The Committee therefore performs an important role in disclosure.\textsuperscript{204} In relation to regulated financial institutions in Australia, they are required to have a Risk Management Committee as part of the prudential standards.\textsuperscript{205}

In Jordan, the Central Bank of Jordan (CBJ) Code states that:

The review of risk management is handled by a Risk Management Committee. This Committee is comprised of directors and may also include executive management...The bank considers that the rapid development and increasing complexity of risk management requires that the Risk Management Committee keep fully informed of the developments in the bank’s risk management functions. Accordingly, the Committee makes regular reports to the full Board.\textsuperscript{206}


Risk Management requires the introduction and application of systems to manage, analyse and control risk. This includes advising the Board of any potential risks and the procedures which will be used to control them. In relation to banks, this Committee assumes particular importance. The areas of risk for banks relate to its liquidity, the capital adequacy system as well as systems for assessing risk, which is discussed further in chapter 3.\(^\text{207}\) Risk management needs to ensure adequate risk management and compliance systems for balancing and monitoring risk.\(^\text{208}\) In Australia there are specific provisions governing Risk Management Committees in regulated financial institutions applying from 2015.\(^\text{209}\)

Risk Management Committees did not prove to be effective in avoiding the 2008 GFC. In the case of Northern Rock it was found that:

…the chairman of the Risk Committee and the senior Non-Executive Director, failed… to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.\(^\text{210}\)

The problems may have been both issues of expertise in assessing and controlling risk and the lack of effective control by the Committee in monitoring risk. Regular evaluation, disclosure and meetings are necessary in evaluating independence of the Committee members. It will be argued in chapter 7 that in relation to banks and the problems with managing risks, this Committee should be mandatory as will be the

\(^{207}\) See the discussion in chapter 3 discussing the main risks affecting the Banks such as Systemic Risk, Liquidity and Credit Risks and the Basel requirements.


case from 2015 in Australia and that the onus should be on banks in relation to the independence of this Committee.

The third Board Committee is the Remuneration Committee.

IV. The Remuneration (Compensation) Committee

The usual practice is that the Committee members are appointed by the Board of Directors. For best practice, this Committee needs to include at least three Non-Executive Directors all with appropriate experience. Independent directors should be the majority of members and the Committee should also be chaired by an independent director. In Australia, at the time of the GFC, 98% of the top 50 institutions (by market capitalisation) had Remuneration Committees. The ASX300 companies are now required to have a Remuneration Committee as are regulated financial institutions. In Australian in relation to the ASX top 300 companies all members of

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212 In Jordan, for example, the CBJ Code states that: ‘the Appointments and Remunerations Committee comprises a minimum of three Non-Executive Directors, the majority (including the Committee chairman) are independent. See Central Bank of Jordan, Corporate Governance Code for Banks in Jordan (2007) (‘CBJ Code’), ch. 3. C, I, 17 <http://www.cbj.gov.jo>. Also see chapter 7.


remuneration committees must be Non-Executive Directors.\textsuperscript{215} In the UK, there are high levels of compliance with the code provision relating to membership of the Remuneration Committee.\textsuperscript{216}

The setting and evaluation of appropriate executive remuneration is one of the main responsibilities of the Committee. The Committee ensures that the executive remuneration packages are subject to appropriate performance indicators and appraisal and are fair remuneration for talent. The point of this Committee is to reduce the agency problem whereby executive officers control their own remuneration.\textsuperscript{217}

This requires regular disclosure, meetings and evaluations by the Committee members to make sure that there is a balance between the executives’ performance and their remuneration packages.\textsuperscript{218} Cadbury (2002) commented that:

First, the more demonstrably pay is related to performance, the better both for the recipients and for the shareholders. Second, the reverse side of that coin, the less that is paid for failure whether by keeping contracts short or through mitigation, the less contentious the parting. Finally, the one benchmark which remuneration committees can and should take into account in setting the level of pay of top executives is how their remuneration fits into the pay structure of the company as a whole. The results which companies achieve are due to the efforts of all those who have contributed to them. There needs to be an acceptable relationship between the pay of the average employee, that of the different levels of management and that of the executive directors.\textsuperscript{219}

\textsuperscript{215} Three of the four major Australian Banks are in the top 300, CBA, WBC, NAB; ANZ is not within this group.


\textsuperscript{217} Idalene F Kesner, ‘Directors’ Characteristics and Committee Membership: An Investigation of Type, Occupation, and Gender’ (1988) 31 (1) \textit{Academy of Management Journal} 66.


The standard practice is that there is no mandatory requirement that corporations have a Remuneration Committee or that it be independent. This enabled executives to control their remuneration packages without any independent control by the Board. In Australian ASX 300 companies are required to have a Remuneration Committee as are regulated financial institutions.  

As noted earlier, this is the typical agency problem where bank’s executives profit at the expense of shareholders. Banks’ remuneration packages were typically structured in ways which encourage executives to take excessive risk to provide high returns in the short term without acknowledging the longer term risks to banks, shareholders and depositors. A study by Bebchuk et al shows that in the period 2000-2008, the top executive officers of Lehman Brothers bank earned about US$1 billion from equity sales as well as the cash bonuses. Many of bonuses of these officers were paid by way of bank stock. There was no evidence that the Board or its Committees acted to rein in excessive remuneration or took any measure to reduce risk taking by executive management.  

This problem of the lack of linkage between remuneration packages and performance has led countries such as Australia and UK to introduce new mechanisms which

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221 See also Razeen Sappideen, ‘Corporate Governance and the Surrogates of Managerial Performance’ (2011) 34 (1) UNSW Law Journal 136, 148.

provide a disciplinary effect. These are respectively the ‘Two Strikes’ rule and the ‘Clawback’ provision.

Turning first to the ‘Two Strikes’ Rule and other mechanisms to monitor executive compensation. The problem of the lack of linkage between remuneration packages and performance has led Australia to introduce a range of measures including the “two strike” rule. Following the 2008 GFC, the Productivity Commission\textsuperscript{223} was asked to examine the efficiency of the Australian existing system in providing oversight, transparency, and accountability of remuneration processes as well as make recommendations as to how the existing system might be improved.\textsuperscript{224} Its report in 2011 found that executives and directors were voting on their own remuneration packages. It recommended the introduction of legislation known as the Two Strikes rule.\textsuperscript{225} The \textit{Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011}, effective from July 1, 2011, was enacted with the main goal to limit excessive executive remuneration.\textsuperscript{226} The objective of the legislation is to empower shareholders to hold directors accountable for the decisions they make relating to the remuneration of the executive management, enhance the capacity of Board members, decrease conflicts of interest, encourage appropriate remuneration strategies and stakeholder engagement, and enhance relevant disclosure.

The key features of legislation include:

\begin{itemize}
\item \textsuperscript{223} It is an Australian governmental independent research and advisory system on a number of social, economic, and environmental matters. See \url{http://www.pc.gov.au/}.
\item \textsuperscript{225} Ibid 296.
\item \textsuperscript{226} See \textit{Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011}.
\end{itemize}
i. No Vacancy Rule: many corporations’ constitutions permit the Board members to announce that there are no available positions even when the maximum number of Board members permitted by the constitution has not been reached. The new legislation requires public corporations to obtain the approval of shareholders for this.\textsuperscript{227}

ii. Voting: the Australian \textit{Corporations Act 2001} does not prevent Board members and executive management from participating in the non-binding vote on remuneration. It does however prevent key management personnel, as well as their closely related parties who have shares, from voting on their own remuneration packages. In relation to proxies, there are provisions aimed at preventing the selective use of proxies. Currently, the Act requires all proxy holders to cast all of their directed proxies on all decisions taken on a poll. When a non-chair directed proxy does not vote on the decision or is not registered as attending the AGM, the proxy may default to the chair,\textsuperscript{228} who needs to vote all proxies as directed.\textsuperscript{229} When there is no vote to these undirected proxies, this is considered an offence.\textsuperscript{230}

iii. Remuneration Consultants: many Board members get remuneration consultants to get advice on issues relating to remuneration processes. This assists corporations benchmark their remuneration against comparable employers. This may increase the possibility of conflicts of interest where remuneration consultants directly report to executive management. The 2011 amendments require the disclosure of the remuneration consultants’ reports directly to Remuneration Committee or Non-

\textsuperscript{227} Ibid section 9, 201 N; 201 P.

\textsuperscript{228} See Corporations Act 2001, section 250BC.

\textsuperscript{229} Ibid section 250BB.

\textsuperscript{230} Ibid.
Executive Directors rather than the executive management. The 2011 amendment also requires the Board of Directors or the Remuneration Committee to sign off on the selection of a remuneration consultant.

iv. Two Strikes rule: the legislation sets out the following steps involved in the two strike rule. The first strike occurs when a vote of more than 25% or more of the eligible votes cast are against adopting the remuneration statement.\(^{231}\) Immediately following the introduction of the two strikes rule, during the 2011 AGM season, over 100 Australian listed companies (or about 5% of all listed companies) received a first strike,\(^{232}\) (see below).

The institution will receive its second strike if a decision to adopt the remuneration statement for the following year gets a second "no" vote of 25% or more of the votes cast. If this occurs, a spill resolution must be put to the AGM. If this is passed by a majority of eligible votes cast, directors will immediately cease to hold office and a special spill meeting must be convened.\(^{233}\) A spill meeting must be held within 90 days.\(^{234}\)

All directors must stand for re-election and will cease holding office immediately unless re-elected.\(^{235}\) This is except for the managing director, who is allowed to hold

\(^{231}\) *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act* 2011, 250 U (B).


\(^{233}\) *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act* 2011, 249L (2).

\(^{234}\) Ibid section 250V.

\(^{235}\) Ibid section 250V(1).
office without re-election\textsuperscript{236} or any director elected after the new remuneration statement was agreed to by the Board of Directors. If the institution does not hold the spill meeting in the 90 days following the passing of the spill resolution, Board members may be subject to criminal fines.\textsuperscript{237}

The Productivity Commission recommended, and the legislation implemented, a threshold level of a 25% "no" vote for each strike. This was regarded as sufficient to indicate serious shareholder concerns about the level of remuneration. Consequently, the legislation reflects the view that the Board and Board Remuneration Committees had not exercised sufficient disciplinary control over remuneration levels for senior management. The remedy, a spill of the Board, reflects the legislative view that effective Board and Remuneration Committee supervision can be achieved by effective Board members.\textsuperscript{238}

Listed companies that have received a ‘first strike’ are required in their remuneration statements in the following year to respond to the concerns of shareholders by explaining what actions have been taken or not taken in response to those concerns.\textsuperscript{239}

One of the criticisms is that:

\begin{quote}
\ldots because a "no" vote is triggered by 25\% of the votes actually cast, a small percentage of disgruntled shareholders who choose to vote can determine the result. The views of shareholders who may have no objection to the remuneration report, but who do not cast a vote, cannot be considered.\textsuperscript{240}
\end{quote}

\begin{footnotes}
\item[236] Ibid section 250W.
\item[237] Ibid section 250W(6).
\item[240]\end{footnotes}
There were 25 listed companies in the S&P/ASX300 index which received a first strike under the 2011 amendments. The following Chart illustrates the percentage of votes cast that were against Remuneration Reports for companies which received first strike.

Chart 2.1. S&P/ASX300 First Strikes

![Chart](chart2_1.png)

Source: ISS analysis

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The above Chart illustrates that the voting against the Remuneration Reports ranged from 25% to 55.7%. The following Chart illustrates the percentage of first strike votes as a percentage of total available votes.

Chart 2.2. S&P/ASX300 First Strikes as % of Total Vote Available as at June 2011

Source: ISS analysis

242 Ibid.
The above Chart illustrates that the negative votes cast were below 25% of the overall available votes in 21 companies and above 25% or more of the overall available votes in 4 companies.

A 2012 study states that:

The low voting on Remuneration Reports will need to be addressed through companies engaging with their shareholders to ensure that they: appreciate that the company’s remuneration policies and practices are reasonable and appropriate to the company’s circumstances, and exercise their voting rights in support of the Remuneration Report resolution. Otherwise, it may be open to an active minority to use Remuneration Report voting and a potential spill of the board to pressure the board to comply with its priorities which may be unrelated to KMP (Key Management Personnel) remuneration matters.

A later 2013 study found that in relation to most of the companies which received a first strike there was only a small minority of shareholders that voted against the remuneration report. Chart 2.1 above illustrates that 16.8% is the average shareholding percentage that led to a first strike.

The voting outcome is also affected by the voting restrictions applying to Key Personnel, who may be significant shareholders. The restrictions prohibit Key Personnel and their closely related parties from voting on the remuneration report and spill resolution, and voting undirected proxies on remuneration related resolutions. These restrictions do not apply if the member of Key Personnel is the chair of the meeting and the shareholder has expressly authorised the chair to vote undirected proxies, even on resolutions relating to remuneration...Members of Key Personnel cannot vote on the remuneration report or a spill resolution but there is no exclusion of their votes at any spill meeting that follows. This means that companies may be put to the considerable expense and disruption of holding a spill meeting, the outcome of which may be determined by Key Personnel who are entitled to vote for their own re-election.

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245 Ibid.

246 Ibid.
Despite this negative view of the two strikes rule, the rule encourages accountability for remuneration and performance both by the Board and its Remuneration Committee as well as executive management. As the rule is still relatively new, it needs more time to evaluate the influence of the reform on the remuneration practices and the monitoring role of the Board and the Remuneration Committee. As observed earlier the low number of spill decisions does not demonstrate that the provisions are not effective; it may indicate greater and more effective supervision and monitoring by Boards and Remuneration Committees.

The UK approach to deal with excessive remuneration is known as Clawback. Because of the linkage between remuneration packages and excessive risk taking, UK since 2009 has implemented a mechanism known as the Clawback Provision. This provision allows the corporation to take back previous performance-based payment based on restated financials. This occurs when the performance of the corporation turns out to have been exaggerated at the time the payment was paid or when the Corporation finds that the executive members were acting in breach of their employment contracts at the time when the payment was made.247

The Clawback provision can be viewed as a method of changing the internal corporate culture of the banks. It addresses the problem of executive officers manipulating their remuneration packages to maximise executive’s return, a typical agency problem discussed above.248 Potentially the Clawback provision benefits the

247 All financial services companies regulated under the Prudential Regulation Authority (PRA) are required to amend existing employment contracts allowing bonus awards to be subject to Clawback. The Remuneration Code (SYSC 19A) of PRA includes 'malus' provisions which prohibit the payment of bonuses which have not yet become totally payable to the employee. See http://fsandbook.info/FS/html/handbook/SYSC/19A.

248 See the discussion at [2.2.2].
shareholders, investors and in relation to banks’ depositors as they all have an interest in mitigating the financial risks and ensuring the banking system is safe and stable. This provides an incentive to avoid excessive risk-taking to achieve short-term benefits, one of the problems implicated in the GFC.249

In relation to banks, the regulator, the Bank of England250 and the Prudential Regulatory Authority (PRA)251 have adopted the former Financial Services Authority (FSA)252 policy.253 It sets out the principles that banks, building societies and designated investment institutions need to meet when setting remuneration packages and payments.254 The main objectives are to ensure that the institution has risk-focused remuneration strategies which lead to effective risk management, promote financial confidence and stability by decreasing the incentives for inappropriate risk taking by the institution.255


250 The Bank of England is a crucial plank in the UK regulatory system governing Banks. It (formally the Governor and Company of the Bank of England) is the central and reserve Bank in UK. See chapter 4 for further discussion.

251 Similar to the Australia regulatory model ‘Twin Peaks’ model which appeared to diminish the impact of the 2008 GFC in Australia, see chapter 5, the UK regulatory system has adopted its own ‘Twin Peaks’ regulatory model to replace the old “tripartite” framework. The new model established the PRA. See chapter 4 for further discussion.

252 The FSA was the regulator for investment business, insurance and banking under the Financial Services and Markets Act (FSMA) 2000. The FSA’s goals include promoting public awareness of the financial system; maintaining confidence in the financial system; and securing the appropriate degree of protection for customers. It has since been replaced, see chapter 4 for further discussion.

253 The Remuneration Code (The Senior Management Arrangements, Systems and Controls (SYSC) 19A sourcebook of the PRA’s Handbook) with effect from the 25th of September 2012.

254 For example, SYSC 19A.3. Remuneration principles for Banks, Building Societies and Investment Firms 3 R (2) states that “When establishing and applying the total remuneration policies for Remuneration Code staff, a firm must comply with this section in a way and to the extent that is appropriate to its size, internal organisation and the nature, the scope and the complexity of its activities.” This Principle and other Remuneration Principles are available from http://fshandbook.info/FS/html/handbook/SYSC/19A/3.
In March 2014, the Bank of England and PRA published a consultation paper on extending the Remuneration Code to require all the authorised institutions of PRA to amend employment agreements to have the ability to implement the Clawback provision. Presumably this was to ensure that the Clawback provisions were consistent with contractual responsibilities.

In accordance with the Remuneration Code principles, the institution needs to be able to Clawback remuneration when there is clear evidence that there is improper conduct or material error and where there is material failure in the institution’s financial performance. When there is risk management failure, Clawback may be applied to staff who, being aware of the risk, did not take sufficient steps to appropriately deal with the issue. Senior staff may bear greater responsibility.

Where the proposal is successful in clawing back vested variable remuneration, firms will benefit from recouping variable pay. In addition, requiring firms to be able to apply Clawback to the vested variable remuneration could lead to longer vesting periods of executive remuneration, which could discourage short-termism. If this proposal is successful in achieving its aims of curbing excessive risk-taking and short-termism, it will help the PRA to achieve both its objective to promote the safety and soundness of firms and its objective to facilitate competition.

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256 Under the UK Financial Services and Markets Act (FSMA) 2000, PRA published this paper to improve incentives for sound risk management which is consistent with the objective of PRA to provide soundness and safety to companies. See FSMA 2000 Section 2B.


258 Ibid.

259 Ibid.

The rule will come into operation on January 1, 2015. It will require employment contracts to be amended to allow Clawback even in relation to bonuses and remuneration that are vested. It allows Clawback for a period of 6 years after vesting consistent with the usual period for enforcement of contracts.\textsuperscript{261} Clawback can apply to bonuses up to 6 years after they were paid even if the bonuses had been deferred. All bonuses paid after 1\textsuperscript{st} of January 2015 will be subject to the new rules. The rules have been criticised.

While any measure to reduce excessive risk-taking by bankers at the expense of taxpayers is a step in the right direction, there is doubt that a clawback is as effective as a limitation on bonuses…Limiting variable compensation reduces incentives ex-ante, clawbacks impose the burden on regulators to prove wrong-doing after the fact. And not every excessive risk-taking can be classified as wrong-doing. So, this seems very much a second-best approach.\textsuperscript{262}

The critical question is whether Clawback achieves its goal of moderating remuneration, linking remuneration to performance and reducing risk taking. There is also the broader question whether Clawback has an affect on the institution’s value in UK.

The Clawback provision has been adopted in the US following the 2008 GFC. The \textit{Dodd-Frank Wall Street Reform and Consumer Protection Act} or \textit{Dodd-Frank Act} \textit{2010} authorises each institution listed on the USA’s national exchange to adopt the Clawback provision to recover extra incentive remuneration. Currently the US Securities and Exchange Commission (SEC) is considering whether this provision should be mandatory rather than voluntary.\textsuperscript{263}

\textsuperscript{261} Ibid 3.


\textsuperscript{263} See \textit{Dodd-Frank Wall Street Reform and Consumer Protection Act 2010} sections 529; 954.
A study by Chen et al 2014 found that in 2006, only 20 US institutions in the Fortune 1000 had voluntarily adopted the Clawback provision; in 2010, more than 400 institutions had adopted the provision. The study found that an institution will be more likely to voluntarily adopt such a provision when the CEO has less risk aversion, earnings are less volatile, or the manager’s internal accounting data quality is high. The study also suggests that voluntary adoption of the Clawback is connected with high sensitivity of the CEO payment to accounting performance, high level of the CEO payment and high reporting quality. The study concluded that:

The total level of CEO pay and the sensitivity of CEO incentive pay to accounting performance are significantly higher in the presence of a voluntary Clawback provision. For example, compared to the case of no provision, the use of a provision is associated, on average, with a sensitivity of incentive pay to Return on Assets (ROA) that is more than twice as high. The total level of annual CEO pay is approximately 6.3% higher, on average, when a Clawback provision is present versus otherwise.\(^\text{264}\)

The study also found that when investors employ a risk-averse manager to improve the earnings’ values with costly, productive effort, these also provide the manager with short-run remuneration incentives. However, such short-term remuneration may also provide the manager with the chance to manipulate remuneration benefits.\(^\text{265}\)

The Remuneration Committee’s role determines remuneration strategies and makes decisions on what employees should be paid as well as to evaluate and approve Clawback provisions for incentive remuneration paid to executives.\(^\text{266}\) However, Clawback can impose substantial costs on both investors and managers. By adopting such a provision, the institution increases the amount of risk carried by the manager,


\(^{265}\) Ibid.

\(^{266}\) For further discussion concerning the Remuneration Committee, see the discussion at [2.3.2.5, IV].
therefore, increasing the cost of giving adequate incentives for effort.\textsuperscript{267} There are many reasons why executive management may not be aware of vulnerability in the short run. This may be because, for instance, there are internal accounting errors, subordinates report incorrectly, or evaluating performance may not be a straightforward exercise where multiple businesses are concerned all of which may distort the data available to management. When there is a long-term Clawback provision, remuneration packages are likely to reflect the additional risk of Clawback by increasing higher remuneration in basic packages; this in turn may result in a lower productive effort by management and lower payment for performance incentives.\textsuperscript{268}

In short there is no simple answer to dealing with excessive executive remuneration.

The fourth Board Committee is the Appointments Committee.

V. The Appointments (Nominations) Committee

The usual practice is that the Committee members are appointed by the Board of Directors. The Committee usually comprises Non-Executive Directors and a majority of independent members all of whom have appropriate experience. The ASX CGC recommends that the Appointments Committee should comprise a majority of independent directors with a formal and transparent procedure for appointment processes.\textsuperscript{269} Similarly in Jordan, the Central Bank of Jordan (CBJ) Code states that

\textsuperscript{267} This means that Clawbacks may impose high risks on managers, requiring higher levels of compensation; it also risks managers avoiding risk and potentially profitable opportunities. For instance, in accordance with such a provision adopted for employees at UBS, the UBS states that its Clawback provision might cut into short-term profits when the employees become too risk-averse. See Patrick Hosking, ‘UBS Turns Bonus Culture on its Head to Claw Back Millions from Failing Executives’, \textit{The Times: Banking and Finance}, (UK), 18 November 2008.

“the Appointments and Remunerations Committee comprises a minimum of three Non-Executive Directors, the majority (including the Committee chairman) are independent.”  

The 2014 UK Corporate Governance Code requires companies to have a majority of Non-Executive Directors determined by the Board to be independent. Cadbury thought that the Committee needed to be chaired by the Board Chair.

The chairman of the board should wherever possible chair this committee, since it is chairmen who are responsible for the working of their boards and who should therefore play a leading part in selecting their team. This is in contrast to other board committees, where the independence of board chairmen is preserved through their not having been party to the discussions and decisions of committees, when the recommendations of those committees come to the board.

Under the 2014 UK Code, the Board Chair may chair this Committee but not in relation to the succession to the Chair. The UK Code does not provide guidance on the size of this Committee. It does how require a “formal, transparent and rigorous procedure” in relation to appointments and a separate section in the annual report outlining procedures and processes. Cadbury thought that flexibility was needed

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274 Ibid B 1.

so that the Committee could adapt as the circumstances required. In some cases a nomination subcommittee might be advisable because:

Recommendations from a nomination committee not only put to rest any question of personal patronage over the appointment of directors, but they also share out the responsibility for not reappointing directors, who might have assumed that they would be reappointed.

The main role of the Committee is to develop criteria for the candidates’ selection and locating potential candidates. This procedure of selection should be objective, formal and transparent. The ASX CGC, for example, suggests that the following information should be given about each candidate standing for election:

- Biographical details, including their relevant qualifications and experience and the skills they bring to the board; details of any other material directorships currently held by the candidate; in the case of a candidate standing for election as a director for the first time: details of any interest, position, association or relationship that might influence… if the board considers that the candidate will, if elected, qualify as an independent director, a statement to that effect; in the case of a candidate standing for re-election as a director: the term of office currently served by the director; and if the board considers the director to be an independent director, a statement to that effect; and a statement by the board as to whether it supports the election or re-election of the candidate.

The members of this Committee need to meet regularly to review and evaluate their performance as well as the overall performance of the Committee. It needs to evaluate whether there is an effective appointment system as well as ensuring that the Committee acts independently of the CEO and management. However, it is not mandatory to have an Appointments Committee and if there is one there is no

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277 Ibid.

requirement that it be independent. The evidence from UK is that the Code provisions are, in all but a few instances, complied with.\textsuperscript{279}

The Australian HIH Commission, examining the failure of the insurer HIH,\textsuperscript{280} found that there was no Appointments Committee nor did the Board have a role in appointment of new Board members. The consequence was that the constitution of the Board lay within the personal remit of the Chair of the Board.\textsuperscript{281} The HIH Commission’s view was that the Board of Directors should have taken on the role of the selection and appointment of new members as well as the chairman with the Board principally responsible for ensuring proper procedures and scrutiny.\textsuperscript{282} Chapter 7 will assess whether, in relation to Jordanian banks, this Committee should be mandatory.

The appointment of Non-Executive Directors and Board Committees are important responses to agency problems. But there are formidable problems in ensuring that the Board and its Committee provide effective oversight and monitoring of the institution to protect the interests of shareholders. The next section examines two key barriers to good corporate governance which are particularly pertinent to Jordan.

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\textsuperscript{280} See section [2.3.1] above for further information concerning the collapse of HIH.

\textsuperscript{281} The Chairman of the HIH Board of Directors was not also CEO but he was Non-Executive Director of HIH from 1992 to 2001. He was the chairman of Audit Committee, Human Resources department, Investment Committee and committees during that period. See <http: // www. apra. gov. au/ MediaReleases/Pages/05_50.aspx>.

2.4. Barriers to Good Corporate Governance

2.4.1. Family Control

A serious barrier to good corporate governance is the family controlled institution. This also extends to Jordanian banks where there is significant family control in some banks.\textsuperscript{283} There is no simple definition of what is a family controlled corporation.\textsuperscript{284}

But a useful definition is that family controlled business occurs when:

1. The majority of votes is in the possession of the natural person(s) who established the firm, in the possession of the natural person(s) who has/have acquired the share capital of the firm or in the possession of their spouses, parents, child or child’s direct heirs.
2. The majority of votes may be indirect or direct.
3. At least one representative of the family or kin is involved in the management or administration of the firm.
4. Listed companies meet the definition of a family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25 per cent of the right to vote mandated by their share capital.\textsuperscript{285}

The dominant features in family businesses are that key officers are frequently family members and management is largely drawn from the family.\textsuperscript{286} Whilst this would not be surprising in relation to small businesses, in some countries there are significant numbers of listed companies that are family controlled. For example, in Taiwan, listed

\textsuperscript{283} See chapter 7.

\textsuperscript{284} Family business may be defined as “A business firm may be considered a family business to the extent that its ownership and management are concentrated within a family unit and to the extent that its members strive to achieve and/or maintain intra-organizational family-based relatedness”. See Reginald A Litz ‘The Family Business: Toward Definitional Clarity’ (1995) 8 (2) Family Business Review 71, 75; 77; also family business has been defined as “the family business is a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small member of families in a manner that is potentially sustainable across generations of the families” See Jess H Chua, James J Chrisman and Pramodita Sharma, ‘Defining the Family Business by Behavior’ (1999) 23 (4) Entrepreneurship: Theory and Practice 19, 25.


companies included a large number of family controlled firms; around eighty percent of the management of the Taiwanese listed firms were controlled by families.\textsuperscript{287} Recent studies suggest that, on average, family businesses tend to be smaller than other businesses, with weaker governance structures, lower performance, and usually focused in more regulated manufacturing.\textsuperscript{288} It has been observed, for example, that in Taiwan, it is:

> characterised by the absence of effective Audit Committees...and an inactive market for corporate control...As families control a substantially larger portion of a firm’s shares than the general public, they are able to elect Board Directors of their choice and appoint management.\textsuperscript{289}

Family ownership and control appear to reduce governance and accountability as family shareholder control tends to confer excessive family benefits and may continue unprofitable businesses which may give them personal benefits.\textsuperscript{290} It is also associated with higher levels of Board control and weaker internal corporate governance. Furthermore, they employ fewer independent Non-Executive Directors and are less likely to separate the role of the Board Chair and the CEO.\textsuperscript{291} There is also the danger that family interests may be given priority over the overall interests of all shareholders.


\textsuperscript{288} See Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer ‘Corporate ownership around the world’ (1999) LIV (2) \textit{Journal of Finance} 471, 475.


\textsuperscript{290} Schulze et al found in their research that private ownership decreases the effectiveness of control procedures as well as creating a self control problem as a result of motivations which cause owners to make actions and activities may which damage themselves and those who connected to them. See William S Schulze et al, ‘Agency Relationships in Family Firms: Theory and Evidence’ (2001) 12 (2) \textit{Organization Science} 99.

\textsuperscript{291} See, David Hillier and Patrick McColgan, ‘Firm Performance and Managerial Succession in Family Managed Firms’ (2009) 36 (3-4) \textit{Journal of Business Finance and Accounting} 461, 463.
Family controlled companies may exhibit a preference for risk reduction and preservation of firm capital, an inability to disentangle the preferences of company shareholders from those of family interests, and a reluctance of family members to sell their stake to outside investors. These conflicts are likely to be at their most acute during the managerial succession process where family CEOs have incentives to appoint ex ante inefficient managers to the CEO position. Family firms may choose to draw from a restricted labor pool, owing to nepotism in the selection of unqualified family members as company executives.292

Consequently, the usual measures that would ensure accountability are less likely to be effective in a family owned company particularly where the CEO is a family member. There is also some evidence in relation to small private companies which suggests that family control may ultimately result in lower profitability. But conversely family owned companies appear to accord greater recognition to stakeholder interests such as employees. There may also be higher levels of flexibility to respond to opportunities and threats.293 The OECD sums up the problems:

In many instances objectivity requires that a sufficient number of Board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being Board members. In others, independence from controlling shareholders or another controlling body will need to be emphasised, in particular if the ex ante rights of minority shareholders are weak and opportunities to obtain redress are limited. This has led to both codes and the law in some jurisdictions to call for some board members to be independent of dominant shareholders, independence extending to not being their representative or having close business ties with them. In other cases, parties such as particular creditors can also exercise significant influence. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgement of the Board.294

As will be discussed in chapter 7, the problem of family ownership in listed banks is significant in Jordan. Some of these banks are held by families who have a concentration of share ownership. This may lead to conflicts of interests and creates

292 Ibid 462.
agency problem which affects negatively on the member’s responsibility and accountability. Other factors in Jordan which may compromise Board and Committee objectivity include the potential for outside political influence.295

The objectivity of independent Non-Executive Directors and Board Committees on governance may also be compromised where there are interlocking directorships.

2.4.2. Interlocking Directorships

Another difficulty in ensuring that Boards and their Committees operate as effective control mechanisms is the problem of interlocking directorships.296 Interlocking Directorships may influence negatively on the directors’ objectivity and their monitoring as network relationships can diminish effective monitoring of the institution.297 This practice may lead to lack of independence in decision making as well as compromising the objectivity of directors and weaken monitoring as network connections lead to decreased monitoring. Also it may cause conflicts of interest in institution.298 This is referred to an ‘agency problem’ between the managers and owners.299

295 Chapter 7 examines the 2010 annual reports of Jordanian listed Banks and the extent to which family ownership is a factor.

296 There is no law making interlocking directorships unlawful (save for a statutory limit in Jordan see chapter 7 [7.5]), but it may be a breach of director’s duties to the company where the director is also on the Board of a competing company because of the risks to trade secrets, intellectual property and business strategies. See Lawrence M Salinger, Encyclopedia of white-collar & corporate crime (SAGE Publications Inc: Arkansas State University UK, 2005, Vol. 1) 438.


299 See section [2.2.2] above for further discussion concerning the agency problem.
A 2006 study examined a panel of large industrial companies in the USA between 1989 and 1995. It concentrated on Boards in which a majority of Non-Executive Directors sit on three or more Boards. The study found a correlation between multiple directorships held by Non-Executive Directors and company performance.\textsuperscript{300} The study concluded that

Companies with a majority of busy outside directors display significantly lower market-to-book ratios. All else equal, firms with busy outside directors have market-to-book ratios about 4.2% lower than other firms. Evidence of weaker performance by companies with busy outside directors is also obtained from tests of operating performance. We show that firms with busy boards display lower operating [Return on Assets] ROAs, lower asset turnover ratios, as well as lower operating return on sales, and that these effects are also economically meaningful.\textsuperscript{301}

A 2003 Brazilian study found that in Brazil, 74% of the 319 sampled corporations had at least one director from another financial institution. The study found that there is a risk that directors are appointed based on relationships rather than performance. This may mean that they are appointed regardless of their objectivity, accountability, professionalism and expertise. The study found that interlocking directorships negatively affects the corporation’s value; where more than half of the Non-Executive Directors hold Board positions in three or more institutions or if the Chairman or the CEO holds directorship in another institution, this led to a decrease in the value of the corporation. This suggests that although interlocking directorships may create better connections between directors, it does not compensate for deterioration in the quality of decision making or the supervision of executive management affecting overall performance.\textsuperscript{302}


\textsuperscript{301} Ibid 721.
Fich and White in their study of 366 large US corporations in 1991 found that 87% of these corporations have at least one mutual director. In corporations which share two or more directors, CEOs receive higher remuneration after controlling for performance, size, as well as other variables. The authors suggest that higher remuneration may be linked to interlocking directorships under the influence of the CEO or because it makes valuable strategic alliances for which the CEO is remunerated. The problem of interlocking directorships may also be present in Jordan. At this stage, there is no formal evidence in Jordan that the banks’ CEOs remunerations are excessive or performance reduced because of interlocking directorships.

2.5. Conclusion

This chapter examined the key principles for good governance in monitoring and supervising the corporation’s management. The principles respond to the agency


304 In Jordan, the Jordanian Companies Law 1997 limits multiple directorships to five. It states that: “Any person is entitled, in his personal capacity, to be a member of the Board of a maximum of three Public Shareholding Companies concurrently. A person is also entitled to represent a corporate body in the Board of Directors of three Public Shareholding Companies at most. In all events, the said person is not entitled to be a member of the Board of Directors of more than five Public Shareholding Companies in his personal capacity in some, and as a representative of a corporate body in the others.” See Companies Law 1997 No. 22 as amended by Provisional Companies Law 2002 No. 40, Official Gazette No. 4533, Article. 146 A <http: // www. mit. gov. jo/ Default.aspx?tabid=502>. A Jordanian study in 2006 found a high incidence of cross-directorships within Jordanian listed companies. According to the study’s sample, about 46% of all directors sit on more than one Board. See Aziz Jaafar and Mahmoud El-Shawa, ‘Ownership concentration, board characteristics and performance: evidence from Jordan’ in Mathew Tsamenyi and Shahzad Uddin (eds), Research in Accounting in Emerging Economies (Emerald Group Publishing Limited, 2009) 73, 81.

305 The Jordanian Companies Law limits the amount that a director can earn. It states that “Remuneration of the Public Shareholding Company Board of Directors chairman and members shall be determined at a rate of 10% of the net profit which can be distributed as dividends to shareholders, after deducting all taxes and reserves there from, provided that the remuneration for each of them not exceed five thousand (5000) (USD 7,089) Jordanian Dinars annually.” See Companies Law 1997 No. 22 as amended by Provisional Companies Law2002 No. 40, Official Gazette No. 4533 article 162 <http: // www. mit. gov. jo/ Default.aspx?tabid=502>. 

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problems created where there is a separation of ownership and management control and managing conflicts of interest between managers acting in their own interests and the interests of shareholders and stakeholders.

Under Anglo American Corporations law based systems, including Jordan, governance is seen as a vertical hierarchy of accountability.

Under the governance hierarchy, the Board is accountable to the Shareholders through the company’s AGM. The CEO is accountable to the Board. The CEO and senior management appoints and monitors the other managers and employees of the entity and they are accountable to the CEO and senior management. However this accountability structure is effectively overturned by the capacity of the CEO to influence and dominate the Board. This has occurred because firstly, businesses of any complexity have to be run by professional managers so diminishing the power
and influence of shareholders and the Board. Secondly, shareholders are not able to exert sufficient influence as the owners because usually there is a significant dispersal of share ownership so that shareholders are largely unable to effectively communicate with each other so are dependent almost entirely on managers to do so.\textsuperscript{306} More important is the ability of the CEO to recommend appointments and reappointments to the Board. This has shifted the power structure considerably in favour of the CEO as against the Board and shareholder power making it more likely that compliant directors are appointed. Consequently, managers effectively have a free hand in carrying on the business activities of the enterprise. Control depends on the extent to which managers are able to keep the Board and shareholders from uniting against managers, and preventing large institutional investors from challenging the authority of management.

Berle and Means referred to this as the erosion of Board power, and the separation of management and ownership, where managers who were not the owners (based on the premise that shareholders own the corporation) of the corporation, with agendas quite different from those of the shareholder owners. The subsequent development of corporate governance has been largely concerned with addressing the alignment of managerial and shareholder interests, namely, of CEO and Board and shareholder interests. Foremost amongst these approaches is agency theory as articulated by Jensen and Meckling in their seminal article 1976. The strategy they advocated was that managers be treated as if they were owners of the corporation, and with this in mind, a substantial part of their compensation package be paid in the form of shares in

\textsuperscript{306} The UK Corporate Governance Code 2014 attempts to deal with this by providing for the appointment of an independent senior Non-Executive Director as a liaison with shareholders who have concerns, see Financial Reporting Council, \textit{The UK Corporate Governance Code} (September 2014), A.4.1 <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>.
the corporation. Subsequent experience however showed that because managers were able to influence Board members, they were able to game both the determination (how much and what went into it) of the compensation package and the realisation (cashing it in when share prices were high, by artificially manipulating it where necessary as well as backdating the award date) of the package. It was in this context that the Cadbury Committee in the UK recommended the appointment of (1) independent directors to the Board (independent of the CEO, the company and its Officers), (2) that these Boards be advised by specialist Committees with its members having appropriate skills, and (3) these specialist Committees to have oversight over the Audit, Remuneration, Appointments, and Risk Management functions of the company. The subsequent development of corporate governance practice has been on the elaboration of the following: (1) the number and composition of independent directors (2) the powers and functions of the committees, (2) who appoints the members of these Committees (the CEO, Board, independent directors), and (3) to whom should the Committee report to (directly to the Board, to the Board through the CEO, or to the shareholder meeting itself). The various Corporate Governance Codes that have sprung up in the various jurisdictions try to accommodate the structural and procedural changes advanced by the philosophy articulated in the Cadbury and the other codes that have followed it in their varying ways.

Attempts to restrain managerial power from within the corporation have met with variable success. For example, the last four decades has witnessed three significant attempts to make managers more and better accountable for their actions and restore this balance. The first of these as noted above, was the use of compensation strategy as a governance device. Contrary to expectations, however, managers found ways to game remuneration packages both in its setting and in its realisation so gaining the
upper hand and leading to a further enhancement of managerial power over both shareholders and the Board. This was responded to by the say on pay legislation which requires managerial compensation packages to be approved by the shareholder body at the AGM. The latter has been strengthened by legislation in the UK and US providing for the Clawback of compensation already paid out in certain circumstances, and in Australia by the Two Strike rule, whereby existing Board members are required to submit themselves for re-election where the compensation package is rejected on two successive occasions. In the event the Board is replaced, the Two Strike rule would appear to again empower shareholders at the expense of both managers and Board members.

What is apparent is that the measures directed to ameliorating agency conflicts, create new issues and problems. These include the methods and means by which the independence of Non-Executive Directors can be assured, how best to motivate management to act for the benefit of the institution through stock and equity remuneration without letting managers manipulate share prices and disclosure to serve their own interests, and how best to manage risk when remuneration packages encourage risk taking by management for short term reward. The 2014 UK Corporate Governance Code provides an important response to many of these issues. Under the Code, the Board is responsible for assessing independence of Non-Executive Directors and reporting its reasons in the annual report. It deals with the tricky issue of shareholders’ difficulty in finding an avenue for complaint or concern by providing that an independent senior Non-Executive Director should be appointed to liaise with shareholders. There are now much more rigours procedures relating to

307 Ibid B.1.1.
308 Ibid A. 4.1.
nominations\textsuperscript{309} and special provisions relating to remuneration. Chapter 7 discusses these issues and suggests that Jordan has much to learn from the UK Code. But it also argues that the “comply or explain” approach used in the UK may not operate effective in Jordan so that a stronger regulatory approach might be required.

The next chapter will examine special requirements relating to the governance of banks. It will examine the importance of banks, the problems that may affect banks such as systemic risk, and the importance of banks’ regulation which may help to avoid bank failure and risks to the broader financial sector.

\textsuperscript{309} Ibid B. 2.
CHAPTER 3

THE GOVERNANCE OF BANKS

3.1. Introduction

The previous chapter outlined the principles and importance of good corporate governance. It explored how corporate governance principles have sought to respond to agency problems through strengthening the role of Boards of Directors, Non-Executive Directors, as well as the Board Committees in achieving independent oversight of management.

The banking sector occupies a special position in the wealth and development of a country and capital markets. This sector is prone to special risks which in turn require more stringent measures to protect depositors, shareholders and stakeholders. The Board Committees have an important role in monitoring the performance of executives to avoid any conflicts of interest as well as monitoring and managing risks which affect banks.

This chapter will examine the special requirements relating to the bank governance. This chapter is divided as follows. Section 3.1 is introductory. Section 3.2 examines the importance of banks and their role in the national economy. It discusses why bank governance is different about governance of other sectors. Section 3.3 investigates special risks which affect banks: Credit Risk, Market Risk, Operational Risk, and Liquidity Risk. Section 3.4 explores the problem of Systemic Risk. Section 3.5 discusses the attempts to address bank risk by investigating the role of Basel Accords.
(Basel I and II). Section 3.6 examines the main reasons of failure of bank governance during the 2008 Global Financial Crisis (GFC). Section 3.7 investigates the bank regulation after the 2008 GFC. It discusses the attempts of Basel III Accord to reduce the risks of future financial crises. Section 3.8 is the conclusion.

### 3.2. The Role of Banks in the National Economy

The economic value of the institution refers to the value of both tangible and intangible assets. Intangible assets extend to growth opportunities, goodwill, and market power or monopoly rents. The chance to gain monopoly rents increases for institutions that operate in an incomplete competitive market. The banking sector may be considered as an example.\(^1\) A reliable and strong banking system plays an important role in the financing of investment and growth of the country.\(^2\) This is illustrated in relation to United Kingdom and Australia in chapters 4 and 5. Regulators have a special interest in maintaining a safe and stable banking sector as a necessary driver for economic growth.\(^3\)

Banks are corporations usually listed on the stock exchange and are owned by shareholders. Banks fund themselves from both retail as well as wholesale sources. Generally, banks rely on deposits as well as funding from private markets. Short term wholesale funding involves interbank loans, with a major role for short-term debt, specially repurchase contracts (repos) and deposit’s certificates. For longer term debt,  

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Banks may rely on, for example, bonds. A key factor which put at risk the entire US economy was the inability of banks to obtain short term funding which lead to a liquidity crisis. Section 3.5 discusses how the Basel Accords have attempted to deal with liquidity and systemic risk.

Banks are engaged in a wide range of activities to increase their capital and profits. Traditionally, banks activities were divided into retail, commercial banking and investment banking. At the retail level, this involves dealing with individual consumers in relation to deposits, personal loans, credit cards and housing loans. Commercial banking generally deals with business loans. Traditionally investment banking was conducted separately to retail and commercial banking, the assumption being that depositors' funds should not be at risk because of speculative risks. In the US, the Glass-Steagall Act 1933 restricted banks from entry into these markets. These limitations were removed by the US Gramm-Leach-Bliley Act 1999. The side stepping of the prohibition leading to its eventual removal set the stage for banks enthusiastic entry into the derivatives markets where huge profits were to be made. This involved the use of complex instruments such as Collateralised Debt Obligations (CDOs) and CDS (Credit Default Swaps), which were seen as a major cause of the GFC. This is discussed below.

Most activities, even everyday retail banking involving housing, business, credit cards and personal loans, involve some level of risk which must be managed effectively.

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5 The *Banking Act* 1933 (US), ss 16,20,21. The UK post GFC has recently moved to this view, see below at [3.7.5].

6 The US *Financial Services Modernization Act* 1999

But CDOs and CDs involved much higher risks that ultimately proved impossible to contain\(^8\) and were seen as one of main causes of the 2008 GFC\(^9\) discussed below.\(^{10}\)

Regulatory bodies\(^{11}\) have been accused of failing to take adequate steps to prevent the GFC. In relation to the UK and Australia, the regulatory framework and its capacity to deal with the risks arising out of the GFC are discussed in chapters 4 and 5.

The next section begins by providing an overview of the main risks that affect banks and the Banking system.

### 3.3. Risks Affecting Banks

There are many types of risks affect banks. This chapter will focus on four main risks: Credit Risk, Market Risk, Operational Risk and Liquidity Risk. Systemic risk is dealt with separately in section 3.4 below.

#### 3.3.1. Credit Risk

Credit risk is risk that a borrower will default on debt repayment or is unable to make a payment due on credit card, a mortgage or other loans. The bank’s risk is not only the loss of principal and interest but also collection costs and disruption to cash flows. It has flow on effects to banks where the banks have borrowed funds if they fail to

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\(^9\) It is not a universally held view, see Maria Carmen Huian, ‘Impact of Current Financial Crisis on Disclosures on Financial Instruments’ (2010) 2010 *Economic Sciences Series* 41 in relation to the role of accounting procedures and rules.

\(^{10}\) For further discussion see below at [3.6].

\(^{11}\) Regulatory bodies such as the financial reporting endorsed by International Accounting Standards Board (IASB) or Financial Accounting Standards Board (FASB).
repay amounts secured by floating or fixed charge over the banks’ assets. Credit risk may occur in a variety of situations, which are discussed below.

1. Sovereign Risk: where a government is unable to meet its loan obligations. This occurs where a bank lends to an institution based in another country, it needs to consider both the risk of government default as well as the risk related to the individual institution.12

2. Counterparty or Default Risk: is the risk of default to each individual party of a contract that the counterparty can’t honour its contractual commitments. This occurs where, for example, a contract contains mutual obligations for the bank to provide funding and the borrower to repay at the due date. Both incur a risk. The borrower might default on the loan or the bank may fail to provide the agreed continuing funding. 13 These types of risks are involved in the new types of debt instruments used extensively prior and during the GFC, Collateralised Debt Obligation (CDO) and Credit Default Swaps (CDS) which are referred to below.

3. A client or business fails to make a payment on a credit card, line of credit, mortgage loan, home loan or any other types of loans.

There is no shortage of methodologies to assess and evaluate risk.14 Some institutions have a credit risk department for this purpose. Some lenders use their own

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12 See also Michael Frenkel, Alexander Karmann and Bert Scholtens, Sovereign Risk and Financial Crises (Springer-Verlag Berlin Heidelberg, 2004).


methodologies to assess default risk. To decrease or mitigate the credit risk, the lender requires a credit assessment of the borrower and frequently that the borrower take out suitable insurance (e.g. Mortgage insurance) or provide other security or guarantees by third parties. In relation to CDOs and CDSs special issues arose in relation to managing default risk, this is discussed below in section 3.6.

It will be argued in chapter 7 that Board Committees, particularly, the Risk Management Committee, play a very important role in oversight of the banks in dealing with Credit Risk. It assumes however that a properly functioning Risk Management Committee would not necessarily trade off short term profits as against long term stability. Some of the problems may be reduced by the adoption of the Basel Accord principles which are referred to below.

The next section turns to examine the exposure of banks to market risk.

### 3.3.2. Market Risk

Market Risk is the risk related to the short-term movement in market prices. It may be a linear risk which occurs due to an exposure to the movement of underlying variables such as interest rates, stock prices, commodity prices, foreign exchange rates or

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17 Risk relating to potential changes or volatility in interest rates (e.g. Libor).

18 Risk from volatility of prices such as crude oil.
credit spreads. A non-linear risk occurs because of exposure to market volatility as may increase in a hedged position. Also it involves exposure to other unexpected movements in financial variables or movements in the implied or actual volatility of prices and asset options. This volatility influences the actual market value of the assets of the institution and the amount needed to cover the obligations. It consequently has an effect on the asset value, capital adequacy and actual surplus of the institution. The liquidity risk following the GFC resulted in the dumping of shares in the market with consequent decline in the value of shares.

The Basel II Accord dealt with market risk; this is discussed below. The Basel principles require an effective market risk management data framework which should have the ability to make accurate, timely and reliable reports for the Board of Directors, Risk Management Committee and other specialised Committees. These reports support decision-making at various levels (such as risk budgeting and strategy formulation) as well as to giving early warning of any potential emerging market risk. It is then the responsibility of the Board, management and other specialised Committees to agree on the market risks and control measures to manage these risks. It is a key function of the Risk Management Committee to provide monitoring and specialised and expert advice to the Board, (see chapter 2).

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23 For further discussion concerning the role of the Risk Management Committee, see chapter 2 [2.3.2.5. III].
The next section considers the exposure of banks to operational risks.

3.3.3. Operational Risk

Operational Risk has been defined as:

The risk of loss resulting from the inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk…legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.24

Because the types of operational risk vary in severity and frequency, this requires different levels of response. Operational risk is usually classified according to the following assessment:

1. High frequency-low severity: this occurs when risks are frequent but low cost losses. These types of risks are more easily controlled with appropriate business procedures and processes; for example, accounting irregularities, credit card fraud, data entry errors or transaction failure. Where there are high frequency incidents, this allows greater opportunities for statistical analysis which can include simulations, estimation processes and regression analysis.25

2. Low frequency-High severity: this type of risk can put the future of the institution at risk and is likely to have serious impacts on bank operations for example serious employee conduct endangering the financial stability of the bank. The low frequency


of these incidents makes it more difficult to estimate possibilities and the extent of possible losses.\textsuperscript{26}

3. Medium frequency-Medium severity: such as lower levels of employee misconduct involving trading activities on the banks’ accounts, fiduciary breaches and forgery.

In relation to these different types of risks, different strategies will be required to monitor and to manage risks if they eventuate. Since the mid 1990s, credit risk and market risk have been familiar territory for banks and financial institutions. Procedures were adopted to identify, measure and control these risks. However, the operations of banks are supported by various frameworks and procedures, such as management, human resources, Information Technology and operational risk management frameworks. These frameworks can have a various elements, each of which needs to adapt to the particular risk. For instance, the bank’s credit risk management framework needs to have processes for the measurement and control of credit risk. Management of Information Technology risk is crucial for data security for banks and policies and procedures must be in place to manage these risks. Risks from IT failure can potentially be catastrophic.\textsuperscript{27}

Operational risks are specific to the individual bank rather than indicating a particular problem within the banking sector. In relation to low frequency, high severity events, it may be difficult to predict the occurrence of this risk as it may arise without warning and have dramatic effects on the value of the bank..\textsuperscript{28}


\textsuperscript{27} Ibid 2.

\textsuperscript{28} Imad Moosa, ‘Operational Risk as a Function of the State of the Economy’ (2011) 28 (5) \textit{Economic Modelling} 2137.
Monitoring includes gathering data about the work processes and activities, checking on the progress and quality of the business as well as evaluating the performance of each employee and overall performance of the institution. Inadequate and ineffective monitoring of risks is especially serious for banks. For example, in relation to currency trading, there may be no separation between front desk and back room operations (e.g. the sales and purchase versus matching of trade functions). This led to collapse of the UK Barings bank in 1995. This bank collapsed after massive trading losses (about US $1.3 billion) due to a combination of speculative investments and unauthorized trading by a bank employee (Nick Leeson):

Barings' collapse was due to the unauthorized and ultimately catastrophic activities of, it appears, one individual (Leeson) that went undetected as a consequence of a failure of management and other internal controls of the most basic kind. Management failed at various levels and in a variety ways…to institute a proper system of internal controls, to enforce accountability for all profits, risks and operations, and adequately to follow up an a number of warning signals over a prolonged period. Neither the external auditors not the regulators discovered Leeson’s unauthorized activities.

Institutions historically have accepted the operational risk as an unavoidable cost of doing business. The Operational risk management system is directed to the identification, measurement, controlling, reporting and systems for avoiding this

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30 The Barings Bank is an English merchant Bank located in London, and it is one of the oldest merchant Banks. It was founded in 1762 and owned by the German Baring family. See Howard Chua-Eoan, ‘Collapse of Barings Bank, 1995’, Time Magazine, (USA), 16 November 2007.


risk.\textsuperscript{33} It is also the area where the Risk Management Committee should play an important role in ensuring that operational risks are assessed and properly monitored.\textsuperscript{34} The Basel II Accord deals with operational risk, (see below).

### 3.3.4. Liquidity Risk

Liquidity risk is the risk that a financial institution is unable to meet its obligations and pay its debts when due. It occurs also when depositors en masse try to withdraw their deposits (a run). Liquidity risk results from the institution’s inability to procure sufficient readily available funds and readily convertible assets to meet these obligations. It can also occur where the cost of procuring funds is prohibitive and likely to affect income as well as its capital funds.\textsuperscript{35} Assets may not be convertible to cash at short notice without engaging in a fire sale. This may be due to the unavailability of ready buyers for particular types of assets, or inefficient markets where it is hard to find buyers in the short period required.\textsuperscript{36}

Banks need to retain assets sufficient to cover its obligations in both normal and risk situations.\textsuperscript{37} Loans, for example, are usually recognised as illiquid assets as attempts to liquidate them before maturity result in reduced value. On the one hand banks are committed to loans during the life of the loan but conversely are at risk of withdrawal


\textsuperscript{34} For further discussion concerning the role of this Committee, see the discussion in chapter 2.


at any time by depositors. Managing this liquidity risk presents a continuing problem for all banks.\textsuperscript{38} For example, in September 2007 the UK Northern Rock had liquidity problems despite being solvent at the time. They were unable to obtain sufficient funds from the short term money markets to cover their obligations, (see section 3.6 which discusses this).

If cash flows of the institutions are largely contingent, processes must be in place to continuously monitor liquidity issues.\textsuperscript{39} This requires regular monitoring and evaluation of the current and future obligations of the institution as well as planning for any future needs for funding.\textsuperscript{40} The Basel Accord liquidity requirements are discussed below.

The previous section has set out key risks for banks. Bank failure affects not only its immediate clients, depositors, creditors and shareholders but can have a rippling effect through the banking industry and the economy. The next section examines the systemic risk arising out of bank failure.

\textbf{3.4. The Problem of Systemic Risk}

Systemic risk is financial system instability due to the risk of failure of an entire financial framework or entire market, as opposed to risk related with any one


\textsuperscript{39} Liquidity Risk could be evaluated by using some scenario analysis. The general method of using scenario analysis can entail the following processes: evaluate daily the cash flows under each scenario and construct multiple scenarios for the movements in market as well as defaults over a provided term of time. See Mathias Drehmann and Kleopatra Nikolaou, ‘Funding Liquidity Risk: Definition and Measurement’ (2013) 37 (7) \textit{Journal of Banking and Finance} 2173, 2174.

\textsuperscript{40} Ibid.
individual institution, group or component of a framework.\textsuperscript{41} It occurs as a result of interlinkages in the market or system where the collapse of a single or group if institutions may cause a cascading collapse which might potentially bring down the entire market or system.\textsuperscript{42} The cascading effect may in part be triggered by a "clustering" of runs on banks.

Interconnections between banks are particularly important to the operation of the financial system. Typically banking sector operations depend on ‘interbank loans’ or ‘interbank transactions’.

These include overnight loans, interbank lending in the federal funds market or its equivalents, intraday debits on payment frameworks, and contingent claims (e.g. interest rate). This short term lending, basically overnight, permits banks to face the shortages in their liquidities to cover commitments and reserve requirements by borrowing from other banks and provides an important short term safety net for the banking sector.\textsuperscript{43}

It has generally been assumed that systemic risk is minimised because governments feel compelled to step in to protect depositors and the economy based on the “Too Big To Fail” or “Too Connected To Fail” principles. This view provides a moral hazard allowing banks to take excessive risks in the belief that governments will bail them


out.\textsuperscript{44} It also removes incentives within the banking sector for the sector itself to take measures to prevent failure.\textsuperscript{45}

The Too Big To Fail approach is the conventional analysis for evaluating the need for government intervention. Factors relevant to this assessment include the size of the institution relative to the international and national marketplace, market share concentration as well as competitive barriers to entry or the ability of the product to be exchanged. Governments may feel compelled to step in to prevent wholesale systemic failure based on the principle “Too Interconnected To Fail” where the effect of failure may have a multiplier effect on other commercial enterprises.\textsuperscript{46} The failure of Lehman Brothers, in September 2008 challenged the orthodoxy that governments will automatically bail out large interconnected banking institutions. But this failure to intervene can have ripple effects on all aspects of the financial market and can lead to failure of basically sound institutions because of the inability to obtain loan funding for normal operations. The Lehman insolvency had serious flow on consequences to Lehman’s creditors which in turn creating market uncertainty and effectively a freeze on interbank loans:

After Lehman’s bankruptcy, Lehman’s debt was essentially worthless, making the Reserve Primary Fund\textsuperscript{47} ...drop below par, an incident which had not occurred for over a decade. This created uncertainty about all money market funds, causing a massive run on the system. Since money market funds are the primary source for funding repos and commercial paper, this was arguably the most serious systemic event of the crisis. The government then had to guarantee all money market funds... When Lehman declared


\textsuperscript{45} Jean-Charles Rochet and Jean Tirole, ‘Interbank Lending and Systemic Risk’ (November 1996) 28 (4) \textit{Journal of Money, Credit and Banking} 733, 734.


\textsuperscript{47} A money market mutual fund.
bankruptcy, its prime brokerage in the U.K. went bankrupt. This meant that any hedge fund whose securities were hypothecated by Lehman was now an unsecured creditor. This led to massive losses across many hedge funds as their securities that had been posted as collateral disappeared in the system. As another illustration, in the wake of Lehman’s failure, inter-bank markets truly froze as no bank trusted another’s solvency and the entire financial intermediation activity was at risk of complete collapse. What the Lehman Brothers episode revealed is that there really is a “too-big-to-fail” label for financial institutions.48

Henry Paulson, the Treasury Secretary, similarly observed that the collapse of Lehman Brothers led to a systemic crisis as well as loss of the confidence in the financial sector:

Credit markets froze and banks substantially reduced interbank lending. Confidence was seriously compromised throughout our financial system. Our system was on the verge of collapse, a collapse that would have significantly worsened and prolonged the economic downturn that was already underway.49

The systemic risks created by bank failure may be so great that governments out of political necessity feel compelled to bail out the bank with public money where the effects could be catastrophic for the market as was the case with the bailouts of AIG (American International Group) in the US and Northern Rock in the UK discussed further at 3.6.

The GFC made clear that the mechanisms in place to mitigate systemic risk were not effective to prevent the worst effects of the GFC. Measures to deal with the problem of systemic risk and how to reduce this risk has been addressed by the Basel III Accord discussed below. It remains to be seen whether governments faced with a new crisis will allow large interconnected financial institutions to fail because of the


catastrophic effects not only on the banking system but more generally on domestic and international economies.

The next section examines the Basel accords (Basel I and II), which are directed to improving bank stability and preventing bank collapse and systemic risk. This is followed by a brief discussion of the 2008 GFC. As Basel III was a response to the 2008 GFC, it will be discussed after that section.

3.5. Preventing Bank Failure: The Basel I and II Accords

The Basel Accords are principles and recommendations on banking laws and regulations published by the Basel Committee on Banking Supervision (BCBS). The committee represents the Central Banks and supervisory authorities of the Group of Ten (G10) industrialised countries plus Luxembourg. The committee aims to improve the co-operation on international regulatory issues by establishing principles and recommendations for effective regulatory and supervision of the international banking sector. According to the Basel Committee:

The Basel Committee provides non binding rules to help promote the adoption of sound corporate governance practices by banking organisations. Its comprehensive reform package addresses the lessons of the financial crisis. Through its reform package, the

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50 The accord’s name came from Basel in Switzerland where the Committee meets.

51 The Group of Ten comprises 11 industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) which provides a consultations on economic as well as financial issues. See also Group of Twenty, The G20 Seoul Summit Leaders’ Declaration (2010) <http://www.g20.org/Documents/2010/11/seoulsummit_declaration.pdf>.


Committee also aims to improve risk management and governance as well as strengthen Banks’ transparency and disclosures.

Most regulatory systems, including the USA, UK, Australia and Jordan have adopted the Basel standards. Basel I focused on Credit Risk; Basel II on Market and Operational Risks and following the 2008 GFC, Basel III focused on Liquidity Risk. The following section discusses the Basel I and II Accords. Basel III is discussed after discussion of the 2008 GFC.

**Basel I**

In 1988, the BCBS issued the initial Basel capital accord in response to increasing risks of bank failure and to ensure the appropriate capitalisation of internationally active banks. To compete for larger market shares, banks had rapidly increased their international and domestic risk exposures. At the national level, capital requirements were not necessarily linked to real risk levels and risk exposures. A regulatory consensus emerged to create global principles and standards which aim to give guidance on the proper capital levels for internationally active banks. This led to the Basel I principles in July 1988.

Basel I contains three main elements. Firstly, the BCBS published the minimum capital ratios for banks. Banks were required to have effective regulatory Capital Adequacy Ratio (CAR) of at least 8% of the total assets on a risk adjusted basis.  

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55 See chapter 4.

56 See chapter 5.

57 See chapter 6.

Secondly, the Basel Committee adopted the basic concept of regulatory capital. The capital of the bank refers to its net worth as well as its capacity to manage losses (e.g. adverse movements against their investments or increase of non-repayments in their loan portfolio). This requires banks to keep an adequate reserve of equity and assets to handle unexpected losses. The required capital is divided into Tier 1 and Tier 2 which are related to the security of the capital. Table 3.1 summarises them.

Table 3.1. Basel I-Minimum 8% Total Capital Ratio

<table>
<thead>
<tr>
<th>Basel I</th>
<th>Pillar I</th>
<th>Capital (High Quality) Tier 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>• Common Equity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Preferred Stock</td>
</tr>
<tr>
<td></td>
<td>Pillar II</td>
<td>Capital (Low Quality) Tier 2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Supplementary Capital</td>
</tr>
</tbody>
</table>

Source: BSBC

Tier 1 comprises the highest quality capital, such as common equity as well as some types of the preferred stock. Basel I required that banks hold at least half of the required capital as Tier 1 capital. Tier 2 capital largely includes a range of lower quality capital usually called supplementary capital. The 8% capital requirement was divided 50/50 between Tier 1 and Tier 2 [Tier 1 (4%) + Tier 2 (4%)]. The BCBS

59 Based on pragmatic considerations particularly that Banks would be able to achieve this within the transition period of 4 years. See Bank for International Settlements, Basel Committee on Banking Supervision: International convergence of capital measurement and capital standards (1998), 13 <http://www.bis.org/publ/bcbsc111.pdf>.

60 Ibid 3-4. Tier 1 is the most secure type of capital being common equity, cash or other similar mechanisms. Tier 2 being less secure. Ibid 14-15.

61 Ibid 4.


63 Ibid.
published a uniform procedure by which banks could calculate the regulatory capital ratios by dividing the capital reserves of the bank by its assets.

The reserves should be increased in the event that a bank faces unexpected risks. To account for the various risk levels inherent in the different assets, the BCBS adopted the concept of Risk Weighted Assets (RWAs). The RWAs classify the assets of the bank according to the credit risk and then weighting each of these classifications accordingly.\(^\text{64}\) In 1996, the BCBS amended the Basel Accord for the year 1998\(^\text{65}\) to incorporate market risk. Market risk is discussed above.

As noted, Basel I concentrated on the credit risk when calculating RWAs. The purpose was to provide a capital cushion for price risks specifically those arising out of their trading processes. The Accord made allowance for the differing degrees of credit risk related to different types of counterparty through allocating all on-balance sheet\(^\text{66}\) and off-balance sheet items\(^\text{67}\) to one of five weighting bands (Zero, 10, 20, 50 or 100).\(^\text{68}\) The weighting factors show general classifications of relative risk.

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\(^\text{64}\) Ibid 11.

\(^\text{65}\) Ibid.

\(^\text{66}\) For the categories of an on-balance sheet, the principal value of every single asset is multiplied by its suitable weight to get a ‘risk-weighted exposure’ for that asset; the risk weighted exposure acts an estimate of the credit exposure the Banks has on the assets. When summed, the risk’s weighted exposures shows an estimate of the total on-balance sheet credit exposure which the Bank has given its approval. See Matthew Brosnahan and Tan Chong Lee, ‘International Convergence of Capital Measurement and Capital Standards for Banks’ (1989) 52 (1) Reserve Bank Bulletin 37, 39-40.

\(^\text{67}\) In relation to off-balance sheet items (except the interest rate as well as the foreign exchange contracts), the principal values first should be change to an on-balance sheet equivalent form (the credit equivalent amount) before being multiplied by the suitable weight to get a risk-weighted exposure. See Ibid.

\(^\text{68}\) See Hal Scott and Anna Gelpern, *International Finance: Transactions, Policy, and Regulation* (Foundation Press, 19\textsuperscript{th} ed, 2012) 570.
In Australia, for example, the Reserve Bank of Australia (RBA)\textsuperscript{69} determined five categories of risk weightings. Table 3.2 summarises them.

**Table 3.2. The RBA’s Categories of Risk Weightings**

<table>
<thead>
<tr>
<th>Risk Weightings</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
<th>50%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and short term Commonwealth government securities.</td>
<td>Other claims on Commonwealth and State Governments as well as the OECD Governments.</td>
<td>Claims on local governments and all other public sector institutions as well as claims on banks incorporated in Australia.</td>
<td>Housing loans.</td>
<td>All other types of loans.</td>
<td></td>
</tr>
</tbody>
</table>

Source: APRA\textsuperscript{70}

The above Table shows:

First, the Zero risk weighting: cash and short term Commonwealth government securities; second, the 10% risk weighting which relates to other claims on Commonwealth and State Governments as well as the OECD Governments; and third, the 20% risk weighting which relates to claims on local governments and all other public sector institutions as well as claims on banks incorporated in Australia. The 50% risk weighting relates to housing loans with the 100% risk weighting which applying to all other loans. In this process, the first step is to convert off-balance sheet items to their on-balance sheet equivalent. The second step is to identify the risk

\textsuperscript{69} See chapter 5 for further discussion concerning this Bank.

\textsuperscript{70} APRA, *APRA transitional prudential standards* (1 July 1999) Prudential Standard 3.2.4, 18-20.
weighted assets by employing the risk weightings to on-balance sheet assets. The third step is to sum the first step with the second step: Total RWA = RWA on-balance sheet + RWA off-balance sheet.\textsuperscript{71}

Using this method, a bank can decrease the total of risk weighted assets by keeping more liquid assets. At one extreme a bank could hold 100% cash reserves so that its risk weighted assets could be Zero. However, in this situation the earnings of the assets are likely to be low and result in lower interest rates being offered to depositors. For the banks, there is a ‘creative tension’ between retaining assets which produce high earning and potential profits but expose the bank to credit risks and holding liquid assets which give security and less exposure to risk.

The achievement of Basel I was the development of uniform risk-weighting factors. But the new system was open to criticism. This was because Basel I deals only with credit risk and targeted G-10 countries although some banks from 120 countries\textsuperscript{72} adopted the Basel I requirements.\textsuperscript{73} There were serious criticisms of the Basel I requirements. Countries such as Greece had the same zero% risk weighting for their debt as the USA and the UK. The same is true with respect to the uniform 100% weighting attributed to all corporate obligations without any reference to the credit standing of personal issuers. Banks could chase higher yields by taking bigger risks without the input of greater capital. Conversely, where banks acted conservatively by investing in low risk capital such as government bonds, this, in theory, inhibited their

\textsuperscript{71} See Ibid.

\textsuperscript{72} Hal Scott and Anna Gelpern, \textit{International Finance: Transactions, Policy, and Regulation} (Foundation Press, 19\textsuperscript{th} ed, 2012) 559.

\textsuperscript{73} It should be noted that the Jordanian banking sector applies only the Basel II standards since 2008, see chapter 6.
ability to lend for commercial purposes and thus hindered business growth.\textsuperscript{74} The inability to accept a single definition for the Tier 1 and Tier 2 capital was another problem of Basel I. These and other defects led to a revision of the Basel accord in the 1990s.\textsuperscript{75} This led to the promulgation of the Basel II accord.

**Basel II**

In response to the banking crises of the 1990s as well as the criticisms of Basel I, in 1999 the Basel Committee developed a more comprehensive capital adequacy system\textsuperscript{76} to be known as the Basel II Accord. While keeping the “pillar” system of Basel I (see below) every pillar is expanded in Basel II to include new methods to deal with credit risk and, adapt to the securitisation of the assets of the banks. It also includes market, operational as well as interest rate risks, and incorporates market based control and regulation. Basel II was revised in 2004 for implementation by 2007.\textsuperscript{77}

The main goal of Basel II was to provide the global financial system greater stability by keeping the average of all regulatory capital in the banks at the same level. It was the intention to make it more ‘risk sensitive’.\textsuperscript{78}

\textsuperscript{74} Ibid 570. But this may not have been the reality, Ibid.


\textsuperscript{76} The Capital adequacy system aims to maintain in reserve resources to provide fallback for credit risk as well as market risk events. See Dimitris N Chorafas, Financial Boom and Gloom: The Credit and Banking Crisis of 2007-2009 and Beyond (Palgrave Macmillan, New York, 2009). 209.

\textsuperscript{77} It was issued on February 2011 and updated on 31\textsuperscript{st} of December 2010 to reflect the adjustments to the Basel II market risk system as well as the stress testing direction, see Bank for International Settlements, Basel Committee on Banking Supervision: Revision to the Basel II Market Risk Framework (February 2011), 1 <http://www.bis.org/publ/bcbs193.pdf>.

\textsuperscript{78} Rules for determining the risk weightings were refined and involved differing regulatory treatment of the same asset across regulated banks. Credit ratings were used as a measure for some risk weights. For the largest Banks, risk weights were to be determined by a system of complicated calculations on the
As noted, Basel II was concerned with Market Risk and Operation Risk. It contains three “pillars”: minimum capital requirements; the supervisory review process and transparency and market discipline. Table 3.3 summarises these 3 pillars.

Table 3.3. Basel II’s Pillars

<table>
<thead>
<tr>
<th>Basel II</th>
<th>Pillar I</th>
<th>Pillar II</th>
<th>Pillar III</th>
</tr>
</thead>
<tbody>
<tr>
<td>MINIMUM CAPITAL REQUIREMENTS</td>
<td>• Credit risk (new measurement)</td>
<td>• Assessment of risks and capital adequacy of the individual banks</td>
<td>• Increasing disclosure of capital requirements as well as methods of risk assessment</td>
</tr>
<tr>
<td>Market Risk (unchanged)</td>
<td></td>
<td>• Constant contact with banks</td>
<td></td>
</tr>
<tr>
<td>Operational Risk (new)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SUPERVISORY REVIEW PROCESS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>TRANSPARENCY AND MARKET DISCIPLINE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

Source: BCBS

The first pillar, minimum capital requirements, was the most important and controversial. As mentioned above, Basel I concentrated on the credit risk of bank assets when calculating RWAs. During the negotiations leading up to Basel II, Market risk and operational risk were also to be considered in calculating the RWAs. The basis of internationally agreed formulae, see Adrian Blundell-Wignall and Paul Atkinson, ‘What Will Basel III Achieve?’ [2010] The German Marshall Fund of the United States: Strengthening Transatlantic Cooperation 4 <http://gem.sciences-po.fr/content/publications/pdf/Blundell_Atkinson_Basel_III_achievements112010.pdf>.

Pillar two requires Banks to develop their own risk management procedures and capital evaluations. Pillar two also imposes a direct duty on the Board of Directors of the Bank as well as the management in ensuring the compliance of Basel II. For general information concerning the Pillar 2 and the supervisory review procedures, see http://www.bis.org/publ/bcbsca08.pdf.

The aim of Pillar three is to impose market discipline by imposing transparency requirements aimed at permitting market participants to evaluate the main pieces of data on the Bank’s capital adequacy. For general information concerning the Pillar 3 and the market discipline, see http://www.bis.org/publ/bcbsca10.pdf.

The major contribution of Basel II was its changes to the “bucket” method of Basel I to RWAs. The Basel II provided two approaches of evaluating credit risk to provide more accurate matching of the capital requirements of the bank to the asset risk: the standardised approach and the internal ratings-based approach.

According to the standardised approach, the banks calculated RWAs by reference to the elementary buckets of Basel I as well as the external credit ratings evaluated for those assets by agencies in order to weight the loans’ risks to borrowers in different classes. The Basel committee used agencies such as Standard & Poor’s classifications.83 Central Banks and sovereigns:84 the highest ratings (AAA to AA-) would be provided a 0% risk weight; 20% risk weight for sovereigns rated (A+ to A-); 50% for those rated (BBB+ to BBB-); 100% for those rated (BB+ to B-); and 150% for those under (B-).85 For the loans to banks, the Basel committee had two choices: provide the bank a risk weight which was one category less favourable than that of the sovereign of the bank’s country.86 The second choice was to use the ratings

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82 The capital amount required by a Bank can be calculated as (1) Credit Risk requirement + Market Risk requirement+ Operational Risk requirement = Pillar one requirement; (b) Pillar one requirement + Pillar two requirement = Total Capital requirement; (c) To calculate each requirement, it is graded such that the capital requirement should be at least 8% of RWAs. The Credit Risk requirement is the total of the credit risk capital requirement, the concentration risk capital requirement, and the counterparty risk capital requirement. The Market Risk requirement is the total of the foreign currency position risk requirement, the interest rate position risk requirement (including the basic interest rate position risk requirement for equity derivatives), the commodity position risk requirement; the option position risk requirement, the equity position risk requirement, and the collective investment undertaking position risk requirement. See Ibid 12.


84 Sovereign is a loan issued to specific country. Under the Basel II Accord, Sovereign includes the central Banks of different countries, the Public Sector Entities (PSEs) as well as the Multilateral Development Banks (MDBs) which meet the criteria for a Zero% risk weight under the Basel standardised method. See Bank for International Settlements, *Basel Committee on Banking Supervision: International convergence of capital measurement and capital standards* (June 2004), A Revised Framework, 51 <http: // www. federalreserve. gov/ boarddocs / press/ bcreg/ 2004/ 20040626/ attachment.pdf>.

85 Ibid 15.
created through a qualifying rating agency. In this case, banks would be weighted 50%, but banks with (AAA to AA-) would be weighted 20%; and those rated (BB+ to B-) would be weighted 100%; and those rated under (B-) would be weighted 150%.\textsuperscript{87}

On the other hand, the internal ratings-based approach was created to allow banks perceived to be more developed to rely in different degrees on their own risk management systems to account for their RWAs and capital requirements. This approach creates a statistical measurement of potential and unexpected losses which banks may face in relation to the credit risk.\textsuperscript{88}

In July 2006, the committee issued the general form of the Basel II Accord. It provided a list of general governance principles for banks and guidance to regulators in evaluating banks’ corporate governance principles. For example, Board members need to be qualified for their positions as well as understand their responsibilities and provide efficient judgment about the affairs of the bank.\textsuperscript{89} The other principles are available in Appendix [H]. Of importance to the thesis are the principles relating to the Board of Directors and their Committees. Committees need to be qualified and able to provide fair and objective judgment on the management and supervision of the bank. The principles recognised the importance of Committees members to provide an

\textsuperscript{86} Ibid.

\textsuperscript{87} For loans to corporate borrowers, the borrowers who rated (AAA to AA-) would be weighted 20%; those rated (A+ to A-) would be weighted 50%; those rated (BBB+ to BB-) would be weighted 100%; and those rated under (BB-) would be weighted 150%. Ibid 18.

\textsuperscript{88} Ibid.

\textsuperscript{89} See Bank for International Settlements, \textit{Enhancing Corporate Governance for Banking Organisations} (February 2006) 6 \texttt{<http://www.bis.org/publ/bcbs122.pdf>}. The Central Bank of Jordan adopted these principles and added them to its governance Code (CBJ Code 2007) to be applied on the Jordanian banking sector, see chapter 7.
independent role in monitoring the bank operations as well as ensuring suitable accountability and transparency.\textsuperscript{90}

Since the 2008 GFC, there have been many questions about the benefit of the Basel II Accord. It has been argued that rather than giving a protective buffer when there is a financial crisis, the capital adequacy system contributed and exacerbated the GFC.\textsuperscript{91} For example, the UK Northern Rock bank was one of the top five mortgage lenders in the UK. In March 2007, the bank had to sell its profitable commercial finance division as a requirement imposed by the Bank of England under the new Basel II Accord. Under the Accord, commercial lenders were required to have higher capital reserves. The compliance with capital adequacy requirements led to loss of a profitable commercial division and consequently accelerated the bank’s failure.\textsuperscript{92} The problem was that Northern Rock should never have been in the position where it had to sell off the most profitable part of its business; it should have had a sufficient capital buffer to avoid this outcome.

The crisis revealed critical flaws in the risk management frameworks used by the large international banks. While these frameworks might have been adequate to evaluate risk under normal market conditions, the GFC demonstrated that these same frameworks underestimated losses when evaluating risk in stress conditions. Nor were the assessments by credit rating agencies any better at evaluating risk prior to the


\textsuperscript{91} Hal Scott and Anna Gelpen, International Finance: Transactions, Policy, and Regulation (Foundation Press, 19\textsuperscript{th} ed, 2012) 585.

The problems were exacerbated by banks gaming the Basel capital adequacy rules particularly with off balance sheet risks. There were ambiguities in the definition of Tier 1 capital which were exploited by the banks. Banks organised their operations in a way which allowed them to comply with Basel II with less capital. Banks were capable of technical compliance with the capital requirements of Basel II while allocating as little as 1% common equity on the balance sheets. Basel II required regulators to be given additional powers in order to fully achieve the process of regulatory and supervisory monitoring described in Pillar II. This may have delayed the application of Basel II principles because of the negotiations that were required between the regulators and banks. Banks pointed to compliance and implementation costs. For example, the banks require general historical information to compute the default risk, this may be a very costly exercise. But this hardly an excuse for what is fundamental to assessment of risk and fundamental to bank operations.

If banks complied with Basel I and II and had in place measures to ensure proper corporate governance and deal with these risks, why were there bank failures during the 2008 GFC?

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95 Scott and Gelpern point to the uneven implementation of Basel II in the USA, see Hal Scott and Anna Gelpern, *International Finance: Transactions, Policy, and Regulation* (Foundation Press, 19th ed, 2012) 582-583.

3.6. The 2008 Global Financial Crisis

The GFC hit the broader banking system in September and October 2008 leading to bank collapses in USA and overseas,\(^97\) huge losses to business, the financial industry and consumers and a global recession.\(^98\) In the US alone\(^99\) in addition to the failure or bailout of the large investment banks of Merrill Lynch, Bear Stearns, Morgan Stanley and Lehman Brothers, there were the very large commercial banks including Citibank, Bank of America and Wachovia Corporation as well as 140 other commercial banks that failed or were bailed out. There was also the failure of large residential mortgage lenders the best known of which were Freddie Mac and Fannie Mae. The failure was not limited to banks and mortgage lenders, it also included the giant US insurer, American International Group (AIG), and car manufacturers General Motors and Chrysler. The scale of these losses was staggering with unemployment in the US reaching 10% with job losses of more than 7.2 million.

This section will briefly discuss some of the key reasons for the GFC. It will start with the problem of subprime lending and the housing market in the US. This is important to understanding how the collapse caused by subprime lending was facilitated by securitization. Securitisation, and key instruments such as Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDS) are discussed below.

\(^97\) Such as Lehman Brothers in the USA and Northern Rock in the UK.

\(^98\) Richard J Payne, *Global Issues: Politics, Economics, and Culture* (Peachpit Press, 4th ed, 2013) Chapter 7, 139. It must be noted here that the banking sector in Jordan is small sector (15 listed Banks) and it was relatively isolated from the impact of the current crisis, due to its limited exposure to the global market, the Banks were not involved much in investment markets, and the restructure taken by the government and the Central Bank of Jordan. See chapter 7.

Subprime lending in the US housing market and the failure of mortgage backed securities are regarded as the main contributors to the 2008 GFC.\textsuperscript{100} Since the late 1990s, US house prices increased rapidly influenced by low interest rates and lax lending procedures involving low documentation loans where risk of default was high. Since the risks created by the subprime mortgage loan were higher than for other kinds of mortgage, mortgage lenders set higher interest rates and higher up-front fees for subprime borrowers to compensate for these risks. The subprime borrowers believed that property values would always increase more than needed to cover the mortgage loan.\textsuperscript{101} There was no shortage of investors for mortgage-related credit derivatives (see below) which produced higher earning yields from ‘supposedly’ safe investments. Incentives for investment focussed not on the quality of the mortgage but on the amount secured.\textsuperscript{102}

Subprime lending in the US property market pre GFC set the stage for securitisation of debt and the use of financial instruments such as Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDS). Securitisation involves the pooling of different types of contractual debt like auto loans or credit card debts, commercial mortgages, residential mortgages, and collateralised mortgage commitments for repackaging and on selling to investors.\textsuperscript{103}

\textsuperscript{100} Stephen Figlewski, ‘Viewing the Financial Crisis from 20,000 Feet Up’ (2009) 16 (3) Journal of Derivatives 53, 57.


Securitisation includes several stages. As an example, a simplified outline of the steps in relation to housing loans is as follows. The first stage is where the household purchaser funds the purchase of the property by taking out a mortgage with a mortgage lender. The long-term interest rate is set on the basis of the applicant’s credit history and assets and liabilities with higher interest payments where the risk of default is high.\textsuperscript{104} The mortgage lender avoids the risk of default by selling the mortgage at a discount to a mortgage banker.\textsuperscript{105} This ability to onsell the mortgage debt and avoid the risk of default led to weakened lending procedures in the pursuit of greater profits. The mortgage banker in turn sells the mortgage on for a profit to an investment banker. The last stage involves the sale by investment bankers of bundled mortgage-based financial products.

In the USA, Fannie Mae, (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) issued bonds to buy mortgages and sell bundled loans to the market. They provided the financial institutions and banks with funds to make new loans to increase home ownership. There was political pressure to increase home ownership to lower income families. In a climate of unsustainable house prices, low doc loans were extended to borrowers with little or no prospects of repaying the loan.\textsuperscript{106}


\textsuperscript{105} Ibid.

Investment bankers pooled mortgages debts (normally between 1,000 and 25,000) into a security called as a Collateralised Debt Obligation (CDO) or a Mortgage-Backed Security (MBS). The security might include various kinds of assets involving mortgages as collateral. The pooling of these securities, could, in theory, decrease the risk of the overall default and produce the same predicted return; in the case of default resort could be had to the asset secured by the initial mortgage. CDOs were a device which allowed the transfer of the risk that borrowers would default on repayment of the loan. The default risk was likely only to be known by the original lender so that purchasers of pooled mortgage debts would not necessarily be in a position to assess the level of risk involved. Moreover the bundled mortgages were increasingly likely to be high risk, low quality loans. In a climate of reduced competition, securitisers more effectively monitor default risk and exert greater control over the originators of the loans. But the reverse was true in the heated atmosphere of quick profits and stiff competition pre GFC where the preference was to take on more risk for greater potential profit.

In the mid-2000s, competition between mortgage securitisers for loans led to deteriorating mortgage underwriting standards and a race to the bottom that ended in the late 2000s financial crisis. Underwriting prevents losses at the front end by basing loan approval decisions and lending terms on data-driven predictions of the likelihood of default, or failure to repay, and the severity of losses to lenders in the event of default. Loose underwriting involves making loans that are likely to default.

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109 Ibid.

110 Ibid 213, 268-269.

111 Ibid.
The Credit Default Swaps (CDS) were an important aspect of risk management and a crucial contributor to the severity of the GFC.\textsuperscript{112} CDS are traded over-the-counter without a formal clearing house or public reporting concerning the pricing of trades.\textsuperscript{113} Credit default swaps are insurance-like contracts that promise to cover losses on certain securities in the event of a default, for which the buyer of the default insurance pays a premium to the seller over the agreed period of time. The seller of the insurance covering the default takes on the risk in return for the insurance premium payment received. Such contracts are typically in relation to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and others. As conceived, they were meant to be like any other form of insurance against risk. Ideally, it would have been necessary for sellers of this insurance to have taken stock of the risks involved in providing this insurance. But this was not the case as CDS were over the counter instruments and not subject to regulation as banks and insurance company activities were. Nevertheless, the purchasers of these instruments were lulled into a false sense of security in the belief that they were insured. The GFC demonstrated that this was a false belief. It begins in the 1990s:

Bankers at JPMorgan Chase … invented credit-default swaps in the 1990s as a way for investors to protect themselves against loans going bad: One party makes regular payments to another in return for a guarantee to be made whole if a borrower defaults on its debt. What started as a simple hedging tool evolved into a playground for hedge funds and bank proprietary trading desks to speculate on debt, from corporate bonds to subprime mortgages. Banks packaged and traded indexes of the swaps, then sliced up the indexes and traded the slices. Investors made and lost money as the value of the swaps rose and fell, regardless of any actual defaults. “Derivatives were in the center of the storm” that led to the $182.5 billion government bailout of American International Group… in September 2008, one of the largest credit-swap


\textsuperscript{113} Anat Admati and Martin Hellwig, Bankers’ New Clothes: What’s Wrong With Banking and What to Do About It (Princeton University Press, 2013) 68-69; and Hal Scott and Anna Gelpern, International Finance: Transactions, Policy, and Regulation (Foundation Press, 19\textsuperscript{th} ed, 2012) 759.
users at the time, the Financial Crisis Inquiry Commission said in its final report in 2011. The next year, CDS trades made by JPMorgan’s Bruno Iksil—the London Whale—ended up costing his bank $6.2 billion.\textsuperscript{114}

One of the largest insurance institutions in the world, the American International Group (AIG) was at the centre of the melt-down of mortgage-backed securities and was bailed out by government.\textsuperscript{115} At the peak of the GFC, their financial exposure through derivatives was approximately $447 billion which AIG was unable to cover.\textsuperscript{116}

The sustainability of the derivatives market ultimately depended on the stability of the housing market. By the end of 2005, the value of subprime mortgages decreased by as much as 30\% as a result of the fall in housing prices and the inability of borrowers to make mortgage payments.\textsuperscript{117} Between September 2007 and June 2008, about US $1.9 trillion of mortgage-backed securities had been downgraded\textsuperscript{118} in line with mounting defaults and reduced asset values.\textsuperscript{119} The default rate on mortgages between 1998 and 2008 is shown in the following Diagram.

\textsuperscript{114} Mary Childs “The Incredible Shrinking Credit-Default Swap Market” in Bloomberg, Business Week Market and Finance, Derivatives, Jan 30, 2014.


\textsuperscript{116} Ibid.

\textsuperscript{117} Hal Scott and Anna Gelpern, International Finance: Transactions, Policy, and Regulation (Foundation Press, 19\textsuperscript{th} ed, 2012) 36; 38; and John Marshall, ‘The Financial Crisis in the USA: Key Events, Causes and Responses’ (2009) 9 (34) House of Commons Library 1, 3.


\textsuperscript{119} Ibid 8.
Diagram 3.1 Residential Mortgage Default Rates in the USA

The above Diagram shows that the default rate of subprime mortgage borrowers against defaults of other mortgages. In 2008, the default rate for subprime mortgages reached 18%; foreclosures primarily involved subprime borrowers. With the onset of the GFC, many borrowers were unable to pay their mortgages leading to high levels of foreclosures and a dramatic fall in housing prices. The risks were exacerbated by adjustable rate mortgages which increased from initial “honeymoon” discount rates. The decrease in house prices caused mounting losses for Fannie Mae and Freddie Mac which funded the majority of mortgages in the USA. Ultimately the US government stepped in and took over both institutions.


121 Subprime mortgages were quite a small component of the mortgage market but were the key trigger for financial collapse, see Paul Mizen, ‘The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses’ (2008) 90 (5) Federal Reserve Bank of St. Louis Review 531, 540. This explains why the default rates for all mortgages sits just above the default rate for prime mortgages.

122 Ibid 539.
protection of the two institutions from collapse cost taxpayers an estimated $224 billion to 360 billion, on top of earlier funding of over $150 billion. In a market not involving financial debt instruments, this would just have resulted in a loss in real estate value. But where real estate is intimately tied up with securitised debt, it provided the trigger for the GFC. Leading commentators explain:

Why did the popping of the housing bubble bring the financial system—rather than just the housing sector of the economy—to its knees? The answer lies in two methods by which banks had evaded regulatory capital requirements. First, they had temporarily placed assets—such as securitized mortgages—in off-balance-sheet entities, so that they did not have to hold significant capital buffers against them. Second, the capital regulations also allowed banks to reduce the amount of capital they held against assets that remained on their balance sheets—if those assets took the form of AAA-rated tranches of securitized mortgages. Thus, by repackaging mortgages into mortgage-backed securities, whether held on or off their balance sheets, banks reduced the amount of capital required against their loans, increasing their ability to make loans many-fold. The principal effect of this regulatory arbitrage, however, was to concentrate the risk of mortgage defaults in the banks and render them insolvent when the housing bubble popped.

Although the subprime crisis had its origins in the US, similar style products were in use in Europe and elsewhere, and financial products such as CDOs and CDSs were purchased on the international market so that the effects of the US crisis were felt internationally. Importantly for this thesis, the GFC revealed serious defects in corporate governance, risk management processes as well as a “hands off” approach by regulators. Why didn’t monitoring and oversight by Boards and their

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124 Paul Davidson, ‘Fannie, Freddie bailout to cost taxpayers $154 billion,’ USA Today, (USA), 22 October 2010.  
Committees prevent these failures? One view is that the failures of corporate governance that led to the crisis occurred as a result of Board members lack of training and experience. Board members and management had insufficient understanding of underlying products and business models, leading to ineffective monitoring by Boards. Independent Non-Executive Directors did not perform an effective role in monitoring or supervision.\(^\text{128}\) Boards did not implement appropriate risk management strategies due to lack of knowledge and experience.\(^\text{129}\)

The failure of corporate governance and in particular Boards and Board Committees were significant factors in the failure of banks during the GFC.

The financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk-taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have, in a number of cases, not been closely related to the strategy and risk appetite of the financial institution and its longer term interests.\(^\text{130}\)

For example, the collapse of Northern Rock Plc in the UK illustrates failure of Boards and their Committees to properly manage risk.\(^\text{131}\) The Treasury committee found that:


\(^{128}\) Paul Moxey and Adrian Berendt, *Corporate Governance and the Credit Crunch* (2008), ACCA Discussion Paper, UK, 4 <http://www2.accaglobal.com/documents/corpgov_credit_crunch.pdf>. Moreover, it was realised that other legal solutions, such as the obligations of the company law of Directors’ provisions as well as shareholder rights’ processes were not sufficient when dealing with the crises. See Roman Tomasic, ‘Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency’ (2009) 2 (1) *Corporate Rescue and Insolvency* 5; and Roman Tomasic, ‘Shareholder Litigation and the Financial Crisis: the Northern Rock Shareholder Appeal Considered’ (2009) 262 *Company Law Newsletter* 1.


\(^{130}\) Ibid 21.

\(^{131}\) Brian Walter, *The Fall of Northern Rock: An Insider’s Story of Britain’s Biggest Banking Disaster* (Harriman House, Petersfield, Hampshire, 2008). 38-41.
The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The Non-Executive members of the Board, and in particular the chairman of the Board, the chairman of the Risk Committee and the senior Non-Executive Director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.  

It was clear that Basel II did not provide a comprehensive solution to avoid the worst effects of the 2008 GFC. This led regulators to consider further reforms to deal with capital adequacy and other risks that may affect banks. This provided the impetus for the Basel III to re-evaluate the risk coverage guidelines and assumptions as well as enhance the quantity and quality of the bank’s capital and liquidity. This is discussed next.

3.7. Basel III

3.7.1. Introduction

In November 2010, the G20 officially confirmed Basel III. In Basel III, the number of principles for good bank governance increased from eight to fourteen principles. There are three new principles relating to the responsibilities, structures and processes of risk management; the responsibility of Board with regard to its own

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134 The G20 comprises members from 19 countries as well as the European Union. For further information, see http://www.dfat.gov.au/trade/g20/.

activities and processes; and the responsibilities and arrangements of Board in group structures.\footnote{136} (see Appendix [I]).

The Basel III aims to increase the bank capital’s quantity and quality as well as re-evaluating the risk coverage guidelines and assumptions.\footnote{137} The most controversial issues are the macro prudential measures. The Basel I and II reforms were almost exclusively directed at the bank-specific level or micro-prudential levels. Basel III takes a wider at macro-prudential approach in setting out principles to evaluate systemic risk within the global financial framework and to reduce the risk of any potential crisis before it occurs.\footnote{138} Basel III includes 3 pillars which are critical to preventing bank collapse. These reforms relate to capital adequacy, liquidity and systemic risk. Table 3.4 summarises these 3 pillars.

\textbf{Table 3.4. Basel III’s Pillars}

<table>
<thead>
<tr>
<th>Basel III</th>
<th>Pillar I</th>
<th>Pillar II</th>
<th>Pillar III</th>
</tr>
</thead>
</table>

Source: BCBS\footnote{139}


Many countries are in the process of implementing the new Basel III principles. It is not uniform with many countries still considering the timing and extent of implementation. For example, in September 2012, Australia published the final Basel III capital reform package. The reforms are to be implemented between 2013 and 2018, with the new Basel III minimum capital requirements effective from 1 January 2013. These principles require the Australian banking sector to have an internal capital adequacy evaluation procedure and to maintain the Basel III required levels of regulatory capital, (see chapter 5).

In Jordan, the CBJ is working to harmonise the identifications, classifications and procedures to comply with Basel III. It involved the development of the general and automated database completed at the end of 2012. According to the 2012 International Monetary Fund (IMF) Report, most of the Jordanian banks met the Basel III’s capital adequacy requirements as well as the main share of banks’ capital is Tier 1 as in the Jordanian banking sector, most of the Jordanian banks hold capital either as paid up or in reserves. This is discussed further in chapter 6.

Basel III deals with 3 areas which are critical to preventing bank collapse. These reforms relate to capital adequacy, liquidity and systemic risk. Table 3.5 provides a summary outline preliminary to more detailed discussion below.
Table 3.5. Basel III’s Main Areas

<table>
<thead>
<tr>
<th>Basel III</th>
<th>Capital Reform</th>
<th>Liquidity Standards</th>
<th>Systemic Risk and Interconnectedness</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quality and Consistency of Capital Base</td>
<td>Short-Term: Liquidity Coverage Ratio (LCR)</td>
<td>Capital Incentives for Using CCPs for OTC</td>
</tr>
<tr>
<td></td>
<td>Capturing of All Risks</td>
<td>Long-Term: Net Stable Funding Ratio (NSFR)</td>
<td>Higher Capital for Systemic Derivatives</td>
</tr>
<tr>
<td></td>
<td>Controlling Leverage</td>
<td></td>
<td>Higher Capital for Inter-Financial Exposures</td>
</tr>
<tr>
<td></td>
<td>Buffers</td>
<td></td>
<td>Contingent Capital</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Capital Surcharge for Systemic Banks</td>
</tr>
</tbody>
</table>

Source: BCBS\textsuperscript{140}

3.7.2. Capital Reform

Increasing the Quality and Quantity of Capital

The primary issue when the Basel committee designed Basel III was the need to strengthen the quality and quantity of bank capital.\textsuperscript{141} As noted, Basel I required risk-weighted capital of at least 8%, with total capital divided equally (50%) between Tier 1 and Tier 2. Basel II maintained this ratio. Basel III has changed the tier I capital requirements by increasing the equity and equity like component of it from 4% to 6%, and by also requiring a capital conservation buffer of 2.5% and discretionary

\textsuperscript{140} Ibid 6-9.

countercyclical buffer 2.5%.\textsuperscript{142} Tier I capital is defined as comprising equity capital and items akin to equity capital such as disclosed reserves (retained earnings) and nonredeemable noncumulative preferred stock. The underlying concept is that Tier 1 capital cannot be called on by its holders at will, unlike creditor claims, and will therefore not destabilise the financial position of banks in a time of crisis. Basel III divided Tier 1 into two factors: “Common Equity Tier 1” and “Additional Tier 1.”\textsuperscript{143} Common Equity Tier 1 must account for at least 4.5% of the RWAs of the bank. The position is summarised in the following Table.

Table 3.6. Basel III-Minimum Total Capital Ratio

<table>
<thead>
<tr>
<th></th>
<th>Tier 1</th>
<th>Common Equity Tier 1 (4.5% of RWAs)</th>
<th>Additional Tier 1 (25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>75% of total capital (Tier 1 capital)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 2</td>
<td>25% of total capital (Tier 2 capital)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BCBS\textsuperscript{144}

From the Table above, Tier 1 (75%) must comprise: Common Equity Tier 1 and Additional Tier 1. The bank’s Common Equity Tier 1 capital contains the total of: common stock, retained earnings, surplus from common stock issuances, minority interests in the common stock of consolidated subsidiaries, certain regulatory

\textsuperscript{142} The new requirements are reported to increased capital from 5 to 10 times the pre GFC level, see Herve Hannoun, ‘Financial Regulatory Reform: Implications for Asia and the Pacific’ (Paper Presented at the BoJ-BIS High Level Seminar, 22 November 2010) 2 <http://www.bis.org/speeches/sp101125a.pdf>.


\textsuperscript{144} Ibid 56.
adjustments, and other comprehensive income. Additional Tier 1 capital primarily includes different types of preferred stock as well as additional paid capital that does not otherwise satisfy the principles of Common Equity Tier 1.

Tier 2 (25%): the purpose of Tier 2 capital is to provide loss absorption on a continuing basis. Although Tier 1 gives the bank’s actual equity base, Tier 2 is absorbed by the bank as the bank suffers losses. Tier 2 capital gives a cushion consisting of lower forms of equity and obligations. Tier 2 contains preferred stock with non-perpetual, debt-like features and different kinds of subordinated debt. Tier 2 may include a variety of mechanisms that fail to qualify for Tier 1. Appendix [K] shows the Basel committee’s criteria for Tier 2. In general, the criteria:

requires that the instrument at issue is subordinated to depositors and general creditors; is neither secured nor guaranteed by the bank; has no credit sensitive dividend features; was issued to a third party in an arms-length transaction; and has no features that permit investors to accelerate payments in cases of insolvency, liquidation, or bankruptcy.146

The goal is to ensure that the capital base of each internationally active bank has a high-quality buffer which makes it able to reduce the risk of bank failure.147

**Additional Buffers**

Because banks may continue distributing dividends as well as paying staff remuneration,148 these distributions may erode capital reserves as well as decreasing

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the capacity of the banks to absorb additional declines in capital reserves to serve as defences against potential losses. Basel III requires banks to put in place additional measures as a buffer against the risk of losses. These are the capital conservation buffer, a countercyclical buffer and a leverage ratio which are discussed in turn.

Banks are required to have an additional 2.5% of the overall capital in the form of Common Equity Tier 1, over and above the 4.5% minimum mentioned above. Consequently, Basel III effectively adds to the Common Equity Tier 1 a requirement of a full 7% of RWAs. The bank could dip below the 7% ratio in periods of crisis, though the bank must reinstate the buffer by decreasing optional distribution such as dividend payments as well as staff bonus payments. When the bank is unable to do this voluntarily, for example, because of contractual obligations, Basel III asks the regulators to compulsorily impose these requirements until the buffer is restored.

For example, when the bank has a Common Equity Tier 1 ratio of 5.5% and a capital conservation buffer of 1% below that of the required 2.5%, the bank should retain 80% of its earnings in the next year to restore the buffer. Its optional distributions are


150 There are items under Basel III: share buy-backs, dividends, discretionary payments on other Tier 1 instruments as well as discretionary bonus payments to staff. Payments that do not result in consuming Common Equity Tier 1 below the 7 percent minimum, such as scrip dividends which are not distribute under Basel III. See Bank for International Settlements, Basel Committee on Banking Supervision: Basel III-A Global Regulatory Framework for More Resilient Banks and Banking Systems, (December 2010), 56 <http://www.bis.org/publ/bcbs189.pdf>.

then limited to just 20% of its earnings. Banks may avoid these restrictions through re-capitalising the buffer by private sector capital raisings (each as rights issues). Although banks can utilise the capital conservation buffer to absorb losses, unless restrictions are imposed, banks may be tempted to use the buffer to improve their competitiveness. With this in mind, Basel III suggests that regulators use their discretion to enforce time limits on banks operating in the buffer.

It should be noted that in the banking system where the banks are highly leveraged, banks can easily increase financial risks or engage in asset substitution without the creditors’ knowledge. This involves a “moral hazard” in that in the banking industry particularly, there are benefits in high risk strategies that can yield large short term profits with creditors bearing the brunt of losses for failure. The moral hazard is exacerbated by the belief that government will step in if there is a risk of bank collapse so that the public picks up the cost of failure of high risk activities. According to the agency theory, it is a principal moral hazard problem between creditors and shareholders. Shareholders may be more interested in short term profit and consequently higher risk. This can leave creditors as the losers if there are significant losses and shareholders with the profits if it pays off. This problem is the main issue for banking regulation. There is evidence that this type of loss shifting

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153 Ibid 56.


156 For further discussion concerning the agency theory, see chapter 2 [2.2.2].
occurred before and during the GFC but not in the short term thereafter. The major argument in favour of increasing minimum capital requirements is that when shareholders have more to lose, this may help reduce motivations to engage in risk shifting. The other buffer that may be required is the countercyclical buffer. The easy availability of credit and the risk of overheated markets led to “asset bubbles” with huge losses when values decrease, loans are unpaid and there is reduced availability of credit. To avoid this, Basel III requires a “countercyclical buffer” to require more capital to be accumulated when there is high credit growth. The buffer may indirectly operate to limit the flow of credit by pushing up interest rates which may assist in quietening an overheated market. The countercyclical capital buffer not only protects the banking sector from losses resulting from periods of excess credit growth followed by periods of stress, but it helps to ensure that credit remains available during this period of stress. Importantly, during the build-up phase, as credit is being granted at a rapid pace, the countercyclical capital buffer may cause the cost of credit to increase, acting as a brake on bank lending.


160 Ibid 12.
Basel III places the onus on each country to exercise control over credit growth and determine whether a countercyclical buffer is required. The size of the buffer is likely vary according to the situation of the individual banking system and may be removed when the risks of failure are reduced.

In Australia, for example, the Australian Prudential Regulation Authority (APRA) in consultation with the Reserve Bank of Australia (RBA) gave regulatory directions which required all banks operating in Australia to satisfy the following:

1. 6% of tier 1 capital and 2% of tier 2 capital for a total 8% of CAR.
2. 2.5% capital conservation buffer. This buffer is intended to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be used to absorb losses during periods of financial and economic stress. The buffer will apply in addition to the minimum Common Equity Tier 1, Additional Tier 1 and Total Capital ratio requirements and will need to be met with Common Equity Tier 1, over and above any Common Equity Tier 1 needed to meet the minimum capital requirements.
3. 2.5% countercyclical buffer. The countercyclical buffer varies between zero and 2.5 per cent of total risk-weighted assets and will be implemented through an extension of the capital conservation buffer. The countercyclical buffer is to be met with Common Equity Tier 1 only, although the Basel Committee is still reviewing the question of permitting other fully loss-absorbing capital.

The Basel Committee also introduced a leverage ratio as another measure to mitigate the risk of bank failure. Basel III rejected the idea that requirements of capital could

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161 Ibid 12.
164 Ibid 27.
165 Ibid 30.
be satisfied only on the basis of RWAs. The Basel Committee created an additional measure. The “leverage ratio” of Basel III could be clarified through comparing Tier 1 capital with the “total exposure” without referring to RWAs. The main goal is a leverage ratio of at least 3% (Tier 1 capital should be at least 3% of the overall exposure).

This needs a determination of the overall exposure. The Basel Committee established the following principles:

1. The assets of subsidiaries that are consolidated for accounting goals need to be excluded from the measure of the overall exposure when the investments in those institutions are deducted from Tier 1 for regulatory goals;

2. In calculating overall exposure, netting of loans as well as deposits will not be permitted and collateral as well as other forms of credit risk mitigation will be not necessary;

3. Derivatives will be added in exposures by using the “loan equivalent” method described by Basel II; and

4. Off-Balance Sheet items are required to be brought into calculation by using a “credit conversion factor” of 100%.

This effectively means that banks will have to run two separate frameworks. The first is to account for their risks depending on the capital requirements. A separate system will need to be established to account for their total risk exposure in determining the leverage ratio. For these rules to be effective, it will be necessary to ensure

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consistency across jurisdictions. This is even if the banks use various accounting procedures.\textsuperscript{168}

Following Basel III, banks are to undergo “stress testing” to test the robustness of their system to withstand a future banking crisis. Furthermore, risk management frameworks and processes need to be checked at least annually in addition to the requirement that banks need to have an independent risk monitoring system which is able to and makes daily evaluations of credit exposure and risk measurement.\textsuperscript{169} This is an important measure to reduce the risks of bank failure. Board Committees should take an active role in monitoring the processes relating to the stress testing as well as overseeing compliance with Basel requirements. One of the key mechanisms to ensure bank stability and protect against systemic risk and bank collapse is the Basel liquidity requirements.

3.7.3. Liquidity Reform

The 2008 GFC was not so much a capital crisis as much as it was, at least initially, a liquidity crisis as discussed above. In response to the liquidity problem, the BCBS issued standards for “Sound Liquidity Risk Management and Supervision” in 2008. This has been added to by Basel III.\textsuperscript{170} The Basel Committee identified two minimum principles for liquidity: the Short-Term Ratio: Liquidity Coverage Ratio (LCR) and the Long-Term Ratio: Net Stable Funding Ratio (NSFR). The LCR standard is directed to ensuring that banks have high quality liquid assets that are readily

\textsuperscript{168} Ibid 63.


convertible to cash to meet its net cash needs for a 30 day period under “severe liquidity stress specified by supervisors.”\textsuperscript{171} The NSFR is concerned with liquidity related to medium and long term funding based on bank assets and activities including off balance sheet commitments over a 12 month period of extended crisis.\textsuperscript{172}

Board Committees will have a critical role in overseeing bank compliance with these liquidity requirements. Capital and Liquidity requirements are critical to individual bank stability but they do not necessarily address the problems relating to systemic risk.

3.7.4. Systemically Important Financial Institutions (SIFIs)

The Basel III rules dealt with the capital and liquidity requirements for the banking sector. Although these rules will reduce the risk of bank failure, it does not specifically address systemic risk. The Basel Committee rules do not fully cover the systemic risk posed by institutional interlinking and financial institutions that are “too big to fail”; these are known as “SIFIs.” As a result, the BCBS is trying to develop frameworks addressing SIFIs; these include tighter big exposure restrictions, compulsory recovery and resolution plans, capital and liquidity surcharges and contingent capital.\textsuperscript{173}

The Basel Committee completed a temporary methodology for evaluating systemic importance at the beginning of 2011. There is currently no consensus on what

\textsuperscript{171} See Ibid 3; 12 -16 for further details of the calculation of LCRs.

\textsuperscript{172} It has two components: required stable funding for assets (RSF) and Available Stable Funding (ASF) for off balance sheet exposures. For further detail on the calculation of these ratios see Ibid 28.

additional requirements may be imposed to respond to systemic risk. There is a proposal that SIFIs be required to pay capital surtaxes to provide a fund to deal with systemic risk. It will not cover all banks so that small retail banks are unlikely to pose high risks are unlikely to be subject to the capital surtax.\textsuperscript{174}

If the Basel Accords are to protect against future bank collapse, the crucial question is how banks have responded to the Basel III Accord?

### 3.7.5. Banks Response to Basel III

The generally accepted position is that:

> Most of the initiatives launched by banks in recent years to improve capital efficiency will still be applicable in the Basel III world. Banks will take the opportunity to reassess what they have implemented so far and identify further correction measures. For example, introduce credit-risk models and central counterparties to the trading book. Some leading banks are currently working to improve their capital efficiency in the trading book through the development of internal counterparty risk and credit valuation adjustment models, centralized counterparty management, and greater use of central counterparties.\textsuperscript{175}

Basel III aims to enhance the stability and soundness of financial institutions. However, regulators are concerned at the speed of these reforms in the light of banks efforts to recover from the GFC. It is recognised that a timetable for introduction of these reforms is required. The Basel Committee has followed a phase-in method for the new system which commenced in January 2013 with full implementation by January 2019, (see Appendix [J]).\textsuperscript{176}


136
The banks need to assess leverage ratios as well as publicly disclose them by January 2015. The minimum 3% leverage ratio will be applicable from January 1, 2017.\textsuperscript{177} The applicable liquidity ratios of Basel III will overlap as the LCR will operate as a minimum requirement on January 1, 2015. The NSFR will not formally come into operation until 2018. There is no published time frame for any additional capital charge for SIFIs, but the Basel Committee is predicted to negotiate the issue with the American Financial Stability Oversight Council\textsuperscript{178} as well as the European Systemic Risk Board\textsuperscript{179} as the two organisations responsible for SIFIs in their

\textsuperscript{176} The transitional arrangements are identified in the Basel III liquidity standard text document, see Appendix [J].

\textsuperscript{177} It should be noted here that verifying a consistent Common Equity Tier 1 ratio of 4.5\% as well as total Tier 1 capital ratio of 6.0\% is the highest priority of the Basel Committee. The core capital requirements of Basel III need to be in use by January 2015. When the core capital ratios of Basel III will be in process, the capital conservation buffer will be issued at the beginning of 2016 with an introductory buffer of 0.625\%. An extra 0.625\% will be added with the buffer at the beginning of every New Year until the buffer becomes 2.5\%. The regulators might increase the size and the application of the countercyclical buffer as circumstances dictate, however, the implementation of the countercyclical buffer uses the same plan as the capital conservation buffer. See Peter King and Heath Tarbert, ‘Basel III: An Overview’ (2011) 30 (5) Banking and Financial Services Policy Report 1, 11 <http://www.weil.com/files/upload/Basel_III_May_2011.pdf>.

\textsuperscript{178} The Financial Stability Oversight Council (FSOC) is a US federal government organization, issued by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act, brought to force in July 21, 2010. The US Dodd-Frank Act 2010 gives the Council with general duties to present and control risk to the American financial framework from the failure of large, interconnected Bank holding companies or non-Bank financial companies, or from risks which may increase outside the financial framework; to avoid predictions that any US financial institutions are ‘too big to fail’ and to react to emerging threats to American financial stability. See www.treasury.gov/initiatives/fsoc/pages/home.aspx; and Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, sec 111.

\textsuperscript{179} The European Systemic Risk Board (ESRB) was set up in 16 December 2010. It is charged with the macro-prudential oversight of the financial framework in the Union and to reducing systemic risks to financial stability in the Union. See http://www.esrb.europa.eu/shared/pdf/ESRB-ECB-en.pdf?bdf1f42803e9c9233cd4ce227bb0e160.
respective jurisdictions. It should be noted that many countries such as UK, Australia and Jordan have adopted the Basel III principles.

While the Basel III introduced new principles to deal with bank liquidity, capital adequacy and risk management, there is need for an effective and independent Board members and Committees to apply these principles on their banking system effectively by monitoring and evaluating the bank performance and ensuring that the bank has effective risk management system and sufficient liquidity and capital adequacy able to prevent any potential deficits may affect the bank. Basel III states that banks need to provide reports to the appropriate Board Committees on a regular basis identifying risks as well as the procedures that are being taken to control that risk. It added that:

The Board of Directors and senior management should be actively involved in the risk control process and must regard credit and counterparty credit risk control as an essential aspect of the business to which significant resources need to be devoted. In this regard, the daily reports prepared by the independent risk control unit must be reviewed by a level of management with sufficient seniority and authority to enforce both reductions of positions taken by individual traders and reductions in the bank’s overall risk exposure.

Banks object to the Basel III requirements on a number of grounds. The first is the difficulty of increasing additional capital for trading or lending losses and the increase

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181 See chapter 4.

182 See chapter 5.

183 See chapter 6.

184 See chapter 2 for further discussion concerning the role of Board of Directors and their Committees.


186 Ibid 48.
in the costs of funding which the banks need as a consequence of liquidity requirements. These additional requirements, banks argue, will have adverse economic impacts of banks curtailing loan growth because of the new capital requirements.\textsuperscript{187} There is also the argument that the higher capital requirements may contribute to the next crisis by making the management, investors and creditors of the banks complacent about their capacity to prevent losses.\textsuperscript{188} There is also a risk that despite the Basel principles, banks will use new creative means of engaging in high risk and high profit strategies.\textsuperscript{189}

It should be noted that there has been significant changes to bank regulation since the 2008 GFC including the phased implementation of Basel III. There is a continuing debate whether the banking system and depositors are better protected through the separation of retail banking from investment banking.\textsuperscript{190} This would isolate the retail banking sector from risks due to excessive risk taking by investment banks.\textsuperscript{191} Separation would require banks which have significant trading activities to create separate entities for investment banking and retail banking activities. Assuming that a

\textsuperscript{187} Hal S Scott and Anna Gelpern, \textit{International Finance: Transactions, Policy, and Regulation} (Foundation Press, 19\textsuperscript{th} ed, 2012) 596-597.


\textsuperscript{189} Ibid.


threshold was set above which banks had to separate retail from investment banking, banks over the threshold would have to transfer that business to a separate legal institution.\textsuperscript{192} This would require separate funding, capital adequacy, liquidity and compliance with regulatory standards for both. As separate financial institutions it would require separate governance and Boards, legal and funding arrangements and financial reporting.\textsuperscript{193}

Such a separation would not, however, prevent a certain degree of intra-group coordination of capital and liquidity management. In the case of a crisis, the retail/commercial banking entity may be allowed to receive support from the trading part of the group, provided that the prudential regulatory requirements are met by both parts of the group. In order to ensure full reparability and protection against intra-group contagion from the trading entity, that entity could neither own nor be owned by an entity itself carrying out other banking activities. An integrated banking group would therefore have to be structured by way of a holding company owning both trading entities and other banking entities. Ownership structures that do not fit this model (e.g. cooperative banks) may deserve separate consideration in this regard.\textsuperscript{194}

In theory this would allow better management, reduced risk taking and tighter control of banks.\textsuperscript{195} It may, however, require increased capital for the retail operations of the bank to protect investors.\textsuperscript{196} In the UK, the approach adopted is to “ring fence” retail operations from investment banking activities rather than requiring the complete separation of banking services into two separate banking systems.\textsuperscript{197}

\textsuperscript{192} Ibid 98.

\textsuperscript{193} Ibid.

\textsuperscript{194} Ibid.

\textsuperscript{195} Ibid 98-99.


\textsuperscript{197} The Independent Commission on Banking (ICB) states that the UK Banking sector has until 2019 to comply with this requirement, see The Independent Commission on Banking, \textit{Financial Regulation...
Critics point out that separation would diminish opportunities for diversification, and increase funding costs. Moreover the experience from the US was that when the prohibitions in the *Glass Stegall Act 1933* were still in force, US banks had managed to avoid many of the restrictions. The experience from the US was that when the prohibitions in the *Glass Stegall Act 1933* were still in force, US banks had managed to avoid many of the restrictions. Whether such an approach would ultimately diminish the risks of bank failure and diminish the risk of government bail out is yet to be tested.

### 3.8. Conclusion

This chapter examined special requirements relating to the governance of banks. It examined the risks that may affect banks as well as the importance of the Basel Accords in establishing standards for the protection of the banking sector against failure.

This is important to the examination of the role of Board Committees which includes monitoring banks compliance with the Basel Accords. The Basel III Accord deals with the role of the Board of Directors in monitoring bank liquidity and capital adequacy as well as evaluating independently the performance of the bank, Board and senior management. Committees should ensure that the bank has efficient risk management systems and sufficient liquidity and capital adequacy to cover any potential deficits which could result in bank collapse.

The two chapters following will examine the international experience relating to the governance of banks in the UK and Australia before and after the global financial crisis.

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crisis in 2008. It will focus on the causes of the crisis and the importance of the UK and Australian regulatory reforms.
CHAPTER 4

BANK GOVERNANCE IN THE UK

4.1. Introduction

The previous chapter provided an overview of bank governance, the crucial role of banking sector in the economy, the special risks that affect banks, and the importance of the Basel Accords to avoid future potential risks.

This chapter will discuss the regulatory and corporate governance framework for banks in the United Kingdom (UK). This will provide both a comparator for the Jordanian banking system and also important lessons about bank governance.

The UK financial system is a very important part of the UK economy. In 2011,\(^1\) the financial system contributed 9.6% of the country’s GDP.\(^2\) Financial services generated a trade surplus of £47.2 (USD 77.8)\(^3\) billion in 2011. “This was roughly the same as the combined surplus of all net exporting industries in the UK and amounted to nearly 4% of GDP on its own.”\(^4\) The financial system in the UK is

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\(^2\) Ibid 45.

\(^3\) The exchange rate for the UK Pound was last updated on February 1, 2014 from Yahoo Finance as £1 equal about USD 1.65.

\(^4\) The main countries for the UK financial services’ exports were Germany, France, Ireland, Netherlands, and Luxembourg. Also the UK financial exports concerned with emerging markets such as South Africa, Russia, Saudi Arabia and Turkey and international centres such as Singapore and Hong Kong. See Financial Stability Board, Peer Review of the United Kingdom: Review Report (10 September 2013), 45.
…a world leader in cross-border bank lending (19% of global share), foreign exchange turnover (37%), interest rate OTC derivatives turnover, (46%) and marine insurance and net premium income (19%).

The UK, internationally, has the second largest share of hedge fund assets and private equity after USA.

The principal banks operating in the UK are HSBC, Barclays, Royal bank of Scotland Group, Lloyds Banking Group, and Santander. The UK banking sector has the fourth largest assets in the world comprising large domestic and branches of foreign-owned financial institutions. Lending accounts more than half of the total assets of these banks in 2009.

There is a significant presence of foreign branches operating in the UK. Foreign banks in UK manage about half of the UK banking sector assets which at the end of 2011 were £8.1 (USD 13.3) trillion. The UK-owned banks have more than half of their assets held overseas. In total, both domestic and foreign banks hold more than £12 (USD 19.8) trillion of assets in the UK and overseas; this is equivalent to more than eight times GDP, of which domestic banks account for assets equal to five times

5 Ibid 46.
6 Ibid.
7 The UK has "ring fenced" retail banking, see chapter 3 [3.7.5].
8 On the other hand, the fifth largest Bank in UK, Standard Chartered Bank, mainly operates in Africa and Asia. See http://www.relbanks.com/europe/uk.
10 International borrowers were responsible for almost a third of the UK Bank lending with USA comes first (17%), followed by Germany (8%) and then the Netherlands (6%). See International Monetary Fund, United Kingdom: Financial System Stability Assessment (July 2011), Country Report No. 11/222, Consultation Washington, DC, USA, 14 <http://www.imf.org>.
11 According to Financial Service Authority (FSA), there are 154 listed Banks incorporated in the UK as complied by FSA on 28 February 2013. See http://www.fsa.gov.uk/static/pubs/list_banks/feb13.pdf.
GDP. The foreign branches alone account for one-third of the UK resident banks’ assets. These branches are permitted by the Financial Services Authority (FSA) and their country of origin to operate in the UK.

The GFC had a serious impact on the UK economy with significant contraction in the economy leading to a recession. The following diagram illustrates.

**Diagram 4.1. Economic Growth in UK**

![Economic Growth in UK](source: Office for National Statistics (ONS))

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13 Ibid.

14 For further discussion concerning FSA, see the discussion below at [4.2.1.2. II].

15 The UK economy suffered significant contraction in 2008; the 2.5% contraction in the three months to the end of December 2008 was the biggest contraction in a three month time demonstrating the sharpness and speed of the recession which badly affected the UK economy. See also International Monetary Fund, *United Kingdom: Financial System Stability Assessment* (July 2011), Country Report No. 11/222, Consultation Washington, DC, USA, 11 <http://www.imf.org>.

Although some UK banks remained profitable, overall UK banks suffered huge losses post GFC. The UK government intervened to prevent the financial sector from collapse and to ensure that the payment system and depositors were protected. The Bank of Scotland (RBS) and Lloyds Banking Group (LBG) were given capital injections of £66 billion with the government taking an 80% stake in RBS and 40% in LBG. The government nationalised Northern Rock and the Bradford and Bingley bank. The retail deposits and branches were transferred to Abbey National plc. Northern Rock was divided up to become Northern Rock plc and Northern Rock Asset Management. Northern Rock plc was purchased by Virgin Money. It is this post GFC climate that has led to regulatory review to avoid future risk of failure.

This chapter is divided into four sections. Section 4.1 is the introduction. Section 4.2 discusses the UK regulatory system. It explores the UK regulatory system and the main reasons of the failure of this system pre the 2008 GFC. Then it investigates the new regulatory system post the crisis. Section 4.3 discusses the development of Corporate Governance Codes from the Cadbury Code to recent amendments. Section 4.4 concludes.

4.2. The UK Regulatory System

4.2.1. Pre 2008 GFC-The ‘Tripartite’ Financial Regulatory System

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17 The total assets of the UK banking sector were £8,474 (USD 13,982) billion in 2007. Post GFC, the total assets of these Banks declined to £7,420 billion (USD 12,243) in 2008. See Financial Stability Board, Peer Review of the United Kingdom: Review Report (10 September 2013), 48. For further discussion concerning the influence of 2008 GFC on the UK Banks, see the discussion at [4.2.1.2].

18 Ibid.

19 Ibid.

20 Ibid. For further discussion concerning the new UK regulatory framework post the GFC, see the discussion below.
4.2.1.1. Introduction

Prior to the 2008 GFC, there was a ‘tripartite’ regulatory system involved in the regulation and management of the financial system in the UK: the Bank of England, the Treasury and the Financial Services Authority (FSA). The Financial Services and Markets Act (FSMA) 2000 provided for a single financial regulator, the FSA to deal with all aspects of financial regulation.21

The Bank of England was divested of its responsibilities and powers to regulate and maintain the financial stability of the UK financial sector. After the Bank of England Act 1998,22 the main role of the Bank of England was to organise monetary policy23 with the Treasury supervising regulatory developments under the FSMA 2000.24 Treasury, through the National Audit Office,25 periodically checked and reviewed the FSA’s performance.26 The FSA was the regulator for the sector, insurance and

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23 It was amended in the Bank of England Act 1998 that the power of Treasury is to give directions to the Bank of England to particularly exclude the power to provide directions with respect to monetary policy. See Julia Black, Managing the Financial Crisis—The Constitutional Dimension (2010), LSE Law, Society and Economy Working Paper: 12/2010, London School of Economics and Political Science, 5. See also section [4.2.2.2] for further discussion concerning the Bank of England.


25 The National Audit Office scrutinises public spending on behalf of the UK Parliament. It reports the audit outcomes to Parliament. It holds government sections and bodies to account for the process they use public money, hence safeguarding the taxpayers’ interests. Also it assists public service managers enhance performance and service delivery. See http://www.nao.org.uk/.
investment business under the *FSMA 2000*. Although it operated independently of the UK government, the FSA’s Board of Directors were appointed by Treasury.\textsuperscript{27}

The ‘tripartite’ regulatory system had many inherent weaknesses which were made clear during the GFC. The most important failures were the inability to respond to risks in the financial industry or to take proactive steps to mitigate or avoid risks to the stability of the UK financial system and failure to adequately deal with the crisis.\textsuperscript{28} The ‘tripartite’ regulatory system imposed nominal responsibilities on the Bank of England and, since the *Banking Act 2009*,\textsuperscript{29} statutory commitments for stability of the financial system. But it did not provide mechanisms to carry out these responsibilities effectively. Although Treasury had overall responsibility, there were no clear lines of responsibility for dealing with any potential crises.\textsuperscript{30} The FSA, as a single and monolithic financial regulator, was expected to handle all matters ranging from the stability and safety of the UK banks as well as the consumer protection.\textsuperscript{31} The following section discusses how the ‘tripartite’ regulatory system failed during the 2008 GFC.


\textsuperscript{27} See also www.fsa.gov.uk/.


\textsuperscript{29} The *Banking Act 2009* is an Act of the UK Parliament which enforced on 21 February 2009. It replaced the old *Banking Act 2008* (Special Provisions). This Act amends the law on Bank insolvency and administration, makes provision for the nationalisation of UK Banks, makes provision about the Financial Services Compensation Scheme, and makes other various amendments to the law on banking. See the *Banking Act 2009* Chapter 1.


\textsuperscript{31} Ibid.
4.2.1.2. The Failure of the ‘Tripartite’ System

I. The Bank of England and Treasury

As mentioned above, under the earlier framework, the Bank of England was responsible for financial stability. However, during the crisis, it did not have the formal mandate or ability to achieve this objective effectively.\(^{32}\) Criticisms of the Bank of England include poor governance, the inability of its Governor to face criticism or take advice and the influence of conservative politicians.\(^{33}\) The Bank of England failed to take action as the credit bubble increased. It also compounded the loss of financial confidence at the beginning of the crisis by failing to take action to ensure liquidity of UK banks.\(^{34}\)

In September 2007, the Bank of England provided emergency liquidity to Northern Rock. This was done without publicity because of the fear that disclosure would breach the disclosure provisions in the Market Abuse Directive.\(^{35}\) When it was apparent that Northern Rock bank was having difficulty meeting depositor demands, this led to a run on the bank. The UK government then guaranteed all existing Northern Rock account holders as soon as markets opened but this couldn’t stem the run on the bank or increase the availability of funding from the wholesale markets.\(^{36}\)

\(^{32}\) See also Financial Stability Board, Peer Review of the United Kingdom: Review Report (10 September 2013), 13.


\(^{34}\) In the United Kingdom, the Bank of England showed a greater willingness to allow short-term rates to rise to the standing credit facility rate, and there was no immediate injection of additional liquidity Alexandre Chailloux et al, Central Bank Response to the 2007–08 Financial Market Turbulence: Experiences and Lessons Drawn (September 2008), IMF Working Paper: 08/210, 18.

Treasury also had a role in maintaining stability of the system, the most serious problem was that there was no clear responsibility for dealing with the crisis.37

Prior to the crisis, bank failures had been a rare occurrence and so, by definition, the Treasury’s senior management had limited personal experience of them. The financial sector had not been a high profile area of the Treasury’s business for a number of years...there was a small Treasury team working on financial stability in the immediate run-up to the crisis.38

The Treasury extended the government guarantee to cover new deposits as well as unsecured wholesale borrowing. In 9 October 2007, Treasury extended the guarantee to new retail deposits and, with the Bank of England, revised the requirements for emergency liquidity support; losses from that date were covered by a Treasury indemnity. The Bank of England lent Northern Rock £27 (USD 44.5) billion in December 2007. Treasury also undertook contingent obligations under guarantees of £29 (USD 47.8) billion, and gave assistance by recapitalising of £3 billion (USD 4.9).39 The level of support being given by the Bank of England couldn’t continue indefinitely. The UK government started to explore suitable options. It was however hampered by the lack of statutory powers to deal with the failure of the Northern Rock. The bank’s depositors would have to resort to a deposit protection plan that was not funded in advance and required a number of mechanisms before payment could be made. This effectively left the bank’s depositors without any access to their

36 See chapter 3 [3.6] for further discussion concerning this Bank.


funds precipitating a run on other banks.\textsuperscript{40} Treasury was concerned that there would be a ‘firesale’ of the assets of Northern Rock, leaving it without sufficient funds to repay its obligations from the money already injected by the UK government.\textsuperscript{41}

The failure of Northern Rock presented serious problems for the UK government. There were difficulties with the government acting as broker for a sale of whatever assets were worthwhile salvaging from Northern Rock. Nor could the government or the regulator take over the running and administration of Northern Rock. The Bank of England and Treasury officials were at risk of becoming ‘shadow directors’ under the company law, and liable for their activities should the institution go into administration.\textsuperscript{42} Treasury limited its role to specifying the requirements for sale. It was not clear as to who was making the resolutions as to Northern Rock’s future direction and, as the National Audit Office found, this caused difficulties in finding a private industry purchaser.\textsuperscript{43}

More importantly, it revealed the failure of the regulatory system to develop procedures or protocols to deal with bank failure and the role of government in rescuing at risk financial institutions. As discussed in chapter 3, the Basel III proposals address some of these issues.

\textsuperscript{40} Subsequently Treasury introduced the Credit Guarantee Scheme (CGS) in October 2008 to give short term liquidity and to ensure that UK Banks have adequacy fund to maintain lending in the medium term, see Sharon White, ‘Review of HM Treasury’s Management Response to the Financial Crisis’ [2012] Crown Copyright, UK, 1, 57 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220506/review_fincrisis_response_290312.pdf>


\textsuperscript{42} Ibid 12. On February 2008, no buyers who would satisfy the requirements of the UK government. On 23 February 2008, the resolution was taken to nationalise the Northern Rock. See Ibid. See also chapter 3 [3.6].

The failure of Northern Rock and the subsequent steps by government to protect depositors points to the failure of the regulatory system to properly manage risk within the banking system. The problems were not just a failure to act proactively by the regulator and lack of clear lines of responsibility but also the inadequacy of capital buffers and liquidity to avoid bank failure. As discussed in chapter 3, the Basle III Accord and its requirements of increased capital buffers and liquidity is directed to helping to avoid the risk of bank failure and systemic risk. The failure to deal with the crisis was not limited to the Bank of England and Treasury but also extended to the FSA.

II. The Financial Services Authority (FSA)

The GFC revealed the failings of the FSA as regulator. The FSA was compromised as a regulator. It was not independent of the UK government or the financial sector. Effectively FSA had been captured by the financial sector with a revolving door to and from the financial sector to the FSA so that the FSA was seen as the lackey of the financial sector. The FSA was not seen as acting in the interests of consumers, taxpayers and the public.

The FSA lacked transparency with its deliberations largely opaque. In addition, the FSA largely ignored warning signals of the risk of bank failure. One month before

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44 From 2000, twenty six of the thirty six members of the Board had direct connections at Board or senior management level with the financial system and Banks either before or after their appointment; e nine members continued to have appointments in financial institutions whilst being members of the FSA, see David Miller and William Dinan, Revolving Doors, Accountability and Transparency: Emerging Regulatory Concerns and Policy Solutions in the Financial Crisis (5 May 2009), OECD, 29.

45 See Ibid 5.


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the Northern Rock collapse, the FSA allowed Northern to continue to operate without taking any proactive procedures to mitigate any potential risks.\textsuperscript{47} The FSA in its own internal report described itself as an inadequate regulatory system.\textsuperscript{48}

### 4.2.2. Post 2008 GFC - The New Financial Regulatory System

The failure of the UK regulatory system to deal with the risks of banking collapse left the UK public holding the debt incurred resulting from bank failure.\textsuperscript{49} It was apparent that the existing regulatory structure had failed to protect the public against bank failure and that a new regulatory system was required.\textsuperscript{50}

In 2010, the UK government announced plans to institute a new framework for bank governance as well as introducing new measures to deal with the risks of bank failure and how to respond to impending bank failure.\textsuperscript{51} On 19 December 2012, the UK Financial Services Act 2012\textsuperscript{52} received royal assent with effect from 1 April

\textsuperscript{47} Brian Walter, \textit{The Fall of Northern Rock: An Insider’s Story of Britain’s Biggest Banking Disaster} (Harriman House, Petersfield, Hampshire, 2008), 38-41.

\textsuperscript{48} See Financial Services Authority, \textit{The Supervision of Northern Rock: A Lessons Learned Review} (March 2008), 4 <http://www.fsa.gov.uk/pubs/other/nr_report.pdf>. The CEO of FSA, Hector Sants, stated that: “It is clear from the thorough review carried out by the Internal Audit team that our supervision of Northern Rock... was not carried out to a standard that is acceptable, although whether that would have affected the outcome in this case is impossible to judge.” Jennifer Hughes, ‘FSA admits failings over Northern Rock’, \textit{Financial Times}, (UK), 26 March 2008.


2013. The Act\textsuperscript{53} established a new regulatory system for financial services. The Act imposed responsibility on the Bank of England as the responsible authority for the safety and security of the financial system.

The Financial Policy Committee (FPC) within the Bank of England had responsibility to respond to and control systemic risks. Under the legislation, a new regulator, the Prudential Regulation Authority (PRA), was established as a subsidiary of the Bank of England and the Financial Conduct Authority (FCA) was established for the protection of consumers, (see Figure 4.1).\textsuperscript{54} The PRA is a legal institution of the Bank of England but retains it operational independence from the broader bank operations. Although the FCA is operationally independent of the UK government, it is limited by guarantee and accountable also to HM Treasury (e.g. Treasury appoints the FCA’s Board of Directors).\textsuperscript{55} A more detailed discussion of the roles of the Bank of England, the FPC, PRA and FCA as parts of the new regulatory framework is set out below.

\textsuperscript{53} The Act sets out eight principles for good regulation. These principles are: efficiency and economy; proportionality; sustainable growth; consumer responsibility; senior management responsibility; recognising the differences in the businesses carried on by different regulated persons; openness and disclosure; and transparency. These principles are available at the FCA website, see \url{http://www.fca.org.uk/about/why-we-do-it/our-remit/principles}.


\textsuperscript{55} Ibid.
Figure 4.1. The New Regulatory System in the UK

Source: Financial Stability Board

Ibid 14.
What is clear is that the new structure and its implementation ensure that there is co-operation and the free flow of communication between the regulatory bodies. The PRA Board has the responsibility for the prioritisation of strategy communication. PRA members are included in the main Financial Policy Committee (FPC) meetings. The Bank of England’s senior management are closely involved in supervisory resolutions of the PRA. The Governor of the bank is PRA’s Board chair and two of the Deputy Governors of the Bank of England serve as Board members. At least fortnightly, the Board of PRA meets to ensure that the senior management of the bank is regularly involved in supervisory issues.\(^{57}\) Although the PRA has operational independence in accordance with its statutory functions, it is effectively a subsidiary of the Bank of England and subordinate to the Bank of England.\(^{58}\) This close knit co-operation has its negative side:

Such an arrangement increases the potential of creating a ‘group-think’ mentality, particularly since a large scope of responsibility is vested in a small number of senior executives... The role played by the independent external members to the FPC and PRA Board is particularly important in that regard.\(^{59}\)

The capacity of the new regulatory framework to deal with risk depends upon its ability to obtain and analyse relevant data.\(^{60}\) The Financial Policy Committee (FPC) has found that no individual group of indicators is sufficient and that it needs to

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\(^{57}\) Ibid. It should be noted that the FPC includes 10 voting members: the Governor (who is the chair of the FPC); the Bank of England’s Deputy Governors who responsible for monetary policy, financial stability and prudential regulation (the latter is also the CEO of the PRA; the Executive Director of the Bank of England who responsible for Financial Stability; the FCA’s CEO; and four external members nominated by the Chancellor of the Exchequer. Moreover, a representative of Treasury is the FPC’s non-voting member as well as the Executive Director of the Bank of England who responsible for Markets routinely attends the FPC meetings. Ibid 15. See also [http://www.bankofengland.co.uk/financialstability/pages/fpc/members/default.aspx](http://www.bankofengland.co.uk/financialstability/pages/fpc/members/default.aspx).


\(^{59}\) Ibid 18

\(^{60}\) Ibid 17.
access a wide group of metrics and qualitative data from market intelligence and other sources.\textsuperscript{61} The PRA and the FPC both have authority to gather relevant data. Equally important is the market intelligence function of Bank of England which has been effective in identifying emerging issues and factors where official information collection is not yet available (e.g. emerging market actions-insuring swaps).\textsuperscript{62}

Banks are subject to regulation, supervision and control through formal legislative regimes. This section deals with the formal legislative regulatory framework in the UK. It deals separately with non mandatory codes for corporate governance in section 4.3. The following discusses the individual components of the current regulatory framework. This section begins with the Treasury, which has overall responsibility for economy policy and financial stability.

4.2.2.1. The Treasury

The Treasury is a strategic policy department within the UK government. The House of Commons appoints the Treasury Committee under Standing Order No. 152 to examine the administration, expenditure and policy of HM Treasury, HM Revenue and Customs, and related public systems, including the Bank of England and the FCA. It is responsible for general expenditure, macroeconomic and financial policies.\textsuperscript{63}

As mentioned before, after the failure of UK Northern Rock, it was clear that existing laws and processes did not adequately deal with systemic risk. Treasury had a small

\textsuperscript{61} See \url{http://www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx}.


team working on financial stability during the crisis. This team were part of a group of nearly eighty working on wider financial services areas. Treasury recognised the need to learn lessons from the GFC in relation to contingency planning, mobilisation and knowledge and risk management. In 2011 the Treasury’s response to the GFC was the subject of review. The review was requested to make recommendations to improve the capability of Treasury to deal with any future crisis. This Review assessed the Treasury’s capacity ahead of the crisis; the pace at which the Treasury responded when the crisis started and whether arrangements put in place effectively dealt with the crisis. The National Audit Office which had earlier reported on the failure of Northern Rock made submissions to the review. The review found that towards the end of 2009 Treasury had acted to improve knowledge and risk management and had made substantial progress towards “contingency planning and mobilisation; establishment of links between financial stability and macroeconomic policy; monitoring of financial risks; and procurement processes for external advisers.” The review recommended that the Treasury needs to consider the training and development of its staff and their capacity to deal with a crisis. It also needed to enhance the commercial and financial expertise within the Treasury as well as developing more efficient mechanisms for working with external advisers. Key staff must have appropriate experience, supplemented as needed by specialist staff.


65 This Review didn’t assess the effectiveness of the policy interventions made during the GFC or the failure of the Treasury to predict the crisis.


members from outside the Treasury on specific matters. \(^{68}\) There was also seen to be a need to enhance the management and leadership of Treasury. \(^{69}\)

These reforms required the Treasury to have the capability to provide independent advice to government as well as communicating effectively with the public and Parliament. Its most important roles are to protect taxpayer interests in case of any instability; control and check the effectiveness of the new regulatory system; and manage the existing interventions in the banking system. \(^{70}\)

In response to the review, there has been an increase in Treasury staff from a low of 20 pre GFC to 150 staff members in 2012 working in financial markets and services of whom about one third concentrate on contingency planning, financial stability and the continuing management of interventions of the government in the UK banks. \(^{71}\)

Following the GFC, legislation clarified the procedures and powers where there is financial institution failure or risk of failure. Statutory authorisation has been given to Treasury under the *Banking (Special Provisions) Act 2008* to nationalise failing banks in emergency cases. \(^{72}\) Another important change was the establishment under the *Banking Act 2009* of a special resolution regime to deal with failing credit institutions.

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\(^{70}\) Ibid. It should be here noted that the Treasury Review requires reporting on the progress of implementing the recommendations, see Ibid 54.

\(^{71}\) See Ibid 33.

\(^{72}\) It would have covered the Northern Rock failure, see *Banking (Special Provisions) Act 2008* Chapter 2, section 2.
Under this new regime, the PRA, in consultation with the Treasury and the Bank of England, determines whether to place a bank into the resolution regime.\(^73\)

While the PRA decides whether to place a bank (or building society) into the resolution regime, the authority charged with implementing the resolution is the Bank of England, except where the failing entity constitutes a serious threat to the stability of the UK financial system, in which case it may be placed into temporary public ownership by the Treasury. The Bank of England must consult the PRA, FCA and the Treasury when deciding which tool(s) to use; the Treasury must consult the PRA, FCA and Bank of England when temporary public ownership is the resolution tool. The *Financial Services Act 2012* extended the resolution regime to investment firms and related financial group companies (including those of banks).\(^74\)

The *Banking Act 2009* authorises Treasury to place failing banks into temporary public ownership.\(^75\) It states that:

For that purpose the Treasury may make one or more share transfer orders in which the transferee is a nominee of the Treasury, or a company wholly owned by the Treasury.\(^76\)

However, when the Treasury makes this, “the Treasury must lay before Parliament a report about the activities of the bank.”\(^77\) The Treasury will continue to have responsibility for the regulatory system as well as the protection of the public finances. Whilst Treasury is responsible for overall management of the financial system, the Bank of England is the regulator specifically charged with monitoring and supervising financial services.


\(^74\) Ibid.

\(^75\) See *Banking Act 2009* Chapter 1, section. 81. When the Northern Rock, for example, was taken into temporary public ownership, it was restructured into two institutions: Northern Rock Asset Management and Northern Rock.

\(^76\) Ibid section 13.2.

\(^77\) Ibid 81.1
4.2.2.2. The Bank of England

The Bank of England is a crucial plank in the UK regulatory system governing banks. It (formally the Governor and Company of the Bank of England) is the central and reserve bank in UK. It provided a model for most modern, large central banks internationally. It was established in 1694 to act as the government's banker a role it continues today. It was initially privately owned but subsequently attached to the Treasury after 1931 and nationalised in 1946. It gained operational independence to set monetary policy in 1997.78

The Bank of England has two core functions to provide monetary and financial stability. Monetary stability relates both to the confidence in the currency and also stability in prices. Inflation targets are set by the government of the day with the bank setting monetary policy to achieve these targets. For the purposes of this thesis, the more important function is ensuring financial stability. Financial stability requires confidence in the financial system as well as an effective flow of funds in the economy. In order to be effective, it must have the capacity to reduce or detect systemic risks and take action where the system is vulnerable. The Bank of England is responsible for controlling and supervising the main financial market bases, including recognised payment frameworks, securities settlement frameworks and central counterparties.79

The Bank of England is a central part of the newly reformed regulatory system. The new financial regulatory system resulted in the Bank of England being entrusted with significant new duties: first responsibility for the macro-prudential regulation of the

78 See http://www.bankofengland.co.uk/about/Pages/default.aspx.

79 Ibid.
financial industry through the establishment of the Financial Policy Committee and secondly, by creating the Prudential Regulatory Authority (PRA) responsible for regulation of deposit-takers, insurers and major investment institutions. By creating these distinct but complementary functions within the Bank of England, the UK government’s aim is to enhance the regulation system and the stability of the UK financial system. The Board of FPC and the PRA are statutory decision making bodies.80 The International body, the Financial Stability Board, in 2013 conducted a peer review on the new regulatory system. Its view was that there are advantages in the centralising of the supervisory and systemic roles within the Bank of England as this would “improve information flow, co-ordination and a shared sense of purpose”.81 Concerns were expressed that significant responsibilities are vested in a small group of executives, the Bank of England Governor and the Deputy Governor for Financial Stability, who serve on all of the Boards of the FPC and PRA. Therefore, the role of the independent members to the Boards of the FPC and PRA will be important in the proper functioning of the new system.82 The importance of these two bodies warrants separate discussion which follows.

I. The Financial Policy Committee (FPC)

On 1 April 2013, The Financial Services Act 2012 established the FPC as an independent official Committee of the Bank of England (the bank’s Committee of the

81 Ibid 18.
82 Ibid.
Court of Board of Directors). The FPC has responsibility for macro-prudential regulation.83

This Committee is responsible for controlling and evaluating systemic risks, recommending measures to mitigate risks which may threaten the financial system’s stability.84 The FPC’s other responsibility is to support the economic policy of the government, and its goals for employment and growth. Unlike the earlier regulatory system in which lines of responsibility were unclear, the Financial Services Act 2012 empowers the FPC to give directions and recommendations to the PRA and FCA requiring those bodies to take required actions.85 This authority vested in the FPC is concerned with system-wide, rather than entity-specific, issues.86 Consequently the FPC is not concerned with micro-prudential regulation related to the application of particular rules to particular institutions. However, as observed by the Financial Stability Board there is no sharp distinction.87

In this sense, the boundary between micro- and macro-prudential supervisory approaches is quite blurred in practice. This blurring is made even more apparent by the fact that certain macro-level factors, such as economic growth and asset price movements, are clearly relevant for individual firms.88

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84 See Ibid Financial Stability Board, 15; and Financial Services Act 2012 para. 9C.

85 See Financial Services Act 2012 Chapter 21, paras. 9H, Q.

86 Ibid para. 9L.


88 Ibid.
To ensure its effectiveness, the FPC is required by statute to meet at least four times a year as well as publish a twice-yearly Financial Stability Report evaluating its progress, the outlook for the financial system as well as potential risks and threats to stability.⁸⁹

In response to criticisms of the previous regulatory framework, the current framework ensures appropriate communication between different bodies in the regulatory system, see above. In addition, Treasury can at any time provide recommendations to the FPC to ensure that the Committee is working effectively. The Committee is required under the Financial Services Act 2012 to respond to any recommendations made by the Treasury and report to Treasury action taken or reasons for not taking any action.⁹⁰

In January 2013, the FPC issued a draft Policy Statement to show how it would utilise its proposed new macro-prudential powers to set counter-cyclical capital buffers as well as capital requirements.⁹¹ The Policy Statement explains how these measures are likely influence growth and financial stability, and the situations in which the FPC would expect to utilise each measure. As observed in chapter 3, the risks of systemic collapse of the banking system internationally led to the development and implementation of the Basel Accords. As a result, the Bank of England since 2012 has acted to develop agreements to meet the significantly higher capital requirements as well as the Liquidity Coverage Ratio (LCR).⁹² The principal requirements of capital adequacy and liquidity required by Basel III are discussed in chapter 3.

⁸⁹ The public policy resolutions of the FPC are announced via the Financial Stability Reports or in former letter to the market shortly after a meeting. See Ibid 15.

⁹⁰ See Financial Services Act 2012 Chapter 21, para. 9E, 3.

The FPC is responsible for policy resolutions on the counter-cyclical capital buffer;\textsuperscript{93} this is in accordance with the European application to the new Basel III requirements. The FPC has authority to make directions relating to capital requirements. The UK government proposes to give the FPC the direction powers over a time-varying leverage ratio device but not before 2018.\textsuperscript{94}

The FPC found that a further crucial factor in ensuring stability of the financial sector and strengthen the capital regime in the UK financial sector, is the implementation in UK of the Basel III Accord.\textsuperscript{95} The FPC recommended that:

- The PRA should consider applying higher capital requirements to any major UK bank or building society with concentrated exposures to vulnerable assets, where there are uncertainties about assets not covered in the FSA's assessment of future expected losses or risk weights analysis, or where banks are highly leveraged relating to trading activities...The PRA should assess current capital adequacy using the Basel III definition of equity capital but after: (i) making deductions from currently-stated capital to reflect an assessment of expected future losses and a realistic assessment of future costs of conduct redress; and (ii) adjusting for a more prudent calculation of risk weights.\textsuperscript{96}

The FPC, in its meeting in March 2013, recommended that the Bank of England and the PRA develop a system for regular stress testing of both macro and micro-prudential aspects.\textsuperscript{97} It is generally assumed that the adoption of the Basel requirements will protect the UK banking sector from other potential crises. It has yet


\textsuperscript{93} Financial Stability Board, \textit{Peer Review of the United Kingdom: Review Report} (10 September 2013), 16.

\textsuperscript{94} Ibid.

\textsuperscript{95} See http://www.bankofengland.co.uk/publications/Pages/news/2013/081.aspx.

\textsuperscript{96} Ibid.

to be tested to see how far the new regulatory system, particularly, the FPC will avoid future systemic risk.

As indicated above, there is a close linkage between the FPC and the PRA which is now discussed.

II. The Prudential Regulatory Authority (PRA)

The PRA was established on April 1, 2013 under the umbrella of the Bank of England. It was given responsibility for the prudential regulation and control of financial institutions including banks. The main goal is to ascertain the key risks which can affect the financial institutions and their stability. It aims to “promote the safety and soundness of the financial institutions and to contribute to the securing of an appropriate degree of protection for policyholders.”

The most significant supervisory functions are undertaken by the PRA Board chaired by the Governor of the Bank of England. In response to earlier criticisms of the lack of communication between the various regulators, three Board members are Bank of England members (the Governor, the Deputy Governor for Prudential Regulation and Deputy Governor for Financial Stability). Members are nominated by the Bank of England’s Court (Court of Directors) with the agreement of the Treasury. A majority of the Board of Directors are required to be Non-Executive Directors. The strategies and policies of the PRA are set by its Board of Directors with consultation with the Court.

98 See http://www.bankofengland.co.uk/pra/Pages/default.aspx.

To achieve the PRA objectives, the PRA undertakes a group of core supervisory actions. The overall supervisory policy, including the need for trading reviews and detailed asset quality are considered in the annual meeting. This meeting is an annual procedure attended by the PRA’s supervisory and management members including, for the highest impact institutions, the PRA’s CEO. Also regular interim reviews can be required based on the perceived risk.\textsuperscript{100}

The PRA works with the Treasury to prevent the risk of disruption to services (e.g. deposit-taking and payment services to customers and small and medium entities) due to entity failure. The PRA advises the Treasury to ensure that participating entities have adequate capital and comply with the relevant eligibility and prudential requirements.\textsuperscript{101}

There is a close linkage between the FPC and the PRA which allows the exchange of information and data relating to the stability of the financial system.\textsuperscript{102} The CEO of the PRA is a member in the FPC thus ensuring effective communication between the two bodies. The PRA provides information to the FPC which affects the financial system. The PRA collects data necessary for assessing the financial system.\textsuperscript{103} The legislation requires PRA to apply the decisions of FPC on the use of its macro-prudential tools by implementing them in all financial institutions.\textsuperscript{104} However, the

\textsuperscript{100} Financial Stability Board, *Peer Review of the United Kingdom: Review Report* (10 September 2013), 25.


\textsuperscript{102} Government has undertaken to legislate if needed to ensure that there are effective information flows between FPC and PRA. See Treasury Committee, *A New Approach to Financial Regulation: Judgement, Focus and Stability* (July 2010), London: the Stationery Office, 18-19.

\textsuperscript{103} Ibid 18-19.

\textsuperscript{104} Ibid.
clear separation of particular macro-prudential devices from the overall prudential system is relatively new and not yet evaluated. The FPC needs to ensure that when implementing its designated macro-prudential devices, it acts consistently with the broader prudential work undertaken by the PRA.\textsuperscript{105} The Financial Services Act 2012 states that, where relevant to systemic stability, the FPC can direct the general policies of PRA towards specific types of institutions or risks.\textsuperscript{106}

Under the earlier regulatory system, the FSA had no capacity to supervise the actions of a holding entity. The Financial Services Act 2012 authorises the PRA to provide a power to direct qualifying parent undertakings.\textsuperscript{107} The power permits the PRA, under particular conditions, to take actions to protect authorised institutions from the adverse influences of being part of a group (e.g. capital, barriers to effective resolution, multiple gearing, financial and reputational contagion, and the influence of intra-group links on authorised institutions).\textsuperscript{108} As a consequence, on 1 April 2013, the PRA published a Policy Statement in relation to its power of direction over qualifying parent undertakings.\textsuperscript{109} This Statement includes the response of PRA to the queries raised on its earlier consultation on the use of the power to direct qualifying

\textsuperscript{105} Financial Stability Board, Peer Review of the United Kingdom: Review Report (10 September 2013), 21.

\textsuperscript{106} See Financial Services Act 2012 Chapter 21, para. 9H, 7. Rules were made by the FSA under the earlier FMSA. These are being modified and adapted for the PRA in a new rule book

\textsuperscript{107} There are three sets of powers could be implemented directly to a qualifying parent undertaking: a rule-making power for data collecting, a power of direction, and a supporting enforcement power to fine or censure for breaches of a direction or data rule. For more information concerning the qualifying parent undertaking, see the Financial Services Act 2012, 192B, C.

\textsuperscript{108} The power of direction gives the authority the capacity to enforce prudential principles or frameworks of governance and monitors on a consolidated basis. Due to this new power, the authority has the capability to conduct more efficient consolidated supervision in accordance with relevant Europe Directives as well as other international principles, in that there will be ability to take action at the qualifying level. See Financial Stability Board, Peer Review of the United Kingdom: Review Report (10 September 2013), 23-24.

parent undertakings and includes the final statement of policy. It has also two annexes that provide a non-exhaustive list of potential directions which the PRA might consider taking as well as a non-exhaustive list of potential cases in which the PRA might consider exercising the power of direction.\textsuperscript{110}

The PRA found that there were no material changes to the policy statement since the consultation. The PRA stated that “there is no requirement that the power of direction must be used only as a last resort and that in some instances the exploration of other regulatory measures may be impracticable or inappropriate.”\textsuperscript{111}

Important also to the work of the PRA is The Handbook and Rulebook of PRA.\textsuperscript{112} The PRA Rulebook sets out rules and directions that the PRA expects PRA-authorised and unauthorised corporations to adhere to. The Rulebook includes rules and directions created under the earlier Act, the \textit{FSMA 2000}, dealing with powers relating to disclosure, internal capital adequacy evaluation and credit risks. The PRA has applied the Capital Requirements Directive in its new Rulebook.\textsuperscript{113} Supervisory statements give more general guidance where necessary.

The Financial Stability Board’s review recommended that the PRA undertake a regular “use test” to measure how risk evaluation tools are being integrated into supervisory judgements and activities. PRA also needs to consider engaging with

\begin{flushleft}
\textsuperscript{110} Ibid.
\textsuperscript{111} Ibid 1.
\textsuperscript{112} See http://www.bankofengland.co.uk/pra/Pages/policy/handbook.aspx.
\textsuperscript{113} When there is a conflict between the Rulebook and the Guide, the Rulebook takes the priority. See http://www.bankofengland.co.uk/pra/Pages/policy/handbook.aspx.
\end{flushleft}
external stakeholders through reviews, to improve accountability and transparency regarding the effectiveness of the changes.\textsuperscript{114}

The PRA and the Bank of England are two of the three planks of the new UK regulatory system. The third is the FCA. Around 2,000 UK entities will be subject to dual regulation by both regulatory bodies, the PRA and the FCA.\textsuperscript{115} This will be discussed next.

\textbf{4.2.2.3. The Financial Conduct Authority (FCA)}

The FCA was established on 1 April 2013 to bring stability to the financial services sector. It exercises its functions under the \textit{Financial Services Act 2012}\textsuperscript{116} and is financially independent and wholly funded by the financial services institutions it regulates. It is accountable to Treasury, which is responsible to the Parliament and financial sector in the UK. It operates the prudential regulation of the financial institutions which are not supervised under the PRA regulation such as an independent financial advisers and assets managers. The FCA requires the financial institutions to report on regular basis to FCA thus ensuring transparency in the market place. The FCA is given important rights in support of their regulatory and compliance role; this includes unannounced visits.\textsuperscript{117}

The FCA regulates financial institutions with a focus on the rights of consumers. The FCA has three main statutory goals: protecting consumers, improving the integrity of the financial sector in the UK, promoting competitive markets as well as providing


\textsuperscript{115} Ibid 7.

\textsuperscript{116} See \textit{Financial Services Act 2012} Chapter 21, paras. 16; 73.

\textsuperscript{117} See \textit{http://www.fca.org.uk/}.
effective competition in the interests of consumers. The purpose is to ensure consumer confidence; in the context of banking ensuring confidence in financial services and financial products.\textsuperscript{118} The FCA states that:

We aim to use forward-looking and judgement based regulation, with a view to understanding firms’ business models and future strategies. We intervene if we see unacceptable risks to the fair treatment of customers or the integrity of the market.\textsuperscript{119}

The FCA has its own Handbook which applies to FCA-regulated corporations. It sets out the legislative, standards and other provisions of the FCA made under powers provided to them by the \textit{FSMA 2000} as amended by the \textit{Financial Services Act 2012}. It includes the prudential requirements for corporations, regulatory and supervisory procedures, and regulatory guides (e.g. financial crimes). The handbook operates as either a ‘sourcebook’ (regulatory requirements) or a ‘manual’ (including provisions relevant to the regulatory connection which the regulators have with companies, such as on enforcement and supervision).\textsuperscript{120}

The FCA evaluates companies’ conduct depending on the size and nature of the company. The largest companies, with the most customers, face regular evaluation over rolling 2 year periods. The evaluations become progressively less for companies in the three other categories, with companies in category four having some form of evaluation every 4 years.\textsuperscript{121} The FCA investigates products or issues that may put the UK consumers at risk. The FCA uses supervision mechanisms to ensure that

\textsuperscript{118} Ibid.

\textsuperscript{119} Ibid.

\textsuperscript{120} See \url{http://fshandbook.info/FS/html/FCA/}.

\textsuperscript{121} Ibid.
companies take remedial action. Undertakings are a standard response to less serious infractions.\(^{122}\)

The FCA has powers to make rules, investigate possible breaches and enforce its rules.\(^{123}\) The *Financial Services Act 2012* empowers the FCA to enforce the law through fines for anti-competitive conduct and the authority to instruct institutions to immediately retract or modify misleading statements.\(^{124}\) Between 2013 and 2014, the FCA took action against 34 companies and 28 persons in the UK, enforced 46 penalties totalling £425 (USD 701) million, made 124 final notices and received 143 outcomes by using the FCA enforcement powers.\(^{125}\)

The legislation requires the FCA, the Bank of England and the PRA consult prior to making directions to ensure that all of its ramifications have been considered particularly if it may affect overall financial stability. The PRA has power to direct the FCA not to act in a particular manner where, in view of the PRA, this might influence the UK financial sector’s stability or lead to failure of a PRA entity in a way that might adversely influence the UK financial sector.\(^{126}\) As set out in the Memorandum of Understanding (MoU) between the FCA and PRA,\(^{127}\) the use of the veto powers require appropriate prior consultation between the FCA and PRA as well as other relevant UK authorities to ensure appropriate data flow and exchange of


\(^{123}\) Some of its powers drive from the earlier *FMSA 2000*, Part 6.


\(^{126}\) See the *FSMA 2000*, Section 31.

\(^{127}\) See http: // www. bankofengland. co. uk/ about/Documents/mous/moufcapra.pdf.
views. The cross membership of PRA and FCA ensures appropriate communication between the agencies.\textsuperscript{128}

The 2012 changes to the regulatory structure respond to the problems that prevented the FSA from responding appropriately to risks of failure of the financial system. It provides for a much better integrated system of appropriate communication between all aspects of the regulatory system as well as setting an expert committee specifically charged to monitor stability of the financial system. PRA has a much stronger mandate to give and enforce directions and deal with issues that may threaten the financial market. This provides some valuable lessons for Jordan as a small country on the regulation of banks and financial institutions and the structures that may help recognise, monitor and manage financial risks. Chapter 6 will consider the regulatory framework in Jordan and how far the regulatory changes enacted in the UK provide useful models for Jordan. The following section examines corporate governance principles and their application in the UK.

4.3. The UK Corporate Governance Codes

Due to the collapse of many institutions in the UK, such as BCCI\textsuperscript{129} and Robert Maxwell\textsuperscript{130} in 1991, a committee chaired by Sir Adrian Cadbury was established to


\textsuperscript{129} The Bank of Credit and Commerce International (BCCI) was a major international Bank founded by a Pakistani financier Agha Hasan Abedi in 1972. The head offices were in Karachi and London and it was registered in Luxembourg, with operations in 69 countries. Depositors and investors lost their investment following the collapse of the Bank. It suffered huge losses from its foreign currency dealings, lending operations and deposit accounts, and involvement in financial crimes and money laundering. See also Richard J Herring, ‘The Collapse of BCCI: Implications for the Supervision of International Banks’ in George G Kaufman (eds), \textit{Reforming Financial Institutions and Markets in the United States} (Boston: Kluwer, 1993), Chapter 8, 121.

review the reasons of these collapses and provide proposals to prevent future failures. The Committee identified many defects with the current system of corporate governance. These included Board members without appropriate experience, institutions run in the executive directors’ interests, unreliable and misleading financial reporting, lack of independent auditors and inadequate risk management. Details on the Report and its recommendations are set out in chapter 2. The Cadbury principles provided a model for corporate governance internationally.

The Report’s recommendations are especially important to banks because of the special risks and serious consequences of bank failure. In relation to banks it emphasises the importance of effective Board supervision to reduce risk. As discussed in chapter 2, the Report recommended the appointment of expert, independent Non-Executive Directors in order for the Board to provide objective, expert supervision. The appointment of independent Non-Executive Directors also helps to avoid agency problems arising out of management acting in its own self interest. Cadbury also recommended that executive salaries be regularly reported so that an assessment could be made whether remuneration was matched by performance. As noted in chapter 2, the approach adopted by the Cadbury principles, was non prescriptive preferring a ‘comply or explain’ approach rather than impose mandatory requirements. It consequently relied on other secondary market mechanisms to provide disciplinary control. It recognised the crucial importance of financial control through the role of auditors and the establishment of a mandatory Audit Committee of

the Board. The purpose of these recommendations was to enhance the effectiveness of the Board in ensuring an effective control system over all the institution’s activities.132

The Report consulted extensively, so that its principles reflected the views of institutions, representative entities and current best practices, (see chapter 2). For example, after publishing the Cadbury Report, about 50% of the large UK companies separated the role of CEO and Chairman.133 These principles provide flexible mechanisms that allow banks and other financial institutions to develop their own measures to achieve good corporate governance. This flexibility allows adaption to changing circumstances without the necessity for new legislative intervention. They can also be seen as a measure to avoid the potential for stricter government intervention and regulation.134

The Cadbury principles of corporate governance were adopted by the London Stock Exchange. These principles, to the extent, that they were incorporated into governance Codes, were not compulsory but were the subject to the ‘comply or explain’ approach. This approach permits corporations to adopt different measures to achieve similar outcomes or not to adopt because, in the individual circumstances it results in high costs without commensurate benefits. This approach was discussed further in chapter 2. However, it is clear from the failure of regulatory system in the UK that the comply or explain approach and the recommendations of the Cadbury Report as well as other governance reports did not prevent the worst effects of the 2008 GFC on the UK

132 Ibid.


134 Ibid.
financial system. There was a lack of an effective internal control system and lack of independence of Non-Executive Directors. The Non-Executive Directors were unable to undertake a confrontational role which may sometimes be necessary to ensure that there is proper supervision.\textsuperscript{135}

In 2009, a UK study found that of the 129 UK corporations examined, only 67 corporations (51.94\%) of UK listed companies in the London Stock Exchange were completely compliant with the Combined Code’s principles for good governance.\textsuperscript{136} This diminished compliance may have been a factor in failure to prevent the GFC. As observed by later commentary, governance failures occurred in a highly developed corporate governance system in the UK.\textsuperscript{137}

A later 2010 study analysed the link between poor governance, the financial crisis, and the failure of banks. The study found that bank failure was related to factors such as the risk governance, the independence, qualifications, remuneration and composition of corporate officers and shareholder engagement. It also found that poor internal controls can cause instability. One of the main weaknesses was the ineffectiveness of the Board of Directors in monitoring and supervising management.\textsuperscript{138} The importance of independent Non-Executive Directors both on the Board and on Board Committees to achieving this has been discussed in chapter 2.

\textsuperscript{135} One of the reasons the UK Northern Rock collapsed in 2008 was because the Non-Executives of Northern Rock failed to ensure that the Northern was effectively liquid to face any risks. See Treasury Committee, \textit{The Run on the Rock: Fifth Report of Session 2007-008} (January 2008) Vol I, London: the Stationery Office, 18-19. For further discussion concerning the independence and whether real independence of Non-Executive Directors is possible as well as whether Board Committees can effectively perform their functions even if they have adequate training and expertise, see chapter 2.

\textsuperscript{136} See chapter 2 for further discussion concerning the 1998 Combined Code. The current Code is the 2012 version which has governance principles available in Appendix [E].

\textsuperscript{137} See David Seidl, Paul Sanderson and John Roberts, ‘Applying ‘Comply-or-Explain’: Conformation with Codes of Corporate Governance in the UK and Germany’ [2009] \textit{Centre for Business Research} Working Paper No. 389, University of Cambridge, 1, 25.

\textsuperscript{138} Ibid 3.
The expertise and skills of Non-Executive members is important to a high-performing Board providing a balance between critical appraisal, objective oversight of management and working to joint objectives. In the case of US Lehman Brothers, the lack of truly independent non executive members led to the failure of the Board to be an effective force in monitoring management.139

The capacity of the Board of Directors and Committees to provide expert, objective oversight is further compromised by a lack of institutional and technical expertise.140 For example, some of the Board members and the CEO of the UK Northern Rock did not have adequate banking experience and qualifications so that there was not a full appreciation of risk or what measures were needed to manage that risk.141

Following the 2008 GFC, Walker, the former Chairman of the Bank of England, was asked to review the effectiveness of the regulatory system of corporate governance in UK banks with particular reference to risk management, the effectiveness of Boards of Directors and their skills, experience and independence. In July 2009, the Walker’s first advisory paper was published.142 The Walker Review examined the relationships between the Non-Executive Directors and executive officers as well as the

139 Ibid. See also chapter 2 [2.3.2.3] for further discussion concerning the importance of independent Non-Executive Directors. See also chapter 3 [3.4] for further discussion concerning the collapse of this Bank.

140 See chapter 2 [2.3.2.2] for further discussion concerning the importance of Board expertise.

141 The UK Treasury Committee commented that “we are concerned that the Chief Executive of Northern Rock was not a qualified Banker, although of course he has significant experience.” See Treasury Committee, The Run on the Rock: Fifth Report of Session 2007-008, House of Commons Treasury Committee HC 56-1 (2008) London: the Stationery Office, Vol 1, 33. For further discussion concerning the collapse of Northern Rock, see chapter 4 [4.2.1.2]; and chapter 3 [3.6].

relationships between the Board of Directors and institutional investors. Walker Review\textsuperscript{143} made the following five recommendations:

1. The size, qualification and composition of Board of Directors

To ensure that Non-Executive Directors have an appropriate knowledge and understanding of the financial processes to enable them to contribute efficiently. It recommended that the regular supervisory process of the FSA (now replaced by the FCA) should provide closer attention to the overall balance of the Board members in accordance with the business’s risk strategy, also taking into account the expertise, behavioural and other qualities of each members and their ability to fully adequate induction and development systems.\textsuperscript{144}

2. The function of Board of Directors as well as the evaluation of their performance

The Non-Executive Directors need to be able to challenge and evaluate systems on strategy put forward by the executive. The Chairman of the Board is responsible for leadership and providing an appropriate forum for discussion and decision-taking on matters of risk as well as promotes an effective link between executive and Non-Executive Directors. The Board of Directors needs to undertake a formal regular evaluation of its performance.\textsuperscript{145}

3. The institutional shareholders and their role, engagement and communication.


\textsuperscript{144} Ibid 14.

\textsuperscript{145} Ibid 15.
The Board of Directors needs to ensure that they are aware of any changes in the share register and understand the reasons for these changes with informing the FSA of these changes. Institutional investors and fund managers need to find opportunities for collective engagement where this leads to possibility of improving sustainable enhancement in the performance of their institutions). 146

4. Risk Governance

The Board of Directors of a UK FTSE 100-listed bank need to appoint an independent Risk Committee with responsibility for oversight and advice to the Board of Directors on the available risk exposures of the bank and any possible risk strategy, including strategy for liquidity and capital management). 147

5. Remuneration

The Remuneration Committee needs to have appropriate knowledge and understanding of the bank’s strategy to ensure that it is a consistent approach to remuneration in respect of all team members. The review recommended that the FTSE 100-listed banks as well as other comparable unlisted institutions (e.g. large building societies), the Remuneration Committee should report remuneration for its top level executives and executive board members in bands for the year 2010. 148 It also recommended a formal process for appointment of Remuneration consultants with provision for independent review of the remuneration consultants code.

146 Ibid 17.
147 Ibid 19.
148 It applied to executive Board members, and required reporting within several bands and within that bands the different elements of remuneration such as salary, bonuses, shares etc. Ibid 21.
Remuneration consultants should put in place a formal constitution for the professional group that has now been formed, with provision: for independent oversight and review of the remuneration consultants code… all remuneration committees should use the code as the basis for determining the contractual terms of engagement of their advisers; and that the remuneration committee report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company.149

The concerns about lack of moderation of executive salaries continued. This was again taken up in the later Turner Report in 2009. The Turner Report reviewed the main causes for the GFC in 2009.150 One of the main concerns of this Review was the high levels of remuneration and bonuses paid to executives and traders in banks prior to the GFC. The Turner Review recommended that banks ensure their remuneration principles are consistent with effective risk management and emphasised the importance of the Remuneration Committees exercising independent judgment and monitoring remuneration. They should take into account measures which may influence short term profit taking by executives and the need for remuneration to be matched by actual performance.151

It should be also noted that due to the linkage between remuneration packages and excessive risk taking, the UK since 2009 has implemented the Clawback Provision. This allows banks to take back previous performance-based payment based on restated financials. This has been discussed in chapter 2.152 There is, in addition, 2013-

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151 Ibid 80.

152 For further discussion concerning the Clawback provision, see chapter 2 [2.3.2.5, IV].
statutory amendments providing for binding shareholder votes on remuneration.\textsuperscript{153} The FCA has also indicated that it will require changes to be made to listings rules to come into force in 2014 to empower minority shareholders to veto transactions between listed companies and a controlling shareholder.\textsuperscript{154}

The Cadbury principles have undergone revision over time. The Financial Reporting Council (FRC)\textsuperscript{155} in 2010 published Corporate Governance Code known as the UK Stewardship Code dealing with best practice for institutional investors.\textsuperscript{156} The year 2012 has seen change in the regulatory system, including changes in the UK Corporate Governance and Stewardship Codes\textsuperscript{157} which commenced in October 2012. The major changes in the UK Corporate Governance Code include the Board members need to declare that the annual report is fair; Audit Committees need to report more fully on their actions. UK FTSE 350 listed companies (which includes the larger UK banks) have additional code provisions. FTSE 350 companies need to put

\textsuperscript{153} See the UK Enterprise and Regulatory Reform Act 2013. Note also further requirements relating to disclosure of remuneration in remuneration reports, see The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

\textsuperscript{154} It would require separate approval “by independent directors by independent shareholders” as well as the shareholders generally, see Financial Reporting Council, Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes (December 2013), 9 <https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>.

\textsuperscript{155} The FRC is an independent regulator responsible for corporate governance, reporting and the revised Corporate Governance Codes. For further information see https://www.frc.org.uk/.


out to tender the contract of the external audit at least every 10 years. From 2010 in FTSE 350 companies there should be an annual election for all directors. The FRC reported that all but two FTSE 350 companies have complied with this Code requirement. This is an important step in empowering shareholders to call to account directors and Board Committee members in their supervision of the company. Similarly the recent 2014 UK Corporate Governance Code provides that FTSE 350 companies should have an external facilitator formally evaluate the Board and its membership every 3 years. This recognises the crucial role of the Board and its Committees and the need to ensure Board and Committee independence. Under the 2014 Code, there are code provisions directed to ensuring that Board and its Committees provide expert, objective oversight of the bank and senior management. The Code imposes responsibility on the Board to assess and report Non-Executive Director’s independence. There are revised rules relating to the re-election of directors; rigorous and transparent processes for nomination of new directors and more extensive reporting requirements in relation to remuneration. In order to give shareholders greater access to the Board, the Code now provides that a senior independent Non-Executive Director be appointed to liaise with shareholders.


159 Ibid 12.


161 Ibid B.7.
These provisions are directed to ensuring that the Board and its Committees fulfil their purpose in providing expert, independent monitoring of senior management and the institution, (see also Appendix [E]).

What is apparent is that code reforms target areas of weakness in corporate governance. Reforms are strategic in that the emphasis is on the very large corporations which would include the largest banks and financial institutions where the risks are highest. These reforms are directed to strengthening the Board and its Committees so that they are able to act independently and objectively in monitoring the performance of the institution and its senior management.

The most recent Financial Reporting Council annual survey of code compliance\textsuperscript{163} shows very high levels of compliance on the principal governance requirements:

i. Separation of the CEO and Chair of the Board, 94\% of FTSE 350 companies were compliant and 97\% of smaller companies;

ii. Minimum requirements for independent Non-Executive Directors, 87\% of FTSE 350 companies and 99\% of smaller companies;

iii. Audit committee: 94\% of FTSE 350 and 96\% of smaller companies satisfied the standard;

iv. Remuneration committee composition: 92\% FTSE 350, 84\% smaller companies;

\textsuperscript{162} Ibid B.2.

\textsuperscript{163} Financial Reporting Council reporting the annual survey of Grant Thornton and Manifest – The Proxy Voting Agency, see Financial Reporting Council, \textit{Developments in Corporate Governance 2013: The Impact and Implementation of the Corporate Governance and Stewardship Codes} (December 2013), 11 <https: // frc. org . uk/ Our- Work/ Publications/ Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf>. There are differing requirements for FTSE 350 companies and smaller companies. The Code provides that FTSE 350 companies should have a majority of independent Non-Executive Directors on the Board; smaller companies require only 2 Non-Executive Directors, see Ibid.
v. Nomination committee: 96% FTSE 350, smaller companies 98%.

These high levels of compliance indicate that corporate governance structures are in place. It remains to be seen whether the new regulatory framework and the high levels of compliance with the Corporate Governance Code will be sufficient to meet future financial crises.

4.4. Conclusion

Prior to the 2008 GFC, there was a ‘tripartite’ regulatory system involved in the regulation and management of the financial system in the UK. This ‘tripartite’ regulatory system had many inherent weaknesses revealed by the GFC. It was ineffective in identifying the risks which were building up in the financial industry; it failed to take proactive steps to mitigate or avoid risks that threatened the stability of the UK financial system and when the crisis unfolded it failed to deal sufficiently with the crisis. Nor did corporate governance Codes act pre-emptively to avoid or mitigate risk. It was clear that the GFC existing regulatory systems and Codes of Corporate Governance did not protect against bank failure. It suggests that too much emphasis was given to the effectiveness of internal governance systems and their ability to exercise appropriate supervision and control over executive management.

As a result, the UK government restructured the UK financial regulation system. The new UK regulatory system has adopted regulatory system with some similarities to the regulatory system in Australia, known as ‘Twin Peaks’ model, which appeared to help protect the system the worst effects of the 2008 GFC. The model adopts a strong regulatory system to protect banking, the financial sector and the national economy
against the risk of bank collapse and systemic risk as well as establishing a body to deal with the protection of consumers of financial products. This will provide lessons for Jordanian banking sector and its regulatory system.

Whilst there are apparently high levels of compliance with the UK Corporate Governance Code before and after the GFC, this does not necessarily ensure that the Board and its Committees operate independently and provide effective oversight of banks and other financial institutions. Whether the special circumstances relating to the Jordanian banking industry require these Codes to be made mandatory is discussed in chapter 7.

The new UK reforms have not yet been tested to determine whether those measures are adequate to protect against a future financial crisis. The next chapter will discuss bank governance in Australia. It will discuss the role of the Australian reforms (the Twin-Peaks model) in avoiding the worst effects of the 2008 GFC and the role of Board Committees in relation to the governance of banks.
CHAPTER 5

BANK GOVERNANCE IN AUSTRALIA

5.1. Introduction

The previous chapter discussed bank governance, its regulation and recent reforms in the UK. It discussed problems leading up to the recent reforms and problems related to the monitoring and supervision of bank Boards and Board committees which were implicated in the 2008 Global Financial Crisis (GFC) in the UK financial system.

This chapter examines the Australian financial regulatory framework and seeks to explain why Australia was able to avoid the worst effects of the 2008 GFC. This examination of the Australian system is important as it provides a useful comparator to determine the structure and effectiveness of bank regulation in Jordan and the role of Board Committees within that structure.

The chapter is divided into five sections. Section 5.1 is introductory. Section 5.2 provides an overview of the role and importance of banks to the Australian economy. Section 5.3 examines the regulatory framework in Australia and the Corporate Law Economic Reform Program (CLERP) which led to the establishment of Australian regulatory model (Twin Peaks). Section 5.4 explores the Corporate Governance Codes applying to banks. Section 5.5 is the conclusion.

5.2. The Banking Sector in Australia

The Australian financial sector is a very large contributor to the national economy. From 2012 until April 2013, the Australian finance and insurance sector contributed
about 10.3% of national economic activity. The finance and insurance sector increased by 4.3% between 2012 and April 2013. In the five year period to the end of March 2013, the average annual growth rate for finance and insurance was 2% per annum.

Australian banks are licensed to carry on banking business under the Australian Banking Act 1959 (Cth). The banking sector comprises both domestic and foreign banks. The Australian federal government has a long standing strategy of ‘four pillars’ that prevents mergers between the four major banks which have the largest market share of the commercial and retail banking sector. The Bloomberg Riskless Return Ranking for the period 2003 until mid 2013, ranked the three of the four major Australian banks first, fourth and seventh; the Commonwealth Bank of Australia (CBA) received the first ranking with a risk-adjusted 18%; the Westpac Banking Corporation (WBC) received the fourth ranking with 11% and the Australia and New Zealand Banking Group (ANZ) Bank received the seventh ranking with 8.7%. Under the market capitalisation ranking at share price on 15 August 2014, the CBA had market capitalisation about AU $ 132 billion (USD 7119 billion), WBC had AU $

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2. Ibid 5.

3. The first Bank established in Australia was the New South Wales Bank in 1817 in Sydney city.


5. These are Commonwealth Bank of Australia (CBA), the Australia and New Zealand Banking Group (ANZ), Westpac Banking Corporation (WBC), and National Australia Bank. The largest of the other domestic retail Bank competitors are Suncorp-Metway, Macquarie Bank, Bendigo Adelaide Bank and the Bank of Queensland.

106 billion (USD 95 billion), ANZ had AU $ 89 billion (USD 80 billion) and NAB had AU $ 82 billion (USD 74 billion). The competitor banks to these four big banks are small and regional Banks (e.g. Bank of Queensland, Bendigo Bank and Suncorp Bank), mutual credit unions and building societies.

Investment banks operating in Australia include the largest players in the global investment banking with a full range of products and services in capital markets, securitisation, underwriting, corporate finance, structured finance, offshore funding, private infrastructure financing, derivative markets, and corporate advisory services. Investment banks comprise around 5% of total financial intermediary assets in Australia, with foreign banks holding about 50% of the assets of investment banks. Of the foreign banks with a subsidiary or branch licence, HSBC, Citigroup, Deutsche Bank, Bank of Scotland and ING have the largest presence as measured by Australian banking assets. There are also a number of small foreign retail banking operations that target particular immigrant groups. These include the Bank of China, the Arab Bank, Beirut Hellenic Bank, and Bank of Cyprus. The retail banks in Australia are relatively concentrated, with 21 banks providing the bulk of banking services to clients (twelve domestic banks and nine foreign owned subsidiaries). Foreign banks licensed in Australia operate through branches as well as Australian-incorporated

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7 The exchange rate for the Australian Dollar varies between AU $1 equal about USD .90 to .94 in 2014.


10 Ibid.

11 For example, ING now ranks as a fifth in retail banking.

foreign bank subsidiaries. The foreign banks operating in Australia are required to operate under the authority of the Australian Banking Act and banking policies.  

The net profits of the Australian banking sector in 2013 were AU $23.7 billion (USD 21.3 billion) with an increase about AU $3.5 billion (USD 3.1 billion) or 15% over 2012. In mid 2013, the Australian banks total Assets were about AU $3.1 trillion (USD 2.7 trillion). Australian banks source their funds from wholesale debt markets, deposits, and securitisation and equity. The Report of the Australian Bankers’ Association in 2013 states that in 2012 the major Australian retail Banks paid about AU $100 billion (USD 90 billion) in interest expense to bond holders as well as the depositors for the funds they required to lend to businesses and households. In August 2012, domestic deposits formed about 53% of the overall Australian banks funding.

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15 Of the twenty one countries surveyed by the Asian Bankers 500, Australia has the third biggest pool of assets in its Banks in the region after Japan and China. See Australian Bureau of Statistics, Australian National Accounts: National Income, Expenditure and Product (December 2010), cat no. 5206.0 – Table 6, Gross Value Added by Industry, chain volume measured, 6. These Assets include AU $2.8 trillion (USD 2.5 trillion) as resident assets (e.g. assets on the books of Banks with any business, personal or institution located in Australia), AU $172.3 billion (155.07 billion) were non-resident assets (e.g. assets on the books of Banks with any business, personal or institution located overseas) and AU $130.8 billion (USD 117.7 billion) as amount was due from operations of Banks overseas. See Australian Bankers’ Association, Assets (2013), 1 <http://www.bankers.asn.au/ArticleDocuments/148/Website%20Assets%20June%202013.pdf.aspx>.


18 Ibid 1.
As a consequence of the GFC, the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme) was introduced in October 2008. It promoted stability in the Australian financial system as well as ongoing provision of credit through providing support and assistance to the Authorised Deposit-taking Institutions (ADIs), so that credit funding could continue. This was to ensure that Australian institutions were not placed at a disadvantage compared to their overseas competitors who might access similar government guarantees on bank deposits. The failure of large international banks such as the US Lehman Brothers, destabilised the financial system internationally as well as a virtually closing parts of international capital markets, and the effective closure of long-term wholesale funding markets to non-sovereign borrowers. ADIs in Australia were influenced by these developments with hesitancy among investors to purchase long-term bank debt. In October 2008, the Australian Government encouraged depositors and investors by providing guarantee arrangements for depositor protection.

Depositor protection arrangements in Australia were mainly strengthened through the introduction of the Financial Claims Scheme, under which deposits of $1 million (USD 1.65 million) or below with Australian-owned banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks are automatically guaranteed by the Government, with no fee payable… Separately, under the Guarantee Scheme, eligible ADIs have been able, for a fee, to offer government guaranteed deposits greater than $1

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20 ADIs is an authorised deposit taking institution under the Banking Act 1959 to obtain deposits from clients. They include Banks, Credit Unions and Building Societies. See also http://www.apra.gov.au/adi/Pages/default.aspx.


22 Ibid.

million, and government-guaranteed wholesale funding with maturity out to five years (less in the case of foreign bank branches).24

On November 2008, these provisions became operational.25 The 2008 GFC did not have any significantly long term deleterious effect on the Australian banking sector. Banks generally were relatively cautious in lending policies so that the subprime housing bubble affecting the US did not occur in Australia despite high levels of derivative trading preceding the GFC.26 Non-bank lenders which were more likely to be involved in low or no doc loans were effectively squeezed out of the home mortgage market and business concentrated in the hands of the largest banks.27 The government guarantee of bank deposits gave preference to banks over other lenders. This gave banks an edge in borrowing to the detriment of higher rates demanded of non-bank lenders. One consequence was the exit of some non-bank lenders.28

Furthermore, the percentage of the mortgage market held by the big four banks


27 See Fitch Ratings, Australian and Canadian Major Banks: Structural Features Favourable, But Funding Remains a Key Issue for Australian Banks (30 January 2012), 7 <http://www.afr.com/rw/2009-2014/ AFR/ 2012/ 01/ 30/ Photos/ 9 4 7 7 7 1 b 7 e 4 b 0 e 1 1e1b5eae65870fe/b10Australian% 20 and %20 Canadian % 20 Major % 20Banks%20300112.pdf>. There were also a number of takeovers and mergers which further concentrated the power of the 4 major banks. The takeover and mergers were: Westpac (took over St George Bank), CBA (took over BankWest). St George Bank and the foreign-owned BankWest was respectively ranked as the fifth and eighth in accordance with the size of the banking hierarchy in Australia at the time they were taken over. See Bernadette Donovan and Adam Gorajek, ‘Developments in the Structure of the Australian Financial System’ [2011] Reserve Bank of Australia Bulletin, 1, 30.

increased sharply as banking concentration increased.\textsuperscript{29} The proportion of the Australian non-performing bank housing loans was low by international standards.\textsuperscript{30} Unlike the US there was no exploding housing bubble and less exposure to subprime lending.

A further reason why the GFC had less impact in Australia was because Australian banks had less exposure to high risk lending and less exposure to high risk securities (e.g. credit default swaps).\textsuperscript{31} Moreover, the lending processes of the Australian banks shown by portfolios were less risky than in the USA or UK due to factors such as less engagement in risky financial instruments as well as a strong regulatory environment.\textsuperscript{32} The following Figure compares the loan quality between Australia, USA and UK before the GFC in 2008.

\textsuperscript{29} Adele Ferguson and Eric Johnston, ‘Back to the bad old days’, \textit{Sydney Morning Herald}, (Sydney), 4 December 2010, 8.


\textsuperscript{32} These reasons and others will be discussed further later below.
The Australian banking sector had less exposure to non-performing loans than that in the UK or USA. This was a factor in preventing bank collapse or the need for government bailouts as occurred elsewhere. This is not to say that there is no risk in banks in the future engaging in ‘exotic securities’ or that competition will not drive banks to extending their loan portfolios to low or no doc loans. It has been suggested that the required high capital adequacy level for banks required by the Australian Prudential Regulation Authority (APRA) was one of the reasons that the Australian banking sector had very low levels of non-conforming or low-doc loans during the 2008 GFC. Another factor was that runs on financial institutions were very unlikely. Banks were given preferential treatment by government guaranteeing deposits.

Source: IMF

Figure 5.1. Non-Performing Loans 2007 (The Ratios of Total Bank Loans)

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35 For example, the RBA warned, in March 2011, that risky lending processes might “reemerge” in accordance with increasing the competition in the home lending market as well as decreased scope for local growth. See Adrian Rollins and Andrew White, ‘Lenders countenance new era of low credit growth’, *Australian Financial Review*, (Australia), 25 March 2011, 47.

Additionally, unlike the US where money market funds could be subject to withdrawal of funds by frightened investors, non deposit funds could not pay out cash on demand. In November 2008, at the peak of the GFC, ADIs in Australia were meeting their capital adequacy requirements and were declared to be sound.

This does not mean that Australia escaped unscathed by the GFC but its effects were far less severe than in other countries. But what is remarkable is the resilience of the financial sector and the stability and security of the banking system. The RBA concluded in its Financial Stability Review for the year ended 2012 that:

The Australian banking system remains in a relatively strong condition. The banks are in a good position to cope with the tighter funding conditions given the improvements they have made to their funding, liquidity and capital positions over recent years. Their wholesale funding task is also more manageable, with deposit growth continuing to outpace growth in credit by a wide margin.

The question is how far the regulatory framework has ensured the stability, security and success of the Australian banking sector and what lessons may be learnt in the regulation of banks in Jordan.


39 For example, there were many high profile Australian business failures during the GFC. Between 2007 and 2009, failures were valued at about AU $66 (USD 59) billion. Many of these were highly leveraged. See Australian Securities and Investments Commission, A Year of Change-ASIC Annual Report 07-08 (August 2008), 12 <http://www.asic.gov.au/asic/pdf/lookupbyfilename/full%20annual%20report%200708.pdf> and Hannah Low, ‘Heat on Banks after $500 million ABC payout’, Financial Review, (Australia), 6 June 2011, 8.

5.3. The Regulatory Framework in Australia

Although there had been a series of reports and inquiries concerning the Australian financial regulatory framework, the most important has been the Financial System Inquiry chaired by Stanley Wallis (Wallis Inquiry) reporting in 1997.\(^41\) The terms of reference for the Inquiry were that it should review the effects of financial deregulation since the 1980s, and “the forces driving further change”, particularly technological developments to ensure that the financial system promotes economic growth, financial stability and fairness. It was also charged with making recommendations on the operation of the regulatory framework.\(^42\)

The regulation of securities and derivatives markets in Australia was largely institutionally and product based so that securities and deposit accounts were regulated differently depending on the classification of the financial instrument. The Inquiry recommended that there a single Commonwealth agency responsible for regulation of the financial system.\(^43\) The recommendations were taken up in the financial sector reforms under the Corporate Law Economic Reform Program

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\(^43\) Ibid Recommendation 31.
CLERP \(^{44}\) dealt with the reforms to the structure of the regulatory system. These were legislated by amendment to the \textit{Corporations Act 2001}, Chapter 7 and the establishment of the Australian Prudential Regulatory Authority (APRA) under the \textit{Australian Prudential Regulation Authority Act 1998}. The amendments reformed the regulatory framework by:

- providing comparable regulation of all financial products, including securities, derivatives, superannuation, life and general insurance and bank-deposit products;
- licensing financial markets and providing consistent and comparable regulation for similar financial products;
- licensing all financial intermediaries and imposing harmonised statutory obligations designed to protect retail investors; and
- ensuring that ‘promoters’ or issuers of financial products provide comprehensible disclosure documents which assist investors to make informed decisions. \(^{46}\)

CLERP 6 brought about enormous changes to the existing regulatory system. Figure 5.2 shows the regulatory framework prior to change.

\(^{44}\) It comprised the following laws: \textit{First Corporate Law Simplification Act 1995} : simplifying Annual Returns); the \textit{Corporate Law Economic Reform Program Act 1999} : new accounting standards and the creation of the Australian Accounting Standards Board (AASB) under the \textit{Australian Securities and Investment Commission Act 2001} Subdivision B, 226. These standards are concerned with the public disclosure of data to promote good corporate governance. See \textit{Corporate Law Economic Reform Program Act 1999; Financial Services Reform Act 2001}: this legislation amended Chapters 7 and 8 of the \textit{Corporations Act 2001} which related to the securities and futures industry. See \textit{Financial Services Reform Act 2001}. There are other amendments not relevant to this thesis.


\(^{46}\) Ibid 10.
Before the reforms, the prudential supervision system was organized according to the type of institution with separate regulators for each type of activity. The Reserve Bank of Australia (RBA) was responsible for the banking sector; the Insurance and Superannuation Commission (ISC) was responsible for insurers and superannuation funds; and the state and territory-based “State Supervisory Authorities” (SSAs) were responsible for building societies, friendly societies as well as credit unions under the management of the Australian Financial Institutions Commission (AFIC). The responsibilities for regulating the financial framework in Australia were divided, under the Constitution, between the States and Commonwealth. This separation of

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48 This was including the overall financial system stability, payments system, monetary policy, and the prudential supervision of Australian Banks. See Ibid.
legislative power led to separation between the territory-based regulatory agencies, Commonwealth regulatory agencies and the state.\textsuperscript{49}

The Wallis Inquiry recommended, and CLERP 6 implemented, widespread reform of the regulatory framework with uniform and consistent regulation of all financial instruments which included securities, futures and other derivatives, foreign exchange, superannuation, general and life insurance and deposit accounts.\textsuperscript{50} The following Figure summarises the re-organisation of regulatory responsibilities resulting from the Wallis Inquiry and the recommendations of CLERP 6. It shows the transfer of regulatory functions from the former system to the new regulatory framework.

\textbf{Figure 5.3. The New Australian Financial Regulatory System}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{new-african-regulatory-system.png}
\caption{The New Australian Financial Regulatory System}
\end{figure}

Source: APRA\textsuperscript{51}

\textsuperscript{49} Ibid

This re-organisation of financial system regulation was guided by two key principles. First, there should be a one-to-one relationship between regulatory bodies and causes of financial-market failure as opposed to the many-to-many relationship that characterised the previous regime. Second, regulation should only be imposed in situations where the risk and consequences of market failure are sufficiently large.\(^5\)

Whilst APRA and ASIC are the main banking and financial regulatory bodies, there are other bodies which impact on the regulation of financial institutions such as the RBA responsible for monetary policy, systems stability and the payment system and the ACCC regulates anti-competitive behaviour and Australia’s competition and consumer protection regulator.\(^53\) All four regulatory bodies are independent statutory institutions.\(^54\) (See the following Figure).

**Figure 5.4. Functional Regulation**

![Functional Regulation Diagram](source: APRA\(^55\))

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\(^{52}\) Ibid.

\(^{53}\) ACCC promote effective markets, protects consumer’s interests and safety and prohibits anti-competitive behaviour, see ACCC, see [http://www.accc.gov.au/](http://www.accc.gov.au/).

\(^{54}\) For example, the Ministers can’t give directions or guidance to APRA in any particular case. “The Minister is precluded from giving directions about particular cases, ensuring APRA’s independence on operational matters. This new power is consistent with directions powers in relation to other statutory agencies, in particular the Australian Securities and Investments Commission.” See *Australian Prudential Regulation Authority Amendment Bill 2003* (Cth) Explanatory Memorandum, Paragraphs 3.19 and 3.20 <http://www.comlaw.gov.au/Details/C2004B01439/Explanatory%20Memorandum/Text>.
Under this new structure the ACCC has retained responsibility for thwarting any anti-competitive behaviour that would otherwise result in sub-optimal price and production outcomes being realised by the market. In particular, the ACCC remains responsible for competition policy and consumer protection across all sectors of the economy. The most common types of behaviour that are of concern to the ACCC are collusion and the exercise of monopoly power...Following the reforms to the regulation of the financial system, the Australian Securities and Investments Commission (ASIC) has become the sole agency responsible for consumer and investor protection, taking the various consumer protection responsibilities in the area of financial products away from the ASC, the ISC and the ACCC.  

The RBA is a statutorily regulated institution wholly owned by the Commonwealth of Australia. It was first established on the 14 January 1960 as Australia’s Central Bank as well as banknote publishing authority. The Reserve Bank Act 1959 (Cth) transferred the central bank functions from the Commonwealth Bank to the Reserve Bank. The RBA acts through two Boards. The first Board is the ‘Reserve Bank Board’ which has obligations for financial stability and monetary policy. The second Board is the ‘Payments System Board’ which governs the payment system policy of the bank. Unlike national banks in many countries, its functions do not include regulation of banks. The main mission of the RBA is to maintain monetary and financial stability including exchange and interest rates, stability of the Australian dollar.

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56 Ibid. See also section [5.3.1.2] for more discussion concerning the role of ASIC.


58 In Jordan, the Central Bank is called as the Central Bank of Jordan (CBJ). See chapter 6 [6.4.2] for more discussion about this Bank.

59 The RBA is governed by this Act which came into effect from 14th of January 1960.


61 Ibid. See also Sheelagh McCracken et al, Banking and Financial Institutions Law (Thomson Reuters, 8th ed, 2013) 28.
The paragraphs following examine the evolution of Australia’s Twin Peaks regulatory model which consists of two independent statutory bodies, namely the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

5.3.1. Twin Peaks Model

The ‘Twin Peaks’, APRA and ASIC, separate the prudential regulatory function from the market regulatory function. Prudential regulation is directed to ensuring that an efficient financial system is able to meet its obligations, remain financially stable and protect financial institutions against failure. The purpose is to ensure financial stability and enhance bank stability and protect institutions from failure which may lead to a loss of confidence in the soundness and safety of the whole financial system. In contrast, market conduct regulation aims to protect consumers who buy financial products and invest funds in financial institutions. This protection is necessary because of the unequal position of financial institutions relative to their customers; retail customers usually do not have the knowledge and data important to protect themselves from risk or market abuse and depend on the financial institutions and their representatives for advice. The purpose is to protect consumers and provide confidence in the overall financial system by providing market integrity for better market conduct, transparency, financial stability and consumer protection.62

The role of APRA in the regulatory system is discussed in the next section.

5.3.1.1. The Australian Prudential Regulation Authority (APRA)

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In July 1998, APRA was established under the *Australian Prudential Regulation Authority Act 1998* as a Commonwealth statutory authority with responsibility for prudential regulation of financial institutions. It manages and licences deposit-taking, life insurance, general insurance and superannuation institutions. APRA is vested with supervisory powers over banks, Authorised Deposit-Taking Institutions (ADIs), Non-Operating Holding Companies (NOHCs), and the general insurance institutions and superannuation funds.

APRA sets prudential standards which are mandatory for regulated financial institutions. APRA also provides practice guides to be observed by supervised financial institutions. APRA evaluates new licence applications and financial soundness of supervised institutions, and if necessary, responds to crisis, carrying out remediation as well as enforcement. APRA follows a risk-based method under which financial institutions exposed to higher risks receive closer supervision so as to be able to employ its resources in a cost-effective way. The prudential practice guides and prudential standards deal with the inherent risks affecting financial institutions, and the systems adopted to control, manage and detect these risks as well as the capital required to face unexpected losses.

Under APRA, a licensed financial institution is subject to APRA’s regular supervision. Supervision includes off-site as well as on-site inspection and analysis.

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64 See *Banking Act 1959*, ss. 11AA, 20.

65 NOHCs and ADIs have formal duties to report in relation to particular issues under the *Banking Act 1959*. There is also a duty to notify and advise APRA once they become aware of any important breach of any prudential principle. Failure to notify results in financial penalties. See *Banking Act 1959* s.62A.

The off-site analysis assesses whether the institution has effective risk management and operation frameworks. The analysis is undertaken on a regular basis and contains, for example, risk-rating assessments; analysis and assessment of prudential issues as they arise; regular financial assessment supported by the APRA’s statistical collections; and evaluating the emerging risk across APRA-supervised industries.

The off-site process is concerned with risk exposure as well as evaluating the capital adequacy; the financial and earning performance; changes to business mix, governance arrangements; the areas that have risks such as the market, liquidity, and operational risks, (see chapter 3). APRA meets regularly with the institution’s management as part of its supervisory role. The second approach involves on-site analysis. APRA regularly visits the institutions which it monitors. This permits APRA to speak with staff and, where appropriate, evaluate and analyse the institutions’ transactions and records. These reviews target a specific risk area. They evaluate the risk management efficiency of these institutions, including their internal governance systems and regulatory procedures.

APRA is responsible for managing the arrangements of the Financial Claims Scheme which give depositors of failed ADIs access to their deposit funds as well as eligible policyholders and other claimants in relation to insurance claims. Where risks are sufficiently serious this may warrant legislative responses as is the case with recent

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67 Ibid 8.
68 Ibid.
69 Ibid 9.
70 Ibid.
71 Ibid 9.
72 Ibid 4.
provisions relating to reporting of trading in derivatives (over the counter products (OTC)).\textsuperscript{73}

APRA takes a proactive approach. For deposit-taking and insurance sectors, for example, APRA has developed a comprehensive system of prudential standards and practice guides to provide an effective financial and risk management system as well as good governance. APRA is required to act proactively in managing risk. It has intervened to remove different types of capitalised expenses (e.g. mortgage broker commissions and loan origination fees) from regulatory capital’s calculations; has set prudential principles for “low doc” as well as other non-traditional mortgage loans; and in relation to lenders’ mortgage insurance.\textsuperscript{74}

A continuing crucial function of APRA is to ensure compliance with capital and liquidity principles based on Basel II which came into effect from 1 January 2008 in Australia.\textsuperscript{75} Under the Basel II model, banks are required to meet the prudential capital ratio (PCR) of 8 percent of total risk-weighted assets. It is important to note that APRA regards the Basel II standards as minimum standards.\textsuperscript{76}

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\textsuperscript{73} See the \textit{Corporations Legislation Amendment (Derivatives Transactions) Act 2012}, in force January 2013 inserting a new Part 7.5A into the \textit{Corporations Act 2001} requiring trade reporting etc of OTC derivatives or classes of derivatives in relation to which the Minister has issued a determination.


\textsuperscript{75} For further discussion concerning Basel II, see chapter 3 [3.5].

mortality insurance. This greater granularity adds considerably to the risk-sensitivity of capital.  

Under the standardised methods of the Basel II system, where there are areas of high risk, APRA might require ADI’s to have a PCR of more than 8% if APRA believes that there are additional risks. In 2004-5, NAB was required to increase its internal capital adequacy ratio to 10 percent in response to a foreign currency risk. This level was to be maintained until APRA was satisfied that the NAB had dealt with the bank’s weaknesses of its internal control processes to cover its losses. In April 2005, the CEO of NAB stated that the bank had complied with 72 of the 81 remedial processes required by APRA.  

Following the Basel III Accord discussed in the previous chapter, APRA as regulator requires the adoption and implementation of the Basel requirements by banks. It has indicated that it will adopt Basel III recommendations relating to capital adequacy and liquidity. Recently, APRA has requested ADIs to provide detailed information on how the Basel III Committed Liquidity Facility (CLF) requirements are to be implemented. 

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In September 2012, APRA published the final Basel III capital reform package for Australia. The reforms are to be implemented in the period 2013 to 2018 (in accordance with the schedule of the Basel Committee), with the new Basel III minimum capital requirements for ADIs. These principles require Australian ADIs to have an internal capital adequacy evaluation procedure, maintain the Basel III required levels of regulatory capital, inform APRA of any adverse risk to real or expected capital adequacy, and obtain APRA’s confirmation of any planned capital reduction. As these requirements are not discretionary, Boards and Board Committees, particularly, the Risk Management Committee’s role is to monitor compliance with Basel and to ensure that internal controls and processes satisfy the requirements.

The gradual introduction of Basel III requirements on Australian banks is likely to reduce disruption to the banking sector. Whilst APRA stated that the impact of Basel III reforms on GDP may be low, it has been argued, but not demonstrated, that Basel III will reduce the annual GDP growth by 2 percent to 3 percent as well as slowing recovery post the GFC. Therefore, Basel III might increase stability but


81 For further discussion concerning the role of Risk Management Committee in particular and Board Committees in general, see chapter 2 [2.3.2.5].

potentially reduce profits and productivity but in the longer term improve bank
stability and security and protect against systemic failure.\textsuperscript{84}

APRA constantly monitors the financial services industry. It publishes monthly
banking and other financial statistics setting out the obligations and assets of each
bank in Australia with details of loans, advances and deposits by various sectors of
the economy; data on securitisation activities of these banks; and the Australian-dollar
denominated transactions as well as the Australian dollar equivalent of international
currencies denominated transactions. APRA also closely monitors the liquidity
strategies of the ADIs to ensure that banks have sufficient liquidity and are able to
meet their financial commitments. It should be here noted that the appropriateness and
adequacy of the liquidity management policies and strategies of the banks in Australia
are reviewed and approved by APRA.\textsuperscript{85}

APRA has legislative authority to intervene where there are risks that may affect the
financial system in general and in particular when there is potential risk which may
affect financial institutions. APRA has wide ranging investigative powers in relation
to supervised institutions and can request the Australian Federal Court to disqualify
persons guilty of misconduct from working in licensed institutions.\textsuperscript{86} APRA has also

APRA\%20Insight\%20Issue\%202\%202012.pdf>.

\textsuperscript{84} See Andrew Papageorgiou, \textit{Opinion-The Basel III Effect} (30 August 2012)

\textsuperscript{85} See also APRA, \textit{Implementation Basel III liquidity Reforms in Australia} (16 November 2011) <http://

\textsuperscript{86} If the Australian Federal Court finds the case proved, the person is disqualified and the person’s
name put with the disqualification registration on website of APRA for public. See APRA, \textit{Protecting
Australia’s Depositors, Insurance Policyholders and Superannuation Fund Members} (2012), 10 <http://
taken measures to ensure capital adequacy of licensed institutions.\textsuperscript{87} For example, in December 2008, APRA requested the CBA to increase its Tier 1 capital beyond its then level of 7.5\% as a proactive procedure against possible loss.\textsuperscript{88} Although CBA initially disagreed with APRA’s risk-based evaluation concerning a hedging agreement and the request to increase Tier 1 capital, ultimately the CBA complied by increasing its Tier 1 capital by about AU $750 million.\textsuperscript{89} APRA’s conservative approach may be more demanding than the minimum capital adequacy requirements of the Basel III Accord\textsuperscript{90} but this gives greater assurance of a stable banking system.

APRA sets prudential principles to deal with inherent risks affecting financial institutions in order to enhance and maintain the safety and stability of the Australian financial system. Its regulation of financial institutions is not limited to banks and thus recognises the importance to the financial system of financial dealings outside the formal banking system. It is proactive in taking measures to protect the financial sector and despite significant resistance has taken steps to implement the Basle III as minimum requirements.

The second plank in the regulatory system is ASIC.

5.3.1.2. The Australian Securities and Investment Commission (ASIC)

ASIC is the financial services regulator which has the duty to control and promote market integrity and protect the consumers and businesses in relation to financial


\textsuperscript{88} Geoff Winestock, ‘Meet the Man We’re All Banking On’, \textit{Australian Financial Review}, (Australia), 14 March 2009, 26.

\textsuperscript{89} Ibid.

services and products. The *Australian Securities and Investments Commission Act 2001* requires ASIC to improve the performance and structure of the financial system and keep data on banks and other organisations. ASIC aims to regulate and decrease fraud and unfair practices in the financial sector and financial products so that consumers can have confidence in the sector.  

ASIC has power to monitor investment schemes, issue licences for financial services, and establish principles to ensure financial market integrity. It also has power to protect customers against misleading information to ensure that the financial services market is transparent and fair to maintain the consumer’s confidence in the Australian financial system. It has power to investigate cases where legal breaches have occurred, enforce an undertaking to comply with the legislation, and prosecute breaches. The chair of ASIC, states that:

> We accept that the vast majority of business in Australia is undertaken legitimately, with directors complying with these obligations. ASIC will not intervene in such circumstances, despite some perceptions that we are lurking under every boardroom table. We do not take enforcement action against those who make honest and reasonable efforts to comply with their legal duties as directors...But we remain vigilant and will take strong action where that action is warranted...To do so, we have a range of regulatory responses at our disposal where directors breach their duties. We can commence civil penalty proceedings or alternatively, criminal proceedings where recklessness or intentional dishonesty is apparent. Alternatively, we can take administrative action, for example, banning directors, where a particular situation

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91 While APRA has the duty for prudential supervision of financial services institutions, however, these institutions will be also subject to the supervision of ASIC. See Louise McCoach and David Landy, ‘Australia’ in Jan Putnis (eds), *The Banking Regulation Review* (Gideon Roberton, 3ed ed, 2012), Chapter 3, 41.


93 See the *Australian Securities and Investments Commission Act 2001*, Subdivision B; 12BAA, 12BAB.

94 See Ibid Subdivision D.

warrants such an approach. In 2005–06, we had 44 people removed from directing companies for a total of 195 years.  

ASIC concentrates on areas that it evaluates as being of the highest risk, such as misconduct and non-compliance that influence the decisions of the consumers, threaten the reputation of the market or the international reputation of Australia as a safe and stable and good regulated area to do business. It also monitors and responds to new or increasing risks. A Complex Products Working Group was established by ASIC in July 2012 to mitigate the risk of complex products being sold to investors by improving disclosure requirements as well as educating investors about complex services and products such as the capital guaranteed products.

To assist ASIC with this role, it regularly consults with consumers and industry through Business and Consumer consultative panels. One of the key issues is the effectiveness of ASIC. It has been subject to considerable criticisms for being too slow to respond to risks and take action to protect the public. One measure of effectiveness is the number of prosecutions. ASIC states that:

In 2012–13 we completed 111 litigation and administrative actions, 92 investigations and 12 criminal proceedings. We secured 12 criminal convictions and seven imprisonments…In April 2013, ASIC obtained orders winding up three Gold Coast-based companies involved in a fraudulent financial services business. ASIC had previously frozen $283,000 before obtaining the orders appointing a liquidator to the companies to redistribute these funds back to investors.

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96 Jeffrey Lucy, *Directors’ Responsibilities: The reality vs the myths* (August 2006), ASIC, 5.


An important factor in responding to the GFC was the preparatory steps taken by ASIC. Much of ASIC’s work concentrated on addressing the weaknesses discovered by the crisis to provide direct support to institutions and investors or seek to prevent similar crisis may occur in the future.\textsuperscript{101}

Since November 2007, ASIC has commenced 18 civil actions seeking to recover funds for the benefit of Westpoint investors, including claims against the directors of Westpoint mezzanine companies, the auditors of the Westpoint Group and certain financial planners and a trustee. In total, the actions seek approximately $559.9 million.\textsuperscript{102}

More recently ASIC has taken measures to deal with improper conduct by financial advisory services provided by banks, particularly the Commonwealth Bank. It has insisted that proper compensation measures be put in place to compensate investors who sustained large losses through the misconduct of bank advisors.\textsuperscript{103} New licence conditions were imposed on the bank requiring the bank to provide a suitable compensation scheme for clients harmed by the misconduct of ‘rogue planners’ of the banks financial planning arm. ASIC appointed a compliance expert (paid for by the bank) to review the banks compensation strategies and in relation to the identification of planners involved in misconduct. The obligation to report, monitor and investigate was placed on the bank’s Board of Directors.\textsuperscript{104}


\textsuperscript{104} Ibid.
ASIC has been criticised for its dual character, it regulates and evaluates business but is at the same time a “corporate watchdog”. It is said to lack transparency, delays in making decisions and lacks effective procedures.\(^{105}\)

The separation of the prudential regulatory function (APRA) from the market regulatory function (ASIC) avoids demarcation disputes and responds to risks outside the formal banking system as regulation is on a functional rather than on an institutional basis. As mentioned in the previous chapter, the UK adopted a similar model after the 2008 GFC.\(^{106}\) Countries like Jordan have a financial system with high levels of ownership and control by families and significant political influence, which may poses risks to its regulatory approach. It also affects the independence of decisions such as the Board Committees and increases the potential for agency conflicts. This is discussed further in chapters 7.

**5.4. Corporate Governance in Australia**

The previous sections have dealt with the regulatory framework governing financial institutions in Australia. This section turns to look at the crucial role of Boards and Board Committees in corporate governance and monitoring and supervising bank operations. As discussed in chapter 2, Australian listed banks are governed by the ASX Code of Corporate Governance and APRA Governance Standards and Guidelines.\(^{107}\) APRA standards are mandatory but Guidelines are only advisory.

\(^{105}\) Allan Fels, the former chairman of Australian Competition and Consumer Commission (ACCC), comments that ASIC is “far less a proactive enforcer” because ASIC has become extremely dependent on enforceable undertakings which have become a substitute for basic legal action”. See Adele Ferguson, Ben Butler and Ruth Williams, ‘Watchdog’s Failures Cost Victims Dearly’, *The Sydney Morning Herald*, (Sydney), 23 November 2013, 9-10.

\(^{106}\) The UK adopted two new regulatory bodies: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), see chapter 4.
Outside those mandatory requirements, like its counterparts in the UK and elsewhere, the codes or guidelines are non mandatory and rely on a comply or explain approach to provide flexibility and innovation in how corporations meet corporate governance requirements.

The Australian Board and Board Committees follow the standard pattern outlined in chapter 2 requiring independent oversight by the Board and Committees, Non-Executive Directors, separation of the role of Chair and CEO and Committees for Audit, Risk Management, Remuneration and Appointments. Under the ASX Corporate Governance Code, it is not mandatory for Boards to appoint Board Committees except for S&P ASX 300 companies. The ASX listing rules (mandatory for listed companies) rules 12.7 and 12.8, require S&P ASX 300 listed companies to have Audit and Remuneration Committees and remuneration committees must have

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108 In 2008, across the top 300 institutions (by market capitalisation), about 74% of directors were Non-Executive Directors, increasing to 80% for top 50 institutions, see Korn/Ferry International and Egan Associates (2008) Board of Directors Study: Australia and New Zealand, 16 <http://www.kornferryasia.com/leadership/2008_Board_of_Directors_Study_In_Australia_And_NZ.pdf>.

109 In 2008, there was about 80% of all listed companies in ASX had separated the role of CEO and chairperson, Australian Stock Exchange, Analysis of Corporate Governance Disclosures in Annual Reports for Year Ended 30 June 2008 (2009), Research Paper, Sydney. There appears to be no more recent analysis.


111 On the 16th of August 2013, the ASX CGC published the 3rd edition of the ASX Corporate Governance Principles and Recommendations. The third edition of the Principles and Recommendations are expected to take effect for the Bank's first full financial year commencing on or after 1 July 2014. See Ibid. Audit Committee (Principle 4, recommendation 4.1, 20); Remuneration Committee (Principle 8, recommendation 8.1, 29); Appointments Committee (Principle 2, recommendation 2.4, 16); and Risk Management Committee (Principle 7, recommendation 7.1, 26).

112 ASX, On-Going Requirements (December 2013), Chapter 12, Rules 12.7 & 12.8, 1203 <http://www.asx.com.au/documents/rules/Chapter12.pdf>. Three of the four major Australian Banks are in the ASX 300 list, Commonwealth Bank of Australia, National Australia Bank, Westpac Bank, the ANZ Bank is not within that list.
only Non-Executive Directors as members of the Committee. But the importance of these Committees to the stability of the bank and its operations has been recognised by requiring regulated financial institutions, including banks, to have Audit and Remuneration Committees and from 2015 to have a Risk Management Committee, (see Appendix [G]).

The importance of these Committees has been discussed in chapter 2. Also discussed in that chapter was the failure of Remuneration Committees to moderate executive remuneration. In relation to remuneration, initially the legislative response (under CLERP 9, The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 was to move from a disclosure based approach to mandatory requirements in particular areas. The legislation required regular disclosure of remuneration packages including disclosure of the remuneration of directors and top five senior managers of both the listed companies and the corporate group with full details in the annual directors’ report. Shareholders also were given the opportunity to comment and vote on non-binding decisions to adopt the disclosure although this vote was not binding on Board members. It was assumed that disclosure itself would have a disciplinary effect but it did little to moderate executive remuneration. It led to the introduction of the ‘two strike’ rule which gave shareholders a greater role in monitoring executive remuneration. The rule is

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113 Ibid Rule 12.8.


115 See chapter 2 [2.3.2.5].


117 Ibid schedule 5.
explained in detail in chapter 2. It should be emphasised that the need to introduce this rule confirmed that Remuneration Committees were unable to constrain the growth in executive salaries nor ensure that remuneration was matched by performance. This is of particular importance because one of the reasons advanced for bank failure in the USA and UK was that executive remuneration packages led to excessive risk taking by the senior executive so adding to the threat of bank failure. The remedy for two strikes is a spill of the Board and the election of a new Board. This reflected the legislative view that effective Board and Remuneration Committee supervision can be achieved by effective Board members.\textsuperscript{118} This provides the Remuneration Committee with a much stronger hand when dealing with executive remuneration and gives greater support to the role of Non-Executive Directors in their ability to monitor and supervise management remuneration and insist that it be matched by performance. The ‘two strike’ rule can have a disciplinary effect even if, from the evidence, the likelihood of a total Board spill may be quite small, (see chapter 2).\textsuperscript{119} In summary, the Two Strikes rule encourages accountability for remuneration and performance both by the Board and its Remuneration Committee as well as executive management. As the rule is still relatively new, it needs more time to evaluate the influence of the reform on the remuneration practices and the monitoring role of the Board and the Remuneration Committee.

As previously explained in chapter 2, the ASX corporate governance code has largely adopted a ‘comply or explain’ approach to corporate governance. This assumes that secondary market mechanisms will make judgments about whether the reasons for


\textsuperscript{119} See chapter 2 [2.3.2.5, iv].
non compliance satisfy the market. This may be more likely where there is an active and critical financial press and shareholder and stakeholder activism.¹²⁰

5.5. Conclusion

This chapter discussed the key components of the “Twin Peaks” regulatory framework applying to the Australian financial system. The ‘Twin Peaks’ model appeared to help avoid some of the worst effects of the 2008 GFC by adopting a strong pro-active regulatory system to protect banking, financial sector and the national economy against the risk of bank collapse and systemic risk.

Corporate governance plays an important role for managing risk and protecting against bank failure. In relation to financial institutions, audit, remuneration (and from 2015 risk) Committees are now mandatory. This confirms the crucial nature of Committees in the supervision of banks and provides committees with a stronger hand in monitoring and supervising bank operations. Board Committees are the first line of defence. They are uniquely placed with knowledge and understanding of the institution they monitor and supervise. The Australian Prudential standards recognise this in requiring that Audit, Remuneration and (from 2015) Risk committees are mandatory. In relation to other corporate governance standards, although Australia has adopted the ‘comply or explain’ approach, there are important secondary market mechanisms at play which hold banks to account for non compliance. This includes a powerful financial press as well as shareholder and stakeholder activism. This examination of the Australian system is important as providing a comparator to

determine the structure and effectiveness of bank regulation in Jordan and the role of
Board Committees within that structure.

The next chapter, chapter 6, will discuss the bank governance in Jordan. It will
examine the main external supervision monitoring system, in particular, the regulatory
system of the Central Bank of Jordan (CBJ). This will be followed by chapter 7 which
will discuss the role of Boards and Board Committees in corporate governance.
CHAPTER 6

BANK GOVERNANCE IN JORDAN

6.1. Introduction

The previous chapter surveyed the regulatory and corporate governance framework applying to Australian financial institutions. This provides a comparator for evaluating bank governance in Jordan, the role of the regulator, the Central Bank of Jordan and the effectiveness of the corporate governance codes.

This chapter provides a detailed examination of bank governance in Jordan. It discusses the regulatory framework and the role of the Central Bank of Jordan (CBJ) as the bank regulator. In the following chapter 7, it considers internal governance of banks and corporate governance codes. This chapter is divided into six sections. Section 6.1 is introductory. Section 6.2 provides a brief history of the Jordanian banking sector and its performance, the type of banks and their structures. Section 6.3 explores the main sources of funds for Jordanian banks. Section 6.4 the regulatory framework and the role of the CBJ in controlling and supervising banks in Jordan. Section 6.5 examines the implementation of the Basel requirements in Jordan. The last section is the conclusion.

6.2. The Jordanian Banking Sector

Jordan is a small country in the Middle East with a small capital market. At the end of April 2014 it had about 237 listed companies including 15 listed banks.\(^1\) In 1925,\(^1\)

\(^1\) See www.ase.com.jo.
the Ottoman Bank,\textsuperscript{2} a British Bank, was established in the capital of Jordan (Amman) and operated as a financial organisation to the government at a time when there was no Jordanian Central Bank. The growth of banks was relatively slow until the period 1970-1980.\textsuperscript{3} During the 1970s and 1980s, the number of financial institutions tripled. By the end of the 1980s, thirty main banks and other financial institutions operated in the country.\textsuperscript{4} The numbers have fluctuated in the ensuing period.\textsuperscript{5} On the latest available figures, at the end of 2013, the number of banks operating in Jordan was 26; 16 are commercial banks (three of them are Islamic banks) and 10 are branches of Foreign banks.\textsuperscript{6}

According to the Financial Stability Report for 2012, the total assets of the financial system at the end of 2012\textsuperscript{7} were JD\textsuperscript{8} 41.6 billion (USD 59 billion) of which licensed banks held 94.2%. Effectively banks comprise almost all of the Jordanian financial


\textsuperscript{3} In 1949, Arab Bank was established in Jordan; first the Arab Bank with its head office in Amman and then the British Bank of the Middle East which opened branch in Jordan. In 1956, Jordan National Bank was established. In 1960, Bank of Jordan and Cairo Amman Bank were established as a commercial Banks. See Al-Zoubi, Khalid, and Atier, Murad, ‘Jordanian Banks Compliance with Basel II & The Effect on Banks' Capital and Risk Managing’ [2010], 1, 6.

\textsuperscript{4} There were eight domestic Commercial Banks, two Islamic Banks and six Foreign Banks.

\textsuperscript{5} By the end of 2006, there were 23 Banks, thirteen Banks were Commercial Banks, eight Foreign Banks and two Islamic Banks. In 2010, the number of Banks remained relatively stable at 25; thirteen are Commercial Banks, three are Islamic Banks and nine are branches of Foreign Banks. See www.cbj.gov.jo.

\textsuperscript{6} Ibid.


\textsuperscript{8} Jordanian Dinar or JD or JOD is a symbol refers to the Jordanian currency. The exchange rate for the Jordanian Dinar was last updated on February 1, 2014 from Yahoo Finance as 1 JOD equal 1.42 USD. See Central Bank of Jordan, Financial Stability Report: Jordanian Banking System (2010), 25 <http://www.cbj.gov.jo/uploads/fsr_3_en.pdf>.
system, ⁹ (see Figure 6.1). Banks are therefore central and crucial to the operation of the Jordanian financial system with financial dealings outside banks insignificant.

**Figure 6.1. Financial Sector Assets in 2012 (JD Billions)** ¹⁰

![Bar Chart]

Source: Financial Stability Report ¹¹

All banks which are operating in Jordan are under the supervision of the Central Bank of Jordan (CBJ). ¹² The thesis will examine a sample of Jordanian banks to assess corporate governance in chapter 7. ¹³ The status of the banks operating in Jordan is set out in Table 6.1 below.

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¹⁰ Note the left axis applies only to Banks and the right axis applies to other financial institutions; other financial institutions individually have financial assets of less than 1 billion.


¹² For further discussion concerning the role of CBJ, see the discussion below at [6.4.2].

¹³ The thesis will focus only on the Jordanian Banks listed on ASE in 2010. This date is chosen as the thesis gives detailed examination to annual reports of these Banks.
Table 6.1. Types of Banks in Jordan

<table>
<thead>
<tr>
<th>Type of Bank</th>
<th>Listed Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Bank</td>
<td>Arab Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Arab Banking Corporation (Jordan)</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Arab Jordan Investment Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Bank of Jordan</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Cairo Amman Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Capital Bank of Jordan</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Jordan Commercial Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Investbank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Jordan Kuwait Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Jordan Ahli Bank</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>Societe de General Banque-Jordanie</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>The Housing Bank for Trade &amp; Finance</td>
</tr>
<tr>
<td>Islamic Bank</td>
<td>Union Bank</td>
</tr>
<tr>
<td>Islamic Bank</td>
<td>Jordan Islamic Bank</td>
</tr>
<tr>
<td>Islamic Bank</td>
<td>Jordan Dubai Islamic Bank</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Type of Bank</th>
<th>Unlisted Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Bank</td>
<td>Islamic International Arab Bank(^\text{14})</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>Standard Chartered</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>Egyptian Arab Land Bank</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>HSBC Bank Middle East</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>CitiBank</td>
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<tr>
<td>Foreign Bank</td>
<td>Rafidain Bank</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>National Bank of Kuwait</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>Banque Audi-Sardar Audi Group</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>Blom Bank</td>
</tr>
<tr>
<td>Foreign Bank</td>
<td>National Bank of Abu Dahbi</td>
</tr>
</tbody>
</table>

Source: CBJ\(^\text{15}\)

\(^{14}\) Islamic International Arab Bank is not listed on the stock exchange (Amman Stock Exchange, ASE). This Bank is fully owned by the Arab Bank which is listed on the ASE.

Commercial Banks

The Commercial banks in Jordan form the largest part of the Jordanian banking sector. They are the main source of funding for the commercial and industrial sectors. These banks offer a range of financial and investment services including deposit accounts, credit card services, the standard stream of loans, currency trading, car and housing loans and others. These banks have modified their operations to match international standards and comply with the requirements of Basel II. Basel requirements are being gradually introduced according to a transition timetable, (see below).

Islamic Banks

In Jordan, approximately 90% of the population (around 6 million) are Muslims. Many clients and investors may wish to do business with banks and institutions that comply with the Sharia Law. They may as a consequence prefer to deal with an Islamic bank.

Islamic banks provide financial services in accordance with the Islamic Sharia Law. Shariah law prohibits the collection and payment of interest or usury (commonly called riba). Moreover, the law prohibits what is called "Maysir" which is involved in

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17 See the discussion below at [6.5] for further discussion concerning the implementation of Basel III in the Jordanian banking sector.

18 Although Jordan is an Islamic country, there are only 3 Islamic Banks operating in Jordan. Most of the Jordanian clients deposit their money in the Commercial and Foreign Banks. This may due to good reputation and long history of these Banks such as Arab Bank which established since 1948.
any venture involving speculative activities such as might occur with derivative instruments. 19

The main sources of the Islamic banks’ funds are retained earnings, paid up capital and bank reserves. By far the largest sources are the deposits of different types as well as Islamic investment bonds, charitable trusts and others.20 It should be noted here that the Islamic banks use sharia in their operations but this is not related to their structures, management and control. Sharia products are not necessarily risk free. Islamic banks face similar risks affecting other types of banks (e.g. liquidity risk, market risk, credit risk and operational risk) as well as other risks special to Islamic banks because of different methodologies in dealing with clients. There may also be special risks related to the requirements of Islamic law. For example, financial risk by ‘Morabaha’ whereby the Islamic bank enters into an oral agreement with the client without any formal documentation or contract. The client gives an oral promise to buy a product (car, house etc) after purchase by the bank. The bank then transfers ownership to the borrower client (the Islamic banks do not add any costs to the product’s actual price). This may lead to two risks: the first risk is when the borrower pulls out of the sale after the bank has already purchased it. The second risk is when the borrower does not pay at the due time leaving the bank with significant losses.21

As with all banks, Islamic banks are required to comply with the Jordanian Banking Law 200022 and the Central Bank of Jordan (CBJ) instructions and control. The


Banking Law of Jordan makes special provision for Islamic banks and the application of Sharia law.23

Foreign Banks

Foreign banks are required to be licensed in order to operate in Jordan.24 The Foreign banks have foreign capital registered outside Jordan.25 Not all foreign banks have listed on the Amman Stock Exchange. All foreign banks operating in Jordan are subject to Jordanian legislation and are supervised by the CBJ and governed by Banking Law of Jordan.26

The establishment of Foreign banks in Jordan has led to an expansion in financial products including financial futures, bill facilities, swaps, options, e-business, all types of derivates as well as the securitised financial assets and provide a more

22 This law published in 2000 applies to all Banks operating in Jordan. This law provides legal standards for the banking sector such as licensing the Banks, managing and controlling the structure of Banks (e.g. structures and roles of the shareholders, Chairman, Boards and Board Committees). See Banking Law 2000 No. 28 <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>.


24 At the end of 2013, there were 10 Foreign Banks in Jordan.

25 In relation to the capitalised requirement for Foreign Banks within Jordan, the Jordanian Banking Law states that “A foreign bank branch shall not launch any of its banking activities until it has transferred to the Kingdom in one lump sum the equivalent of half of the capital stipulated for a Jordanian Bank. The Central Bank may from time to time increase such amount up to the amount of capital stipulated for a Jordanian Bank.” See Banking Law 2000 No. 28 article 12, a <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>.

26 The Banking Law of Jordan states that: “If the Bank to be inspected is a branch of a foreign Bank or a subsidiary thereof, it shall be subject to the inspection of the competent supervisory authorities in the country of its head office or regional office, in addition to the inspection of the Central Bank”. See Banking Law 2000 No. 28 articles 70 B, 11, 12 <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>. 224
competitive market for banking services and incentives for local banks to improve their performance.\textsuperscript{27}

6.3. Sources of Funds for Jordanian Banks\textsuperscript{28}

Deposits constitute the major source of funds for Jordanian banks. Deposits comprise 64.3\% of total liabilities at the end of 2012.\textsuperscript{29} Despite the 2008 Global Financial Crisis (GFC), they reached JD\textsuperscript{30} 25 billion (USD 35.4 billion) at the end of 2012.\textsuperscript{31} This share has been stable during the previous year’s indicating funding stability and confidence in the Jordanian banking sector.\textsuperscript{32} This illustrated in the following figure.

Figure 6.2. Structure of Liabilities in Jordanian Banks

![Structure of Liabilities in Jordanian Banks](image)

Source: Financial Stability Report\textsuperscript{33}


\textsuperscript{28} The sources of funds for Islamic Banks are referred above, see section [6.2].


\textsuperscript{30} Jordanian Dinar or JD or JOD is a symbol refers to the Jordanian currency. The exchange rate for the Jordanian Dinar was last updated on February 1, 2014 from Yahoo Finance as 1 JOD equal 1.42 USD. See Central Bank of Jordan, Financial Stability Report: Jordanian Banking System (2010), 25 <http://www.cbj.gov.jo/uploads/fsr_3_en.pdf>.


\textsuperscript{32} Ibid 26.

\textsuperscript{33} Ibid.
In contrast to other countries, the loan/deposit ratio in Jordan has been extremely conservative so providing an important buffer against future financial crises.\(^{34}\) Similarly the ratio of household debt to household income has been one of the best in the region and internationally during and following the GFC.\(^{35}\)

The Jordanian banks performance from the beginning of 2010 showed improvement and recovery from the effects of the 2008 GFC following significant government intervention in the economy.\(^{36}\) Improvements in the economy are also reflected in the extension of credit facilities by Jordanian banks promoting economic growth and increased investment.\(^{37}\) At the end of 2012, credit facilities increased by 12.57% to reach JD17.7 billion (USD 25 billion), increasing from 11.35% at the end of 2011. It should be noted that in 2012, the credit facilities formed about 80.64% of the Jordanian GDP.\(^{38}\)

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\(^{34}\) The Loan-to-Deposit ratio increased from 65% (2009) to 70.9% (2012). See Central Bank of Jordan, *Financial Stability Report* (2012), Figure 2.17, 27 <http://www.cbj.gov.jo/uploads/JFSR2012E.pdf>. Jordan’s deposit ratio to GDP is comparatively large with the 2012 figures exceeding 100%, There seems to be some variation in figures ranging from 102% to 177%, see Ibid 16, 28.

\(^{35}\) Approximately 50% - 57.5% in Jordan in contrast to Europe with approximately 100%. This might require some qualification based on access to credit, see Ibid 59, 61 Figures 4.1, 4.3.

\(^{36}\) In November 2008 in response to the GFC, the CBJ put in place measures to stimulate the economy, principally a series of interest rate cuts. Another measure was the cut of the enforceable monetary reserve 3 times by 1.0% every time to reach to 7.0%. These activities encouraged the Jordanian licensed Banks to increase the credit facilities to promote economic growth. See Central Bank of Jordan, *Financial Stability Report: Borrowing Sector* (2010), ch 4, 41 <http://www.cbj.gov.jo/uploads/fsr_4_en.pdf>.


The Global Competitiveness Report placed Jordan in the 64th rank out of 144 countries, falling from 57th in 2011.\textsuperscript{39} Although the Jordanian banking system is stable, the unstable regional and global position continued to influence the Jordanian economy in 2012 and led to an International Monetary Fund (IMF)\textsuperscript{40} standby loan facility to assist the economy.\textsuperscript{41} The increase in gas prices from Egypt and the political crisis in Syria in 2012 led thousands of refugees to move to Jordan; this has had a significant negative impact on the Jordanian economy with its limited resources.\textsuperscript{42} Much of the inflow of funds came from donor countries to support humanitarian support to refugees. The situation improved in early 2013, the IMF reporting that the CBJ had been able to manage “the pressure on reserves and, with sizeable grants coming in early 2013, rebuilt its buffers.”\textsuperscript{43}

Despite the difficulties in the Jordanian economy, the Jordanian banking sector is seen as safe and stable. The importance of the regulatory system in achieving stability is considered next.


\textsuperscript{40} The International Monetary Fund is an organisation comprising 184 countries, see http://www.imf.org.

\textsuperscript{41} IMF had provided Jordan with a three year bailout package to keep the Jordanian economy growing as well as control the budget deficit. See International Monetary Fund, Jordan: Request for a Stand-By Arrangement (July 2012), 12/343, Consultation Washington, DC, USA, 14 <http://www.imf.org/external/pubs/ft/scr/2012/cr12343.pdf>.

\textsuperscript{42} In 2012, the real growth ratio was 2.7% of GDP up from as 2.6% in 2011. This was below the average level of growth between 2000 to 2008 which averaged 6.6% per year. See Central Bank of Jordan, Annual Report: Summary of Jordanian Economic Developments in 2012 (2012), 1 <http://www.cbj.gov.jo/uploads/summary.pdf>.

\textsuperscript{43} International Monetary Fund, Jordan (March 2013), 13/130, Consultation Washington, DC, USA, 1 <http://www.imf.org/external/pubs/ft/scr/2013/cr13130.pdf>. The Jordanian economy improved on some but not all indicators in 2011 and 2012 with decreases in unemployment, increases in GDP but reduction in stock market capitalisation and worsening of the deficit and inflation. Ibid 3.
6.4. Regulation of Banks in Jordan

6.4.1. Introduction

The principal legislation governing banks in Jordan is: the *Companies Law 1997*, the *Securities Law 2002* and the *Banking Law 2000*. The banks in Jordan are Public Shareholding Companies and as such subject to the *Companies Law* and the *Securities Law 2002*. The *Securities Law 2002* regulates the organisation and control of activities of the Amman Stock Exchange (ASE), Jordan Securities Commission (JSC), Securities Depository Commission (SDC), and market intermediaries. These institutions lay down the framework for governance with legislation imposing duties and obligations on securities issuers and auditors as well as protection

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47 The ASE is an independent institution created in March 1999 with a semi-public character and governed by a seven member Board of Directors. There are proposals to privatise the ASE. The ASE is followed the principles of efficiency, transparency, fairness and liquidity. The exchange aims to give its listed securities an effective environment as well as protecting its investors’ rights. Therefore, the ASE has applied internationally recognised proactive regarding market sectors and listing standards (e.g. OECD principles). For more information, see www.ase.com.jo.

48 The JSC is a government institution. The Council of Ministers appointed the commission and it contains a chairman, deputy chairman, and three commissioners. It aims to control the publishement, dealings and disclosure the securities as well as control and regulate the activities and procedures of the organisations which are under its control. The authority and power of the JSC were exercised significantly with the legislations of the *Securities Law 2002*. The JSC is regulated pursuant to articles 7-15 of the *Securities Law*. See *Securities Law 2002* No. 76 <http://www.jsc.gov.jo/Public/English.aspx?Site_ID=1&Page_ID=1698>. Also for more information, see http://www.jsc.gov.jo.

49 The SDC which was established in May 1999 is a non profit private institution which has a legal personality with administrative and financial autonomy. It was created to manage the transferral and registration of ownership of securities traded on the ASE as well as to check the safe custody of ownership of securities as it is one of the main institutions in the Jordan Capital Market as it keeps the registers of ownership of all published shares. The SDC is regulated pursuant to articles 76-89 of the *Securities Law 2002*. See Ibid.
processes such as the requirements of disclosure to maintain transparency on financial matters which may affect the capital market.\(^50\)

Jordanian banks are subject to the following regulatory framework: first banks are required to obtain banking licences from the Ministry of Industry and Trade\(^51\) and the CBJ; secondly, banks are subject to the requirements of the Jordan Securities Commission (JSC) in relation to the issues of shares and securities for banks; thirdly, publicly listed banks are also subject to listing requirements and rules of the Amman Stock Exchange (ASE). Chapter 7 discusses the requirements of the ASE corporate governance code.

This chapter is concerned with the regulatory framework for Jordanian banks rather than the detailed requirements applying to corporations generally. The principal regulator for banks is the Central Bank of Jordan (CBJ) which is discussed in the next section. The second plank is the Jordanian Securities Commission (JSC), the corporate regulator which combines the functions of regulator as well as protector of consumer interests. In the UK, this combined role led to an ineffective regulator (the FSA) which was seen as being captured by the corporate sector, (see chapter 4); its functions were later divided between the corporate regulator PRA and FCA. As the Jordanian banking and corporate sector is very small with only 237 listed companies in 2014,\(^52\) the JSC it has not assumed any significant regulatory role in relation to

\(^{50}\) Securities Law 2002 No. 76, Chapter 2, articles: 1, 7 & 8 <http://www.jsc.gov.jo/Public/English.aspx?Site_ID=1&Page_ID=1698>. However, under the Australian federal system, powers relating to banking and corporations rest with the federal government such as the Australian Corporations Act 2001. See chapter 5 for further discussion concerning the Bank governance in Australia.


\(^{52}\) At the end of April 2014, the number of listed companies at the ASE was 237, see www.ase.com.jo.
banks. Its role in consumer protection is beyond the scope of this thesis. This section will consequently focus on the role of the CBJ as the bank regulator.

6.4.2. The Central Bank of Jordan (CBJ)

The CBJ as the regulator has taken significant steps to ensure effective bank regulation, financial stability and maintaining the value and the convertibility of the JD. The CBJ as the bank regulator is an independent corporate body and acts as the fiscal agent for the government as well as it has an important role in issuing bank notes as well as application of the monetary policy of the country. It has a formal regulatory role as well as supervising Commercial banks, financing the issue of new financial institutions and has statutory responsibilities if a bank becomes insolvent. It is permitted to bailout insolvent Jordanian banks.

The objectives of the Central Bank shall be to maintain monetary stability in the Kingdom and to ensure the convertibility of the Jordan Dinar, and to promote the sustained economic growth in the Kingdom in accordance with the general economic policy of the Government. The Central Bank shall accomplish these objectives by the following means: Supervising Licensed banks to ensure the soundness of their financial positions and the protection of the rights of depositors and shareholders.

The CBJ was established in 1959. In 1964, the CBJ commenced operations by assuming the responsibilities of the Jordan Monetary Committee which operated since

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54 This is not like Australia which has Reserve Bank of Australia (RBA) which no longer operates as regulator of Banks. See chapter 5 for further discussion concerning the RBA.


1950.\textsuperscript{57} To do this, the CBJ enforces strict compliance with international standards. The principal legislation governing the CBJ is the Jordanian Banking Law 2000.\textsuperscript{58}

The CBJ’s organisational structure contains a special unit for risk management.\textsuperscript{59} It supervises the banks in Jordan by requiring periodic information about the performance of the banks in order to evaluate their financial positions as well as the extent to which these banks comply with its instructions, regulations and laws. In 2013, the CBJ established the Financial Stability Department to monitor financial stability, and reduce systemic risk in the financial framework in Jordan. This Department works with other CBJ’s departments particularly the Banking Supervision Department to apply monetary policy to improve the financial and monetary stability in Jordan.\textsuperscript{60}

The Jordanian Banking Law gives CBJ punitive powers which can include prohibiting the bank from continuing to operate, dissolving the Board of Directors, directing bank merger or cancellation of licence.\textsuperscript{61} The CBJ also conducts onsite audits to ensure compliance. This can be important to an effective assessment of internal control

\begin{itemize}
\item \textsuperscript{57} It should be here noted that the source of CBJ funding comes from the Banks deposits in CBJ; this has 2 forms: Cash reserve (compulsory), additional deposits (second reserve) for Banks; government deposit and other governmental institutions deposits; deposits from international commissions; the CBJ’s Capital and its reserves (CBJ Capital, which is completely owned by the Jordanian government, is JD 18 million (USD 25.5 million) by law and its Reserve is about 32 million (USD 45 million). See Central Bank of Jordan Law 1971 No.23, article 7 <http://www.cbj.gov.jo/pages.php>. See also Central Bank of Jordan, Annual Report: Summary of Jordanian Economic Developments in 2012 (2012), 133 <http://www.cbj.gov.jo/uploads/summary.pdf>.
\item \textsuperscript{58} The statute governing the CBJ is The Central Bank of Jordan Law 1971 No. 23, see <http://www.cbj.gov.jo/pages.php>.
\item \textsuperscript{61} Banking Law 2000 No. 28, Article 88 <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>. See also Appendix [D].
\end{itemize}
frameworks. The CBJ has taken an active role in ensuring that bank practice matches international standards. In 2012, for example, the CBJ issued an instruction to all licensed banks within a defined period to develop electronic controlling systems according to international standards. Failure to implement the instruction is subject to penalties under the Banking Law, (see Appendix [D]).

This did not prove necessary. According to the recent annual reports of all banks in Jordan all listed banks appear to have complied. However, it is clear that the threat of penalties can have a deterrent effect. There is, however, no clear evidence of breach of statutory requirements by the Jordanian banks, nor that the CBJ has ever imposed penalties on non-complying banks such as dissolving the Board of Directors or cancellation of licence of the bank. This may give rise to two opposing inferences: first that banks have always complied with the legal requirements and directions of the CBJ or secondly, that the CBJ has not prosecuted breaches. In relation to the second inference, it is possible that breaches are not advertised and details of prosecutions are not made public. If this is so, this diminishes the opportunities of the CBJ to provide deterrent signals to the banking sector.

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63 The instruction was accompanied by a CD explained how these Banks require to develop their electronic systems according to the international standards. Therefore, these Banks required to download the new electronic system to their programs correctly and accurately and apply it on their annual reports for the year ended 2011. The CBJ required these Banks to apply this new system from the issue date of this instruction and not more than 30 days of this date.


65 See Appendix [D] which sets out the penalties of the Banking Law, Companies Law and Securities Law of Jordan. In particular, see Article 88B.

66 In regard to the CBJ’s mandatory directions which are not subject to a comply or explain approach (e.g. directions related to Bank security), when the Bank is seen not to comply with these directions, the CBJ gives continuous warnings until the Bank complies with these directions.

67 Although this issue is not clear in relation to share ownership exceeding prescribed levels, see chapter 7.
It should be noted that the CBJ plays a crucial role in ensuring that banks comply with Basel standards relating to capital adequacy, liquidity, risk management and operational standards. The CBJ uses these standards as additional factors to improve risk management in the Jordanian banks, in terms of liquidity in particular; this is discussed next.

6.5. The CBJ and the Implementation of Basel Requirements in the Jordanian Banking Sector

In Jordan, over the last decade bank regulation has been concerned to reduce the risk of bank failure with the CBJ imposing strict requirements relating to capital adequacy. According to the CBJ’s banking supervision for the year 2007 and earlier, the CBJ implemented Basel I standardised approach since the 1990s.

The Banking Law of Jordan requires that “A bank shall at all times maintain the minimum regulatory capital as determined from time to time by the Central Bank.”

In June 2003, the CBJ issued instructions based on the Jordanian Banking Law 2000, that the minimum level of the Jordanian regulatory banking capital must contain at least 12% of the assets and off-Balance sheet items risk weighted as well as market risks. 12% is the minimum Capital Adequacy Ratio (CAR) required in

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71 See Banking Law 2000 No. 28, Articles 2a; 36a <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>.
Jordan which all licensed banks in Jordan required to follow.\textsuperscript{73} This compares favourably to the minimum ratio set by the Basel Committee (8\%). The CBJ uses the ratio of (12\%) instead of the Basel ratio (8\%) in order to have comfortable margin for the Jordanian banks to avoid default.\textsuperscript{74} According to this instruction the total capital is divided 50/50 between Tier 1 and Tier 2 [Tier 1 (6\%) + Tier 2 (6\%)]. The total CAR which contains market risk is to be calculated as Regulatory Capital\textsuperscript{75} / Assets and Off-Balance sheet items risk weighted + Market Risk. Tier 1 = Basic Capital\textsuperscript{76} / Assets and Off-Balance sheet items risk weighted.\textsuperscript{77}

The Jordanian Financial Stability Report states that:

The value of capital adequacy ratio and the Tier 1 capital ratio are very close to each other, which implies that the bulk of banks’ capital in Jordan is the core capital. The core capital is the best component of capital in terms of quality and ability to absorb losses. This in turn reflects positively on enhancing financial stability in Jordan.\textsuperscript{78}

The effect is that since most of the capital is Tier 1 capital Jordanian banks have exceptionally strong capital adequacy. The CBJ implemented Basel II standards\textsuperscript{79} from the first quarter of 2008.\textsuperscript{80} To prepare the banks in Jordan to implement this

\textsuperscript{72} See chapter 3[3.7.2] for further discussion.


\textsuperscript{74} Ibid.

\textsuperscript{75} Regulatory Capital should be not less than 12\% of Assets and Off-Balance sheet items risk weighted.

\textsuperscript{76} Basic Capital should be not less than 6\% of Assets and Off-Balance sheet items risk weighted.


\textsuperscript{79} See chapter 3 [3.5] for further discussion concerning Basel II.

accord, 2007 was used for experimental application which could be used to identify problems of application and implementation. At the beginning of this experimental approach, the direct methods recommended by the Basel II Accord were implemented. In applying credit risk, the standardised method was applied and banks were given the option to apply either the simple or general method to evaluate the impact of credit risk mitigation.\textsuperscript{81} The implementation of the standardised method continued to evaluate market risks as well as the implementation of the basic indicator method to evaluate Operational Risks, (see also chapter 3). The CBJ has since moved to more developed methods to evaluate and measure risks. The CBJ published instructions about credit, market and operational risks aimed to reduce these risks by using, for example, derivative credit and mutual funds which aimed to help investors to select mutual funds able to achieve their goals.\textsuperscript{82} The CBJ sets out liquidity standards and has published instructions related to the management of liquidity risk under Basel II which requires the banking sector to have accepted policies as well as clear measures to manage its liquidity.\textsuperscript{83}

It should be noted that credit risk is one of the main risks facing the Jordanian banking sector. At the end of 2012, credit risk was about 84\% of total risk, operational risk (12\%), and market risk (4\%).\textsuperscript{84}

Between 2003 and 2012, the CAR kept a comfortable margin well above the minimum required ratio in Jordan 12\%.\textsuperscript{85} The higher capital adequacy rules provide a


\textsuperscript{82} Ibid.

\textsuperscript{83} Ibid 48–49.


\textsuperscript{85}
greater safety buffer for Jordanian banks. But this withdraws capital out of the productive economy so it is not a cost free choice. The CAR after the GFC remains above the minimum required rate (12%). The CAR was between 18% and 20% between 2007 and 2012.

In relation to liquidity, the 2012 Financial Stability report indicated:

The banking system has comfortable levels of liquidity…. The ratio of cash and cash balances to total assets (comprised) 27% of total assets. The highly liquid portfolio formed 22% of total assets. Hence, the total highly liquid assets represented 49% of total assets at the end of 2012.

During the financial crisis banks chose to reduce credit so as to maintain liquidity.

Liquidity is set out in the following Figure.

Figure 6.3. Liquidity in Jordanian Dinars, Minimum Required Liquidity and Total Liquidity (2008-2013) (%)

Source: Financial Stability Report


86 Ibid 45.

87 Ibid 53.


90 Ibid 39.
The possible reasons for Jordan’s high capital ratio and high levels of liquidity are the following. First Jordan is located in a volatile unstable region where circumstances may rapidly change with higher than usual risks to the economy and the financial system particularly the risk of unforwarned withdrawals.\textsuperscript{92} It has also been suggested that loans typically operate as unsecured overdraft accounts which increases the level of risk.\textsuperscript{93} There is also concern that housing loans\textsuperscript{94} secured by mortgage could be seriously affected if there were a reduction in property values which is not out of the question in Jordan. Risks also arise out of the concentration of ownership, the political influence on Jordanian bank Boards and the absence of restrictions on foreign ownership.\textsuperscript{95} This is referred to in the examination of compliance by Jordanian banks in chapter 7. The higher risks in Jordan are due to the volatile environment in the Middle East where political crises such as the conflict in Syria and Iraq have resulted in the large inflow of refugees to Jordan and assistance from the donor countries.\textsuperscript{96}

Following the 2008 GFC, the CBJ in 2011 acted to improve the monitoring and evaluation of capital adequacy of Jordanian banks. The CBJ adopted the Basel III requirements.\textsuperscript{97} According to the 2012 International Monetary Fund (IMF) Report, most of the Jordanian banks met the Basel III’s capital adequacy requirements; the

\textsuperscript{91} Ibid.

\textsuperscript{92} In 2012, 76% of deposits were classified as short-term deposits suggesting a higher risk of sudden withdrawal, see Ibid 31.

\textsuperscript{93} Personal communication with Bank officers. This is only possible factors as there is no formal evidence.


\textsuperscript{95} Non Jordanians owned 47% of equity in 2012, reported to be the highest in the Middle East; Jordan does not restrict shareholding in Banks by non Jordanians, see Ibid 19.

\textsuperscript{96} These are only possible factors as there is no formal evidence.

\textsuperscript{97} See chapter 3[3.7] for further discussion concerning Basel III and its requirements.
main component of banks’ capital is Tier 1. In the Jordanian banking sector, most of the Jordanian banks hold capital either as paid up capital or in reserves. Table 6.2 shows that according to the data available from the year 2011, the Jordanian banking sector held capital (at 18.2% of risk weighted assets) well in excess of the regulatory minimum of the CBJ (12%) as well as well in excess of Basel III standards.98

Table 6.2. Jordanian Banks CAR Compared to Basel III Requirements

<table>
<thead>
<tr>
<th></th>
<th>Jordan</th>
<th>Basel III Minimum</th>
<th>Basel III Min + Capital Buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weighted CAR</td>
<td>18.2%</td>
<td>8%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Total Paid-up Capital +</td>
<td>17.5%</td>
<td>-----</td>
<td>-----</td>
</tr>
<tr>
<td>Reserves/Total Assets</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

Source: IMF99

The IMF Report reviewing the implementation of the Basel standards concluded that:

A. Basel II implementation…The CBJ has now issued all the regulations for Basel II implementation. The CBJ in May 2011 started conducting its Supervisory Review and Evaluation Process (SREP) on banks’ submitted Internal Capital Adequacy and Assessment Processes (ICAAPs) by visiting them, in collaboration with external auditing firms, to validate the stress tests conducted by banks.

B. Jordan is well placed to implement Basel III. The CBJ is working on harmonizing definitions, classifications and methodologies to calculate various Basel III metrics, and on finalizing the development of a comprehensive and automated database, possibly by end-2012, to be used to improve off-site monitoring of banks and allow for a statistical-based Early Warning System.

C. The CBJ is revising liquidity definitions to align them with Basel III, but given that the two largest banks in Jordan (Arab Bank and Housing Bank) are heavily liquid, the CBJ does not expect the revised ratios to fall short of Basel III requirements. Banks in Jordan are conservative in their funding practices (with the JD loan/deposit ratio near 73 percent at December 2011). This is partly due to their reliance on deposits, sourced largely from the Jordanian diaspora and the region.100


99 Ibid.

100 Ibid 27; 32.
But since Jordan has long met capital adequacy and liquidity requirements, this is not likely to impose greater burdens. The implementation of Basel III commenced with advice from the CBJ in October 2011 to all banks operating in Jordan to comply with Basel III requirements which were published in 2010. The CBJ required all banks in Jordan to apply the standards of Basel III for the year 2011, as stated below.

1. All banks in Jordan need to consider how Basel III requirements can be applied to the banks’ semi annual reports for the year ending 30/06/2011. There is a need to account for the capital adequacy ratio (by accounting the influences on liquidity and evaluating the need for increasing the assets, current funds and leverage ratio as well as evaluate the future recourses for the capital); liquidity ratio, leverage ratio; equity returns and distribute profits when there is need for bank within the next 5 years to increase its capital as well as invest in the current assets; the reports and information technology as needed to monitor compliance and strategic plan for the bank.101

2. The banks need to evaluate their ability (according to Basel III requirements) to meet capital adequacy requirement; connect the current reserves with the obligation reserves when applying Basel III such as the additional capital for conservation buffer as well as countercyclical buffer to face any systemic buffer; update the corporate governance system by applying the control requirements for capital adequacy and liquidity.102

3. All banks were required to report to the CBJ not later than December 2011. These reports include the procedures to account for the difference in ratios, the processes needed to apply Basel III in the long term to account for the capital, liquidity and


102 Ibid.
leverage ratios (according to Basel III) on a daily basis. There is need for an independent committee such as the internal audit department to review this report and confirm it by the Board of Directors of the bank as well as the general manager or the territory manager of the foreign banks.  

4. Banks are required to demonstrate that they can meet the Basel CAR and liquidity requirements at any point of time and continuously.

The CBJ issued a further instruction on 22nd of December 2011 delaying the requirements set out above until 30th June 2012. According to the 2012 Financial Stability Report, Jordanian banks are able to satisfy the Basel II standards. The CBJ will continue to review the evaluation systems to assess the ability of the Jordanian banking sector to comply with the liquidity requirements.

It is apparent that the Jordanian banking system more than complies with the Basel requirements. This should ensure a stable banking system. But as noted above, Jordan is located in a volatile region requiring greater precautions to avoid risk. The issue is whether this risk adverse approach means that Jordanian banks are not performing an adequate role in funding economic development in Jordanian. But conversely, this cautious approach meant that bank stability was not threatened during the GFC. This

\[\text{\textsuperscript{103}}\text{Ibid.}\]

\[\text{\textsuperscript{104}}\text{Ibid.}\]


\[\text{\textsuperscript{107} The distribution of loans between the various sectors is set out in the Central Bank of Jordan, \textit{Financial Stability Report} (2012), Table 2.11 which indicates that large companies are the biggest borrowers with 45.2% of borrowings in 2012; the household sector has 18.5%, (40% of which was housing loans, see Table 2.12); real estate 18.3%, government and the public sector 9.1% and SMEs 8.9%.}\]
cautious approach is apparent from the household income to debt ratios,\textsuperscript{108} deposit to loan ratios,\textsuperscript{109} and the high capital adequacy and liquidity levels in Jordan.\textsuperscript{110} It appears that the banks largely operate as deposit institutions with little exposure to risks involved in derivatives trading. If banks are to take a larger role in funding development, this will necessarily mean greater risk, reduced liquidity and capital buffers. In the future, this will make the role of CBJ and bank internal governance systems crucial to ensuring stability and security.

\textbf{6.6. Conclusion}

This chapter explains bank regulation in Jordan. The two key regulators of the banks are the JSC and the CBJ. It has been noted that the JSC has a similar role to that performed by the now dissolved FSA in the UK performing both the role of corporate regulator and consumer protection. The failure of the UK FSA to be able to perform both roles in a time of crisis suggests that Jordan might consider whether to split the role of the JSC into separate regulatory and consumer protection arms. In relation to the bank regulator the CBJ, there is an absence of evidence relating to its effectiveness in enforcing regulatory standards. As observed this may be that in a small market with just 15 listed banks there is a greater ‘hands on’ approach and the ability to monitor closely and ensure compliance.

\textsuperscript{108} Approximately 50\% - 57.5\% in Jordan in contrast to Europe with approximately 100\%. This might require some qualification based on access to credit, see Central Bank of Jordan, \textit{Financial Stability Report} (2012), 59, 61 Figures 4.1, 4.3 \texttt{<http://www.cbj.gov.jo/uploads/JFSR2012E.pdf>}.\textsuperscript{109} The Loan-to-Deposit ratio increased from 65\% (2009) to 70.9\% (2012). See Ibid Figure 2.17, 27. Jordan’s deposit ratio to GDP is comparatively large with the 2012 figures exceeding 100\%, There seems to be some variation in figures ranging from 102\% to 177\%, see Ibid 16, 28.\textsuperscript{110} Ibid 38, Figure 2.30.
This chapter has discussed the implementation of the Basel Accords in Jordan. It was observed that the capital reserves exceeded Basle II requirements. This may have been in response to the quite different economic environment in Jordan. As with many developing economies, cash inflows come from international donor countries and remittances. It might also be observed that Jordan provides a safe economic haven and this may be due to the thousands of refugees from Syria, and is also likely to benefit from cash flows from those economies. It has been also noted that there is only a small business and industrial sector and the funding of new enterprises may be quite modest. As is common in the Middle East, listings on the Jordanian exchange are very small\(^{111}\) in comparison with developed countries suggesting little need for capital raising and a diminished role for Jordanian banks.

However, Jordan has a stable banking system. Because Jordan is a small country with a small market business and scarce resources, this makes it even more important that there is effective regulatory control and governance of Jordanian banks as the experience in Iceland which led to a collapse of its financial system has shown.

The previous chapter outlined the Australian Twin Peaks regulatory model in which the two key elements were the regulation on a functional rather than an institutional basis, so that all financial bodies were subject to regulation rather than just the banks.\(^{112}\) The second key element was the separation of the prudential regulatory function from the market regulatory function.

\(^{111}\) At the end of April 2014, the number of listed companies at the ASE was 237 including 15 Banks, see www.ase.com.jo.

In relation to Jordan, the banks dominate the financial sector. Non-banking institutions are a very small component. Banks hold almost all of the financial sector assets with just under JD 40 billion of financial sector assets; insurance companies, foreign currency companies, financial services and intermediation, micro finance and other lending companies individually hold less than JD 1 billion in financial assets and in total account for just JD 2.75 billion in assets. Consequently, the issue for Jordan is not as compelling as for Australia when it reformed its regulatory system to cover non-banking financial institutions. But Jordan must look to the future and that the risks to the financial system may increasingly come from outside the formal banking system. This suggests that Jordan consider a functional approach bringing non-bank institutions into the regulatory framework. This is currently under consideration by the CBJ. The JSC performs the dual role of regulator and consumer protection much like the position in the UK prior to the 2013 reforms, (see chapter 4). As a consequence, consideration should be given to splitting the functions of the JSC so that a different body undertakes the consumer protection aspects of regulation.

The regulatory framework is one aspect of the external governance of banks. The next chapter turns to the crucial role to be played by bank Boards and their committees in the monitoring and supervision of banks and the implementation of codes of corporate governance. The next chapter will examine the internal control system, particularly, the role of Board Committees in Jordanian banks and Corporate Governance Codes.

113 Ibid.

114 The Insurance Commission and Securities supervises Insurers and JSC monitors financial brokerage companies. There is no specified supervision body for microfinance companies. Ibid 15.

115 Ibid 18.
7.1. Introduction

The previous chapter discussed the formal regulation of banks in Jordan. It discussed the main external supervision monitoring system, in particular, the role of the primary regulator, the Central Bank of Jordan (CBJ).

This chapter investigates the internal monitoring system in the Jordanian banking system. In particular, it examines the role of Board Committees in achieving effective bank governance. As discussed in chapter 2, this needs to be set in the broader context of the interplay between Boards, Shareholders and Management. Jordan follows the standard pattern of American Corporations law based systems under which accountability is hierarchical. At the top of the hierarchy are shareholders who as owners of the corporation, elect the Board of Directors. The Board of Directors is accountable to the shareholders in the Annual General Meeting (AGM). In turn the CEO is accountable to the Board for management of the corporation. The CEO appoints and monitors the other managers and employees of the entity. Under this structure the Board, its directors and the CEO are all accountable to the shareholders as owners of the corporation. But as seen in chapter 2, this accountability structure is effectively overturned by the capacity of the CEO to influence and dominate the Board. Chapter 2 suggested some reasons for this. First, the power of Boards and
Shareholders is diminished because businesses of any complexity have to be run by professional managers. The second reason is that shareholders as owners of the corporation are not usually in a position to exercise concerted influence; as communication mechanisms are almost entirely dependent on management. But most importantly, the accountability structure is undermined by the ability of the CEO to influence, if not control, the Board and recommend appointments and reappointments to the Board. The appointment of compliant Boards effectively allows the CEO and senior managers to have a free hand in carrying on the business. This influence will only be diminished by a strong independent Board and independent Committees reporting to the Board or by shareholder activism.

Corporate Governance is essentially about re-investing the owners of the corporation with ultimate authority and ensuring that the corporation’s business is run efficiently and competitively for the benefit of the owners, the shareholders. Chapter 2 discussed the importance of the aligning shareholder and managerial interests and what strategies could be adopted to assist this alignment. Jensen and Meckling in 1976 argued that if managers were given a sufficient stake in the company, then managers as owners would advance the interests of the corporation. This might be achieved by ensuring that a substantial part of their compensation package is paid in the form of shares in the corporation. Subsequent experience however shows that because managers were able to influence Board members, they were able to game both the determination of the compensation package (how much and what went into it), and the realisation (cashing it in when share prices were high, by artificially manipulating it where necessary as well as backdating the award date) of the package. It was in this

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1 This may be ameliorated in the UK by the requirement that companies appoint a senior independent Non-Executive Director to liaise with shareholders, see chapter 4 [4.3].
context that the Cadbury Committee in the UK recommended the appointment of (1) independent directors to the Board (independent of the CEO, the company and its Officers), (2) that these Boards be advised by specialist committees with its members having appropriate skills, and (3) these specialist committees to have oversight over the Audit, Remuneration, Appointments, and Risk Management functions of the company. As examined in chapter 2, the subsequent development of corporate governance practice was directed to avoiding the agency problem by defining (1) the number of independent directors and composition of the Board (2) the powers and functions of the committees, (3) who appoints the members of these committees (the CEO, Board, independent directors), and (4) to whom should the committee report to (directly to the Board, to the Board through the CEO, or to the shareholder meeting itself). Because of the special risks associated with banks, greater measures need to be taken to ensure effective monitoring and supervision of bank activities. Ideally there should be mandatory Board Committees consisting of independent members; appointment of those independent members on the recommendations of an independent appointments committee and thirdly committees should be answerable directly to the shareholder body through the AGM and not through the Board and certainly not the CEO.

This chapter is divided into seven sections. Following this introduction section, section 7.2 discusses the significance of Jordanian Corporate Governance Codes, the CBJ Code, in particular, as providing guidance to all banks operating in Jordan. Section 7.3 examines the role and structure of Board Committees in Jordanian banks. Section 7.4 investigates the factors which affect negatively the effectiveness of Board Committees in the Jordanian banking sector. Section 7.5 evaluates the Jordanian banks’ compliance with governance Codes. It discusses how far family relationships
as well as other factors can affect the independence of Board of Directors and Board Committees in these banks. Section 7.6 explores measures that may be taken to enhance the role of Board Committees. The last section is the conclusion.

7.2. Jordanian Corporate Governance Codes

7.2.1. The Jordanian Companies Law

The current Companies Law commenced in June 1997. It applies to banks as Public Shareholding Companies. It provides that in Public Shareholder Companies, the Board of Directors must comprise a minimum of three, and a maximum thirteen members. The law does not stipulate any special requirements for appointment of Board members. It should be noted here that Jordan has similar election procedures for directors as other countries such as Australia and the UK. Chapter 2 has discussed

2 The Companies Law of Jordan includes six types of companies: Public Shareholding Company; Private Shareholding Company; Limited Partnership; Limited Liability Company; Listed Trust; Limited Partnership in Shares. A Public Shareholding Company could be created by two or more shareholders whose obligation is limited to their own share of the equity of the company. The Board members who manage these companies and these members are elected by the shareholders of the company. The authorised capital of these companies is not less than JD500,000 (USD 708900) and the subscribed capital must be over JD100,000 or 20% of the authorised capital. All of the financial institutions, Banks and insurance companies are under this type companies as they are allowed to publish shares to the public by the ASE. See Companies Law 1997 No. 22 as amended by Provisional Companies Law 2002 No. 40, Official Gazette No. 4533, articles. 6, 90a, 209, 210 <http: // www. mit. gov. jo/ Default.aspx?tabid=502>.

3 The functions of Boards set out in the legislation include: investing the funds of the company; acting on behalf of the shareholders, making loans, appointing management and send to shareholders the financial statements result.

4 For example, there are no special requirements about the minimum years of experience or the minimum age of the member. Ibid article. 133.b. “The management of a Public Shareholding Company is entrusted to a Board of Directors whose members shall not be less than three and not more than thirteen as determined by the Company Memorandum of Association. The members of the Board shall be elected by the Company General Assembly by means of a secret ballot in accordance with the provisions of this Law. The Board of Directors shall undertake the management of the Company for four years as from the date of its election”. Ibid 132, A.

5 In Australia, for example, the Board of Directors are elected by shareholders. However, they are elected for 3 years in each AGM. In UK, for example, there is annual election and Boards are subject to re-election of no more than three years. For further discussion, see chapter 2.
in greater detail the requirements that apply to public companies. Companies are listed in Jordan’s only stock exchange, the Amman Stock Exchange (ASE).

7.2.2. The Amman Stock Exchange (ASE) Code

Banks listed on the ASE are subject to the ASE’s mandatory listing rules. In addition to these rules, in 2007, the ASE promulgated the Corporate Governance Code for listed Shareholder Companies (referred to hereafter as the ASE Code). The Code, amongst other things, sets out rules relating to the structure and responsibilities of Board of Directors and Board Committees; the general meetings and rights of the shareholders as well as principles for financial disclosure and auditing. These rules are based principally on legislation and Codes such as the Companies Law 1997, the Securities Law 2002 and related regulations, and the Organization of Economic Cooperation and Development (OECD)’s principles of Corporate Governance. The ASE Code requires listed companies to comply with its rules, (see Appendix [B]).

The Jordan Securities Commission (JSC) published a Guide which illustrates mandatory, general and guidance rules for the ASE Code’s principles of Corporate Governance for listed companies, (see Appendix [C]). The mandatory rules are

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10 Appendix [C] illustrates all of the ASE Code’s rules and shows each rule whether it is mandatory, general or guidance rule. See Jordan Securities Commission Guide, Mandatory rules Index (general
compulsory rules and all companies listed in ASE must follow them under penalty of legal liability (*Companies Law* and *Securities Law*). For example, appointing an Audit Committee is mandatory rule and all listed companies must have this Committee, but appointing other Committees is a guidance rule. In relation to non mandatory rules, as with corporate governance Codes internationally, these are principally subject to ‘comply or explain’ approach.\(^{11}\) The ASE Code states that:

It was decided that the application of these rules would initially be through "compliance or explain" approach, which means that companies must comply with the rules of the guide, and in case of non compliance with any of these rules, other than those based on a legal provision that is binding under responsibility, it would be necessary to explain clearly the reason for non compliance in the company’s annual report. This approach is intended to give companies flexibility in implementing the corporate governance rules and sufficient time to adapt to them, in order to enhance awareness of these rules and to achieve full compliance gradually.\(^ {12}\)

As discussed in chapter 2, the ASE Code follows the standard provisions relating to the operation of Boards, Board Committees, Non-Executive Directors and the separation of the role of Chairman and CEO. The Code provisions are not mandatory and subject to the ‘comply or explain’ rule discussed in chapter 2.\(^ {13}\)

In relation to banks, there is a special banking Code, the Central Bank of Jordan Code (CBJ Code).

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\(^{11}\) For further discussion concerning the comply or explain approach, see the discussion in chapter 2 [2.3.1].


\(^{13}\) Ibid 7; 9.


7.2.3. The Central Bank of Jordan (CBJ) Code

The CBJ Code is concerned with internal control, risk, internal audit and anti-money laundering as well as the implementation of good corporate governance. The Corporate Governance Code for Banks (2007), (referred to hereafter as the CBJ Code) promotes international best practice based on the Jordanian Banking Law 2000, the OECD principles of Corporate Governance, and the guidance of the Basel Committee to improve the corporate governance in the banking sector in Jordan, (see Appendix [A]). Listed banks in Jordan are governed by both the ASE Code and CBJ Code. In the case of conflict between the codes, the CBJ Code prevails. The ASE Code of corporate governance for listed companies, states clearly in reference to each principle in the Code whether it is mandatory, general or guidance. The CBJ Code sets out ‘guiding principles’ for banks concerning good corporate governance such as the functions of Board of Directors and their Committees, control processes, treatment of shareholders, and transparency and disclosure. Some of the CBJ Code’s principles may be mandatory as required by the Jordanian Companies Law, Securities Law or Banking Law to be implemented as a mandatory rule. Other principles not based on statutory obligations will be treated as a guidance principles under a ‘comply

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15 In 2004, the CBJ created the ‘Bank Directors’ Handbook of Corporate Governance’ as guidelines.

16 This law published in 2000 applies to all Banks operating in Jordan. This law provides legal standards for the banking sector such as licensing the Banks, managing and controlling the structure of Banks (e.g. structures and roles of the shareholders, Chairman, Boards and Board Committees). See Banking Law 2000 No. 28 <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&local_details1=0&localsite_branchname=CBJ>.

17 See chapter 3 in relation to the Basel requirements.


19 Ibid 5.
or explain’ approach.\footnote{20} According to the mandatory rules, all listed banks must implement them under penalty of legal liability, (see Appendix [D]).\footnote{21} Under the Code, it is mandatory under the Banking Law,\footnote{22} that all banks appoint an Audit Committee; appointing other Committees is a guidance rule only. The CBJ Code states that:

\begin{quote}
The bank on an annual basis publicly reports its compliance with the Code, where necessary detailing how each provision of the Code has been implemented and, where relevant, where and why the bank’s executive management has adopted procedures that are different from those recommended by the Code.\footnote{23}
\end{quote}

The Code sets a range of policies for bank governance, particularly in relation to related party transactions:

\begin{quote}
[Bank] loans extended to directors and their companies are made at market rates and not on preferential terms and the directors involved in any such transaction do not participate in discussions, nor vote, on it. Related party transactions are subject to individual approval by those directors of the bank who are unrelated to the transaction, and they are disclosed in the Annual Report. The bank’s internal controls ensure that all related party transactions are handled in accordance with this policy; and clear controls preventing directors or employees benefiting from the use of insider information have been put in place.\footnote{24}
\end{quote}

The CBJ requires banks to explain in their annual reports in detail how they comply with each provision of the CBJ Code and explain, where relevant, why or where the

\footnotetext[20]{See chapter 2 [2.3.1] for further discussion concerning this approach.}
\footnotetext[21]{The Banking Law has penalties for those Banks which do not follow any of its laws. See Banking Law 2000 No. 28, article 69, A <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>. See also the penalties of not applying these laws in Appendix [D].}
\footnotetext[22]{See Banking Law 2000 No. 28, 32, A <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>.}
\footnotetext[24]{Ibid 2, h, ii, 1 & 2, 15.}
executive managers do not comply with the Code’s principles.\(^\text{25}\) The CBJ Code states that:

The bank’s policy is that it has an independent compliance function which is adequately resourced, trained and remunerated, in accordance with the Central Bank’s instructions in this regard... The compliance function establishes effective mechanisms to ensure that the bank complies with all applicable laws and regulations, and any non-statutory guidelines and codes. The functions, powers and responsibilities of the compliance function are documented and published within the bank... The compliance function is responsible for developing the compliance policy of the bank and ensuring its implementation throughout the bank. The Board is responsible for approving the compliance policy and overseeing its implementation... The compliance function reports on operational compliance within the bank to the Chairman or a committee of the Board, copying the General Manager on each report, in accordance with the Central Bank’s instructions in this regard.\(^\text{26}\)

In order to enhance the banking system and continued evolution, the CBJ requires all banks operating in Jordan to develop the principles of this Code and keep it under regular review to meet all potential changes that may occur in the local or international market.\(^\text{27}\) The role of Board Committees is important to ensure that the banks apply the principles of CBJ Code effectively. This will be discussed next.

### 7.3. Board Committees in the Jordanian Banking Sector

The establishment of Board Committees\(^\text{28}\) was one of the major measures to improve the effectiveness of Board of Directors in providing internal supervision and

\(^{25}\) Ibid 1, ii, 9.

\(^{26}\) Ibid 22–23.

\(^{27}\) The CBJ published in May 2014 instructions for Bank governance with the aim of providing Jordanian Banks with guidance for good Bank governance; it sets out the main principles, definitions and other instructions for good governance. For example, the CBJ requires Banks to publish in their websites their own governance codes and refer to any revisions and how they implement their own Codes; a copy is to be sent to the CBJ within 90 days of the approval of these Codes by the Banks’ Boards. See Central Bank of Jordan, *Instructions of Corporate Governance for Banks* (May 2014) 3; 5 <http://www.cbj.gov.jo/uploads/gov2014.pdf> (Only available in Arabic script). It should be noted that the CBJ is considering, in consultation with the Banks in Jordan, whether to make all principles of CBJ Code mandatory whether based on statutory requirements or not. This would dispense with the ‘comply or explain’ in relation to non-mandatory rules. See [www.cbj.gov.jo](http://www.cbj.gov.jo).

\(^{28}\) For further discussion concerning the Board Committees, see the discussion in chapter 2 at [2.3.2.5].
monitoring of banks. The Amman Stock Exchange (ASE) Code (2007) sets out the roles only in relation to three Committees: Audit, Remuneration and Appointments Committees.\(^{29}\) The Central Bank of Jordan (CBJ) Code (2007) adds the Risk Management Committee.\(^{30}\) The CBJ Code recognises that management of special risks, which are identified in the Basel Accords, is crucially important for the stability of banks\(^{31}\) and this needs a special Risk Management Committee for this purpose. However, this Committee is not mandatory. In Australia, for example, it has mandated the establishment of Risk Management Committee for regulated financial institutions from 2015.\(^{32}\)

The CBJ Code permits the Board of Directors to create additional Committees if in the view of the Board of Directors and their Committees it enhances the effectiveness of the monitoring system as well as an efficient response to monitoring Board decisions.\(^{33}\) The names of members and the structures of Board Committees as well as their duties and achievements during the year should be disclosed in the annual reports of the banks\(^{34}\) as well as the remuneration system of the bank, particularly the

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\(^{30}\) See also Appendix [A] which sets out the principles of the CBJ Code.

\(^{31}\) See chapter 3 [3.3] for further discussion concerning these risks.


\(^{33}\) Most of the Jordanian Banks combine Appointments Committee with the Remuneration Committee. See the discussion below at [7.3.3].

\(^{34}\) The CBJ Code requires “the membership of Board Committees, together with summaries of their responsibilities and duties, are disclosed in the Bank’s Annual Report.” See Central Bank of Jordan, *Corporate Governance Code for Banks in Jordan* (2007) (‘CBJ Code’), 3. A. i, ii, iii, 16 <http://www.cbj.gov.jo>. See the discussion below at [7.5] for further discussion to see whether the banking sector in Jordan follows the CBJ requirements.
remuneration of Board members.\textsuperscript{35} This is to provide transparency to shareholders, stakeholders as well as investors in the determination and awarding of the Board members’ remunerations and appointments.

Board Committees have a crucial role to play in monitoring banks’ compliance with the international standards such as Basel Accords as well as evaluating independently the performance of the bank, Board and corporate officers, (see chapter 3). Board Committees also have an important role in ensuring that the bank has efficient risk management systems and sufficient liquidity and capital adequacy to cover any potential deficits which may result the bank collapse. However, the independence of Boards and their Committees is recommended rather than mandatory in Jordan, this will be discussed later in this chapter.

The next part looks in more detail at the four Committees.

\section*{7.3.1. The Audit Committee}

In Jordan, the Board of Directors appoints the Audit Committee.\textsuperscript{36} This Committee appears under the disclosure and transparency chapter of Jordan Securities guide which sets out mandatory rules.\textsuperscript{37} The \textit{Banking Law} of Jordan states that:

An "Auditing Committee” shall be formed in each bank by decision of its Board of Directors comprising a chairman and two members selected by the bank Board of

\begin{small}
\footnotesize
\textsuperscript{35} The CBJ Code requires “A summary of the Bank’s remuneration policy is disclosed in the Annual Report. In particular, the remuneration of individual Directors and the highest-paid non-Director executives is disclosed, including salary and benefits in kind.” See Ibid vii, 18.

\textsuperscript{36} For further discussion concerning this Committee, see the discussion in chapter 2 [2.3.2.5, II].

\textsuperscript{37} See Jordan Securities Commission Guide, \textit{Mandatory rules Index (general and mandatory) and guidance rules for the Code of Corporate Governance for listed companies in the Amman Stock Exchange} (January 2010), Ch.2, section. 2.1, a, 5 <http: // www. jsc. gov. jo/ library/ 63401117005421250.pdf> (only available in Arabic script). See Appendix [C].
\end{small}
Directors from among its members other than those entrusted with executive tasks within the bank.\textsuperscript{38}

The Board establishes the Audit Committee with an appropriate charter to enable it to effectively carry out its activities. This Committee should have three Non-Executive Directors and the membership is required to be disclosed in the annual report.\textsuperscript{39} A minimum of two members must have relevant financial management qualifications and/or expertise.\textsuperscript{40} The Audit Committee operates in accordance with the principles of the Jordanian \textit{Banking Law} and other laws which require it to review and evaluate the effectiveness of the internal and external audits procedures, review the scope, results and adequacy of the bank’s internal and external audits, review the financial reports to ensure fairness in accordance with the international standards as well as review and evaluate the internal control system of the bank to ensure its effectiveness.\textsuperscript{41}

The CBJ Code sets out detailed requirements only for the Audit Committee.\textsuperscript{42} It requires the Committee to meet with the bank’s internal and external auditors and with the banks compliance officers. This meeting must occur every year and without the presence of executive management.\textsuperscript{43} The CBJ Code does not set out any

\textsuperscript{38} See \textit{Banking Law 2000} No. 28, 32, A \texttt{<http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&localsite_branchname=CBJ>}. \\

\textsuperscript{40} Ibid, ii. The experience of the Board Committees is a guidance rule. Ibid Ch. 5, section 1.1, 11.

\textsuperscript{41} Ibid iii, 16-17.

\textsuperscript{42} These requirements are also required in other jurisdictions such as UK and Australia. See also the discussion below at [7.5] for further discussion to see whether the banking sector in Jordan follows the CBJ requirements or no.


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requirements relating to the frequency of meetings of the Audit Committee but the ASE Code requires it meet at least four times a year.\textsuperscript{44}

The structure, composition and duties of the Audit Committee in Jordan is similar to other countries such as UK and Australia. All Jordanian banks and other listed corporations are required to have an Audit Committees under the Jordanian \textit{Banking law} and \textit{Companies Law}. In Jordan, it is not a mandatory requirement that this Committee operate independently under the Jordanian laws. Not all jurisdictions make Audit Committees mandatory. In relation to corporations generally, in Australia only the top 300 listed companies are required by the Australian Stock Exchange (ASX) to create an Audit Committee.\textsuperscript{45} But Australian regulated financial institutions, including banks, are required to have an Audit Committee under the Prudential Regulatory Standards.\textsuperscript{46}

A Jordanian study in 2012 examined the importance and the role of the Audit Committee and whether the Audit Committee is able to contribute to assessing the internal control system, audit function and supporting the external audit system in enhancing and increasing the effectiveness of the internal control framework to mitigate money laundering in the Jordanian banking sector.\textsuperscript{47} The study found that the

\begin{itemize}
  \item \textsuperscript{44}Ibid section one, Para. 2,14. See also Jordan Securities Commission Guide, \textit{Mandatory rules Index (general and mandatory) and guidance rules for the Code of Corporate Governance for listed companies in the Amman Stock Exchange} (January 2010), Ch.1. b. 11 <http:// www. jsc. gov. jo/ library/ 63401117005421250.pdf> (only available in Arabic script). See Appendix [C].
  \item \textsuperscript{45}Lois Munro and Sherrena Buckby, ‘Audit Committee Regulation in Australia: How far Have We Come?’ (2008) 18 (4) \textit{Australian Accounting Review} 310.
  \item \textsuperscript{47}This study used a questionnaire distributed to the external, internal and auditors as well as the members of Audit Committees of the Jordanian listed Banks in 2012, see Reem Kasswana, ‘The Role of the Audit Committee in Raising the Efficiency of the Internal Control System to Combat Money
\end{itemize}
Audit Committees were effective in carrying out these functions and in developing appropriate procedures to ensure that the Jordanian banks comply with implementation of anti-money laundering instructions.  

Although the study found that the Audit Committees sufficiently control internal audit processes, it suggested, for best practice, that the role of the Audit Committee needed to be developed having regard to their importance in evaluating the control system in relating to money laundering to protect the banking sector from any potential risks. There have been no other studies examining the efficiency of the Audit Committee in relation to their other roles. It does suggest that Audit committees in Jordanian banks have been able to act as an appropriate monitor of bank operations in relation money laundering. But what is not clear is whether there is overall efficacy of this Committee.

7.3.2. The Risk Management Committee

In Jordan, the Board of Directors appoints the Risk Management Committee. The CBJ Code makes limited reference to this Committee simply that this Committee manages risk and that it comprises directors and may include executive management. This Committee is not mandatory in Jordan. In Australia, for example, it has mandated the establishment of this Committee for regulated financial institutions from 2015. The CBJ Code states that:


48 Ibid 102.

49 Ibid 117.


Executive management is responsible for implementing the strategies that have been approved by the Board, and for developing the policies and procedures for managing the various types of risk.\textsuperscript{52}

However, as discussed in chapter 2, the presence of executive management may inhibit the Committee operating independently free from the influence of the CEO on the decisions of this Committee.\textsuperscript{53} If the Committee is to provide independent, objective oversight, its membership should be drawn principally from Non-Executive Directors.\textsuperscript{54}

The Board of Directors review and approve the strategies for the bank’s risk management. This Committee is responsible for assessing, measuring, managing and dealing with risk and consequently is crucial for bank stability.\textsuperscript{55} This Committee would be expected to monitor the risks identified in the Basel Accords.\textsuperscript{56} The risk management department should be reviewed by the Committee and obtain the Board’s approval. The Committee should disclose reports to Boards regularly about the risk management department and its development in order to keep them fully informed about the functions of this department and its effectiveness in managing and controlling the risks.\textsuperscript{57} For example, the Jordan Islamic Bank uses this Committee to:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
| Year | Event |
\hline
| 2007 | Jordan Islamic Bank uses this Committee to: |
\hline
\end{tabular}
\end{table}


\textsuperscript{53} In Australia for example, the Risk Management Committee contains at least three members, at least two of whom require be an independent Non-Executive Directors, each of whom should be appointed or removed by the Board of Directors. See Chapter 5.

\textsuperscript{54} See the discussion below at [7.5] to see whether the banking sector in Jordan actually complies with these instructions. As to other jurisdictions, see chapter 2 [2.3.2.5, III] for further discussion.

\textsuperscript{55} See chapter 3 [3.3] for further discussion concerning the main risks may affect the banking sector.

\textsuperscript{56} See chapter 3 [3.5] for further discussion concerning Basel Committee.

Review and evaluate the strategies and polices of the bank's Risk Management before they are confirmed by the Board of Directors. This is especially in the areas of liquidity and capital; review the mechanisms that are used to evaluate the Risk Management in banks; and review all accounts, deposits, withdrawals and any activities that have potential risks, to avoid prohibited activities like Money Laundering.  

This Committee needs to meet regularly to evaluate its own performance as well as the overall performance of the bank. Moreover, Committee members must have sufficient expertise and experience to assess and monitor risks. The CBJ Code is silent on the need to meet, or how often, or if the Committee’s members need to have any qualifications or experience. But in order to be an effective Committee which is capable of monitoring risk, it needs, as in Australia, to have Committee members who have appropriate experience and knowledge of the financial as well as operational and legal issues.

7.3.3. The Appointments and Remunerations Committee

In Jordan, most of the financial institutions and banks combine these two Committees in one Committee. The ASE Code and CBJ Code also combine them in their Codes as they consider those two Committees have similar duties and structures.

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59 See chapter 2 [2.3.2] for further discussion concerning the importance of regular meetings as being strongly related to effectiveness.

60 See the discussion below at [7.5] to see whether the banking sector in Jordan actually complies with these instructions.

61 This was clear from the failure of some international Banks due to lack of expertise of corporate officers. For example, in the UK Northern Rock, the Chairman of Board of Directors did not have an appropriate experience to lead a large banking institution nor did Board members have appropriate experience in the banking sector. These members could not provide the necessary checks and balances and failed to appropriately monitor the CEO. This issue contributed to the failure of the Bank. See chapter 3 [3.6]; and chapter 4 [4.2.1.2] for further discussion concerning the collapse of Northern Rock. Also see chapter 2 [2.3.2] for further discussion concerning the importance of Board’s expertise.

62 See chapter 2 [2.3.2] for further discussion concerning the importance of members’ experience which is strongly related to effectiveness.
The Boards of Directors appoint the members of the joint Committee. However, at law there is no legal requirement to establish these Committees in Jordan. The CBJ Code (2007) sets out the composition of the Committee with “a minimum three Non-Executive Directors, the majority of whom (including the Committee Chairman) are independent.”

The Appointments and Remuneration Committee sends to shareholders names of persons seeking election to the Board at the annual general assembly, (see the discussion in chapter 2). The Committee considers whether the candidates are independent according to the independence principles.

The combined Committee is responsible for the remuneration package (including salary and other bonuses) of each Board member, the CEO as well as the executive management. As noted in the previous chapters, the Committee performs a crucial

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64 The CBJ Code states that “the Board may decide to combine the functions of several Committees if appropriate or if administratively more convenient.” See Central Bank of Jordan, Corporate Governance Code for Banks in Jordan (2007) (“CBJ Code’), 3. A, iii, 16 <http://www.cbj.gov.jo>. Also Arab Bank, for example, has merged the two Committees. See Arab Bank, Arab Bank Code (2008), ch. 3, D, 12 <http://www.arabbank.com.jo>. However, in countries such as UK and Australia, they separate these Committees because each Committee has special character and duty as well as to protect them from any conflict of interests when they do their duties and have decisions. See chapter 2 [2.3.2, 5, IV & V] for further discussion concerning these two Committees.

65 See Jordan Securities Commission Guide, Mandatory rules Index (general and mandatory) and guidance rules for the Code of Corporate Governance for listed companies in the Amman Stock Exchange (January 2010), Ch.2, section. 2.1, b, 5 <http: // www. jsc. gov. jo/ library/ 63401117005421250.pdf> (only available in Arabic script). See Appendix [C].


role in ensuring that the bank’s remuneration packages match the qualifications and performance of Board members and executive management as the bank’s peers in the market place. The Committee reviews and discloses the remuneration for each member in the financial statement available to shareholders, stakeholders and investors.\textsuperscript{68} The Companies Law of Jordan requires all listed companies including listed banks to comply with disclosure requirements especially in the area of remuneration and benefits of the Board members and executive management or changes of directors.\textsuperscript{69} Exceptionally, the Companies Law limits Board members’ remuneration. It states that the remuneration of Public Shareholding Company Directors, including the Chairman of the Board, is limited to 10% of the net profit of the company after allowing for reserves and taxes. It is subject to the further limit that remuneration must not exceed (JD 5000) or (USD 7,089) per year. Remuneration is distributed in proportion to the number of meetings attended by each member.\textsuperscript{70}

The Companies Law further provides that if the company is a new company not yet earning profits, the annual remuneration for Board members and the chairman must not exceed (JD 1000) or (USD 1418) for every member until the company starts to earn profits, then the usual rule referred to above applies.\textsuperscript{71} If the company is not earning profits, or incurring losses, remuneration is limited to (JD 20) or (USD 28) for each Board or Committee meeting with an upper annual limit of (JD 600) or (USD 851) per year per Board member or Chairman.\textsuperscript{72}

\textsuperscript{68} Ibid Ch. 3. C, 17-18. See the discussion below at [7.5] to see whether the banking sector in Jordan actually complies with these instructions.


\textsuperscript{70} Ibid article. 162 (a).

\textsuperscript{71} Ibid article. 162 (b).
This type of provision is unique with no equivalent in the UK or Australian systems setting financial limits on director remuneration. As there is some evidence that high levels of Board remuneration may affect the independence of directors, this limit may render less likely that the independence of a director can be compromised. But the question is whether this is monitored and whether the statutory limits might be effectively side stepped so that the reported remuneration does not fully reflect all benefits that directors may obtain.

In order to be effective, there should be regular meetings, review, and evaluation of the performance of appointments and remuneration systems. Its role, as explained in chapter 2, is to ensure that remuneration is appropriate to the position and matched by performance. Neither the ASE Code, nor the CBJ Code set out how often the Committee should meet. Moreover, it is not a mandatory requirement that Appointments and Remuneration Committee operate independently in Jordan. However, in Australia, for example, the ASX300 companies are now required to have a Remuneration Committee as are all regulated financial institutions.

Because the Committee’s independence is not mandatory in Jordan, and there is a risk of management influence, some jurisdictions have introduced additional measures to manage remuneration. Australia has introduced the Two Strikes rule and the United Kingdom has introduced the Clawback provision. That this should have been necessary suggests that Boards and Board Committees have not been effective in ensuring that remuneration packages were reasonable and executives sufficiently

72 Ibid article. 162 (c).


accountable for their performance. Of particular importance in relation to banks is the link between excessive risk taking and remuneration packages and manipulation of share prices for the benefit of executives.\(^75\) The Two Strikes Rule and Clawback provision have been discussed in Chapter 2.

The crucial question is whether the Board of Directors and Board Committees can realistically perform a supervisory role in relation to executive remuneration. If it does not, then what needs to be done to remedy this? Legislative intervention such as the Two Strikes rule may assist. There is no direct evidence in Jordan that executive remuneration is regarded as excessive and this might be assisted by the statutory limits in relation to directors referred to above. But to avoid problems of excessive risk taking, the issue of matching performance, it is argued that in Jordan, Board Committees should be authorised to report directly to shareholders in order to improve transparency and accountability. It will also be argued that this Committee and its independence should be mandatory. This provides an efficient mechanism to deal with the problems of excessive remuneration. This may assist in monitoring performance based remuneration and excessive risks taking by executives.

The next section investigates the main factors which may negatively influence decisions of the Board of Directors and Board Committees in the Jordanian banking sector.

7.4. Factors Influencing the Effectiveness of Board Committees in the Jordanian Banking Sector

The CBJ as the regulator of Jordanian banks is responsible for the safety and stability of Jordanian banks. Jordanian banks are considered as safe and stable, (see chapter 6). Unlike many other countries, there are no foreign ownership limits on shareholdings in Jordanian banks. In 2012 non-Jordanians own 47% of bank equity. This demonstrates confidence in the Jordanian banking system, in particular, and in the economy of Jordan, in general.\(^7^6\) However, the Jordanian economy is a relatively small market.\(^7^7\) As mentioned in the previous chapter, at the end of April 2014, the number of listed companies at the ASE was 237 including 15 banks. Significant shareholding is held by families\(^7^8\) or governmental institutions. The Jordanian Social Security Corporation\(^7^9\) has the largest holding in Arab Bank about JD 88 million (USD 125 million).\(^8^0\) There are also significant holdings by local and international families, banks, and organisations. A 2008 study found that Jordan has high ownership concentration in its institutions. “Jordan…emerges as the country with the

78 For further discussion concerning the family control and its effect on the controlling system of the institution, see chapter 2 [2.4.1].
79 The Jordanian Social Security Corporation is a governmental institution has independent financial and administrative system, and owns shares in the most of the Jordanian Banks in different ratios. See <http://www.ssc.gov.jo/).
highest private ownership, having more than 80% of firm ownership in the hands of private institutions and individuals.\textsuperscript{81}

According to the Jordanian Securities Depository Center (SDC)’s website, the Bahraini Al Baraka Group with representation on the Board of Directors in Jordan Islamic Bank owns about 99% of the bank’s shares; the Jordanian Al Qadi family represented on the Board of Directors in Arab Jordan Investment Bank owns about 49% of the bank’s shares.\textsuperscript{82} This is all the more remarkable because the Banking Law of Jordan restricts ownership of bank shares. The Jordanian Banking Law provides that:

\begin{quote}
A Bank, whether acting alone or in collaboration with others and whether it is acting directly or indirectly, shall be prohibited from the following:
1. Holding in a company whose objectives do not include acceptance of deposits, an ownership stake exceeding the ratio prescribed by the Central Bank. Such ratio shall not in any case exceed 10 percent of the company's subscribed capital.
2. Owning shares without a prior written approval of the Central Bank, in any other bank or company that accepts deposits. Such ownership shall not in any case exceed 10 percent of either its own subscribed capital or of the subscribed capital of the bank or company in which the bank owns shares. This prohibition shall not apply to shares already owned by banks in excess of this percentage upon entry of this law into force.
3. Owning capital shares in companies, the total of which exceeds the percentage decided by the Central Bank. In all cases, this total shall not exceed 50 percent of the subscribed capital of the bank. Where a bank has exceeded this percentage it shall be allowed a period of five years from the effective date of this law to rectify its state of affairs.\textsuperscript{83}
\end{quote}

If current holdings breach the statutory requirements and no steps have been taken to ensure autonomy, integrity and compliance, it suggests a problem with enforcing compliance. It also causes problems where large shareholders are members of the


\textsuperscript{82} Available from SDC’s website, see \url{http://www.sdc.com.jo/}.\textsuperscript{83} See Banking Law 2000 No. 28, 38 A <\url{http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&local_details1=0&localsite_branchname=CBJ}>.

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Board of Directors. The independence of Boards and their Committees is recommended rather than mandatory in Jordan,\textsuperscript{84} both for listed companies and under the CBJ Code (2007).\textsuperscript{85} As argued in chapter 2, this may compromise the ability of the Board of Director to monitor and supervise the bank’s operations.

The next section examines Jordanian banks’ compliance with the corporate Governance Codes.

7.5. Evaluation of Jordanian Banks’ Compliance with Governance Codes

Chapter 2 discussed some factors (e.g. management influence, family control, lack of experience, meetings and evaluations, composition of the Committees and others) that may negatively affect the monitoring and effective oversight of the bank and its management as well as the overall performance of the bank and the Board of Directors. This section examines how far these factors are reflected in Board Committees of Jordanian listed banks. To do so, it will examine the Board Committees of Jordanian listed banks in relation to two issues. First, whether the requirements of the CBJ Code\textsuperscript{86} and ASE Code\textsuperscript{87} dealing with independent Board Committees are complied with. Secondly, how far the factors which affect Board Committees independence can be found in relation to Jordanian banks. The purpose of this is to provide evidence upon which an assessment may be made whether Board

\textsuperscript{84} See Jordan Securities Commission Guide, \textit{Mandatory rules Index (general and mandatory) and guidance rules for the Code of Corporate Governance for listed companies in the Amman Stock Exchange} (January 2010), Ch.2, section. 2.2, 5 \textltt<http://www.jsc.gov.jo/ library/6340111705421250.pdf> (only available in Arabic script). See Appendix [C].


\textsuperscript{86} The CBJ Code's principles are available in Appendix [A].

\textsuperscript{87} The ASE Code's principles are available in Appendix [B].
of Directors and Board Committees operate independently to monitor and supervise executive management.

This section examines the 15 banks that are listed on the ASE. Listed banks are selected for examination as there is relevant information available through their Annual Reports. It uses data from the Annual Reports of each listed bank in 2010. The findings are set out in two Tables. Table 1 sets out information about the Boards of Directors’ composition, positions and nationalities, and other factors which may have an affect on the Board independence. This information is required under the Codes. Table 2 sets out information about the Board Committees’ positions, the number of independent members, their expertise, the number of meetings and other factors may effect on the their independence (e.g. family relationships). 88 This will be followed by an analysis of the information and whether the ASE and CBJ Codes’ principles are met. The findings in the table below relate to the 15 listed Jordanian banks.

Table 7.1. The Compliance of Directors with the Governance Principles of CBJ Code in Jordanian Listed Banks.

<table>
<thead>
<tr>
<th>Category (Board of Directors)</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experience</td>
<td>All of the banks have not less than five and not more than thirteen Board members and all of them are experienced members.</td>
</tr>
<tr>
<td>Position &amp; Nationality</td>
<td>All of the banks’ Annual Reports state the positions and nationalities of the Boards members.</td>
</tr>
<tr>
<td>Family relationship between CEO &amp; the Board members</td>
<td>10 banks.</td>
</tr>
<tr>
<td>Family relationship between major investors &amp; Boards members</td>
<td>8 banks.</td>
</tr>
</tbody>
</table>

88 Although the information is publicly available, this chapter does not identify Banks or relevant parties.
| Board members who are a current or previous government ministers from Jordan or other countries. | 8 banks. |
| Composition of the Board whether they are Executive, Non-Executive or Independent. | -No information: 8 banks.  
-Limited information: 2 banks.  
-Detailed information shows the composition and independency of all Board members: 5 banks. |
| Chairman whether he/she is Executive, Non-Executive or Independent | -No information: 8 banks.  
-Don’t give full information (e.g. the Chairman is independent but doesn’t say if he/she Executive or Non-Executive): 7 banks. |
| Separating the role of Chairman and CEO. | -14 banks separated the role.  
-1 bank did not separate the role. |
| Board of Directors meetings | -Met (not less than 6 times during 2010): 8 banks.  
-No information: 7 banks. |

The above Table shows that all banks have Boards consisting of between five and thirteen members elected by the annual general shareholder meeting for a term of four years. This follows the requirements of the Jordanian Companies Law 1997. These reports show each member’s position (Chairman, Vice Chairman, Board members), nationality, experience and date of appointment. This is in order to comply with the CBJ Code requirement. The Board of Directors of all listed banks have formal

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90 “As part of its commitment to transparency and full disclosure, the Bank in its Annual Report includes the following information: information on each individual Director: qualifications and experience; shareholding in the Bank; whether an independent, non-executive, or executive Director; the membership of Board Committees; dates of appointment to the Board; other directorships.” See Central Bank of Jordan, *Corporate Governance Code for Banks in Jordan* (2007) (‘CBJ Code’), Ch. 6, vi, 26 <http://www.cbj.gov.jo>. See also *Banking Law 2000* No. 28, articles. 60A. 2 & 69A <http://www.cbj.gov.jo>.  

91 It should be here noted that the *Banking Law of Jordan* requires Board members and Chairman to meet additional requirements: article No. 22 says: “a. In addition to the provisions of the Law of Companies, the chairman and each member of the board of directors of a bank shall meet the following special requirements:  
1. His age is not less than twenty-five years.  
2. He is of good conduct and reputation.  
3. He is not a member of the board of directors, a general manager, a regional manager or an officer of another bank unless it is a subsidiary of the bank.
banking experience. This is in compliance with the CBJ Code that “composition of the Board should be determined in order to obtain the optimal mix of skills and experience that enable each of them to participate in the Board discussions independently.”

In relation to the issue of independence, in the listed banks, there are family relationships between Board members and the bank’s Chairman in ten of the fifteen listed banks. Moreover, in eight banks, members of the Board have a family relationship with the major investors.

Another factor which may impinge on the independence of Board Committees is the tendency of bank Board Committees to include members with political influence. Although the Jordanian government does not have substantial holdings in the Jordanian banking sector, eight banks have either the chairman or Board members who currently or previously worked as ministers in the government of Jordan or the government of other countries. This may lead to a lack of Board independence as external influences may not necessarily be in the best interests of the shareholders or

b. The Central Bank shall have the right to object to the nomination of any person for membership in the board of directors of a bank if it finds that he does not fulfil any of the requirements stipulated in paragraph (a) of this article.” Also article No. 23 says: “A member of the board of directors of a bank shall forfeit his membership pursuant to a decision by the Central Bank in any of the following cases:

a. If he no more fulfils any of the conditions for membership pursuant to the provisions of the Law of Companies in effect and this law.

b. If the Board has requested the removal of the chairman or any of the members of the board of directors of a Bank, provided that the removal is justified by the interests of depositors or shareholders.” See Ibid articles. 22 & 23.

92 This means that these members have expertise in banking system and knowledge gained through long term experience and work in the fields of finance, business, accounting or any related field which enables them to effectively understand and evaluate all the complexities of the banking processes, procedures and requirements.

93 Also the stakeholders of the Bank need to have appropriate experience to understand the various financial and operational issues in their Banks. The Appointments Committee needs to select stakeholders members who are able to provide benefits to the Banks and assist Board of Directors in providing values and enhance the system in the Bank. See Central Bank of Jordan, Corporate Governance Code for Banks in Jordan (2007) (“CBJ Code”), ch 2. D. I, 11 <http://www.cbj.gov.jo>.
the Jordanian market. This may occur when these members control appointments or remuneration systems or other systems in the banks. There is a risk of loans at non-commercial rates, provision of services by family members or relatives at non-competitive rates to the bank. This is contrary to the Banking Law of Jordan which prohibits the award of tenders to relatives of first and second class. 

The Jordanian Banking Law requires the banks in Jordan to disclose full data to shareholders, stakeholders and investors about their performance, structures and other issues. The Banking Law 2000 provides that:

A bank shall comply with the orders of the Central Bank pertaining to…preparing its financial statements comprehensively to reflect the actual financial position of the bank and its branches and subsidiaries with due compliance with any special requirements specified by the Central Bank in this regard…A bank shall furnish the Central Bank with a copy of its annual report, which shall include: the statements required under the Law of Companies and the Law of Securities and instructions issued pursuant thereto; the amount of capital shares belonging to each of the chairman and members of the board of directors of the bank and their relatives up to and including those of the third degree.

Only five of the fifteen listed banks disclose full data about the composition of their Boards of Directors (Executive, Non-Executive, or Independent). Two banks give some limited data about the composition and eight banks did not disclose any data on this. Seven banks disclosed data about the Chairman and whether the Chair is Executive, Non-Executive, or Independent. Eight banks did not disclose any of this.

94 Banking Law states that:

“a. If a bank administrator, or his wife or a relative of his up to the third-degree, has a personal interest in any dealing or contract to which the bank is a party, or if any of them has an effective interest in a company to which such dealing or contract is related, the bank administrator shall disclose such interest in writing, and shall not participate in any meeting wherein the deal or contract is discussed.

b. If, in violation of the provisions of paragraph (a) of this article, the bank administrator fails to disclose such interest in writing, the bank shall resort to the competent court on its own initiative, or upon a request of the Central Bank, to contest the validity of the contract in question if it contains terms damaging to the bank's interest. The competent court may nullify the contract or amend its terms in such a way as to uphold the bank's interests. The Central Bank may also issue a written order to the bank to terminate the administrator's service or relationship with the bank.” See Banking Law 2000 No. 28, articles: 31 & 46 <http://www.cbj.gov.jo/pages.php?menu_id=123&local_type=0&local_id=0&local_details=0&local_details1=0&localsite_branchname=CBJ>.

95 See Ibid Article 60. A. 2; 68. A.B.
data about the status of the chairman. It is clear that not all of the banks follow the principles of CBJ Code in this regard.

As part of its commitment to transparency, the bank in its Annual Report includes information on each individual director whether an independent, Non-Executive, or Executive Director…to foster an independent element within the Board, the bank’s policy is that the Board should have at least three Non-Executive Directors and the majority independent members.96

Furthermore, fourteen of the fifteen listed banks separated the role of the Chairman and CEO. Only one bank combines the role of Chairman and the CEO.97 Separating the CEO and Chairperson positions is important as it provides greater opportunity for Board of Directors to monitor management decisions without influence. The CBJ comments that:

If the Chairman is an executive, then the bank will consider appointing an independent member of the Board as a Deputy Chairman to act as an independent resource and conduit for shareholders. The bank acknowledges that it is international best practice to have a non-executive Chairman, and will keep this matter under review. The status of the Chairman (whether executive or non-executive) is publicly disclosed.98

The Jordanian experience is in line with other countries (see chapter 2). Because of the greater risks in relation to banks and financial institutions in Australia, amendment


97 See the discussion in chapter 2 [2.3.2.4] for further discussion concerning the important of separate the role of Chairman and CEO. The CBJ Code states that “the position of Chairman of the Board is separated from that of General Manager. In addition, there is no family relationship up to the third degree between the Chairman and the General Manager. The division of responsibilities between the Chairman and the General Manager has been set down in writing, is subject to review and revision from time to time as necessary, and is approved by the Board.” See Central Bank of Jordan, Corporate Governance Code for Banks in Jordan (2007) (‘CBJ Code’), ch. 6, 26 & ch. 2. B, I, 10 <http://www.cbj.gov.jo>.

98 Ibid i, ii.
to the regulatory standards now require the position of CEO and Chair of the Board of Directors to be separated.\(^9^9\)

According to the Annual Reports of the fifteen listed banks, in eight banks, the Boards met not less than six times during 2010 which satisfies the CBJ Code.\(^1^0^0\) However, there is no information related to other banks.\(^1^0^1\) Some banks did not disclose data about their Board’ meetings and gave no explanation for the failure to comply with the CBJ Code which requires that banks in their Annual Reports include information concerning the frequency of Board meetings.\(^1^0^2\)

Thus, it is clear that the majority of the Boards members of the Jordanian listed banks do not fully comply with the principles of the CBJ Code such as the Board members regular meetings and disclose data related these meetings, their performance and overall performance, which is considered very important for effective corporate governance of banks. It is not clear whether the CBJ acted in response to this failure to report. It suggests poor governance structures and reporting mechanisms. The following table deals with compliance with the Code in relation to Board committees.

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\(^1^0^0\) It should be here noted that the Jordanian Companies Law has some requirements for Board meetings. Article No. 144 says: “The Invitation to the General Assembly Meeting and its Agenda:

a) The Board of Directors of a Public Shareholding Company shall direct an invitation to each shareholder to attend the General Assembly meeting to be sent via ordinary mail at least fourteen days prior to the date set for the meeting. The invitations may be delivered to the shareholder by hand against a signature of receipt.


\(^1^0^2\) See Ibid Ch. 6, vi, 5, 26.
Table 7.2. The Compliance of Board Committees with the Governance Principles of CBJ Code in Jordanian Listed Banks.

<table>
<thead>
<tr>
<th>Category (Board Committees)</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Committees</strong></td>
<td>All of the 15 listed banks state in their Annual Reports that they have the 4 permanent Committees (Audit Committee, Risk Management Committee, Appointments Committee and Remuneration Committee) as well as other additional Committees. However, 4 banks don’t state in their Annual Reports the names of their members.</td>
</tr>
<tr>
<td><strong>At least 3 Non-Executives and majority Independent members.</strong></td>
<td>11 banks do not comply</td>
</tr>
<tr>
<td><strong>Structure of the permanent Committees members (Executive, Non-Executive, Independent)</strong></td>
<td>- No information: 9 banks. - State for some members not all (e.g. 6 members, 2 are Non-Executives without mention to structure of the other members): 6 banks.</td>
</tr>
<tr>
<td><strong>Structure of the additional Committees (e.g. Corporate Governance Committee, Investment Committee)</strong></td>
<td>- No structure for some Committees: 6 banks. - Banks state all information about all of the additional Committees: 8 banks.</td>
</tr>
<tr>
<td><strong>Committees meetings</strong></td>
<td>- Met (not less than 4 times during 2010): 1 bank. - Didn’t meet at all or met but less than 4 times: 9 banks. - No information: 5 banks.</td>
</tr>
</tbody>
</table>

The Table above shows that all of the fifteen listed banks indicate in their Annual Reports that they have the four permanent Committees (Audit Committee, Risk Management Committee, Appointment Committee and Remuneration Committee). Four banks do not state in their Annual Reports the names of their members although the CBJ Code states that membership of the Committees should be disclosed in the bank’s Annual Reports.\textsuperscript{103} This can be important because when named it may be apparent that the Board member may not be independent.

The CBJ Code provides that the “Committees comprise a minimum of three Non-Executive Directors, the majority of which (including the Committee chairman) are

\textsuperscript{103} The membership of Board Committees, together with summaries of their responsibilities and duties, are disclosed in the Bank’s Annual Report. See Ibid, Ch. 3, ii, 16.
independent.” However, eleven banks did not comply despite its importance in avoiding potential conflict of interests and risks. However, this is not mandatory in Jordan and this may be the reason why the CBJ does not enforce its Code on this issue as it is a ‘comply or explain’ rule. This is the usual approach in many countries. The effectiveness of the ‘comply or explain’ approach is discussed in chapter 2.

The independence of Non-Executive Directors is very important to the monitoring and supervision of banks and the Board. There is low compliance in Jordan where eleven out of fifteen banks do not comply. Nine banks do not report the composition of Committees (Executives, Non-Executives, Independent). Six do not include full information. Furthermore, according to the banks’ Annual Reports, fourteen banks use additional Committees and six did not report the composition of the Committees. This appears to be a low level of compliance of what is considered very important for effective corporate governance of banks. It is not clear whether this is a failure to report or the failure to appoint as set out in the Code. Either way, it suggests poor governance structures and reporting mechanisms.

The Annual Reports of the fifteen listed banks indicate that the Audit Committees members of the fifteen listed banks meet the required four meetings annually. Although there is no binding legal requirement which require the other Committees to meet or state the number of their meetings, the Annual Reports of the fifteen listed banks indicate that in only one bank the other Committees met not less than four

104 See Ibid, Ch. 3, 16-19.

105 See chapter 2 [2.3.1].

106 See the discussion in chapter 2 [2.3.2.3] for further discussion concerning the important of Non-Executive Directors and their independent.

107 Six Banks report but for some members not for all of them (e.g. Audit Committee for X Bank includes six members, two Non-executives but no information about the other members if they are Executives or independent or dependent members).
times. In nine banks, some Committees did not meet at all and some met less than four times. In five banks, the Annual Reports do not report the number of meetings of the other Committees. However, some of these banks used the ‘Comply or Explain’ approach to explain why their Committees did not meet. For example, one of these banks in its Annual Report states that all members of the Remuneration Committee met only twice in 2010 because most of these members were on leave during 2010. If Committees do not meet on a regular basis, this puts into question whether they are actually performing their role of providing independent oversight of the bank. It has been observed previously that Jordan may lack secondary market mechanisms which can operate to discipline companies that do not have appropriate corporate governance.

In the review of Jordanian listed banks, it is not clear how far most of the Jordanian listed banks are actually engaging in best governance practices such as the use of properly constituted Boards and Committees, regular meetings, evaluations, disclosures and use of independent Non-Executive Directors. Many factors affect negatively on the application of good corporate governance practices, particularly issues relating to foreign influence and family relationships. This will lead to lack of independence of Board Committees in monitoring the performance of Boards as the main objective in acting the in best interest of shareholders. Overall there appears to be low levels of compliance with the ASE and CBJ Codes and also a failure to explain lack of compliance.

7.6. Empowering Board Committees in the Jordanian Banking Sector

The banking sector in Jordan is stable with Jordanian banks exceeding Basel requirements so that the risks of banking failure are theoretically small, (see chapter
However, as discussed in this chapter, due to the influence of family members on Board of Directors, there is a risk of influence on Board Committees particularly in relation to remuneration and appointments systems. Chapter 2 discussed the agency problem that arises out of these connections.\textsuperscript{109}

Also as discussed in chapter 2, good governance emphasises the importance of monitoring by the Board, Board Committees, Non-Executive Directors and the desirability of independence. Remuneration packages require to be monitored by independent Board Committees to avoid agency problems encountered when executives control their own remuneration without requiring matching performance. It is also important because there is evidence that remuneration incentives can lead to excessive risk taking by executive in order to achieve short term benefits, (see chapter 2).\textsuperscript{110}

Board Committees are a key mechanism for monitoring risks. Although all Jordanian banks have the requisite four Committees, it is not clear how far these Committees operate independently of management and effectively monitor risk and management processes. There is need for formal and independent appointments system based on the member’s expertise not family relationships. The appointment procedure must be transparent and provide a greater role for shareholders to ensure that the appointments system is fair and executives (particularly the CEO) do not influence it. One method of achieving this is for the bank’s shareholders to elect or appoint independent Appointments Committee as well as require this Committee with the other

\begin{footnotes}
\item[108] See chapter 6 \[6.5\].
\item[109] See chapter 2 \[2.2.2\]. Also see the discussion concerning family control at \[2.4.1\].
\item[110] See chapter 2 \[2.3.2.5, IV\].
\end{footnotes}
Committees to report directly to shareholders so the Board of Directors, executive members in particular, do not influence their decisions.\textsuperscript{111} One other measure is to insist that if banks do not comply with governance codes, there be adequate justification for non-compliance. The explanation given in one of the annual report, members on leave, would not be regarded as satisfactory in other jurisdictions.

7.7. Conclusion

This chapter discussed the internal monitoring system in the Jordanian banks. In particular, it considered the role of Board Committees in achieving effective corporate governance in the Jordanian banks and assessed how far Jordanian listed banks complied with governance Codes. It is apparent that there is a modest level of compliance with governance Codes. It does appear that some banks do not regard compliance as a matter of good governance and, in relation to those who do not comply; there are usually no explanations for non-compliance. There appears to be no pressure from major shareholders such as pension funds and other institutional shareholders to exert influence on Boards to comply. Nor does it seem that there is an active financial press or shareholder or stakeholder activism which exercises some disciplinary role in this regard. This might be partially explained by family and political membership of Boards who exercise significant influence on the workings of the Boards and its Committees so that independence of the Board and its Committees may be a real issue.

Because the independence of Board Committees is not mandatory and there is a risk of management influence, some jurisdictions have introduced additional measures to

\textsuperscript{111} Note the responsibilities imposed on the Board under the 2014 UK Corporate Governance Code which requires a rigorous, transparent process, see Financial Reporting Council, \textit{The UK Corporate Governance Code} (September 2014), B.1; B. 2 <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>. See also chapter 4 [4.3].
manage remuneration. Australia has introduced the Two Strike rule, and the US and UK the Clawback rule as methods of ensuring that executive management’s remuneration is reasonable and matched by performance, (see chapter 2).\textsuperscript{112} At this time, there is no evidence that in Jordan, there is unreasonable executive remuneration not matched by performance. But this may be a function of a financial press that is not sufficiently informed or interested rather than that there is no problem to be addressed. The experience in Australia and UK suggest that Jordan should act pre-emptively to avoid these problems.

It is argued that because of these special factors which influence the proper governance of banks in Jordan, the CBJ Code should impose a compulsory rule that make Board Committees and their independence mandatory. The 2014 UK Corporate Governance Code provides a possible approach to dealing with independence of Non-Executive Directors. Under the UK Code, Boards take responsibility for assessing the independence of Non-Executive Directors and are to report to the AGM the basis for this assessment.\textsuperscript{113} Although the UK Code operates on a ‘comply or explain’ basis, it is argued that there are special reasons why under the CBJ code Board Committees should be made mandatory and be required to report directly to the AGM and shareholders. First, it can be seen from the tables above, that in Jordan there is a fairly modest level of compliance with the Codes and a significant failure to explain the noncompliance. Unlike Australia or the UK, there is an absence of secondary market mechanisms which make the ‘comply or explain’ rule effective within Jordan. There is no evidence of a vigorous financial press, shareholder or stakeholder activism or pressure imposed by large institutional shareholders,

\textsuperscript{112} See chapter 2 [2.2.2.5, IV].

\textsuperscript{113} See chapter 4 [4.3].
Although there have not been particular problems because of highly liquid, adequately capitalised banks. But Jordanian banks need to perform the critical role of funding new developments, infrastructure and growing the economy, which necessarily involves taking on risk. If banks operate merely as depository for depositors funds they may be failing in this key function. It is in this context that Board Committees would need to be an effective force in monitoring increased risk taking that investment in the economy requires. Thus, Jordanian regulators should re-examine the role of Board Committees in Jordanian banks and take the further step of making the four Committees more effective, independent, and mandatory as well as stipulating membership and a majority of independent Non-Executive Directors.

The next chapter provides concluding remarks as well as some recommendations to provide an efficient bank governance system in Jordan.
CHAPTER 8

SUMMARY AND CONCLUSIONS

8.1. Introduction

This thesis considered the role of Board Committees in promoting effective corporate governance in Jordanian banks and the importance of independent Board Committees as a means of ensuring the financial stability and integrity of banks in Jordan. It examined the role of independent Board Committees in ensuring management accountability to the shareholders as owners of the banks and how independent Board Committees are essential to diminish agency conflicts between management and shareholders.

This chapter is structured as follows. Section 8.1 is introductory. Section 8.2 presents an overview of the thesis’ findings. The last section provides recommendations for reform of the Jordanian banking system and concludes.

8.2. Overview

The banking sector in Jordan is stable. Under the supervision of the Central Bank of Jordan (CBJ), Jordanian banks exceed Basel requirements so that the risks of banking failure are theoretically small (see chapter 6). But as observed in the previous chapters, if Jordanian banks are to fulfil their role of promoting and funding economic development, this requires strategic investment which necessarily carries with it a
higher level of risk. This is the context in which Board Committees will play a crucial role.

Agency theory, discussed in chapter 2, deals with conflicts between executive management self-interest and the interest of the owners of the corporation, the shareholders. Codes of Corporate Governance, originating in the UK Cadbury Code, reduce the potential for conflict. The purpose of Codes of Corporate Governance is to empower Boards and Board committees to play an active role in providing objective oversight of management, to try and ensure the alignment of management and shareholder interests, and that management acts in the best interests of the company, its shareholders and stakeholders. In order to achieve this goal, code rules provide for the separation of the role of CEO and Board Chair; independent Non-Executive Directors, and the establishment of independent Board Committees: Audit, Risk Management, Appointments, and Remuneration. But as observed in chapter 2, code rules are largely not mandatory in that the “comply or explain” rule applies. Whilst this approach is intended to give flexibility to banks and their Boards to devise their own procedures for monitoring and supervising their operations, it is clear that Boards and Board Committees have not been effective to prevent bank failure during the Global Financial Crisis (GFC). Reasons for this include the lack of expertise on Boards and Board Committees, lack of regular meetings, control and influence wielded by management, as well as lack of Board and Committee independence. Particular problems occur in relation to management remuneration schemes tied to excessive risk taking. In this respect Boards and their committees failed to act as a moderating influence on excessive risk taking and executive remuneration. Indicative of this failure has been the measures taken in the UK and Australia to deal with excessive executive remuneration using “Clawback” and the “Two Strikes rule”.

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Chapter 2 makes it clear that in order for Board Committees to perform their role, a much stronger hand needs to be taken to ensure their expertise and independence so that there is effective oversight and monitoring of executive management and bank operations.

This is particularly important in dealing with the special risks involving banks. Chapter 3 discussed the special risks that apply to banks and particularly problems of risk taking leading to the GFC. Of special importance is the role of Board Committees in supervising and monitoring these risks and the importance of independent Non-Executive Directors in providing expert, objective assessment and monitoring. Board Committees, (particularly the Risk Management Committee), are the key mechanism for monitoring these risks and compliance with Basel requirements. The Basel Accords have established rules which mitigate the risk of bank failure and systemic risk. Under the Basel Accords as implemented by regulators, the banks are required to put in place defined measures to reduce the risk of failure and systemic risk. The rules relating to capital adequacy and liquidity place the onus on the banks to protect against failure rather than assuming that governments will feel impelled to bail out banks that regarded as too big to fail (see chapter 3). The management of risk and the monitoring of the observance of the Basel Accords is an important role for bank Board Committees.

Codes operate in a broader regulatory context which imposes mandatory rules, oversight and monitoring of banks. Chapter 4 examined the regulatory framework and corporate governance codes applying to banks in the UK. In relation to internal governance through Corporate Governance codes, there have been, at least superficially, high levels of compliance by banks. The problem is that although the
structures are there to support good governance, this does not ensure that Boards and Board Committees effectively supervise and monitor the operations of the bank and executive management. The poor performance of Board Committees is regarded an important factor contributing to bank failure in the UK during the GFC.

The financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk-taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have, in a number of cases, not been closely related to the strategy and risk appetite of the financial institution and its longer term interests.¹

Significantly, during the GFC, Boards and Board Committees failed to ensure proper monitoring of executive remuneration. It was not just a problem of management gouging excessive benefits to the costs of the owners, the shareholders, but the evidence that remuneration incentives can lead to excessive risk taking by executives in order to achieve short term benefits. As already noted the failure of Board Committees to manage and monitor this risk is recognised through the institution of the ‘Clawback’ rule discussed in chapter 2. The 2014 UK Corporate Governance Code addresses many of these issues. There are code provisions directed to ensuring that Board and its Committees provide expert, objective oversight of the bank and senior Management. The Code imposes responsibility on the Board to assess and report Non-Executive Director’s independence. There are revised rules relating to the re-election of directors; rigorous and transparent processes for nomination of new directors and more extensive reporting requirements in relation to remuneration.² In order to give shareholders greater access to the Board, the Code now provides that a


² See chapter 4 [4.3].
senior independent Non-Executive Director be appointed to liaise with shareholders. These provisions are directed to ensuring that the Board and its Committees fulfil their purpose in providing expert, independent monitoring of senior management and the institution.

In the UK, the Bank of England is the primary regulator for banks. Following bank failure in the UK during the GFC, a new regulatory framework under the Bank of England has been adopted with the establishment of the Financial Policy Committee, the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). The shift from a tripartite regulatory system in the UK in 2013 to a variation of the Australian Twin Peaks approach attempted to deal with problems of overlapping responsibilities with lack of clarity about which regulatory body was responsible and who was to take action where banks were at risk. The new provisions set in place legislative measures to ensure that there is a free flow of information between the two new regulatory bodies with PRA having broad responsibility for macro measures and the FCA for micro management of financial products and consumers’ rights. In recognition of the special risks of bank failure, the legislation also establishes a separate Bank of England committee, the Financial Policy Committee to make recommendations relating to the stability of banks. Although Jordan has a very small financial sector, the UK experience provides some important lessons for Jordan which is discussed below.

As discussed in chapter 5, the Australian financial sector proved resilient during the GFC. An important reason for this resilience is the strong regulatory framework and proactive approach to risk applying to banks and other financial institutions discussed

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3 See chapter 4 [4.3].
in chapter 5. The Australian Twin Peaks model comprises the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC). In Australia the financial regulatory framework applies to all financial institutions not just banks; this recognises that the risks to the economy are not limited to the banking sector and a consistent approach to regulation of the financial market is essential. The Australian twin peaks model separates the prudential regulatory function (APRA) from the market regulatory function (ASIC) Since equal weight is provided to prudential as well as market conduct regulation, it is considered as the ideal way to ensure that market integrity and consumer protection get sufficient priority and are not routinely made subservient to prudential regulation (see chapter 5).

In relation to corporate governance codes, the Australian financial sector regulator, APRA, makes it mandatory for financial institutions including banks to have audit and remuneration committees and from 2015 risk committees as well. This recognises the importance of bank committees as the first line of defence against excessive risk taking. It is the Boards and its Committees that best know the business of the bank and are in a strategic position to insist on, and monitor, changes to bank operations. In Australia, like the UK, codes of corporate governance typically are comply or explain rules. Chapter 5 discussed the importance of secondary market mechanisms in making the ‘comply or explain’ approach work. Secondary market mechanisms in Australia include a vigorous financial press and shareholder and stakeholder activism which can call banks and their Boards to account for non compliance.

Chapter 6 examined the regulation of Jordanian banks. As noted in chapter 6, Jordan is a small country with a relatively small financial sector with just fifteen listed banks.
Banks are regulated by the Central Bank of Jordan (CBJ) with corporate regulation through the Jordanian Securities Commission (JSC). Effectively Jordanian banks constitute most of the financial sector and deposits their principal source of funding. The Jordanian banking system remained stable during and following the GFC. As indicated in chapter 6, the amounts of capital reserves held by Jordanian banks exceeded the capital adequacy requirements prescribed by the Basel requirements. Chapter 6 canvassed some possible reasons why the CBJ may have taken such a conservative approach. These included overdraft loan portfolios, the risks of inflationary housing prices, problems relating to political influence and significant shareholdings by families in banks. More important, perhaps, is that Jordan is a small country in a highly volatile environment in the Middle East affected by civil strife, and in which circumstances, Jordan has become a haven to high numbers of refugees from the region. This has led to the inflow of income from donor countries as well as funds from surrounding regions.

The CBJ has an important role in ensuring banks stability and requiring capital and liquidity above Basel requirements. Despite this lessons may be learnt from the Australian approach in which consistent regulation is applied across the financial sector not just banks. Although Jordan has an extremely small non-banking financial sector, it might consider in the future whether the role of the CBJ should be extended to cover non banking financial institutions also. The UK experience also provides lessons for Jordan on the importance of a regulatory system in which its constituent parts interact effectively and fluidly to deal with a changing financial sector. This may require providing flexible mechanisms for avoiding lack of clarity about responsibilities and, in a more developed system, consideration of a special committee similar to the UK Prudential Regulation Authority (PRA) specifically dedicated to
issues of bank stability. This is further discussed below. There is a lack of evidence about the extent to which the CBJ has been an active regulator in relation to Jordanian banks other than compliance with Basel standards and the continuing stability of the banking sector.

The second aspect of bank regulation is the corporate governance rules. Chapter 7 examined the CBJ and ASE codes applying to Jordanian banks. In Jordan like many jurisdictions the Codes are not mandatory and allow banks to comply or explain. In relation to internal bank governance, the survey of the 15 listed Jordanian banks in chapter 7 indicates that there are significant failures to comply with the CBJ and ASE codes. Although all listed Jordanian banks have the requisite Committees, Audit, Risk Management, Remuneration, and Appointments, it is not clear how far these Committees operate independently of management and effectively monitor risk and management processes. Jordan does not appear to have secondary market mechanisms that can call financial institutions to account and force financial institutions to substantiate failure to comply with the codes. There is no evidence that Board Committees perform an active role or even that they meet regularly. There is also no available evidence that there is unreasonable executive remuneration not matched by performance in Jordanian banks. This is important because of the link between excessive risk taking by senior management in order to achieve short term benefits. The lack of evidence on this issue may simply reflect the absence of secondary market mechanisms (see above) which call banks and their senior management to account. In these circumstances, it may be premature for Jordan to consider adopting the strategies used in Australia and the UK, the ‘Two Strikes’ and “Clawback” rules referred to in chapter 2. The more general recommendation of mandatory independent Board Committees may provide a satisfactory and suitable response.
These issues are set in the wider context of ensuring appropriate accountability by management to the owners of the bank, the shareholders. The failure of Boards and Board Committees to properly monitor and supervise management, leads to agency problems described in chapter 2 where the financial institution is run for the benefit of executive management rather than the owners, the shareholders. There are other factors which diminish the effectiveness of governance Codes. The ability of Boards and Board Committees to act objectively to monitor and supervise bank management is compromised by high levels of family shareholdings and high levels of external political influence. Unlike many countries, Jordan does not limit foreign ownership in Jordanian banks.

Overall, it is argued that Jordanian regulators should re-examine the role of Board Committees in Jordanian banks and take the further step of making the Committees mandatory as well as stipulating membership and a majority of independent Non-Executive Director members on the Board and its Committees. Most important is that the accountability of these Committees should be directly to the shareholders, and not via the Board of Directors.

8.3. Recommendations and Conclusions

This section begins by reflecting on the two key aspects of bank regulation. First, the primary principle that corporations, including banks, are owned by, and operate for the benefit of, their shareholders and that corporate governance is essentially concerned with avoiding the agency conflicts between senior management and shareholders as owners. Secondly, that banks and other financial institutions are essential components of the financial market and their stability is essential to the
wellbeing of the economy. This leads to two key questions and related recommendations: what needs to be done to ensure that Board Committees fulfil their role in monitoring banks so as to reduce agency conflicts; how do Board committees interact with the regulatory framework to ensure stability and security of the banking system.

8.3.1. The Agency Problem

Agency problems can only be diminished and accountability to shareholders can only be effective if Board Committees are mandatory and required to operate independently in monitoring the performance of the bank and management.

*Mandatory Board Committees*

It is first recommended that in Jordan, banks be required to appoint independent Audit, Risk, Remuneration, and Appointments Committees. The reasons for this are: first that Board Committees perform a crucial role in monitoring the bank and senior management; without this constraint, senior management are given a free hand to act in its own interests rather than that of the shareholders. Secondly, while the “comply or explain” rule might achieve its goals of allowing flexibility in achieving corporate governance standards in some jurisdictions, it may not in others. For example, in Jordan there are significant levels of non compliance and lack of explanation for non compliance with corporate governance Code (see chapter 7). Unlike other jurisdictions, there are no secondary market mechanisms for calling banks and management to account for non compliance. There is no evidence of a vigorous

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4 This could be imposed as a licence condition or as a prudential standard, see chapter 5 [5.4].

5 See chapter 7 [7.5].
financial press or large institutional shareholders such as pension funds which demand accountability or engaged in shareholder or stakeholder activism. The third rationale relates to some special factors in Jordan that compromise the independence of Boards, particularly large family holdings and significant political influence.

*Independent, Expert Board Committees*

There is of no value in making Board Committees compulsory if the CEO and senior management continue to influence if not control appointments to the Board, and Board Committees. The hierarchy of accountability described in chapter 2 requires that management and the Board are accountable to the general shareholder body. This can only occur if the Board and its Committees are able to provide expert, objective oversight of the bank and management. So in order for the Board and its Committees to work effectively in monitoring the CEO and senior management, the Board and its Committees must be independent. This in turn requires that the Board and Committees have a majority of expert, independent Non-Executive Director members. A combination of approaches are adopted in the 2014 UK Corporate Governance Code to ensure independent Non-Executive Directors. The Code imposes the responsibility on the Board to assess, provide reasons and report to the Annual General Meeting (AGM) on the independence of Non-Executive Directors. 6

Secondly, it also requires appointments (nominations) committee to set in place and separately report rigorous and transparent procedures for nomination of directors, (see below). Thirdly, director’s remuneration and service contracts are required, and for

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FTSE 350 companies there should be an annual re-election of directors.\(^7\) These are important steps in empowering shareholders to call to account directors and Board Committee members in their supervision of the institution. Fourthly, it requires independent external evaluation of the performance of the Board on a regular basis.\(^8\) These measures appear to provide an effective solution to issues of independence of the Board and its Committees and should be adopted in Jordan.

Committees should be required to meet and evaluate their performance regularly with members having the necessary independence and expertise to be able to contribute to decision making and the control of management of the financial institutions. This expertise extends to improving procedures to ensure the stability in the business, strategic planning, evaluating performance, and in the banking sector in particular, monitoring compliance with regulatory requirements including managing liquidity. A measure such as that adopted in the UK providing for external evaluation on a periodic basis should be implemented.

Most important is that these Committees should report directly to the shareholders at the AGM, and not to the Board of Directors exclusively so that the independent voice of committees is not muted by management in the annual reporting mechanisms. The Committee membership must be disclosed in the financial institution’s annual report together with the terms of reference and relevant arrangements for the Committee. This allows effective scrutiny of Committees by shareholders as owners of the

\(^7\) Ibid B.7. In the UK, FTSE 350 companies under the Corporate Governance Code should have an annual election for all directors. The FRC reported that all but two FTSE 350 companies have complied with this Code requirement. Financial Reporting Council, *Developments in Corporate Governance 2013: The Impact and Implementation of the UK Corporate Governance and Stewardship Codes* 12.

corporation. The pre-requisite to the independence of the Board and Board committees is that there be an effective independent appointments committee.

Appointments Committee

Since Committees are drawn from membership of the Board of Directors, this requires that Boards have a majority of independent Non-Executive Directors. As observed in chapter 2, Boards usually do not have significant influence over the process of appointment of new directors, whereas executive officers (particularly the CEO) are a powerful force in getting the people they want on the Board and getting rid of less favoured directors. The CEO is able to exert this influence over the Board principally by being in control of the recommendations and process for appointment, and where necessary, being able to persuade major shareholders to appoint particular Non-Executive Directors who are likely to be compliant with the CEO’s views. This constrains the Board and its Committees from operating as expert objective monitors of management for the benefit of shareholders. This has been a particular problem with the capacity of the CEO to influence executive remuneration packages and the problems that arise when senior management seeking to maximise returns undertake excessive risk. These agency conflicts can be mitigated by vesting the bank’s shareholders with the power to elect independent Appointments Committee members based on expertise, and not on family relationships or political influence such as currently appears to occur in respect of Jordanian bank Board Committees (see chapter 7). The Appointments Committee should provide an explanation on how Board members were selected, the interview process and the assessment of the expertise and independence of new Board members. Such a procedure would ensure that management influence on appointments is diminished thus giving greater
opportunities for independent, objective oversight of the bank and Management. This has not been done before in Jordan or other countries where the practice is that the Appointments Committee recommends candidates to the Board of Directors who appoint these candidates. The recommendation seeks to empower the shareholders of the institution. However, this procedure needs effective and independent internal control systems, including independent Appointments Committee members.

Remuneration Committee

An independent Remuneration Committee will be in a position to scrutinise remuneration packages balancing the importance of providing executive incentives as a means of aligning shareholder and management interests as against the potential for senior executives to game the system for their own benefit. Chapter 2 indicated that disclosure of senior executive remuneration did not have the desired effect of constraining executive remuneration and ensuring that remuneration was matched by performance. But for a small financial system like Jordan with only 15 listed banks and where there is no available evidence concerning excessive executive remuneration, it may be premature to put in place measures such as those adopted in Australia and the UK. It may be sufficient to ensure that the Committee is both expert and independent as a first step.

Risk Management Committee

The role of the Risk Management Committee includes monitoring banks compliance with the Basel Accords. The Basel III Accord deals with the role of the Board of Directors in monitoring bank liquidity and capital adequacy, as well as evaluating independently the performance of the bank, Board, and corporate officers. Board
Committees, particularly, the Risk Management Committee, should ensure that the bank has efficient risk management systems and sufficient liquidity and capital adequacy to cover any potential deficits if the bank is at risk. The Risk Management Committee should review the effectiveness of internal control frameworks and report this data to shareholders. Ensuring the regular and relevant corporate disclosure, shareholders are in a better place to control the management of the institution (see chapter 2).

In order to be effective, Committees members should be required to meet and evaluate their performance regularly, and have the necessary independence and expertise to be able to contribute to decision making, as well as control of the management of the financial institutions. In addition to the requirement that banks be required to appoint a risk management committee and that the committee comprise of a majority of independent Non-Executive Directors, it is recommended that the Committee membership be disclosed in the financial institution’s annual report together with the terms of reference and relevant arrangements for the Committee. It is also recommended (see below) that the Committee report directly to the AGM and shareholders.

*Committees reporting directly to Shareholders*

As discussed in chapters 2 and 7, Management and Boards are accountable to shareholders as owners of the bank. But the problem is that senior management is able to exert influence on Boards and their Committees so muting their capacity to ensure management accountability. In addition to the requirements that Board committees

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be mandatory and that Committee membership be expert and independent, true accountability to shareholders can be restored by requiring Committees to report directly to shareholders. There are also special factors applying to Jordan which make this recommendation even more important. First, the significant lack of compliance and explanation under the ‘comply or explain’ regime; secondly, the lack of secondary market mechanisms which call banks and their management to account and thirdly political influence and the influence of families on bank Boards.

8.3.2. Board Committees and the Regulatory Framework

Because banks are crucial to the stability of the economy, there is a further reason why independent Board Committees are crucial. Effective corporate governance in the banking sector is essential to protect investors, depositors, stakeholders and the economy. This is because of the heightened risk to the economy and depositors arising out of overall systemic risk, the effects of which were witnessed in the GFC in 2008. Whilst the Basel Accords put in place measures to help avoid bank collapse and global meltdown of the banking sector, it is the regulator, the CBJ, Boards, and Committees that ultimately are the supervisors and monitors of whether these requirements are met. To make the banking system more stable and efficient, there must be an effective system for managing and monitoring the risk of individual bank failure and systemic risk. This requires a two pronged approach. First a strong regulatory system and secondly effective bank Boards and Board committees. Boards and Board Committees play a crucial role in implementing risk management and regulatory requirements including Basel rules within individual banks.
The CBJ is the bank regulator and responsible for the protection and stability of the banking system. The non-banking financial sector is miniscule (see chapter 6) so that there is not a pressing need to extend the role of the CBJ to non-banking financial institutions. But there are benefits in extending a consistent regulatory framework to all components of the financial system; this suggests that Jordan should consider whether to extend the role of the CBJ to cover all financial institutions as has occurred in Australia.

Although there have not been particular problems because of highly liquid, adequately capitalised banks, in order for Jordanian banks to perform the critical role of funding new developments, infrastructure and growing the economy, this necessarily involves taking on risk. If banks operate merely as a depository for depositors funds they may be failing in this key function. If banks fund new development, infrastructure, industry, this necessarily involves significant risks. It is in this context that Board Committees would need to be an effective force in monitoring increased risk taking that investment in the economy requires. Thus, Jordanian regulators should re-examine the role of Board Committees in Jordanian banks and take the further step of making the four Committees more effective and mandatory as well as stipulating membership and a majority of independent Non-Executive members. Reporting by Committees directly to shareholders and the AGM will bring greater transparency and reduce the risk of management influence.

These recommendations seek to re-establish the hierarchy of accountability by management to the shareholders as owners of banks by empowering Board Committees, ensuring their independence in monitoring and supervising the CEO and senior management. It also recognises that banks perform a crucial role within the
economy so that Board Committees are also charged with monitoring bank stability, liquidity and capital adequacy for the benefit of shareholders, depositors and the financial sector and the community at large.
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Appendix [A]. The Principles of the Central Bank of Jordan (CBJ) Code.¹

The following sets out the main principles of the CBJ Code 2007 concerning the Board of Directors and Board Committees.

The Pillars of the Code:

1) Commitment to Corporate Governance

i) The Bank has compiled this Code, which has been approved by the Bank’s Board and is published. An up-to-date version of the Code is available to the public on request and on the Bank’s website.

ii) The Bank has formed a corporate governance committee of the Board, comprising the Chairman of the Board and two of the non-executive Directors, to direct the preparation, updating, and implementation of the Code.

iii) The Bank on an annual basis publicly reports its compliance with the Code, where necessary detailing how each provision of the Code has been implemented and, where relevant, where and why the Bank’s executive management has adopted procedures that are different from those recommended by the Code.

2) The Functions of the Board of Directors

a) General principles

i) The Board of Directors has overall responsibility for the operations and the financial soundness of the Bank and ensures that the interests of shareholders, depositors, creditors, employees, and other stakeholders, including the Central Bank of Jordan, are met. The Board ensures that the Bank is managed prudently and within the framework of laws and regulations and the Bank’s own policies.

ii) The Bank affirms that the obligations of each Director are owed to the Bank as a whole, and not to any particular shareholder.

iii) The Board sets the Bank’s strategic goals, as well as overseeing the executive management of the Bank. The day-to-day operation of the Bank is the responsibility of executive management, but the Board as a whole ensures and certifies that internal control systems are effective and that the Bank’s activities comply with strategy, policies and procedures approved by the Board or as required by law or regulation. As a critical part of these internal controls, the Board ensures that all dimensions of the Bank’s risk are managed properly.

b) The Chairman and the General Manager

i) The position of Chairman of the Board is separated from that of General Manager. In addition, there is no family relationship up to the third degree between the Chairman and the General Manager. The division of responsibilities between the Chairman and the General Manager has been set down in writing, is subject to review and revision from time to time as necessary, and is approved by the Board.

ii) If the Chairman is an executive, then the Bank will consider appointing an independent member of the Board as a Deputy Chairman to act as an independent resource and conduit for shareholders. The Bank acknowledges that it is international best practice to have a non-executive Chairman, and will keep this matter under review.

iii) The status of the Chairman (whether executive or non-executive) is publicly disclosed.

c) The role of the Chairman of the Board

i) The Chairman promotes a constructive relationship between the Board and the Bank’s executive management, and between the executive Directors and the non-executive Directors.

ii) The Chairman promotes a culture in the boardroom that encourages constructive criticism and alternative views on certain issues under consideration, and encourages discussion and voting on these issues.
iii) The Chairman ensures that both Directors and the Bank’s shareholders receive adequate and timely information.

iv) The Chairman ensures high standards of corporate governance by the Bank.

d) Composition of the Board

i) The Bank intends that the composition of the Board is determined in order to obtain the optimal mix of skills and experience. Accordingly, there should be a mix of executive Directors (i.e. Directors who also occupy an operational management position in the Bank) and non-executive Directors (i.e. Directors who do not have an operational management position in the Bank). To establish a substantial weight of non-executive opinion on the Board, the majority of Directors shall be non-executive. Some of these non-executive Directors may also be described as independent Directors.

ii) To foster an independent element within the Board, the Bank’s policy is that the Board should have at least three independent, non-executive, Directors.

iii) An ‘independent’ Director (whether natural person or representing legal entity) is one whose directorship constitutes his only connection to the Bank, and whose judgment is therefore unlikely to be influenced by external considerations. Minimum standards for an ‘independent’ Director include:

(1) one who has not been employed by the Bank for the preceding three years;

(2) is not a relative (up to the second degree) of an administrator of the bank;

(3) is not receiving payment or compensation from the Bank (other than as a Director);

(4) is not a director or owner of a company with which the Bank does business (other than business relationships made in the ordinary course of business of the Bank and
on substantially the same terms as those prevailing at the time for comparable transactions with non-affiliated parties);

(5) is not, nor in the past three years has been, affiliated with or employed by a present or former auditor of the Bank; and

(6) is neither a shareholder with effective interest in the capital of the Bank nor affiliated with one.

e) Board practices

i) The Bank’s Board meetings take place at least six times a year. In order to ensure that a full range of topics is considered, it is the practice of the Bank’s executive management to schedule a specific topic to be highlighted at each meeting.

ii) The Bank’s policy is that the Board should include independent element in order that it can exercise objective judgment. In addition, the independent element enables the Board to maintain a level of checks and balances to balance the influence of all parties, including executive management and significant shareholders, and ensures that decisions are taken in the Bank’s best interest.

iii) The Bank provides adequate information to Directors sufficiently in advance of meetings to enable them to reach informed decisions.

iv) A permanent written record of Board discussions and Directors’ votes is kept by the Board Secretary.

v) The responsibilities of the Board shall be clearly identified in accordance with relevant legislation. Each Director of the Bank is provided with a formal appointment letter upon his election, in which he is advised about his rights, responsibilities and duties.
vi) The categories of transactions that require Board approval (including loans larger than a set amount and transactions with related parties) have been clearly defined in writing.

vii) It is a key responsibility of Directors to ensure they be kept informed of developments within the Bank, and in the banking industry as a whole, both local and international. Accordingly, the Bank provides Directors with appropriate briefings regarding the Bank throughout their tenure, and upon the Director’s request.

viii) Individual Directors have independent access to executive management, and in particular the Committees of the Board have access to executive management.

ix) The Board and its Committees have access, as required, to external resources, to enable them to adequately fulfill their mandate.

x) The Bank has drawn up an organisation chart, showing lines of reporting and authority, and including board and executive management committees. The portion of the chart showing the more senior levels is made public.

xi) The Bank believes that the role of Board Secretary (or Company Secretary) is an important one. In addition to the arrangement of Board meetings and the taking of meeting minutes, the responsibilities include ensuring that Board procedures are followed, and that information is conveyed between the members of the Board, the members of the Board Committees, and the executive management. The function and duties of the Board Secretary are formally defined in writing and, in accordance with this level of responsibility, any decision on the Board Secretary’s removal, as well as his appointment, is taken by the whole Board.

f) Board activities: appointments and succession

i) The Board’s policy is to appoint a General Manager with integrity, technical competence, and experience in banking.

ii) The Board is required to approve the appointment of some senior executives such as the Chief Financial Officer and the head of internal audit, and to ensure that they have the requisite skills.
iii) The Board has approved executive management succession plans for senior executives of the Bank, which set out the required qualifications and requirements of the positions.

**g) Board activities: Self-Assessment and the General Manager Performance Appraisal**

i) The Board, through the Nominations and Remuneration Committee, at least annually assesses its own performance as a Board.

ii) There is a formal annual evaluation of the General Manager by the Board.

**h) Board activities: planning, controls, code of conduct, conflict of interest policy**

i) The Board has established the Bank’s business objectives, and has directed the executive management to draw up a business strategy for achieving them. Through a planning process, involving input from the Bank’s various departments, executive management also draws up business plans that are consistent with these strategies. The Board is required to approve the strategy, and the business plans, and the Board ensures that performance against plan is reviewed and that corrective action is taken as needed. The Bank’s budgeting process is part of the short-term planning and performance measurement.

ii) The Board ensures that the Bank maintains a high degree of integrity in its operations. Formal policies, including a Code of Conduct, and definitions and controls on conflicts of interest and insider dealing, have been established and are required to be assented to by all employees and Directors, and these have been published.

**3) Board Committees**

**a) General principles**

i) The Board is ultimately responsible for the conduct of the Bank’s affairs, but for greater efficiency Board Committees have been set up with formally delegated
objectives, authorities, responsibilities and tenure, in the form of board committee charters or terms of reference. The Board Committees regularly report to the full Board and do not substitute for the Board and its’ responsibilities.

ii) There is a formal and transparent process for appointments to the Board Committees. The membership of Board Committees, together with summaries of their responsibilities and duties, are disclosed in the Bank’s Annual Report.

iii) The Board may decide to combine the functions of several Committees if appropriate or if administratively more convenient.

b) The Audit Committee

i) In accordance with the Banking Law the Bank has an Audit Committee comprising three non-executive Directors. Membership of the Audit Committee is disclosed in the Annual Report.

ii) The Bank’s policy is that at least two members of the Audit Committee should have relevant financial management qualifications and/ or expertise and at least two members of the Audit Committee are independent Directors.

iii) The Audit Committee has all the duties and responsibilities required by the Banking Law and other relevant laws and regulations, including the duties to review:

(1) the scope, results and adequacy of the Bank’s internal and external audits,

(2) the accounting judgements that are intrinsic to the financial statements; and

(3) the Bank’s internal controls.

iv) The Audit Committee recommends to the Board the appointment or the removal, the remuneration, and other contractual terms of the external auditors, in addition to assessing the objectivity of the external auditors, including the consideration of any other non-audit work performed by the external auditors.
v) The Audit Committee has, by a specific provision in the written charter of its functions and responsibilities, the ability to obtain any information from executive management, and the ability to call any executive or Director to attend its meetings.

vi) The Audit Committee meets each of the Bank’s external auditors, its internal auditors and its compliance officers, without executive management being present, at least once a year.

vii) The Bank recognises that the Audit Committee does not substitute for the responsibilities of the Board of Directors or the Bank’s executive management for the supervision and adequacy of the Bank’s internal control systems.

c) The Nominations and Remuneration Committee

i) The Nominations and Remuneration Committee comprises a minimum of three non-executive Directors, the majority of which (including the Committee chairman) are independent.

ii) The Nominations and Remuneration Committee nominates all Board appointments, duly considering candidates’ abilities and qualifications and, for re-nominations, their attendance and the quality and extent of their participation in Board meetings. In accordance with the Companies Law, the tenure of the Board of Directors expires every four years from the date of election, and each Director may re-submit itself for election at the Annual General Assembly.

iii) The Nominations and Remuneration Committee makes the determination of whether a Director is ‘independent’ considering the minimum standards for independence set out in this Code.

iv) The Nominations and Remuneration Committee has implemented a formal method of assessing the effectiveness of the Board. Performance criteria are objective and include comparison with other similar banks and financial institutions, as well as safety and soundness criteria and regulatory compliance.
v) The Nominations and Remuneration Committee is responsible for providing background briefing material for Directors as requested, as well as ensuring that they are kept up to date on relevant banking topics. The Bank encourages Directors to attend seminars and events that allow them meet local and international organizations, entities and companies.

vi) The Nominations and Remuneration Committee recommends to the Board the remuneration (including monthly salary and other benefits) of each Director and the General Manager. The Nominations and Remuneration Committee also reviews the remuneration (including salaries) of other executive management.

vii) The Nominations and Remuneration Committee ensures that the bank has a remuneration policy, which is sufficient to attract and retain qualified individuals, and is in line with the Bank’s peers in the market.

viii) A summary of the Bank’s remuneration policy is disclosed in the Annual Report. In particular, the remuneration of individual Directors and the highest-paid non-Director executives is disclosed, including salary and benefits in kind.

d) The Risk Management Committee

i) The review of risk management is handled by a Risk Management Committee. This Committee is comprised of Directors and may also include executive management.

ii) The Board on a regular basis reviews and approves the risk management strategies and policies of the Bank. Executive management is responsible for implementing the strategies that have been approved by the Board, and for developing the policies and procedures for managing the various types of risk.

iii) The structure and development of a coherent and comprehensive risk management department within the Bank has been proposed by executive management, reviewed by the Risk Management Committee, and approved by the Board.

iv) The Bank considers that the rapid development and increasing complexity of risk management requires that the Risk Management Committee keep fully informed of
the developments in the Bank’s risk management functions. Accordingly, the Committee makes regular reports to the full Board.
Appendix [B]. The Principles of the Amman Stock Exchange (ASE) Code.²

The following sets out the main principles of the ASE Code 2007 concerning the Board of Directors and Board Committees.

Section One: Board of Directors Tasks and Responsibilities

The board of directors shall set an internal by-law to be reviewed annually, which defines in details the duties, powers, and responsibilities of the board of directors, including:

1. Setting strategies, policies, plans and procedures that realize the objectives of the company, serve its interests, maximize the rights of its shareholders, and serve the local community.
2. Setting necessary procedures to ensure that all shareholders, including non-Jordanians, enjoy their full rights and that they are treated in justice and equality without any discrimination.
3. Taking necessary measures to ensure compliance with the laws in force.
4. Setting a risk management policy to address the risks that the company may face.
5. Organizing the company's financial, accounting and administrative affairs by means of special internal regulations.
6. Preparing annual, semi-annual and quarterly reports and annual preliminary results on the company's activities, including financial statements for each period in accordance with the laws in force. Dates of disclosure of these financial statements should be announced at least before three working days.
7. Setting the company's disclosure and transparency policy, and overseeing its implementation in accordance with the requirements of the regulatory authorities and the laws in force.
8. Setting procedures that forbid insiders in the company from using inside information to achieve material or moral gains.
9. Setting a clear authorization policy for the company identifying the authorized personnel and the limits of the powers entrusted to them.


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10. Appointing the company's general manager and terminating his services.

11. Defining duties and powers of the company's executive management.

12. Taking necessary steps to ensure internal supervision on the company’s work in progress, including ensuring compliance with the laws in force, the requirements of supervisory authorities, policies, plans and procedures set by the board of directors.

13. Reviewing and evaluating the performance of the company’s executive management, and the degree to which it implements the strategies, policies, plans and procedures in force.

14. Setting a mechanism for receiving shareholders' complaints and suggestions, including those related to listing certain items on the agenda of the general assembly meeting, in a manner that would ensure that they are studied and that proper action is taken on them within a certain period of time.

15. Adopting criteria for granting incentives, compensations, and privileges to members of the board of directors and executive management, in a manner that serves the company’s interests and realizes its objectives.

16. Setting a policy to organize relations with stakeholders in a manner that ensures fulfilment of the company’s commitments towards them, safeguards their rights, provides them with adequate information, and maintains good relations with them.

17. Setting written procedures for implementing the rules of good corporate governance in the company and reviewing them annually to evaluate the degree to which they are implemented.

Section Two: Committees Formed by the Board of Directors

1. The board of directors shall form the following permanent committees:

A. The Audit Committee, whose tasks are defined under the “Disclosure and Transparency Chapter.”

B. The Nominations and Compensations Committee, whose main tasks are:

1. Ensuring the independence of independent members on a continuous basis.

2. Setting the policy of compensations, privileges, incentives, and salaries and to review them on a yearly basis.

3. Defining the company's needs of qualifications at the upper executive management and employees levels, and the criteria for their selection.
4. Drawing the company’s human resources and training policy, monitoring its implementation, and reviewing it on an annual basis.

2. The committees shall be composed of not less than three non-executive members of the board of directors, at least two of whom must be independent members and one of the two independent members must preside over the committee.

3. The committees with the approval of the board of directors shall set written procedures that regulate their activities and define their duties.

4. The committees above-mentioned shall make their decisions and recommendations by an absolute majority vote by their members.

5. The committees shall submit their reports and recommendations to the board of directors, and a report on their activities to the company’s general assembly annual meeting.

6. The committees shall enjoy the following powers:

A. Requesting any information from the company's employees who should cooperate in providing this information fully and accurately.

B. Seeking legal, financial, administrative or technical advice from any external consultant.

C. Requesting the presence of any employee to provide the committee with more clarifications.

7. The board of directors may form committees to carry out specific tasks for limited periods of time in accordance with procedures that define issues related to the committee such as its mandate, duration and powers.

Section Three: Meetings of the Board of Directors

1. The board of directors shall be convened to meet by a written invitation from its chairman or by a written request submitted to the chairman by at least one-quarter of the board members, in the presence of the absolute majority of board members.

2. Voting on the board of directors’ decisions shall be in person. Voting by proxy, by correspondence, or by any other indirect manner shall not be permitted.

3. Decisions of the board of directors shall be adopted by an absolute majority of members present at the meeting.

4. The board of directors shall meet at least once every two months, provided that the number of meetings in the fiscal year must not be less than six.
5. The board of directors shall appoint the secretary of the board who shall record minutes of board meetings and its decisions, as well as the list of members present and any reservations that they express in a special sequentially numbered register.

Chapter Three: General Assembly Meetings

1. The general assembly is composed of all shareholders who have the right to vote.
2. The general assembly shall hold an ordinary meeting at least once a year, provided that it takes place within the four months following the end of the company’s fiscal year. The general assembly may also hold an extraordinary meeting at any time in accordance with the legislations in force.
3. The board of directors shall address an invitation to each shareholder to attend the general assembly meeting, which should be delivered either by hand, or ordinary mail and e-mail to the shareholder at least twenty one days before the date set for the meeting. Appropriate preparations should be made for the meeting, including the choice of time and place, in a manner that encourages and helps the largest possible number of shareholders to attend.
4. The invitation to the meeting should specify the place and time of the meeting. It should be accompanied by the agenda of the meeting which should include in detail and clear manner topics to be addressed, in addition to any documents or attachments related to these subjects. The rules of good corporate governance for companies require that no new topic should be addressed at the meeting that was not listed on the agenda sent previously to the shareholders.

Chapter Five: Disclosure and Transparency

1. The company shall establish written work procedures in accordance with the disclosure policy adopted by the board of directors to regulate disclosure of information and follow up on the implementation of the policy in accordance with the requirements of the regulatory authorities and the legislations in force.
2. The company shall provide shareholders and investors with accurate, clear, timely disclosure information, in accordance with the requirements of the supervisory authorities and the legislations in force, in a manner that would enable them to take their decisions.
Section One: The Audit Committee

1. All members of the Audit Committee must have knowledge and experience in finance and accounting, and at least one of them must have worked previously in accounting or finance fields, and that person must have an academic or professional certificate in accounting, finance or related fields.
2. The Committee shall meet regularly, not less than four times a year, and minutes of its meetings must be taken appropriately.
3. The company shall put at the disposal of the Committee all facilities that it needs to perform its duties, including the authority to seek expert assistance whenever needed.
4. At least once a year, the Audit Committee shall meet with the company’s external auditor, without the presence of the executive management or any person representing it.

Section Two: Duties of the Audit Committee

The Audit Committee shall undertake the task of overseeing and monitoring accounting and internal control and auditing activities in the company, including the following:
1. Discussing matters related to the nomination of the external auditor to ensure that he meets all the requirements stipulated in legislations in force, and to ensure his independence.
2. Discussing matters related to the work of the external auditor, including his, observations, suggestions, and reservations, pursuing the level of responsiveness of the company’s management to them, and submitting recommendations to the board of directors accordingly.
3. Reviewing the company’s correspondence with the external auditor, evaluating its contents, and providing comments and recommendations thereabout to the board of directors.
4. Monitoring the company's compliance with Laws and regulations in force, and the requirements of regulatory institutions.
5. Studying periodic reports prior to their presentation to the board of directors, and submitting recommendations thereabout, with emphasis on:
   A. Any change in the company’s accounting policies.
B. Any change in the company's accounts as a result of the auditing processes or the suggestions of the external auditor.

6. Studying the external auditor's plan of work, and ensuring that the company provides him with all facilities needed to perform his work.

7. Studying and evaluating the internal control and auditing procedures.

8. Reviewing the external auditor’s evaluation of internal control and auditing procedures.

9. Reviewing the external auditor’s reports, particularly those related to any violations revealed by the internal auditor.

10. Submitting recommendations to the board of directors regarding internal audit procedures and the work of the external auditor.

11. Ensuring that no conflict of interest may arise from the company’s transactions, contracts or projects with related parties.

12. Reviewing and approving related party transactions prior to their ratification by the company.

13. Any other issues determined by the board of directors.

Section Three: Powers of the Audit Committee

1. Requesting the presence of the external auditor if the Committee sees the need to discuss with him any issues related to his work at the company. It also has the authority to request clarifications or to seek his opinion in writing.

2. Submitting recommendations to the board of directors to nominate the external auditor for election by the general assembly.

3. Nominating a candidate to be appointed as the company’s internal auditor.

The ASE Code for all listed Companies that follows the Jordanian *Companies Law* includes a group of general, mandatory and guidance rules. The general and mandatory rules are compulsory rules and the listed companies must follow them under penalty of legal liability that requires punishment according to the progress legislation. The following shows each role as well as other issues whether it is a general or mandatory or guidance principle.³

(A) The Board of Directors of a Shareholding Company

1. The administration of the Company is entrusted to a board of directors whose members shall be not less than five and not more than thirteen, as determined by the Company’s memorandum of association. Principles of good corporate governance require that board members be elected by the company’s general assembly in a secret ballot, by means of cumulative voting system, provided that at least one third of the board members are independent members. If the result in calculating the above-mentioned third is with a fraction, the fraction is removed by rounding the result to the following figure. (Guidance Rule)

2. The board of directors shall manage the company for the period specified in the company’s memorandum of association, provided that this period must not be less than three years and not more than four years starting on the date of its election. (Mandatory Rule)

3. A legal board member person shall name a natural person to represent him during the board’s term of office. (Guidance Rule)

4. The board of directors represents all shareholders. It should exercise due professional care in managing the company, and devote the time needed to carry out

its activities in honesty and transparency in order to serve the company's interests and realize its objectives. (General Rule)

5. It is not allowed for one person to hold the positions of chairman of the board of directors and any executive position in the company at the same time. (Guidance Rule)

6. Member of the board of directors should be qualified and enjoys adequate knowledge and experience in administrative affairs. He should also be aware of relevant legislation and of the rights and duties of the board. (Guidance Rule)

7. A member of the board of directors or his representative should not be a member of the board or a representative of a member of the board of directors of another company that has similar business, has identical objectives, or is a competitor thereof. In all cases, a natural person must not combine membership of the boards of more than five companies whether in his personal capacity or as a representative of a legal person. (Mandatory Rule)

8. The company is not allowed to provide a cash loan of any kind to the chairman or any member of the board of directors or to any of their relatives. Excluded from this condition are banks and financial companies that may advance loans to any of the aforesaid persons within the limits of these companies’ objectives and in accordance with the same conditions that apply to all customers. (Mandatory Rule)

9. The company shall provide members of the board of directors with all information and data related to the company, to enable them to perform their duties and to be aware of all aspects related to the company's work. (Guidance Rule)

10. The board of directors shall ensure that members of the executive management have the administrative and technical qualifications and experience that they need to carry out their duties. (Mandatory Rule)
11. The board may seek the opinion of any external consultant at the company’s expense provided that the majority of board members approve the measure and that there is no conflict of interests. (Guidance Rule)

12. The chairman of the board of directors or any board member or the company’s general manager or its auditor is required, under legal responsibility, to notify the supervisory authorities concerned in any of the following cases:
   A. If the company suffers financial or administrative disorders or if it suffers serious losses that affect the rights of its shareholders or creditors.
   B. If the company’s board of directors or any board member or the company’s general manager exploits his/their powers and position/s in any manner that derives benefit to him/ them or to others in an illegal manner. This provision shall apply equally should any of the above refrain from carrying out this an activity that is required by law.
   C. If the company’s board of directors or any board member or the company’s general manager perform any act that implies fraud, embezzlement, misrepresentation, forgery or betrayal of confidence in a manner that affects the rights of the Company, its shareholders or others. (Mandatory Rule)

(B) Board of Directors Tasks and Responsibilities

The board of directors shall set an internal by-law to be reviewed annually, which defines in details the duties, powers, and responsibilities of the board of directors, including:
1. Setting strategies, policies, plans and procedures that realize the objectives of the company, serve its interests, maximize the rights of its shareholders, and serve the local community. (Guidance Rule)

2. Setting necessary procedures to ensure that all shareholders, including non-Jordanians, enjoy their full rights and that they are treated in justice and equality without any discrimination. (General Rule)

3. Taking necessary measures to ensure compliance with the laws in force. (General Rule)
4. Setting a risk management policy to address the risks that the company may face. (Guidance Rule)

5. Organizing the company's financial, accounting and administrative affairs by means of special internal regulations. (Mandatory Rules)

6. Preparing annual, semiannual and quarterly reports and annual preliminary results on the company's activities, including financial statements for each period in accordance with the laws in force. (Mandatory Rule) Dates of disclosure of these financial statements should be announced at least before three working days. (Guidance Rule)

7. Setting the company’s disclosure and transparency policy, and overseeing its implementation in accordance with the requirements of the regulatory authorities and the laws in force. (Guidance Rule)

8. Setting procedures that forbid insiders in the company from using inside information to achieve material or moral gains. (Guidance Rule)

9. Setting a clear authorization policy for the company identifying the authorized personnel and the limits of the powers entrusted to them. (Guidance Rule)

10. Appointing the company's general manager and terminating his services. (Mandatory Rule)

11. Defining duties and powers of the company’s executive management. (Mandatory Rule)

12. Taking necessary steps to ensure internal supervision on the company's work in progress, including ensuring compliance with the laws in force, the requirements of supervisory authorities, policies, plans and procedures set by the board of directors. (Guidance Rule)
13. Reviewing and evaluating the performance of the company’s executive management, and the degree to which it implements the strategies, policies, plans and procedures in force. (Guidance Rule)

14. Setting a mechanism for receiving shareholders' complaints and suggestions, including those related to listing certain items on the agenda of the general assembly meeting, in a manner that would ensure that they are studied and that proper action is taken on them within a certain period of time. (Guidance Rule)

15. Adopting criteria for granting incentives, compensations, and privileges to members of the board of directors and executive management, in a manner that serves the company’s interests and realizes its objectives. (Guidance Rule)

16. Setting a policy to organize relations with stakeholders in a manner that ensures fulfillment of the company’s commitments towards them, safeguards their rights, provides them with adequate information, and maintains good relations with them. (Guidance Rule)

17. Setting written procedures for implementing the rules of good corporate governance in the company and reviewing them annually to evaluate the degree to which they are implemented. (Guidance Rule)

(C) Meetings of the Board of Directors

1. The board of directors shall be convened to meet by a written invitation from its chairman or by a written request submitted to the chairman by at least one-quarter of the board members, in the presence of the absolute majority of board members. (Mandatory Rule)

2. Voting on the board of directors’ decisions shall be in person. Voting by proxy, by correspondence, or by any other indirect manner shall not be permitted. (Mandatory Rule)
3. Decisions of the board of directors shall be adopted by an absolute majority of members present at the meeting. *(Mandatory Rule)*

4. The board of directors shall meet at least once every two months, provided that the number of meetings in the fiscal year must not be less than six *(Mandatory Rule)* and the number of meetings should be included in the annual report. *(Guidance Rule)*

5. The board of directors shall appoint the secretary of the board who shall record minutes of board meetings and its decisions, as well as the list of members present and any reservations that they express in a special sequentially numbered register. *(Mandatory Rule)*

**(D) Committees Formed by the Board of Directors**

1. The board of directors shall form the following permanent committees:
   A. The Audit Committee, whose tasks are defined under the “Disclosure and Transparency Chapter.” *(Mandatory Rule)*

   B. The Nominations and Remuneration Committee, whose main tasks are:
      I. Ensuring the independence of independent members on a continuous basis.
      II. Setting the policy of compensations, privileges, incentives, and salaries and to review them on a yearly basis.
      III. Defining the company's needs of qualifications at the upper executive management and employees levels, and the criteria for their selection.
      IV. Drawing the company’s human resources and training policy, monitoring its implementation, and reviewing it on an annual basis. *(general, mandatory and guidance rules)*. *(Guidance Rule)*

2. The committees shall be composed of not less than three non-executive members of the board of directors, at least two of whom must be independent members and one of the two independent members must preside over the committee. *(Guidance Rule)*

3. The committees with the approval of the board of directors shall set written procedures that regulate their activities and define their duties. *(Guidance Rule)*
4. The committees above-mentioned shall make their decisions and recommendations by an absolute majority vote by their members. (General Rule)

5. The committees shall submit their reports and recommendations to the board of directors, and a report on their activities to the company’s general assembly annual meeting. (Guidance Rule)

6. The committees shall enjoy the following powers:
   A. Requesting any information from the company's employees who should cooperate in providing this information fully and accurately.
   B. Seeking legal, financial, administrative or technical advice from any external consultant.
   C. Requesting the presence of any employee to provide the committee with more clarifications. (For the responsibilities of Audit Committee; Mandatory Role and For the responsibilities of the other Committees; guidance rule)

7. The board of directors may form committees to carry out specific tasks for limited periods of time in accordance with procedures that define issues related to the committee such as its mandate, duration and powers. (Guidance rule)

(E) Disclosure and Transparency

1. The company shall establish written work procedures in accordance with the disclosure policy adopted by the board of directors to regulate disclosure of information and follow up on the implementation of the policy in accordance with the requirements of the regulatory authorities and the legislations in force. (Guidance rule)

2. The company shall provide shareholders and investors with accurate, clear, timely disclosure information, in accordance with the requirements of the supervisory authorities and the legislations in force, in a manner that would enable them to take their decisions. (Mandatory Role) This includes disclosures related to:
   - Periodic reports.
   - Material information.
- Dealings of insiders and their relatives in securities issued by the company, including members of the board of directors and upper executive management.
- Related party transactions. (Guidance rule)

3. The company shall organize its accounts and keep its books and records in accordance with the International Financial Reporting Standards (IFRS). (Mandatory Role)

4. The company shall use its internet web-site to enhance disclosure and transparency, and to provide information. (Guidance rule)

5. The company shall disclose its policy regarding the local community and the environment. (Guidance rule)

6. No insider in the company may disclose inside information related to the company to parties other than the authorities concerned or the judiciary. It is not allowed to trade in securities issued by the company or to urge others to trade in them based on inside or secret information, to achieve financial or incorporeal benefit. (Mandatory Role).
Appendix [D]. The Penalties of the Jordanian Laws.

Here are some of the main penalties of the Jordanian Banking Law, Companies Law, and Securities Law which are related with the supervision laws.

1. The Jordanian Banking Law

Article (26)

The general manager of a bank shall have the following obligations:

a. Effecting internal control on the conduct of the bank operations and ensuring compliance with laws, regulations, and directives in force.

b. Providing the board of directors of the bank with periodical status reports, ensuring that all of the bank's activities are carried out according to the board of director's policies, and recommending to the board of directors any proposals he deems necessary for improving the business of the bank.

c. Providing the Central Bank with information and data required by the provisions of this law and the regulations and orders issued pursuant thereto.

Article (32)

a. An "auditing committee" shall be formed in each bank by decision of its board of directors comprising a chairman and two members selected by the bank board of directors from among its members other than those entrusted with executive tasks within the bank. It shall continue to function throughout the tenure of the board of directors and shall assume the following duties and authorities:

1. Monitoring the extent of comprehensiveness of the external audit of the bank's operations, and ensuring coordination between the external auditors in case they are more than one.

2. Reviewing the observations in the reports of the Central Bank and the reports of the external auditor, and following up measures taken in their respect.

3. Studying the annual plan of the internal audit and reviewing the notes in the inspection reports and the internal audit reports, and following up measures taken in their respect.

4. Reviewing the financial statements of the bank before presenting them to the board of directors, particularly, verifying the orders of the Central Bank regarding the adequacy of doubtful debts' provisions and securities portfolios' provisions, as well as giving opinion on the non-performing debts of the bank and on those proposed to be classified as bad debts.

5. Ascertaining the accuracy and soundness of the accounting and control procedures and the extent of compliance therewith.

6. Ensuring full compliance with the laws, regulations, and orders governing the activities of the bank.

**Article (70)**

a. A bank and any subsidiary thereof shall be subject to inspection by the Central bank or by auditors appointed for inspection by the Central Bank at the bank's expense. The bank and its subsidiaries shall cooperate therewith to enable them to perform their tasks in full.

b. If the bank to be inspected is a branch of a foreign bank or a subsidiary thereof, it shall be subject to the inspection of the competent supervisory authorities in the country of its head office or regional office, in addition to the inspection of the Central Bank.

c. The Central Bank and the auditors appointed thereby, shall, during their inspection of a bank and any of its subsidiaries, be authorized of the following:

1. To examine and obtain copies of any accounts, records, and documents, including minutes of the meetings and resolutions of the board of directors and the auditing committee.

2. To ascertain that the statements of accounts of a foreign bank branch operating in the Kingdom include the consolidated budget, end of year balance of accounts and the income statement of the parent company and its branches in other countries.

3. To request the bank’s administrators, agents and subsidiaries to provide them with any information, which the Central Bank or the appointed auditors deem necessary for this purpose.
**Article (75)**

A person who has violated the provisions of Article 72\(^5\) or Article 73\(^6\) of this law shall be punished with imprisonment for a period not less than six months, a fine not less than ten thousand Dinars and not more than fifty thousand Dinars, or with both penalties.

**Article (88)**

a. The Central Bank may take any measure or impose any penalty of those provided for in paragraph (b) of this Article in the cases where it is realized that a bank or any of its administrators has committed any of the following violations:

1. Contravention of the provisions of this law or any regulations, instructions, or orders issued pursuant thereto.
2. Conducting by the bank or one of its subsidiaries unsound and unsafe operations against the interest of shareholders, creditors, or depositors thereof.

b. Subject to the provisions of paragraph (d) of this Article, if any of the violations provided for in paragraph (a) of this Article is committed, the Governor may take one or more of the measures or impose one or more of the penalties provided below:

1. Addressing a written warning.
2. Instructing the bank to submit a satisfactory program of measures to be taken thereby to eliminate the violation and rectify the situation.
3. Instructing the bank to cease certain activities, or forbidding the bank from distributing dividends.

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\(^5\) Article 72 says that:
“A bank shall observe full confidentiality regarding all accounts, deposits, trusts, and safe-deposit boxes of its customers. It shall be prohibited from providing directly or indirectly any information thereon except upon a written consent of the owner of such account, deposit, trust or the safe-deposit box, or an heir of his, upon a decision issued by a competent judicial authority in a current litigation, or due to one of the permissible situations pursuant to the provisions of this law. This prohibition shall remain in effect even if the relationship between the Bank and the client has terminated for any reason whatsoever.”

\(^6\) Article 73 says that:
“All present and former administrators of the bank shall be prohibited from providing any information or data on the clients or their accounts, deposits, trusts, safe-deposit boxes, or any of their transactions, or disclosing or enabling others to have access to such information and data in situations other than those permitted under this law. Such prohibition shall apply to anyone who by virtue of his profession, position or work, directly or indirectly, may have access to such information and data, including employees of the Central Bank and auditors.”
4. Imposing a fine on the bank not exceeding one hundred thousand Jordanian Dinars.

5. Instructing the bank to temporarily suspend from service any administrator, other than a member of its board of directors, or to dismiss such administrator, depending on the gravity of the violation.

6. Removing the chairman or any member of the board of directors of the bank.

7. Dissolving the board of directors of the bank and placing the bank under the management of the Central Bank for a period not to exceed twenty four months. The Governor may extend the said period as necessary.

8. Revoking the license of the bank.

c. Before taking any of the measures or imposing any of the penalties prescribed in items 4, 5, 6, 7, and 8 of paragraph (b) of this Article, the Governor shall obtain the prior consent of the Board.

d. Any interested party may contest measures or decisions of the Central Bank, provided for in paragraph (b) of this Article, to the Supreme Court of Justice within thirty days as of the date the measure was taken or the decision issued.

e. Should it be decided to take any measure or to impose any penalty provided for in this Article, this shall not preclude the civil and criminal accountability under the provisions of any other legislation.

2. The Jordanian Companies Law

Article (279)


a) Should a Public Shareholding Company, a Limited Partnership in Shares, a Limited Liability Company or a Private Shareholding Company commit any violation to the provisions of this Law, it shall be penalized by a fine not less than one thousand USD.

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Jordanian Dinars (USD 1418) and not more than ten thousand Jordanian Dinars (USD14178), along with nullification of the violating act if the Court deems so.

Article (280)

The Penalty of the Auditor Violating the Provisions of this Law An auditor who violates the provisions of this Law by submitting reports or statements incompatible with the real position of the Company which he audited, shall be deemed to have committed a crime, and shall be penalized therefore by imprisonment for a period not less than six months and not more than three years, or by a fine of not less than one thousand Dinars or by both penalties, and that shall not preclude subjecting him to the penalties provided for under the auditing profession laws in force.

3. The Jordanian Securities Law

Article (43)

A- Every Issuer shall file with the Commission, in accordance with the instructions issued by the Board, and publish the following periodic reports:
1. An annual report, including financial statements certified by an auditor, within 90 days of the end of its fiscal year;
2. A semi-annual report within 30 days of the end of its biannual fiscal year;
3. A preliminary report about its activities submitted after a preliminary audit thereof, within a maximum period forty five days from the end of the fiscal year;
4. A report pertaining to the election of the board of directors or the executive board or any change in the composition or identity of any members thereof.

B- The Board may prescribe the form and content of the reports required under Paragraph (A) of this Article, provided it specifies the persons required to sign the report. In so doing, the Board shall give due consideration to the feasibility of electronic filing.

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C- Publication of the reports specified in Paragraph (A) of this Article may be in a local daily newspaper, or by means of written or electronic mailings addressed to each security holder or by such other means adopted by Commission according to instructions issued by the Board.

D- Every Issuer must make public, and file with the Commission, any material facts upon recognizing such.

**Article (107)**

The following shall be regarded as a violation of the provisions of this Law:

A- Submitting false or misleading data in any document filed with the Commission;

B- Offering or selling securities on the basis of false or misleading data regarding:

1. the rights and privileges conferred by the security being offered or sold;
2. the nature of the Issuer's business, the success thereof, the Issuer's financial conditions or future prospects.

C- Certifying by an auditor or accountant of false or misleading financial statements or statements which are in violation of adopted accounting and auditing standards. In such a case, the accountant or auditor, as the case may be, shall be liable for damages to any party suffering financial loss as a result of such false or misleading financial statements.

**Article (110)**

A- Any person who violates the provisions of this Law or the regulations, instructions or decisions issued pursuant thereto shall be subject to a fine of not more than one hundred thousand (100,000) Dinars (USD141780), in addition to a fine of not less than twice the amount, and not more than five times the amount, of profit made or loss avoided by the person committing the violation.

B- Without prejudice to any stricter penalties imposed by any other legislation, and in addition to the fines specified in Paragraph (A) of this Article, any person violating the provisions of the Articles mentioned hereunder shall be subject to the following penalties:
1. Imprisonment of up to three years for violations of the provisions of Paragraph (C) of Article (63), Paragraphs (A) and (B) of Article (108), and Article (109) of this Law;

2. Imprisonment of up to one year for violations of the provisions of Subparagraph (1) of Paragraph (A) of Article (34), Paragraph (D) of Article (42), and Paragraphs (A) and (B) of Article (47) of this Law.

C- The Competent Court may exempt from the imprisonment penalty first offenders and offenders who deposit in Court or with the Commission sufficient funds to pay the amount of the fines which may be ordered by the Court, provided the funds are paid before the Court decision becomes final.

D- Accomplices, aiders and abettors shall be subject to the same penalties.
Appendix [E]. The 2014 UK Corporate Governance Code.⁹

Section A: Leadership

A.1: The Role of the Board

Main Principle

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

Supporting Principles

The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met. All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties.

Code Provisions

A.1.1. The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

A.1.2. The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the board committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.

A.1.3. The company should arrange appropriate insurance cover in respect of legal action against its directors.

A.2: Division of Responsibilities

Main Principle

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision.

Code Provision

A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.

A.3: The Chairman

Main Principle

The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.

Supporting Principle

The chairman is responsible for setting the board’s agenda and ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues. The chairman should also promote a culture of openness and debate by facilitating the effective contribution of non-executive directors in particular and ensuring constructive relations between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders.
Code Provisions
A.3.1. The chairman should on appointment meet the independence criteria set out in B.1.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.

A.4: Non-executive Directors

Main Principle

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.

Supporting Principles
Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.

Code Provisions
A.4.1. The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chairman and to serve as an intermediary for the other directors when necessary. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate.
A.4.2. The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman’s performance and on such other occasions as are deemed appropriate.
A.4.3. Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.

Section B: Effectiveness

B.1: The Composition of the Board

Main Principle

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

Supporting Principles

The board should be of sufficient size that the requirements of the business can be met and that changes to the board’s composition and that of its committees can be managed without undue disruption, and should not be so large as to be unwieldy. The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board’s decision taking. The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees. No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

Code Provisions

B.1.1. The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s
judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:
- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme;
- has close family ties with any of the company’s advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

B.1.2. Except for smaller companies, at least half the board, excluding the chairman, should comprise nonexecutive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

B.2: Appointments to the Board

Main Principle

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

Supporting Principles

The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender. The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board and to ensure progressive refreshing of the board.
**Code Provisions**

B.2.1. There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.

B.2.2. The nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

B.2.3. Non-executive directors should be appointed for specified terms subject to re-election and to statutory provisions relating to the removal of a director. Any term beyond six years for a nonexecutive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board.

B.2.4. A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments. This section should include a description of the board’s policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director. Where an external search consultancy has been used, it should be identified in the annual report and a statement made as to whether it has any other connection with the company.

**B.3: Commitment**

**Main Principle**

All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.
**Code Provisions**

B.3.1. For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman’s other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and their impact explained in the next annual report.

B.3.2. The terms and conditions of appointment of non-executive directors should be made available for inspection. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.

B.3.3. The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.

**B.4: Development**

**Main Principle**

All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

**Supporting Principles**

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors’ knowledge and capabilities.

To function effectively all directors need appropriate knowledge of the company and access to its operations and staff.
**Code Provisions**

B.4.1. The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, directors should avail themselves of opportunities to meet major shareholders.

B.4.2. The chairman should regularly review and agree with each director their training and development needs.

**B.5: Information and Support**

**Main Principle**

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

**B.6: Evaluation**

**Main Principle**

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

**Supporting Principles**

Evaluation of the board should consider the balance of skills, experience, independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness. The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors. Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties).
B.7: Re-election

Main Principle
All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

Code Provisions

B.7.1. All directors of FTSE 350 companies should be subject to annual election by shareholders. All other directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. Non-executive directors who have served longer than nine years should be subject to annual re-election. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.

B.7.2. The board should set out to shareholders in the papers accompanying a resolution to elect a nonexecutive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual’s performance continues to be effective and to demonstrate commitment to the role.

Section C: Accountability

C.1: Financial and Business Reporting

Main Principle
The board should present a fair, balanced and understandable assessment of the company’s position and prospects.

Supporting Principle
The board’s responsibility to present a fair, balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements. The board
should establish arrangements that will enable it to ensure that the information presented is fair, balanced and understandable.

**Code Provisions**

C.1.1. The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company’s position and performance, business model and strategy. There should be a statement by the auditor about their reporting responsibilities.

C.1.2. The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company.

C.1.3. In annual and half-yearly financial statements, the directors should state whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company’s ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

C.2: Risk Management and Internal Control

**Main Principle**

The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

**Code Provisions**

C.2.1. The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated.
C.2.2. Taking account of the company’s current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

C.2.3. The board should monitor the company’s risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls.

C.3: Audit Committee and Auditors

Main Principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company’s auditors.

Code Provisions

C.3.1. The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2. The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgements contained in them;
to review the company’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control and risk management systems;

to monitor and review the effectiveness of the company’s internal audit function;

to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

to review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and

to report to the board on how it has discharged its responsibilities.

C.3.3. The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.

C.3.4. Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company’s position and performance, business model and strategy.

C.3.5. The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.6. The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.
C.3.7. The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee’s recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.8. A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence are safeguarded.

Section D: Remuneration

D.1: The Level and Components of Remuneration

Main Principle

Executive directors’ remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.

Supporting Principles

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in corporate and individual performance, and should avoid paying more than is
necessary. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

**Code Provisions**

D.1.1. In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which it would be appropriate to do so.

D.1.2. Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

D.1.3. Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision B.1.1).

D.1.4. The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors’ terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors’ obligations to mitigate loss.

D.1.5. Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

**D.2: Procedure**

**Main Principle**

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual
directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles

The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. The chairman of the board should ensure that the committee chairman maintains contact as required with its principal shareholders about remuneration.

Code Provisions

D.2.1. The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, they should be identified in the annual report and a statement made as to whether they have any other connection with the company.

D.2.2. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of ‘senior management’ for this purpose should be determined by the board but should normally include the first layer of management below board level.

D.2.3. The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
D.2.4. Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

Section E: Relations with Shareholders

E.1: Dialogue with Shareholders

Main Principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors are made aware of their major shareholders’ issues and concerns. The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

Code Provisions

E.1.1. The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

E.1.2. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact, analysts’ or brokers’ briefings and surveys of shareholder opinion.
Appendix [F]. The Australian Stock Exchange Corporate Governance Council (ASX CGC)’s 8 Core Principles.\textsuperscript{10}

\textbf{Principle 1: Lay solid foundations for management and oversight}

Companies should establish and disclose the respective roles and responsibilities of board and management.
- Recommendation 1.1: Companies should establish the functions reserved to the board and those delegated to senior executives and disclose those functions.
- Recommendation 1.2: Companies should disclose the process for evaluating the performance of senior executives.
- Recommendation 1.3: Companies should provide the information indicated in the Guide to reporting on Principle 1.

\textbf{Principle 2 - Structure the board to add value}

Companies should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.
- Recommendation 2.1: A majority of the board should be independent directors.
- Box 2.1: Relationships affecting independent status
- Recommendation 2.2: The chair should be an independent director.
- Recommendation 2.3: The roles of chair and chief executive officer should not be exercised by the same individual.
- Recommendation 2.4: The board should establish a nomination committee.
- Recommendation 2.5: Companies should disclose the process for evaluating the performance of the board, its committees and individual directors.
- Recommendation 2.6: Companies should provide the information indicated in the Guide to reporting on Principle 2.

\textbf{Principle 3 - Promote ethical and responsible decision-making}

Companies should actively promote ethical and responsible decision-making.
- Recommendation 3.1: Companies should establish a code of conduct and disclose the code or a summary of the code as to:


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• the practices necessary to maintain confidence in the company’s integrity;
• the practices necessary to take into account their legal obligations and the reasonable expectations of their stakeholders; and
• the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.

• Recommendation 3.2: Companies should establish a policy concerning diversity and disclose the policy or a summary of that policy. The policy should include requirements for the board to establish measurable objectives for achieving gender diversity for the board to assess annually both the objectives and progress in achieving them.
• Recommendation 3.3: Companies should disclose in each annual report the measurable objectives for achieving gender diversity set by the board in accordance with the diversity policy and progress towards achieving them.
• Recommendation 3.4: Companies should disclose in each annual report the proportion of women employees in the whole organization, women in senior executive positions and women on the board.
• Recommendation 3.5: Companies should provide the information indicated in the Guide to reporting on Principle 3.

**Principle 4 - Safeguard integrity in financial reporting**

Companies should have a structure to independently verify and safeguard the integrity of their financial reporting.

• Recommendation 4.1: The board should establish an audit committee.
• Recommendation 4.2: The audit committee should be structured so that it:
  • consists only of non-executive directors;
  • consists of a majority of independent directors;
  • is chaired by an independent chair, who is not chair of the board; and
  • has at least three members.
• Recommendation 4.3: The audit committee should have a formal charter.
• Recommendation 4.4: Companies should provide the information indicated in the Guide to reporting on Principle 4.
Principle 5 - Make timely and balanced disclosure

Companies should promote timely and balanced disclosure of all material matters concerning the company.

- Recommendation 5.1: Companies should establish written policies designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior executive level for that compliance and disclose those policies or a summary of those policies.
- Recommendation 5.2: Companies should provide the information indicated in the Guide to reporting on Principle 5.

Principle 6 - Respect the rights of shareholders

Companies should respect the rights of shareholders and facilitate the effective exercise of those rights.

- Recommendation 6.1: Companies should design a communications policy for promoting effective communication with shareholders and encouraging their participation at general meetings and disclose their policy or a summary of that policy.
- Recommendation 6.2: Companies should provide the information indicated in the Guide to reporting on Principle 6.

Principle 7 - Recognise and manage risk

Companies should establish a sound system of risk oversight and management and internal control.

- Recommendation 7.1: Companies should establish policies for the oversight and management of material business risks and disclose a summary of those policies.
- Recommendation 7.2: The board should require management to design and implement the risk management and internal control system to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it as to the effectiveness of the company's management of its material business risks.
- Recommendation 7.3: The board should disclose whether it has received assurance from the chief executive officer (or equivalent) and the chief financial officer (or equivalent) that the declaration provided in accordance with section 295A of the
Corporations Act is founded on a sound system of risk management and internal control and that the system is operating effectively in all material respects in relation to financial reporting risks.

- Recommendation 7.4: Companies should provide the information indicated in the Guide to reporting on Principle 7.

**Principle 8 - Remunerate fairly and responsibly**

Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear.

- Recommendation 8.1: The board should establish a remuneration committee.
- Recommendation 8.2: The remuneration committee should be structured so that it:
  - consists of a majority of independent directors;
  - is chaired by an independent chair; and
  - has at least three members.
- Recommendation 8.3: Companies should clearly distinguish the structure of non-executive directors’ remuneration from that of executive directors and senior executives.
- Recommendation 8.4: Companies should provide the information indicated in the Guide to reporting on Principle 8.
Appendix [G]. Prudential Standard CPS 510 Governance.\textsuperscript{11}

It applies up to the beginning of 2015 then a revised standard comes into force. The revised standard requires Risk Committee Governance.

Objectives and key requirements of this Prudential Standard

This Prudential Standard sets out minimum foundations for good governance of an APRA-regulated institution in the deposit-taking, general insurance and life insurance industries or of a Head of a group. Its objective is to ensure that an institution is managed soundly and prudently by a competent Board (or equivalent), which can make reasonable and impartial business judgements in the best interests of the institution and which duly considers the impact of its decisions on depositors and/or policyholders.

The ultimate responsibility for the sound and prudent management of an APRA regulated institution rests with its Board of directors (or equivalent).

It is essential that an APRA-regulated institution has a sound governance framework and conducts its affairs with a high degree of integrity. A culture that promotes good governance benefits all stakeholders of an institution and helps to maintain public confidence in the institution.

The governance of an APRA-regulated institution builds on these foundations in ways that take account of the size, complexity and risk profile of the institution or group.

The key requirements of this Prudential Standard for locally incorporated APRA regulated institutions are that:
- specific requirements with respect to Board size and composition are met;
- the chairperson of the Board of directors must be an independent director;
- the Board must have a policy on Board renewal and procedures for assessing Board performance;
- a Board Remuneration Committee must be established and the institution must have a Remuneration Policy that aligns remuneration and risk management; and

- A Board Audit Committee and a Board Risk Committee must be established.

A number of the requirements in this Prudential Standard apply to foreign authorised deposit-taking institutions, Category C insurers and eligible foreign life insurance companies.

**Independence**

25. For the purposes of this Prudential Standard, an ‘independent director’ is a non executive director who is free from any business or other association including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser — that could materially interfere with the exercise of their independent judgement. The circumstances that will not meet this test of independence include, but are not limited to, those set out in Attachment A.

26. If the Board of a locally incorporated APRA-regulated institution is in doubt about a director’s independence for the purposes of this Prudential Standard, the institution may refer the matter to APRA for guidance.

**Attachment A**

A director is not independent if the director:

1. is a substantial shareholder of the APRA-regulated institution or an officer of, or otherwise associated directly with, a substantial shareholder of the institution;
2. is employed, or has previously been employed in an executive capacity by the institution or another member of the group, and there has not been a period of at least three years between ceasing such employment and serving on the Board;
3. has within the last three years been a principal of a material professional adviser or a material consultant to the institution or another member of the group, or an employee materially associated with the service provided;
4. is a material supplier or customer of the institution or another member of the group, or an officer of or otherwise associated directly or indirectly with a material supplier or customer; or

5. has a material contractual relationship with the institution or another member of the group other than as a director.

**Definition of Non-Executive Director**

27. For the purposes of this Prudential Standard, a reference to a ‘non-executive director’ is interpreted as meaning reference to a director who is not a member of the APRA-regulated institution’s management. Non-executive directors may include Board members or senior managers of the parent company of the locally incorporated institution or of the parent company’s subsidiaries, but not executives of the institution or its subsidiaries.

**C. Remuneration**

**Remuneration policy**

53. An APRA-regulated institution must establish and maintain a documented Remuneration Policy. The Remuneration Policy must outline the remuneration objectives and the structure of the remuneration arrangements, including, but not limited to, the performance-based remuneration components of that institution or group.

54. The Remuneration Policy must be approved by the Board, the senior officer outside Australia or the Compliance Committee, as relevant.

55. For the purposes of this Prudential Standard, remuneration arrangements include measures of performance, the mix of forms of remuneration (such as fixed and variable components, and cash and equity-related benefits) and the timing of eligibility to receive payments. All forms of remuneration are captured by this Prudential Standard, regardless of where, or from whom, the remuneration is sourced.
56. In addition to any other objectives, the Remuneration Policy’s performance based components of remuneration must be designed to encourage behaviour that supports: 
(a) the APRA-regulated institution’s long-term financial soundness; and 
(b) the risk management framework of the institution.

57. The performance-based components of an APRA-regulated institution’s remuneration arrangements must be designed to align remuneration with prudent risk-taking and must incorporate adjustments to reflect: 
(a) the outcomes of business activities; 
(b) the risks related to the business activities taking account, where relevant, of the cost of the associated capital; and 
(c) the time necessary for the outcomes of those business activities to be reliably measured.

58. The Remuneration Policy must provide for the Board, the senior officer outside Australia or the Compliance Committee, as relevant, to adjust performance based components of remuneration downwards, to zero if appropriate, in relation to relevant persons or classes of persons, if such adjustments are necessary to: 
(a) protect the financial soundness of the APRA-regulated institution; or 
(b) respond to significant unexpected or unintended consequences that were not foreseen by the Board Remuneration Committee, the senior officer outside Australia or the Compliance Committee, as relevant.

59. The Remuneration Policy must set out who is covered by the Policy. The Remuneration Policy must cover, as a minimum:
(a) each responsible person, as that term is defined in Prudential Standard CPS 520 Fit and Proper (CPS 520), excluding:
(i) non-executive directors;
(ii) auditors described in paragraphs 13(a) to (e) inclusive;
(iii) for foreign ADIs, the senior officer outside Australia;
(iv) for general insurers, external Appointed Actuaries and the Reviewing Actuary;
(v) for Category C insurers, the senior officer outside Australia, and non-executive directors of the Category C insurer’s agent in Australia where the agent in Australia is a corporate agent;
(vi) for life companies, external Appointed Actuaries; and
(vii) in the case of an EFLIC, members of the Compliance Committee;

(b) persons whose primary role is risk management, compliance, internal audit, financial control or actuarial control (collectively ‘risk and financial control personnel’); and

(c) all other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution or group.

A person will be included within one of the above categories if that person is: employed directly by the institution; retained directly by the institution under contract; employed by, or a contractor of, a body corporate (including a service company) that is a related body corporate of the institution; or, subject to paragraph 60, an entity that is not a related body corporate of that institution.

60. The Remuneration Policy must cover a service contract between an APRA regulated institution and a body that is not a related body corporate of the institution, if:
(a) the primary role of the body is to provide risk management, compliance, internal audit, financial control or actuarial control services to the institution; or
(b) the services provided by the body, either individually or collectively with like services provided by other bodies, may affect the financial soundness of the institution and, under the services contract with the institution, a significant portion of the total payment to the body is based on performance.

However, the Remuneration Policy need not cover a service contract with such a body if:
(i) the institution’s risk management framework explicitly addresses the structure of payments to bodies of the relevant kind and the risk that payment incentives can give rise to inappropriate behaviour; and
(ii) oversight of this risk has been delegated to a Board Committee, the senior officer outside Australia or the Compliance Committee, as relevant.
61. APRA may determine that an individual or class of individuals must be covered by the APRA-regulated institution’s Remuneration Policy.

62. The Remuneration Policy must prohibit persons covered by paragraph 59(a), who receive equity or equity-linked deferred remuneration, from hedging their economic exposures to the resultant equity price risk before the equity-linked remuneration is fully vested and able to be sold for cash by the recipient. The Remuneration Policy must specify the actions to be taken where a person is found to have breached this requirement.

63. The Remuneration Policy must ensure that the structure of the remuneration of risk and financial control personnel, including performance-based components if any, does not compromise the independence of these personnel in carrying out their functions.

64. Nothing in this Prudential Standard prevents an APRA-regulated institution from adopting and applying a group Remuneration Policy that is also used by a related body corporate provided that the policy has been approved by the Board, the senior officer outside Australia or the Compliance Committee, as relevant, in accordance with paragraph 54 and meets the requirements of this Prudential Standard.

65. The Remuneration Policy must form part of an APRA-regulated institution’s and group’s risk management framework.

66. The Remuneration Policy of an APRA-regulated institution or member of a group must be provided to APRA on request.

**Board Remuneration Committee**

67. A locally incorporated APRA-regulated institution must, unless otherwise approved by APRA, have a Board Remuneration Committee that complies with the requirements of this Prudential Standard.
68. The Board Remuneration Committee must have at least three members. All members of the Committee must be non-executive directors of the APRA regulated institution. A majority of the members of the Committee must be independent. The chairperson of the Committee must be an independent director of the institution.

69. The Board Remuneration Committee must have a written charter and terms of reference that outline the Committee’s roles, responsibilities and terms of operation. The Remuneration Committee must be provided with the powers necessary to enable it to perform its functions.

70. The responsibilities of the Board Remuneration Committee must include:
(a) conducting regular reviews of, and making recommendations to the Board on, the Remuneration Policy. This must include an assessment of the Remuneration Policy’s effectiveness and compliance with the requirements of this Prudential Standard;
(b) making annual recommendations to the Board on the remuneration of the CEO, direct reports of the CEO, other persons whose activities may, in the Board Remuneration Committee’s opinion, affect the financial soundness of the APRA-regulated institution or group and any other person specified by APRA; and
(c) making annual recommendations to the Board on the remuneration of the categories of persons covered by the Remuneration Policy (other than those persons for whom such recommendations are already required under paragraph 70(b)).

71. The Board Remuneration Committee, the senior officer outside Australia or the Compliance Committee, as relevant, must:
(a) have free and unfettered access to risk and financial control personnel and other parties (internal and external) in carrying out its duties; and
(b) if choosing to engage third-party experts, have power to do so in a manner that ensures that the engagement, including any advice received, is independent.

72. Where a locally incorporated APRA-regulated institution is part of a Level 2 group, Level 3 group or other corporate group, the Board of the institution may use a group Board Remuneration Committee in order to meet the requirements of paragraph 67 and 68 of this Prudential Standard, provided that the other requirements set out in this Prudential Standard are met, all members of the Board Remuneration Committee
are non-executive directors of the Head of the group and the Board of the institution has unfettered access to the group Board Remuneration Committee.

73. Members of the Board Remuneration Committee must be available to meet with APRA on request.

74. For foreign ADIs and Category C insurers, the senior officer outside Australia, and for EFLICs, the Compliance Committee, must:
(a) conduct regular reviews of, and make decisions in relation to, the Remuneration Policy. This must include an assessment of the Remuneration Policy’s effectiveness and compliance with the requirements of this Prudential Standard;
(b) make annual decisions on the remuneration of the Head of the Australian branch operation, direct reports to that person, other persons whose activities may in the opinion of the senior officer outside Australia or of the Compliance Committee, as relevant, affect the financial soundness of the institution, and any other person specified by APRA; and
(c) make annual decisions on the remuneration of the categories of persons covered by the Remuneration Policy (other than those persons for whom such recommendations are already required under paragraph 74(b)).

D. Audit arrangements

Board Audit Committee

75. An APRA-regulated institution (excluding foreign ADIs and Category C insurers but including EFLICs) must have a Board Audit Committee, which assists the Board by providing an objective non-executive review of the effectiveness of the institution’s or group’s financial reporting and risk management framework.

76. The Board Audit Committee must have sufficient powers to enable it to obtain all information necessary for the performance of its functions.
77. The Board Audit Committee must have at least three members. All members of the Committee must be non-executive directors of the APRA-regulated institution. A majority of the members of the Committee must be independent.

78. The chairperson of the Board Audit Committee must be an independent director of the APRA-regulated institution.

79. The chairperson of the Board may be a member of the Board Audit Committee, but may not chair the Committee.

80. The Board Audit Committee must have a written charter that outlines its roles, responsibilities and terms of operation. The responsibilities of the Committee must include oversight of:
(a) all APRA statutory reporting requirements;
(b) other financial reporting requirements;
(c) professional accounting requirements;
(d) internal and external audit; and
(e) the appointment and removal of that APRA-regulated institution’s auditor and Head of Internal Audit.

81. The Board Audit Committee is required to provide prior endorsement for the appointment or removal of that APRA-regulated institution’s auditor and Head of Internal Audit. If the auditor or Head of Internal Audit is removed from their position, the reasons for removal must be discussed with APRA as soon as practicable, and no more than 10 business days, after the Committee’s endorsement is agreed upon.

82. The Board Audit Committee must review the engagement of the auditor at least annually, including making an assessment of whether the auditor meets the Audit Independence tests set out in APES 110 Code of Ethics for Professional Accountants, as well as the additional auditor independence requirements set out in this Prudential Standard.

83. For a foreign ADI or a Category C insurer, the assessment referred to in paragraph 82 is the responsibility of the senior officer outside Australia, and for an EFLIC, it is the responsibility of the Compliance Committee.
84. The Board Audit Committee must regularly review the internal and external audit plans, ensuring that they cover all material risks and financial reporting requirements of the APRA-regulated institution. It must also regularly review the findings of audits, and ensure that issues are being managed and rectified in an appropriate and timely manner.

85. The Board Audit Committee must ensure the adequacy and independence of both the internal and external audit functions.

86. The members of the Board Audit Committee must, at all times, have free and unfettered access to senior management, the internal auditor, the heads of all risk management functions, the auditor and the Appointed Actuary, as applicable, and vice versa.

87. The Board Audit Committee must establish and maintain policies and procedures for employees of the APRA-regulated institution or group to submit, confidentially, information about accounting, internal control, compliance, audit, and other matters about which the employee has concerns. The Committee must also have a process for ensuring employees are aware of these policies and for dealing with matters raised by employees under these policies.

88. Members of the Board Audit Committee must be available to meet with APRA on request.

89. The Board Audit Committee must invite the auditor and the Appointed Actuary, as applicable, to meetings of the Committee.

90. The internal auditor must have a reporting line and unfettered access to the Board Audit Committee.

91. For a foreign ADI, a Category C insurer and an EFLIC, the auditor of the local operation must have direct access to the Head Office audit function.
E. Board Risk Committee

103. The Board of an APRA-regulated institution (excluding foreign ADIs and Category C insurers but including EFLICs) must have a Board Risk Committee, which assists the Board by providing an objective non-executive oversight of the implementation and operation of the institution’s risk management framework.

104. The Board Risk Committee must be provided with the powers necessary to enable it to perform its functions.

105. The chairperson of the Board Risk Committee must be an independent director of the APRA-regulated institution.

106. The chairperson of the Board may be a member of the Board Risk Committee, but may not chair the Committee. The chair of the Board Audit Committee may also chair the Board Risk Committee.

107. The Board Risk Committee must have at least three members. All members of the Committee must be non-executive directors of the APRA-regulated institution. A majority of the members of the Committee must be independent.

108. The Board Risk Committee must have a written charter that outlines its roles, responsibilities and terms of operation. The responsibilities of the Committee must include:
   (a) advising the Board on the APRA-regulated institution’s overall current and future risk appetite and risk management strategy;
   (b) establishing an institution-wide view of the institution’s current and future risk position relative to its risk appetite and capital strength;
   (c) oversight of senior management’s implementation of the risk management strategy;
   (d) constructive challenge of senior management’s proposals and decisions on all aspects of risk management arising from the institution’s activities;
   (e) reviewing the performance and setting the objectives of the institution’s Chief Risk Officer (CRO), and ensuring the CRO has unfettered access to the Board and the Committee; and
(f) oversight of the appointment and removal of the CRO.

109. The Board Risk Committee is required to provide prior endorsement for the appointment or removal of the APRA-regulated institution’s CRO. If the CRO is removed from their position, the reasons for removal must be discussed with APRA as soon as practicable, and no more than 10 business days, after the Committee’s endorsement is agreed upon.

110. The Board Risk Committee must have free and unfettered access to senior management, risk and financial control personnel, and other parties (internal and external) in carrying out its duties.

111. The Board Risk Committee must invite the CRO to attend all relevant sections of meetings of the Committee.
Appendix [H]. The Basel Bank Corporate Governance Principles: BCBS 122 February 2006.\textsuperscript{12}

**Principle 1**

Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.

**Principle 2**

The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation.

**Principle 3**

The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.

**Principle 4**

The board should ensure that there is appropriate oversight by senior management consistent with board policy.

**Principle 5**

The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.

**Principle 6**

The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives and strategy, and control environment.

\textsuperscript{12} Bank for International Settlements, \textit{Enhancing Corporate Governance for Banking Organisations} (February 2006) 6 <http://www.bis.org/publ/bcbs122.pdf>.
**Principle 7**

The bank should be governed in a transparent manner.

**Principle 8**

The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (e.g. “know-your-structure”).

#The Role of Supervisors

**BCBS 122 Feb 2006**

1. Supervisors should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place.
2. Supervisors should consider corporate governance as one element of depositor protection.
3. Supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices.
4. Supervisors should assess the quality of banks’ audit and control functions.
5. Supervisors should evaluate the effects of the bank’s group structure.
6. Supervisors should bring to the board of directors’ and management’s attention problems that they detect through their supervisory efforts.

Principle 1

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank’s strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management. (BCBS 122 #2)

Principle 2

Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. (BCBS 122 #1)

Principle 3

The board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement.

Principle 4

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

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**Principle 5**

Under the direction of the board, senior management should ensure that the bank’s activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board. (BCBS122 #4).

**Principle 6**

Banks should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

**Principle 7**

Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank’s risk management and internal control infrastructures should keep pace with any changes to the bank’s risk profile (including its growth), and to the external risk landscape.

**Principle 8**

Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

**Principle 9**

The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions. (BCBS 122 #5).
Principle 10

The board should actively oversee the compensation system’s design and operation, and should monitor and review the compensation system to ensure that it operates as intended. (BCBS 122 #6).

Principle 11

An employee’s compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment. (BCBS 122 #6).

Principle 12

The board and senior management should know and understand the bank’s operational structure and the risks that it poses (ie “know-your-structure”). (BCBS 122 #8).

Principle 13

Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. They should also seek to mitigate the risks identified (ie “understand-your-structure”).

Principle 14

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants. (BCBS 122 #7).
1. Supervisors should provide guidance to banks on expectations for sound corporate governance. (BCBS 122 #1)
2. Supervisors should regularly perform a comprehensive evaluation of a bank’s overall corporate governance policies and practices and evaluate the bank’s implementation of the principles. (BCBS 122 #3)
3. Supervisors should supplement their regular evaluation of a bank’s corporate governance policies and practices by monitoring a combination of internal reports and prudential reports. (BCBS 122 #4)
4. Supervisors should require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices, and should have the appropriate tools for this. (BCBS 122 #2)
5. Supervisors should cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices. The tools for cooperation can include memorandum of understanding, supervisory colleges and periodic meetings among supervisors (BCBS 122 #5).
Appendix [J]. The Transitional Arrangements of the Basel III Liquidity Rules.

<table>
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<td>1 Jan 2013–1 Jan 2017</td>
<td>Disclosures starts 1 Jan 2015</td>
</tr>
<tr>
<td>Minimum Common Equity Capital Ratio</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Capital Conservation Buffer</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Minimum common equity plus capital conservation buffer</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
</tr>
<tr>
<td>Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Minimum Total Capital</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Minimum Total Capital plus conservation buffer</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
</tr>
<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</td>
<td>Phased out over 10 year horizon beginning 2013</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity coverage ratio</td>
<td>Observation period begins</td>
<td>Introduce minimum standard</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net stable funding ratio</td>
<td>Observation period begins</td>
<td>Introduce minimum standard</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix [K]. Criteria for Inclusion in Tier 2 Capital.\textsuperscript{15}

1. Issued and paid-in.

2. Subordinated to depositors and general creditors of the Bank.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-a-vis depositors and general Bank creditors.

4. Maturity:
   a. minimum original maturity of at least five years.
   b. recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis.
   c. there are no step-ups or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years:
   a. To exercise a call option a bank must receive prior supervisory approval;
   b. A Bank must not do anything that creates an expectation that the call will be exercised;\textsuperscript{16} and
   c. Banks must not exercise a call unless:
      i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank;\textsuperscript{17} or

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\textsuperscript{16} The choice to call the mechanism after 5 years but before to the beginning of the amortization period will not be seen as an motivation to redeem as long as the Bank can not do anything that makes an predictions that the call will be done at this point.

\textsuperscript{17} The Replacement issues may be matched with but not after the mechanism is called.
ii. The Bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.\(^\text{18}\)

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

7. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization’s credit standing.

8. Neither the Bank nor a related party over which the Bank exercises control or significant influence can have purchased the instrument, nor can the Bank directly or indirectly have funded the purchase of the instrument.

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle or “SPV”), proceeds must be immediately available without limitation to an operating entity\(^\text{19}\) or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.

\(^{18}\) Minimum shows the supervisor’s prescribed minimum requirement, which can be more than the Pillar 1 minimum requirement of Basel III.

\(^{19}\) An operating institution is an institution set up to demeaning business with customers with the intention of earning a profit in its own right.