



**Faculty of Graduate Studies: MBA Program**

**“Assessment of Corporate Governance Practices**

**In the Palestinian Banking Sector in the Light of Basel II Regulations.”**

**تقييم تطبيق مبادئ حوكمة الشركات في القطاع المصرفي الفلسطيني في ظل اتفاقية بازل الثانية**

**MASTER THESIS**

**By: Lubna Ahmad Al Shobaki**

**Palestine**

**May, 2007**



**Faculty of Graduate Studies: MBA Program**  
**“Assessment of Corporate Governance Practices**  
**In the Palestinian Banking Sector in the Light of Basel II Regulations.”**

"تقييم تطبيق مبادئ حوكمة الشركات في القطاع المصرفي الفلسطيني في ظل اتفاقية بازل الثانية"

**MASTER THESIS**

By: Lubna Ahmad Al Shobaki

Supervised by: Dr.Naser Abdel Kariem

**Palestine**

**May 2007**



**Faculty of Graduate Studies: MBA Program**

**“Assessment of Corporate Governance Practices  
In the Palestinian Banking Sector in the Light of Basel II Regulations.”**

"تقييم تطبيق مبادئ حوكمة الشركات في القطاع المصرفي الفلسطيني في ظل اتفاقية بازل الثانية"

This Thesis was submitted in partial fulfillment of the requirements for the Master Degree in **Business Administration** from the Graduate Faculty at Birzeit University.

By: Lubna Ahmad Al Shobaki

**Date of Discussion: 19, May 2007**

**Approved by:**

**Dr. Nasr Abdel Karim-** (Chairperson of Supervisory Committee)

**Dr. Anis AL Hajeh** - (Member of Supervisory Committee)

**Dr. Munzer Najem** - (Member of Supervisory Committee)



**Faculty of Graduate Studies: MBA Program**

**“Assessment of Corporate Governance Practices**

**In the Palestinian Banking Sector in the Light of Basel II Regulations.”**

**"تقييم تطبيق مبادئ حوكمة الشركات في القطاع المصرفي الفلسطيني في ظل اتفاقية بازل الثانية"**

This Thesis was submitted in partial fulfillment of the requirements for the Master Degree in **Business Administration** from the Graduate Faculty at Birzeit University.

By: Lubna Ahmad Al Shobaki

**Date of Discussion: 19, May 2007**

**Approved by:**

**Dr. Nasr Abdel Karim**

(Chairperson of Supervisory Committee) .....

**Dr. Anis AL Hajeh**

(Member of Supervisory Committee) .....

**Dr. Munzer Najem**

(Member of Supervisory Committee) .....

### ***Acknowledgment***

*I would like to dedicate this thesis to Shobaki family for a lifetime of love and support. Mother and father, you pushed me ahead and put me in charge of what I am doing. I especially appreciate their patience of my being very nervous while writing this thesis.*

*I would like to express my deep appreciation for Dr. Naser Abdl Karim, whose criticism and suggestions helped enhance and improve each draft of this thesis, he deserved a special note thanks.*

*And I would like to dedicate it to my friend Sami (Dabeet), not merely because he literally started it all, but primarily because with his help I learned all of the things I ever really needed to know how to work without forgetting how to study, how to get joy out of giving, and how to care deeply.*

## Table of Contents

<b>ABSTRACT .....</b>	<b>7</b>
<b>CHAPTER ONE: INTRODUCTION .....</b>	<b>1</b>
BACKGROUND OF THE STUDY .....	1
PROBLEM STATEMENT .....	3
STUDY OBJECTIVES:.....	3
RESEARCH QUESTIONS.....	3
SCOPE AND LIMITATIONS OF THE STUDY.....	4
TERM DEFINITIONS.....	4
<b>CHAPTER TWO: LITERATURE REVIEW AND CONCEPTUAL FRAMEWORK.....</b>	<b>13</b>
LITERATURE REVIEW .....	13
ELEMENTS OF CORPORATE GOVERNANCE.....	31
THE BANKING SYSTEM IN PALESTINE .....	33
CORPORATE GOVERNANCE IN PALESTINIAN BANKING SECTOR.....	40
PRINCIPLES OF GOOD CORPORATE GOVERNANCE.....	43
<b>CHAPTER THREE: METHODOLOGY.....</b>	<b>50</b>
RESEARCH METHODOLOGY.....	50
SAMPLING DESIGN .....	50
SURVEY INSTRUMENT .....	51
ANALYTICAL TECHNIQUES.....	51
<b>CHAPTER FOUR: FINDINGS AND DISCUSSION .....</b>	<b>54</b>
FINDINGS.....	54
DISCUSSION OF FINDINGS.....	65
<b>CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS: .....</b>	<b>75</b>
<b>REFERENCES.....</b>	<b>83</b>

## **List of Figures**

Figure 1: The Conceptual Framework.....	7
Figure 2: Corporate Governance Mechanisms .....	8
Figure 3 : How the Board of Directors is Appointed.....	54
Figure 4 : Professional Qualifications of Board Members .....	55
Figure 5 : Existing Board Operating Documents .....	57
Figure 6 : Whether Session Plan Exists.....	60
Figure 7 : Whether Succession Plan Exists .....	62

## **List of Tables**

Table 1 - A: Number of Banks / Governorates During the Period 1995 - 2005 .....	39
Table 2 – B: Number of Banks' Branches and Offices during the Period 1995 - 2005 .....	39
Table 3 : Practices for corporate governance .....	48
Table 4 : Strategy, Value, Performance and Compliance.....	63

## **Abstract**

This study was based on a sample survey conducted among seventeen commercial banks in Palestine. Both quantitative and qualitative data was collected for the purpose of this study.

Study concluded that corporate governance procedures applied in the banking sector in Palestine are effective to some extent in achieving the goals and objectives (what are they?) for which they were established. However, it is still in its infancy. The existing corporate governance procedures in the surveyed banks are still not effectively nor efficiently implemented. However, some of the noted improvements in the Palestinian banking sector can be attributed to the deliberate efforts in improving corporate governance in Palestine. Therefore there is a need for stakeholders to play an effective role in providing banks with necessary professional and technical assistance towards the implementation of these (Basel 2 regulations).

The regulatory and supervision systems have been issued by the Palestinian Monetary Authority. It is recommended that strategic training for banks' board members and senior bank managers be intensified by stakeholders in corporate governance to promote good corporate governance in these institutions. Banks should be assisted to develop principles of corporate governance that cut across all the functions of the banks. Expedient solution to the stalemate on Palestinian Monetary Authority.

Following this ruling, various conflicting legal interpretations have been published which most banks find confusing. Issues of delays in decision making due to the existing legal framework should be addressed.



## الملخص بالعربية

الحوكمة هي مجموعة من القوانين والنظم والقرارات تهدف إلى تحقيق الجودة والتميز في الأداء عن طريق اختيار الأساليب المناسبة والفعالة لتحقيق خطط وأهداف الشركة. بمعنى آخر فإن الحوكمة تعني النظام أي وجود نظم تحكم العلاقات بين الأطراف الأساسية التي تؤثر في الأداء، كما تشمل مقومات تقوية المؤسسة على المدى البعيد وتحديد المسؤل والمسئولة.

أما في البنوك فتعني الحوكمة مراقبة الأداء من قبل مجلس الإدارة والإدارة العليا للبنك وحماية حقوق حملة الأسهم والمودعين، بالإضافة إلى الاهتمام بعلاقة هؤلاء بالفاعلين الخارجيين، والتي تتحدد من خلال الإطار التنظيمي وسلطات الهيئة الرقابية. من الواضح بأن تطوير وحماية النظام المصرفي في فلسطين هو أهم ما يمكن أن تساهم به سلطة النقد من أجل تحقيق التطور الاقتصادي والمالي في فلسطين علماً بأن القيام بمراقبة البنوك بشكل فعال هو مهمة بالغة التحدي لجميع البنوك المركزية والسلطات النقدية.

تزاول سلطة النقد الفلسطينية عمليات الرقبة داخل المواقع وخارجها في معظم البنوك وقد أصدرت السلطة تعليمات تغطي معظم الجوانب الهامة لعمل البنوك. إلا أن الدراسة بيّنت الـ إلى مزيدٍ من الأنظمة والتعليمات، كما أن هناك ضرورة لـ لتحقيق انسجام ومقاربة أكبر بين الأنظمة المصرفية في فلسطين وتلك المتعارف عليها دولياً. وكذلك ضرورة تزويد سلطة النقد بتقارير شهرية من البنوك عن موجوداتها ومطلوباتها وحالة السيولة لديها Large Exposures (القروض الكبيرة) والتركيب القطاعي.

استخدمت الدراسة طرقاً مختلفة لجمع البيانات الأساسية والثانوية، مثل المراجعات الأدبية والتي شملت بعض الحالات العملية، نوعان من الاستبيانات أرسلت إلى البنوك، كما تمت مقابلة بعض المدراء من المستويات الإدارية العليا والوسطى. عملت هذه الدراسة على عينة تتكون من سبعة عشر (17) نأ أي د 87% من البنوك الموجودة في فلسطين حتى العام 2005. تمت مقابلة ثلاثة وأربعين (43) نأ من الإدارات العليا. وقد تم تحليل الاستبيان والمقابلات بمساعدة خبير في هذا المجال عن طريق استخدام برنامج التحليل الإحصائي SPSS فتبين ما يـ :

أولاً: فيما يتعلق بمجالس إدارات البنوك العامة. يوجد التزام إلى حد ما بمعايير الشفافية في توظيف أفضل الخبرات والكفاءات. وكل عضو مجلس إدارة على حدة وكل الأعضاء مجتمعين مدركين لمسؤوليتهم، وتضم تركيبة معظم مجالس إدارات البنوك في فلسطين عدة تخصصات مهنية مثل الاقتصاديين، مدققي حسابات قانونيين CPAs مهندسين، وتخصصات مالية، ومختصي تأمين. كما تجدر الإشارة إلى أن 50% من أعضاء مجالس الإدارة يتم تعيينهم بتصويت الأغلبية من حملة الأسهم.

كما أن هناك عدم توازن ما بين المديرين التنفيذيين وغير التنفيذيين، أكثر من ( 80 % ) للبنوك لديه لجان لمراجعة الحسابات، الانتماء الموارد البشرية الاستثمار. العلاقات الخارجية الأصول والديون. تم تشكيل هذه اللجان من قبل مجلس الإدارة وتسمى هذه اللجان باللجان المعاونة لمجلس الإدارة لمساعدتها على التأكد من أن إدارة البنوك تتم بشكل سليم.

: فيما يتعلق بالالتزام والتوافق مع المعايير التي وضعتها اتفاقية بازل الثانية قامت بعض البنوك بوضع لائحة تنظيمية للالتزام تتضمن تعريف ومحتويات الالتزام، متطلبات العمل بإدارة الالتزام، علاقة الالتزام بالجهات المختلفة بالداخل والخارج، والصلاحيات والمسؤوليات.

بعض من البنوك تديرها عائلات فلسطينية لا تفصح عن البيانات المالية، البنوك بحاجة إلى بيانات مالية ومعلومات ضرورية لقرارها الائتماني-ضعف المعلومات-عدم وجود بيانات مالية وان وجدت فهي غير صحيحة وغير مدققة حسب الأصول، عدم استيفاء بعض البنوك لشروط ومتطلبات واحتياجات مراقب سلطة النقد ، التي تضمن استمرار عملها وفق الأصول القانونية.

## **Chapter One: Introduction**

### **Background of the Study**

The key role of a banking system is to intermediate between public savings and investments, which is very crucial for market economies to prosper and function properly. To ensure this role, banks are subject to special licensing and supervision rules that address the safety and soundness of individual banks, and regulations that are concerned about the safety and soundness of the banking system as a whole – and ultimately the national economy. When assessing the efficiency of banks it is important to assess the compliance of banks with Basel II.<sup>1</sup> Basel II embraces a comprehensive approach to risk management and bank supervision; it enhances banks' safety and soundness, strengthens the stability of financial system as a whole, and improves the financial sector's ability to serve as sources for sustainable growth for the boarder economy, through the rules and regulations that specifically encompass pillar three which stipulates transparency and disclosure rules that conforms to corporate governance principles.

Since the establishment of the Palestinian National Authority (PNA) in 1994, there has been very little research done on corporate governance in financial institutions in general and in banks in particular. This observation is very

<sup>1</sup> The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has about twenty-five technical working groups and task forces which also meet regularly.

interesting in light of the fact that a significant amount of attention has been paid to the role of banks themselves they play in the governance of the other sorts of firms (*Macey and O'Hara 2003*).

The corporate governance of banks operating in Palestine is very essential for the following reasons:

1. Due to recently of supervision, local banks' managers have obtained greater freedom and power in how they run their banks and how and where to invest their resources.
2. Local banks have been the subject to criticism on the ground of having very limited role in the development and revitalization of Palestinian economy. Savings of local Palestinians are being "transferred" or "shipped out" to be invested outside Palestine.
3. Most of the banks operating in the PA territories are not Palestinian banks. The vast majority of banks in Palestine is regional and international and follows investment policies and regulations of their top management outside Palestine. In short, local banks' priorities do not eventually match with Palestinian national economic priorities and interests.
4. Most local banks are accused that they have, unprofessionally, "utilized" the political instability and the fragile political system emerging in PA territories. Banks' senior management has deliberately developed unprofessional relationships with senior PA officials. These relationships were employed as a means of getting more political power and to "cover" banks' senior management faults and, abuse of bank's funds and other violations.

Enhancing corporate governance in the PNA territories will ultimately lead to more economic progress and prosperity and reduce the adverse effects, probability, frequency and severity of risks of local banks and banking system.

## **Problem Statement**

When assessing the efficiency of banks it is important to assess the compliance of banks with Basel II relating to the corporate governance. Basel II embraces a comprehensive approach to risk management and bank supervision; it enhances banks' safety and soundness, strengthens the stability of financial system as a whole, and improves the financial sector's ability to serve as a source of sustainable growth for the boarder economy, through the rules and regulations that specifically encompass pillar three which stipulates transparency and disclosure rules that conforms to corporate governance principles.

## **Study Objectives:**

1. To assess the governance status in the Palestinian banks.
2. To survey the banking sector and asses status of its adherence to the corporate governance principles and compliance to Basel II in this respect.
3. To create a benchmark for future monitoring assessment

## **Research Questions**

This study will attempt to answer the following pertinent questions emerging within the domain of the study problem:

1. What factors influence corporate governance within the banking industry in Palestine?
2. Does poor economic performance of banks influence corporate governance interventions and if so what type of influence exists?

3. How are banks in Palestine responding to the call for higher standards of corporate governance and have they grasped the full meaning of governance in a financial institution?

### **Scope and Limitations of the Study**

This study is the first phase in a multi – phase program which seeks to look into the effects of corporate governance regulations on the practices of directors of bank in Palestine. The thesis limited itself to directors of rural banks in Ramalla area. Ramalla is the center of business and government in Palestine. It sets the trend in banking and finance, education and training, and practically all aspects of business and development. It was felt that the thesis should first be delimited to focus on how corporate governance regulations affected the practices of directors of banks on other areas. The thesis relies principally on the perceptions and reports of directors themselves. Social desirability affects may affect responses and the conclusions will have to be taken in light of this limitation.

The comparison of the corporate governance regulations with other regulations in other countries was limited due to special situation we live in.

Data for this thesis are of June 21, 2006. any developments after this date are not included.

### **Term Definitions**

Before traversing the subject of assessment of corporate governance in Palestinian banking system, I think it would be useful to begin by defining what the mean by corporate governance. In this address, Corporate Governance 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.

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.”

OECD Principles of Corporate Governance, June 21,1999.

This involves a number of elements, including a clear understanding by directors of their company's strategic objectives, structures to ensure that the objectives are being met, and systems to ensure the effective management of risks, and the mechanisms to ensure that the company's obligations are identified and discharged. Although corporate governance involves many systems and structures, the heart of it lies in the boardroom - a point I hardly need to stress with this audience. Others may define corporate governance as follows:

"Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”, The Journal of Finance, Shleifer and Vishny [1997, page 737]. "Corporate governance - which can be defined narrowly as the relationship of a company to its shareholders, or, more broadly, as its relationship to society -." from an article in Financial Times [1997]. "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, president of the World bank, as quoted by an article in Financial Times, June 21, 1999. “Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges...corporate governance as a subject, as an objective, or as a

regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy” Maw et al. [1994, page1].

It is self evident that sound corporate governance is essential to the wellbeing of an individual company and its stakeholders, particularly its shareholders and creditors. We need only remind ourselves of the many companies, both at home and abroad, whose financial difficulties and, in some cases, ultimate demise have been substantially attributable to weak corporate governance. But sound corporate governance is not just a vital factor at the level of the individual corporation. It is also a critical ingredient in maintaining a sound financial system and a robust economy. And that is why governments have taken such an interest in recent examples of corporate governance failures. It is also why banking supervisors are placing greater emphasis on the role that corporate governance can play in promoting financial stability.

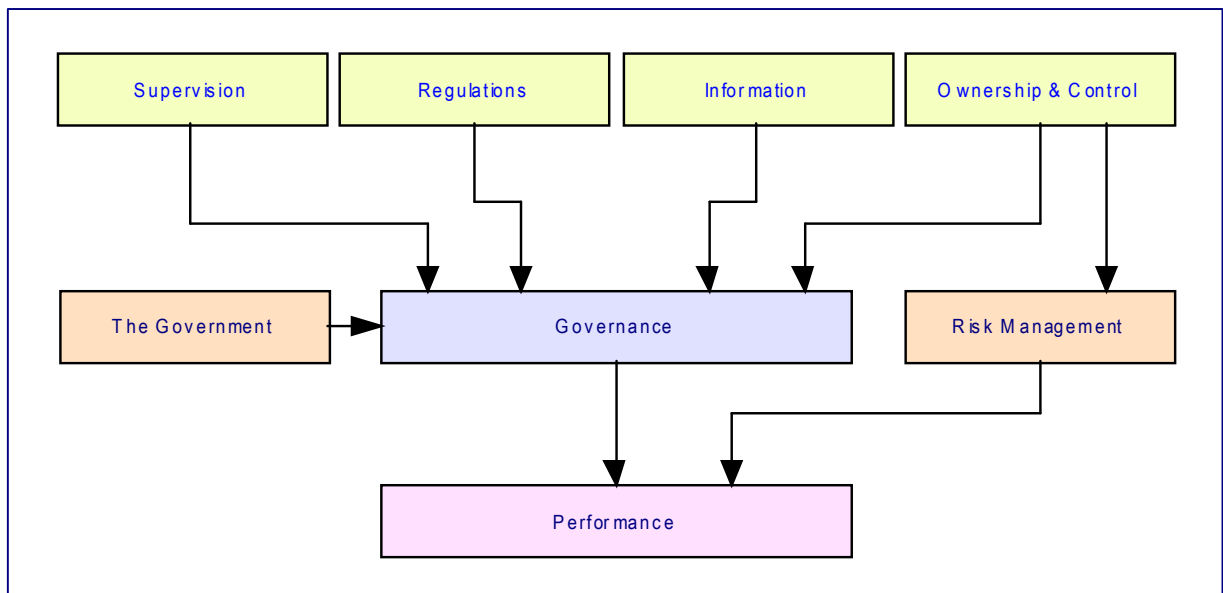
In the financial system, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the financial system much depends on the underlying soundness of its individual components and the connections between them - such as the banks, the non-bank financial institutions and the payment systems. In turn, their soundness largely depends on their capacity to identify measure, monitor and control their risks. Banks in Palestine play a major role in enhancing Palestinian economic performance by financing projects and business. Presently, 23 banks with 126 branches are operating in Palestine. The banks are three types; commercial, investment, and Islamic banks. Governance in banking system in Palestine considers more complex issue than in other sectors. Banks will attempt to comply with the same codes of board governance as other companies but, in addition, factors like risk management, capital



adequacy and funding, internal control and compliance all have an impact on their matrix of governance.

This thesis will examine the issue of corporate governance in the banking sector in Palestine. The thesis seeks to explore the link between the bank performance and the governance principles. The structure of the thesis proceeds as follows: Section I provides an overview of the relevant literature. Section II describes the econometric methodology. The data pertaining to the study in will describe in section III. A discussion of the results is contained in the final section.

**Figure 1: The Conceptual Framework**

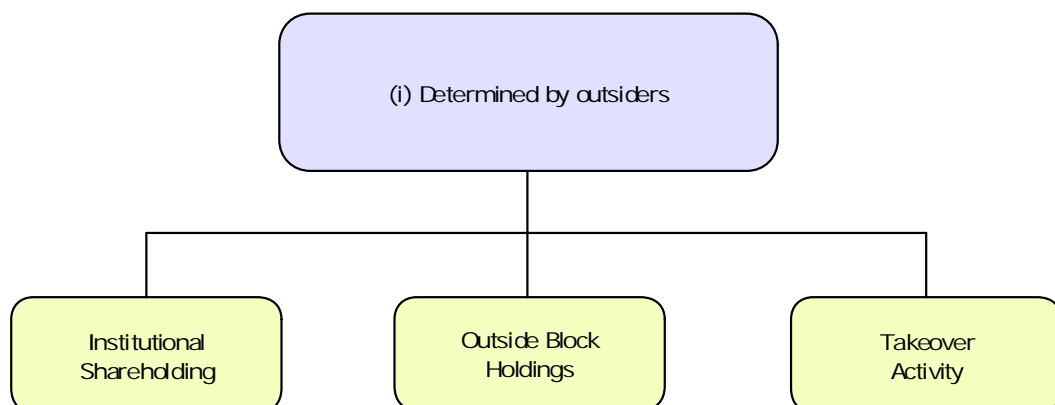


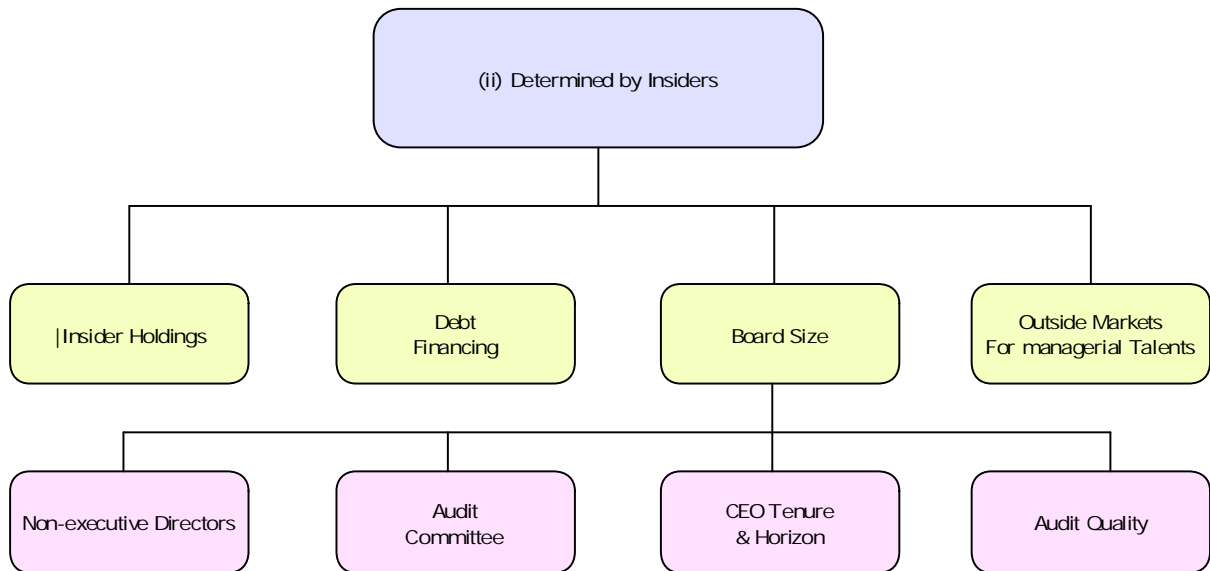
Within this framework, we argue that:

- First, governments construct the basic legal system underpinning corporate governance,

- Second, governments may influence the flow of corporate finance by insuring corporate finance and other intermediaries like providing guarantees for holders of the largest mutual funds.
- Type of ownership and control, directly have a bearing on the shareholders (minority and concentrated shareholders) on how they exert corporate governance through their votes.
- Information asymmetry between inside and outside investors create more difficulty for equity and debt holders to monitor managers and use incentive contracts. It makes it easier for managers and large investors to exploit the benefits of control rather than maximize value. It also makes it difficult for potential outside bidders with poor information to generate a sufficiently effective takeover threat to improve governance substantially.
- Regulations frequently impede natural corporate governance mechanisms.
- Government ownership of banks fundamentally alters the corporate governance equation within banks.

**Figure 2: Corporate Governance Mechanisms**





### **Regulation and supervision as elements of corporate governance**

In most instances it has been argued that given the special nature of banks and financial institutions some form of economic regulations are necessary. However, there is a notable shift from such regulations which have always been offered by governments over time in different economies all over the world. As has been observed by Arun and Turner (2002e), over the last two decades or so, many governments around the world have moved away from using these economic regulations towards using prudential regulation as part of their reform process in the financial sector. They note that prudential regulation involves banks having to hold capital proportional to their risk-taking, early warning systems, bank resolution schemes and banks being examined on an on-site and off-site basis by banking supervisors. They assert that the main objective of prudential regulation is to safeguard the stability of the financial system and to protect deposits.

However, Brownbridge (2002) observe that the prudential reforms already implemented in developing countries have not been effective in preventing banking crises, and a question remains as to how prudential systems can be strengthened to make them more effective. In a

rejoinder Arun and Turner- argue that there have been gray areas in the ability of developing economies to strengthen their prudential supervision and that questions have been raised on this issues for several reasons:

- Firstly, it is accepted that banks in developing economies should have substantially higher capital requirements than banks in developed economies. However, many banks in developing economies find it very costly to raise even small amounts of capital.
- Secondly, there are not enough well trained supervisors in developing economies to examine banks.
- Thirdly, supervisory bodies in developing economies typically lack political independence, which may undermine their ability to coerce banks to comply with prudential requirements and impose suitable penalties.
- Fourthly, prudential supervision completely relies on accurate and timely accounting information. However, in many developing economies, accounting rules, if they exist at all, are flexible, and typically, there is a paucity of information disclosure requirements.

They argue further that if a developing economy liberalizes without sufficiently strengthening its prudential supervisory system, bank managers will find it easier to expropriate depositors and deposit insurance providers. A prudential approach to regulation will typically result in banks in developing economies having to raise equity in order to comply with capital adequacy norms. They maintain that prior to developing economies deregulating their banking systems, much attention will need to be paid to the speedy implementation of robust corporate governance mechanisms in order to protect shareholders.

In an earlier discourse, Arun and Turner (2002d) argued that in developing economies, the introduction of sound corporate governance principles into banking has been partially hampered by poor legal protection, weak information disclosure requirements and dominant owners. They observed further that in many developing countries, the private banking sector is not enthusiastic to introduce corporate governance principles.

Besides control mechanisms in banks, supervision of banks is another concept that can have both positive and negative impact on the performance of banks. The Basel Committee on Banking Supervision (1999) uphold that banking supervision cannot function as well if sound corporate governance is not in place and, consequently, banking supervisors have strong interests in ensuring that there is effective corporate governance at every banking organization. They add that supervisory experience underscores the necessity having the appropriate levels of accountability and checks and balances within each bank and that, put plainly, sound corporate governance makes the work of supervisors infinitely easier. Sound corporate governance therefore can contribute to collaborative working relationship between management and bank supervision.

In the Palestine context, the Palestinian Monetary Authority observes that problems still exist in the implementation of core principles for effective banking supervision. Principally, the following particular core principles have generally posed problems in implementations:

- Autonomy of the supervisory authorities,
- Assessment of country and market risks as well as derivatives ,
- Money laundering,
- Consolidated supervision,

- Prompt corrective actions,

The Palestinian Monetary Authority also note that the high level non-performing loans continue to be an issue of major supervisory concern in Palestine. The level of non-performing loans has been increasing steadily .The bank states that there are two main reasons for the increase of non-performing loans. First, the depressed performance in the economy and secondly, the Palestinian Monetary Authority in corporation with external auditors has strictly enforced the classification guidelines and hence a sizeable portion of the increase is attributed to better identification.

Given this scenario, several remedies have been proposed to assist in reducing the level of non-performing loans and these include:

Management of lending rates is also a major problem which is occasioned largely by lack of effective competition, use of outdated systems and procedures, poor risk assessment and weak corporate governance.

## Chapter Two: Literature Review And Conceptual Framework

### Literature Review

Until fairly recently, corporate governance was not a topic that attracted much public attention. Now corporate governance is a topic of considerable interest to a larger and expanding cross section of the community after the events that relate to fraud and Asian crisis. It is also of interest of monetary authority, in its capacity as a supervisor of the banking system. However, recent events such as the establishment of Palestinian Stock Exchange Market have put corporate governance on the front pages of our main newspapers.

Corporate governance has a wide variety of definitions since it potentially covers a large number of economic aspects. The OECD paper, which focuses on the sound corporate governance, defines the corporate governance as "*a set of relationship between a company's management, its board, shareholders and other stockholders. It also provides the structure through which the objectives of the company are and the means of attaining those objectives and monitoring performance are determined.*" *OECD – Economic co-operation and development, which issue paper about the principal of corporate governance.* Economists and social scientists have tended to define it as "*the institution that influences how a business corporation allocates and returns.*" (Mary O Sullivan, "corporate governance and globalization, July 2002).

The World Bank development report (2002) (p. 68) defined corporate governance as "*the organizations and rules that affect expectations about the exercise of control of resources in a firm.*" Oliver E. Williamson, (1996) defined it as "*an institutional framework in which integrity of the transaction is decided.*" Corporate managers, investors, policy makers, and lawyers define corporate governance as "*the system of rules and institution's that determine the control and direction of corporation and that define relations among the corporation's*

*primary participants- the shareholders, board of directors, and company management.*"(Robert A. G. Monks and Nell Minow, (1995). Beak, and Kang (2004), examined the importance of corporate governance measures in determining the firm value during the 1997 Korean financial crisis. The study suggested that a change in a firm value during a crisis is a function of the firm level differences in corporate governance measures. They found that firms having large equity ownership by foreign investors, and firms that have higher disclosure quality and alternative sources of external financing, they have small reduction in their share value and also they suffered less. Gedajlovic and Shapiro(2003, examined the relationship between the ownership structure and financial performance of 334 Japanese corporations during the period 1986 through 1991, they used the ownership by five large stock holders, ownership by financial institutions and ownership by non-financial companies as independent variables, and they control the firm size, and they used the rate of return on assets (ROA) to measure the firm' profitability as dependent variable, they found a positive relationship between ownership concentration and financial performance that is consistent with agency theory predictions. The 1997 Asian financial crisis focused public attention on the importance of corporate governance in Asian capital markets (Suleik, 2002). The recent debacles at Enron and WorldCom intensified this attention on a worldwide scale. A significant number of academics have conducted research into corporate governance (Kang and Shivdasani, 1995; Kang and Shivdasani, 1997; Kim and Limpaphayom, 1998; Almazan and Suarez, 2003; Ferris, Jagannathan, and Pritchard, 2003; and Lemmon and Lins, 2003). To set forth a common policy agenda, the Asian Roundtable on Corporate Governance, which was organized by the Organization for Economic Cooperation and Development (OECD) and the World Bank, met in March 2003 and developed a White Paper on Corporate Governance in Asia (OECD, 2003). Despite the general interest in this topic, very few studies have focused on the corporate governance of banks (Macey and O'Hara, 2003), even though some



have examined the role that banks play in the governance of other types of firms (Kaplan and Minton, 1994; and Kroszner and Strahan, 2001). Some studies have been conducted on the corporate governance of Asian banks, but they are mainly based on self-assessment surveys (Haddock, 2002, and Business World, 2003).

To standardize corporate governance assessments and make them comparable among firms, some rating agencies and financial consultancy firms started to develop their own criteria and methodologies for assessing corporate governance practices. Credit Lyonnais Securities Asia (CLSA), Deminor Rating (Deminor), GovernanceMetrics International (GMI), Institutional Shareholder Services (ISS), Standard and Poor's Governance Services (S&P's) among others launched corporate governance scoring/ranking services in recent years (CLSA, 2004; Deminor, 2003; GMI, 2004; ISS, 2004; and S&P's, 2003). These models apply to corporations in general, and are not specifically designed for banks. As some of these models are still in their infancy stage, there have been no studies that examined the relationship between the scores and financial performance.

The narrow approach to corporate governance considers corporate governance as the mechanism through which shareholders are assured that managers will act in their best interests. Indeed, as far back as Adam Smith, it has been recognized that managers do not always act in the best interests of shareholders (Henderson, 1986). This problem has been especially exacerbated in the Anglo-Saxon economies by the evolution of the modern firm characterized by a large number of atomized shareholders, leading to a separation of ownership and control. The separation of ownership and control has given rise to an agency problem whereby management operates the firm in their own interests, not those of shareholders (Jensen and Meckling, 1976; Fama and Jensen, 1983). This creates opportunities for managerial shirking or empire building and, in the extreme, outright expropriation.

However, there is a broader view of corporate governance, which views the subject as the method by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment (Shleifer and Vishny, 1997, p.737; Vives, 2000, p.1; Oman, 2001, p.13).

We will argue below that the special nature of banking is more appropriate to adopt the broader view of corporate governance for banks. Notably, Macey and O'Hara (2001) argue that a broader view of corporate governance should be adopted in the case of banking institutions, arguing that because of the peculiar contractual form of banking, corporate governance mechanisms for banks should encapsulate depositors as well as shareholders. As we shall see below, the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behavior of banks management.

Depositors do not know the true value of a bank's loan portfolio as such information is incommunicable and very costly to reveal, implying that a bank's loan portfolio is highly fungible (Bhattacharya et al, 1998, p.761). As a consequence of this asymmetric information problem, bank managers have an incentive to invest in riskier assets than they promised they would ex ante. In order to credibly commit that they will not expropriate depositors, banks could make investments in brand-name or reputation capital (Klein, 1974; Gorton 1994; Demetz et al 1996; Bhattacharya et al 1998), but these schemes give depositors little confidence, especially when contracts have a finite nature and discount rates are sufficiently high (Hickson and Turner, 2003). The opaqueness of banks also makes it very costly for depositors to constrain managerial discretion through debt covenants (Capiro and Levine, 2002, p.2). Consequently, rational depositors will require some form of guarantee before they would deposit with a bank. Government-provided guarantees in the form of implicit and

explicit deposit insurance might encourage economic agents to deposit their wealth with a bank, as a substantial part of the moral hazard cost is borne by the government.

Nevertheless, even if the government provides deposit insurance, bank managers still have an incentive to opportunistically increase their risk-taking, but now it is mainly at the government's expense. This well-known moral hazard problem can be ameliorated through the use of economic regulations such as asset restrictions; interest rate ceilings; separation of commercial banking from insurance; investment banking and reserve requirements. Amongst the effects of these regulations is that they limit the ability of bank managers to over-issue liabilities or divert assets into high-risk ventures.

Thus far we have argued that the special nature of the banking firm requires public protection of depositors from opportunistic bank management. However, the special nature of the banking firm also affects the relationship between shareholders and managers. For example, the opaqueness of bank assets makes it very costly for diffuse equity holders to write and enforce effective incentive contracts or to use their voting rights as a vehicle for influencing firm decisions (Caprio and Levine, 2002, p.2). Furthermore, the existence of deposit insurance may reduce the need for banks to raise capital from large, uninsured investors who have the incentive to exert corporate control (Capiro and Levine, 2002).

A further issue is that the interests of bank shareholders may oppose those of governmental regulators, who have their own agendas, which may not necessarily coincide with maximizing bank value (Boot and Thakor, 1993).

Shareholders may want managers to take more risk than is socially optimal, whereas regulators have a preference for managers to take substantially less risk due to their concerns about system-wide financial stability .

Shareholders could motivate such risk-taking using incentive-compatible compensation schemes. However, from the regulators point of view, managers' compensation schemes should be structured so as to discourage banks from becoming too risky. For example, regulators could, through directives or moral suasion, restrict the issue of option grants to bank managers. Alternatively, regulators could vary capital requirements depending on the extent to which compensation policies encourage risk-taking (Caprio and Levine, 2002, p.22 .

Some economists argue that competition in the product or service market may act as a substitute for corporate governance mechanisms (Allen and Gale, 2000). The basic argument is that firms with inferior and expropriating management will be forced out of the market by firms possessing non-expropriating managers due to sheer competitive pressure .

However the banking industry, possibly due to its information-intensive nature, may be a lot less competitive than other business sectors (Caprio and Levine, 2002). Therefore this lack of competitive pressure as well as the special nature of banking suggests that banks may need stronger corporate governance mechanisms than other firms .

Effective corporate governance is no longer just desirable, it is being mandated, and soon it will be another part of doing business. Corporate governance is not an end in itself, but it designed to improve the banking system for innovative, responsive and, ultimately, profitable decision-making.

Todd Mitten, (2002), studied the legal protection of minority shareholders as a key element of corporate governance in a sample of 398 firms that had strong impact on firm performance during East Asian financial crisis of 1997-1998. He suggested that at least some power of improving minority shareholders protection lies at the firm level and companies that offered higher disclosure quality and greater transparency. A more favorable ownership structure and more focused organizations appear to have provided greater protection to their minority

shareholders during the East Asian crisis. He found that countries should build strong institutional foundation before opening to foreign capital flows.

Since safe and sound banking systems are indispensable for sustainable economic growth, banks are subject to special licensing, regulation and supervision rules. Researchers have studied the implications of concentrated ownership that is common in many emerging and developed markets.

Despite the growing literature in the field, very little attention has been focused on the issue of corporate governance, especially in banking organizations. Shleifer and Vishny (1997) have observed in their survey that “despite the general focus on this topic, very little attention has been paid to the corporate governance of banks. This is particularly strange in light of the fact that a significant amount of attention has been paid to the role that the banks themselves play in the governance of other sorts of firms”.

La Porta et al (1999) studied corporate governance patterns in 27 countries and concluded that “the principle agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders”. Some recent studies have attempted to explore the issue of corporate governance in banking organizations. Boubkari et al (2003) examined the corporate governance features of newly privatized firms in Asia and documented how their ownership structure evolves after privatization. The results suggest that, on the one hand, privatization leads to significant improvements in profitability, while on the other hand, it creates value for shareholders.

In the case of Palestinian banking system, there is still no consensus on whether banks need to be regulated and, if so, how? This partly reflects the lack of consensus on the nature of the market failure that makes free banking not optimal (Dowd and Benston (1996).

Nonetheless, there are two justifications that are often presented for regulating banks: the risk of systematic crisis and inability of depositors to monitor banks. (Goodhart et al (1998) and bank's provision of liquidity services leaves them exposed to runs (Diamond and Dybvig (19983)). The reason is that a bank needs to operate with a balance sheet where the liquidation value of its assets is less than the value of liquid deposits in order to provide liquidity services. Under these circumstances, given that depositors' expectations about the value of their deposits depend on their place in line at the time of withdrawal because of the first come, first served rule, a run can occur without the release of adverse information about bank's assets and even when there is perfect information about the bank's assets.

The corporate governance of banks in our economy is important for several reasons.

1. Banks have an overwhelmingly dominant position in developing economy financial systems, and are extremely important engines of economic growth. (King and Levine 1993 a,b ; Levine 1997).
2. As financial markets are usually underdeveloped, banks are typically the most important source of finance for majority firms.
3. As well as providing a generally accepted means of payment, banks in any countries are usually the main depository for the economy's savings.
4. Many economies have recently liberalized their banking systems through privatization/disinvestments and reducing the role of economic regulation.

Consequently, managers of banks have obtained grater freedom in how they run their banks. The international governance of bank capital regulation started with the 1998 Basel Accord on capital standards. The G10 countries signed the Accord, which intended to apply only to internationally active banks. Its focus was the measurement of capital and the definition of

capital standards for credit risk. As a part of its on-going efforts to address supervisory issues, the Basel Committee on Banking Supervision (OECD Principles of Corporate Governance issued June 21, 1999), has been active in drawing from the collective supervisory experts and other supervisors in issuing guidance to foster safe and sound banking practices. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Basel Committee issued several papers including principles for the management of interest rate risk (September 1997), framework for internal control systems in banking organization (September 1998), enhancing bank transparency (September 1998), and principles for management of credit risk (issued as consultative document in July 1999). There are many factors of good governance practice by banks. According to Bank for International Settlements (BIS) (a key element of good governance of the banking industry is the quality of governance of monetary authorities and bank supervision agencies. According to Fluency (1996), bank soundness is evaluated based on capital adequacy, assets quality, management capability, earnings potential and liquidity. A bank can be transparent to market participants both before and after investments are made in the bank. If it ex post transpires that the value of bank's assets is low, its creditors, and particularly its uninsured depositors, may withdraw their funds. The threat of a bank run can then discipline bankers in their risk-taking. (Calomiris and Khan 1999). Ex ante transparency implies that potential depositors and other creditors can appreciate a bank's financial condition prior to placing funds in it. This strengthens market discipline, because the better investors are able to evaluate banks' risk positions, the more risk –sensitive the supply of funds to the banks should be. (Billet 1998. corporate governance became an investor demand in the 1990s around the world. As far as shareholders are concerned, the new insistence on corporate governance represents the victory of the individual investor over corporate tyranny and executive greed (Farrely, 1993). Good corporate governance means interacting between

shareholders and the market in timely and transparent manner, and setting remuneration levels of directors and key staffs. In general great corporate governance is important element to culture the long- term development of banks. (Vishny. 1997).some studies (Butter, 2004) argue that there are three approaches for corporate governance in the world according to the different national legal systems that are shaped by unique political, social, and economic forces. One study made by Matutes and Vives (2000), who analyze the impact of market power on banks' risk –taking incentives. They find that the introduction of flat premium deposit insurance eliminates the beneficial effects of the competition and that unobservable portfolio risk, along with limited liability, leads to maximal risk-taking incentives. They also document an interesting equivalence result: full transparency and risk-based lead an equal risk- taking incentives. Another related paper is Cordella and Levy (1998), who point out that if the shocks are economy- wide and banks cannot control their asset portfolio risks, then full transparency of banks' risk positions may increase financial fragility. In general, and after reviewing a lot of literatures, we conclude that corporate governance is clearly of fundamental importance, both at the level of individuals and for the financial system and economy as a whole. It is important in respect of ethics, politic, social, economic aspect. According to (OECD. The corporate governance principles are: shareholders Rights, Equitable Treatment of Shareholders, Stakeholders Role, Disclosure & Transparency, and Board responsibilities.

Although the subject of corporate governance in developing economies has recently received a lot of attention in the literature (Oman, 2001; Goswami, 2001; Lin, 2001; Malherbe and Segal, 2001), the corporate governance of banks in developing economies has been almost ignored by researchers (Caprio and Levine, 2002). Even in developed economies, the corporate governance of banks has only recently been discussed in the literature (Macey and O'Hara, 2001). In order to address this deficiency, this paper discusses some of the key concepts and issues for the corporate governance of banks in developing economies.



Recent research on corporate governance around the world has established a number of empirical regularities. Such diverse elements of countries' financial systems as the breadth and depth of their capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation appear to be explained both conceptually and empirically by how well the laws in these countries protect outside investors. According to this research, the protection of shareholders and creditors by the legal system is central to understanding the patterns of corporate finance in different countries.

Investor protection turns out to be crucial because, in many countries, expropriation of minority shareholders and creditors by the controlling shareholders is extensive. When outside investors finance firms, they face a risk, and sometimes near certainty, that the returns on their investments will never materialize because the controlling shareholders or managers expropriate them. (We refer to both managers and controlling shareholders as "the insiders.") Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders. Expropriation can take a variety of forms. In some instances, the insiders simply steal the profits. In other instances, the insiders sell the output, the assets, or the additional securities in the firm they control to another firm they own at below market prices. Such transfer pricing, asset stripping, and investor dilution, though often legal, have largely the same effect as theft. In still other instances, expropriation takes the form of diversion of corporate opportunities from the firm, installing possibly unqualified family members in managerial positions, or overpaying executives. In general, expropriation is related to the agency problem described by Jensen and Meckling (1976), who focus on the consumption of "perquisites" by managers and other types of empire building. It means that the insiders use the profits of the firm to benefit themselves rather than return the money to the outside investors. If extensive expropriation undermines

the functioning of a financial system, how can it be limited? The legal approach to corporate governance holds that the key mechanism is the protection of outside investors—whether shareholders or creditors—through the legal system, meaning both laws and their enforcement. Although reputations and bubbles can help raise funds, variations in law and its enforcement are central to understanding why firms raise more funds in some countries than in others. Largely, potential shareholders and creditors finance firms because the law protects their rights. These outside investors are more vulnerable to expropriation, and more dependent on the law, than either the employees or the suppliers, who remain continually useful to the firm and are thus at a lesser risk of being mistreated.

The legal approach to corporate governance is a natural continuation of the field as it has developed over the last 40 years. Modigliani and Miller (1958) think of firms as collections of investment projects and the cash flows these projects create, and hence naturally interpret securities such as debt and equity as claims to these cash flows. They do not explain why the managers would return the cash flows to investors. Jensen and Meckling (1976) point out that the return of the cash flows from projects to investors cannot be taken for granted, and that the insiders of firms may use these resources for their own benefit. Jensen and Meckling view financial claims as contracts that give outside investors, such as shareholders and creditors, claims to the cash flows. In their model, the limitation on expropriation is the residual equity ownership by entrepreneurs that enhances their interest in dividends relative to perquisites.

Research by Grossman, Hart, and Moore, summarized in Hart (1995), makes a further key advance by focusing squarely on investor power vis a vis the insiders, and distinguishing between the contractual and residual control rights that investors have. Economists have used this idea to model financial instruments not in terms of their cash flows, but in terms of the rights they allocate to their holders. In this framework, investors get cash only because they

have power. This can be the power to change directors, to force dividend payments, to stop a project or a scheme that benefits the insiders at the expense of outside investors, to sue directors and get compensation, or to liquidate the firm and receive the proceeds. Unlike in the Modigliani-Miller world, changing the capital structure of the firm changes the allocation of power between the insiders and the outside investors, and thus almost surely changes the firm's investment policy .

In both the contractual framework of Jensen and Meckling and the residual control rights framework of Grossman, Hart, and Moore, the rights of the investors are protected and sometimes even specified by the legal system. For example, contract law deals with privately negotiated arrangements, whereas company, bankruptcy, and securities laws specifically describe some of the rights of corporate insiders and outside investors. These laws, and the quality of their enforcement by the regulators and courts, are essential elements of corporate governance and finance (La Porta, Lopez-de-Silanes, Shleifer and Vishny 1997, 1998). When investor rights such as the voting rights of the shareholders and the reorganization and liquidation rights of the creditors are extensive and well enforced by regulators or courts, investors are willing to finance firms. In contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well .Jensen and Meckling (1976) recognize the role of the legal system when they write :This view of the firm points up the important role which the legal system and the law play in social organizations, especially, the organization of economic activity. Statutory law sets bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate contracts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed

and the extent to which contracting is relied upon (p. 311). (One way to think about legal protection of outside investors is that it makes the expropriation technology less efficient. At the extreme of no investor protection, the insiders can steal a firm's profits perfectly efficiently. Without a strong reputation, no rational outsider would finance such a firm. As investor protection improves, the insiders must engage in more distorted and wasteful diversion practices such as setting up intermediary companies into which they channel profits. Yet these mechanisms are still efficient enough for the insiders to choose to divert extensively. When investor protection is very good, the most the insiders can do is overpay them, put relatives in management, and undertake some wasteful projects. After a point, it may be better just to pay dividends. As the diversion technology becomes less efficient, the insiders expropriate less, and their private benefits of control diminish. Firms then obtain outside finance on better terms. By shaping the expropriation technology, the law also shapes the opportunities for external finance. S&P's Governance Services defines corporate governance as "the interaction of managers, directors and shareholders to direct and control the company, and to ensure that all financial stakeholders receive their fair share of a company's earnings and assets" (S&P's 2003). There are two major systems of corporate governance: the Anglo-American/Anglo-Saxon model and the Franco-German or Japanese model. The Anglo-American model focuses primarily on shareholder wealth maximization, while the Franco-German model advocates a greater balance of interests between shareholders and other external stakeholders, particularly banks and employee groups (Macey and O'Hara, 2003; and S&P's, 2003).

Kang and Shivdasani (1995), and Kim and Limpaphayom (1998) examined the corporate governance structure in Japan. Kang and Shivdasani (1995) studied the role of corporate governance mechanisms during top executive turnover in Japanese corporations. Consistent with the U.S. evidence, the chance of non-routine turnover is significantly associated with

industry-adjusted return on assets, excess stock returns, and negative operating income, but is not associated with industry performance. Kim and Limpaphayom (1998) investigated the impact of corporate governance structure on the relationship between ownership structure and financial leverage among Japanese firms, but found no significant relationship between them. Lemmon and Lins (2003) examined the effect of ownership structure on changes in shareholder value during the Asian financial crisis using a sample of 800 firms in eight East Asian countries. The crisis negatively affected the investment opportunities of firms in these countries and raised the incentives of controlling shareholders to expropriate minority shareholders. Kaplan and Minton (1994) and Kroszner and Strahan (2001) examined the role that banks play in the governance of other types of firms. Kaplan and Minton (1994) investigated the determinants of the appointment of outsiders (bank and corporate directors) to Japanese boards of directors. Their results indicate that banks and corporate shareholders play a significant monitoring and disciplinary role in Japan. Kroszner and Strahan (2001) examined the costs and benefits when a banker is represented on a firm's board of directors in the U.S. The results of their study show that banks in the U.S. tend to lend more to firms in industries in which their executives serve on the board, and U.S. bankers are more heavily involved in the corporate board network than are executives of other corporations.

Macey and O'Hara (2002 and 2003) studied the corporate governance of banks in the U.S. In their 2002 study they argue that the most acute corporate governance problem that American banks encounter is the incentive of shareholders to transfer wealth to themselves from fixed claimants such as depositors and government insurers by increasing the riskiness of the business. They proposed solutions to solve the corporate governance problems of banks in the U.S. Specifically, they suggested changing the law to expand the scope of the fiduciary duties of bank directors, to raise the conflict of interest rules for bank directors, and to establish and implement monitoring systems to incorporate solvency risk into directors' decision-making.

Banks provide a substantial proportion of external finance to corporations around the globe (Mayer, 1988). Yet, there have been no studies of whether international differences in bank supervision influence the obstacles that corporations face in raising external finance.

This thesis examines competing theories regarding which bank supervisory approaches work best to facilitate the flow of credit to firms. Due to information and transaction costs, core theories of public policy and regulation imply that strong official supervision of banks can improve the corporate governance of banks (Atkinson and Stiglitz, 1980; Stigler, 1971).<sup>1</sup> This “**official supervision view**” holds that private agents frequently lack the information, incentives, and capabilities to monitor powerful firms and banks (Becker, 1968; Becker and Stigler, 1974). From this perspective a powerful supervisory agency will enhance corporate governance of banks, improve the incentives facing bank managers, and thereby boost the efficiency with which banks intermediate society’s savings. The official supervision theory assumes that governments have both the expertise and the incentives to ameliorate information, enforcement, and transaction costs and improve corporate governance of banks. An alternative to the official supervision view also draws on core theories of public policy and regulation. The “**political/regulatory capture view**” argues that politicians do not maximize social welfare; they maximize their own welfare (Hamilton, et al., 1788; Buchanan and Tullock, 1962; Becker, 1983). Thus, politicians may induce banks to divert the flow of credit to politically connected firms, or powerful banks may “capture” politicians and induce official supervisors to act in the best interests of banks rather than in the best interests of society (Stigler, 1975).<sup>2</sup>

(Becker and Stigler, 1974; Stigler, 1975; Rajan and Zingales, 2003). This political/regulatory capture theory suggests that direct official supervision of banks may actually reduce the efficiency with which banks allocate credit. Specifically, while powerful official supervision

may increase the flow of credit to a few well-connected firms, the political/regulatory capture theory holds that powerful supervision will hurt the availability of credit to firms in general. Economists have attempted to derive mechanisms that simultaneously recognize the importance of market failures, which motivate government intervention, and political failures, which suggest that politicians and regulators do not necessarily have incentives to ease market failures (Becker and Stigler, 1974). From this perspective, the challenge is to create mechanisms that negate the “grabbing hand” of politicians while creating incentives for official agencies to improve social welfare (North, 1990; Shleifer and Vishny, 1998; Haber, 2003).<sup>2</sup>

In the area of bank supervision, proponents of the “**independent supervision view**” argue that creating an independent agency is a useful mechanism for balancing market and political failures. This view holds that if supervisors are independent from the government and if supervisors have proper incentives, then this reduces the likelihood that politicians will use the supervisory agency to induce banks to funnel credit to favored ends. Similarly, if the supervisory agency is independent from banks and if supervisors have proper incentives, then this lowers the probability that banks will capture supervisors. Thus, the independent supervision view proposes a compromise to create a supervisory agency that has the resources to overcome information asymmetries but that is sufficiently independent so that it avoids political/regulatory capture. Under these conditions, independent supervision can enhance the corporate governance of banks and lower firms’ external financing obstacles. The “**private empowerment view**” takes a different approach to confronting information and enforcement costs while recognizing that politicians act in their own interests. The private empowerment theory suggests that bank supervisory strategies should (1) focus on enhancing the ability and incentives of private agents to overcome informational barriers and exert corporate control over banks and (2) limit the power of official supervisors. Thus, the “private empowerment”

theory seeks to limit the powers of the supervisory agency so that the government is unable to use bank supervision to achieve political ends. Simultaneously, the private empowerment theory seeks to provide the supervisor with sufficient power to force accurate information disclosure so that private agents can more easily monitor banks (Hay and Shleifer, 1998). This will boost private monitoring of banks and thereby enhance the incentives of bank managers to allocate capital based on efficiency considerations (Grossman and Hart, 1980). Furthermore, this view argues that many empowered bank creditors will be less susceptible to capture by politicians and banks than a single government supervisory agency.

Thus, special connections and corruption may play less of a role in countries that foster private monitoring. Finally, a second component of the private empowerment view stresses incentives. Private creditors will more effectively exert corporate governance of banks and therefore enhance corporate financing if the government does not distort incentives through excessively generous deposit insurance. This paper is further motivated by basic finance theory, banking sector policy concerns, and broad public policy debates. Consider first corporate finance theory and core theories of financial intermediation. An enormous theoretical literature examines the role of banks, along with shareholders and other financiers, in easing financing constraints and exerting corporate governance (Shleifer and Vishny, 1997). Based on some of these models, new research examines how laws and regulations concerning shareholders influence corporate finance (e.g., La Porta et al., 2000). Yet, there exists no corresponding work that examines how bank supervision influences corporate finance. Also, core theories of financial intermediation provide a theoretical mechanism linking bank supervisory approaches to credit availability. Calomiris and Kahn

(1991), Flannery (1994), and Diamond and Rajan (2001) develop models in which the fragile structure of banks, i.e., liquid deposits and illiquid assets, serves as an effective commitment



device that keeps banks from assuming excessive risks or from shirking on collecting payment from firms. Put succinctly, the sequential service constraint on bank deposits creates a collective action problem among depositors that induces depositors to run if they acquire information that the bank is not monitoring firms and managing risk appropriately. In this context, generous deposit insurance impedes the commitment device (threat of a run) and raises barriers to firm financing (Diamond and Rajan, 2001). Similarly, supervisory policies that induce greater information disclosure by banks will enhance the commitment mechanism and facilitate external finance. This paper is an initial attempt to understand how different supervisory strategies affect the obstacles faced by firms in raising external finance.

Second, bank supervision is frequently discussed in the context of avoiding banking crises. However, crises cannot be the only criterion because policymakers can essentially eliminate banking crises through a 100 percent reserve requirement. Thus, an important objective of bank supervision – though often under-stated – is to foster efficient capital allocation; i.e., to finance worthy firms. This is the first paper to assess the impact of bank supervision on the firms' financing obstacles across a broad cross-section of countries.

### **Elements of corporate governance**

Different authors and management specialists have argued that corporate governance requires laid down procedures, processes, systems and codes of regulation and ethics that ensures its implementation in organizations. Some suggestions that have been underscored in this respect include the need for banks to set strategies – which have been commonly referred to as corporate strategies - for their operations and establish accountability for executing these strategies. El-Kharouf (2000) while examining strategy, corporate governance and the future of the Arab banking industry, points out that corporate strategy is a deliberate search for a plan of action that will develop the corporate competitive advantage and compounds it.

In addition to this, the BCBS (1999) contends that transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank. The Committee advances further that various corporate governance structures exist in different countries hence there is no universally correct answer to structural issues and that laws do not need to be consistent from one country to another. Sound governance therefore, can be practiced regardless of the form used by a banking organization. The Committee therefore suggests four important forms of oversight that should be included in the organizational structure of any bank in order to ensure the appropriate checks and balances and these include:

1. oversight by the board of directors or supervisory board;
2. oversight by individuals not involved in the day-to-day running of the various business areas;
3. direct line supervision of different business areas, and;
4. Independent risk management and audit functions.

In summary, they demonstrate the importance of key personnel being fit and proper for their jobs and the potentiality of government ownership of a bank to alter the strategies and objectives of the bank as well as the internal structure of governance hence the general principles of sound corporate governance are also beneficial to government-owned banks.

The concept of good governance in banking industry empirically implies total quality management which includes six performance areas (Khatoun, 2002). These performance areas include capital adequacy, assets quality, management, earnings, liquidity, and sensitivity risk.

Khatoon argues that the degree of adherence to these parameters determines the quality rating of an organization.

According to Tsui and Gul (2000), corporate governance mechanisms including accounting and auditing standards are designed to monitor managers and improve corporate transparency. A number of corporate governance mechanisms have been identified analytically and empirically. These, according to Agrawal and Knoeber, (1996), may be broadly classified as internal and external mechanisms as summarized in figure 2.1

### **The Banking System in Palestine**

The historical development of the banking sector in Palestine was, initially, marked by weakness and deformity in its structure and activities due to the political circumstances that Palestine went through. Apparently, there was an immense need for building a strong banking system able to meet the economical and financial requirements in Palestine. PNA had realized this need, thus, H.E. President Yaser Arafat had passed resolution number 184 on 1/12/1994 that stipulated the establishment of the Palestine Monetary Authority. Since then, PMA made every effort to restructure the banking sector in Palestine according to modern international standards. It carried out the responsibility of building a strong and safe banking sector and had accomplished some remarkable achievements in this regard.

Following is a historical review of the development of the Palestinian banking sector since 1948 until 2003 and the PMA's role in developing this sector.

#### ***Before 1994***

Before 1948 there were many banks and financial institutions working in Palestine. Arab bank was the most famous. It was established in 1930 in Jerusalem and spread out its branches over many Palestinian cities after that.

During this period, the West Bank (WB) was governed by the Jordanian rules and regulations.

There were (8) operating banks with (32) branches. Those banks were:

Arab Bank, Arab Land Bank, Cairo-Amman Bank, ANZ Grindlays Bank (Ottoman Bank), Bank of Jordan, Jordan-National Bank, Intra Bank (Orient), and British Bank of Middle East.

At the same time, Gaza Strip (GS) was governed by the Egyptian administration.

Accordingly, banks in GS were operating according to Egyptian rules and regulations. There were (6) operating banks in GS with (7) branches. Those banks were: Bank of Palestine, Arab Bank, Alexandria Bank, Nation Bank, and Agriculture Lending Bank.

During this period all operating banks in WB and GS were closed due to Israeli occupation and replaced by Israeli banks to take over in the Palestinian territories. The Israeli banks in these territories were (6) with (39) branches. The main aim of those banks was to facilitate the exchange of commercial operations between the WB and GS on one side, and between them and Israel on the other side. However, Israeli banks continued to exist in the WB and GS until the eruption of the Palestinian Intifada in 1987. Palestinian people rejected the existence of Israeli banks, consequently, these banks were forced to pull out from the Palestinian territories except for Mercantile Discount Bank in Bethlehem city that kept operating until December of 2000.

In 1981, Bank of Palestine was permitted to operate in Gaza city and banned from opening new branches in Khan-Younis. However, in 1989 it was allowed to open new branches and by the end of 1993 there were (5) branches. In 1986, Cairo-Amman Bank was permitted to operate in Nablus city and had, thereafter, spread out its branches over many of the Palestinian cities. By the end of 1993, Cairo-Amman bank was operating (8) branches. At that time, those banks were unable to function as intermediaries between depositors and borrowers

due to Israeli obstacles and restrictions. The main job of these banks was to facilitate the commercial operations and to hold deposits.

During this period, many of the specialized lending institutions were operating, side by side with banks. These institutions included The Specialized Development Institution, The Economical Development Group, and The Higher Joint Jordanian-Palestinian committee that had financed many projects in Palestine.

After signing Paris protocol on Economic Relation between Palestine National Authority (PNA) and Israel, many political and economical changes took place.

Article (4) of this protocol gave the PNA the right to establish their own Monetary Authority to implement and regulate monetary policies in Palestine.

Accordingly, PMA was established, many old banks were permitted to reopen their branches, and new banks had opened during the same year. The number of banks in Palestine increased to (8) with (34) branches by the end of the year 1994. These banks were classified as (2) national banks operating (9) branches and (6) foreign banks operating (25) branches.

***From 1/1/1995 to 2000:***

During this period many license applications had been submitted to the PMA asking for opening new banks or new branches. As a result, eight new banks and (23) branches were granted licenses. Thus, the total number of banks operating in Palestine increased to (16) with a network of (57) branches. These banks were classified as (6) national banks

(Consisting 37.5% of total banks) with (14) branches or (24.56% of total branches) and (10) foreign banks (consisting 62.5% of total banks) with (43) branches or (75.44% of total branches).

During this year (4) new banks were licensed in Palestine with (14) branches. The total number of banks increased to (20) with (71) branches. National banks went up to (8) (Consisting 40% of total banks) with (20) branches or (28.17% of total branches). On the other hand, foreign banks went up to (12) banks or (60% of total banks) with (51) branches or (71.83% of total banks' branches).

During this year one new bank was licensed in addition to (18) new branches. This has increased the total number of banks to (21) with (89) branches. Nine of these banks were national banks which consisted (42.86%) of total banks with (29) branches or (32.58% of total banks' branches). Foreign banks remained (12) banks which consisted (57.14%) of total banks with (60) branches or (67.41%) of total banks' branches operating in Palestine. During this year one new bank was licensed and another (16) new branches were opened. This had increased the total number of banks to (22) with (105) branches. However, the number of national banks remained the same, that is, (9) banks which consisted (40.91%) of total operating banks with (40) branches or (38.1%) of total branches. On the other hand, the number of foreign banks had increased to (13) banks or (59.09%) of total operating banks with (65) branches or (61.9%) of total branches operating in Palestine.

This period was characterized by the expanding of the branches network in Palestine. Twelve new branches were licensed to operate which had led to increase the total number of branches to (117) while the total number of banks remained the same with (22) banks. Branches of national banks went up to (50) or (42.74%) of total branches. At the same time, the number of branches of foreign banks had, also, increased to (67) or (57.26%) of the total number of branches in Palestine.

***From 1/1/2000 to 31/12/2005:***

The number of banks in Palestine decreased to (21) by the end of this period with (120) branches. The number of national banks remained the same with (9) banks or (42.86%) of total banks operating (52) branches or (40.9%) of total branches operating in Palestine. However, foreign banks had decreased to (12) banks or (57.14%) of total banks operating (68) branches or (59.09%) of total branches in Palestine.

By the end of this year, the number of banks had increased again to (22) banks operating (126) branches. Palestinian Banking Corporation was licensed as a specialized institution. Thus, national banks went up to (10) banks or (45.45%) of the total banks with (58) branches or (46.03%) of total branches. Foreign Banks remained (12) banks which consisted (54.56%) of total banks in Palestine with (68) branches or (53.97%) of total branches in Palestine.

The number of banks at the end of this period was (21) with a net of (127) branches distributed over the Palestinian Governorates. Ten of these banks were classified as national banks which consisted (47.62%) of total banks with (59) branches or (46.46%) of total branches. Foreign Banks were (11) which consisted (52.38%) of total banks and were operating (68) branches or (53.54%) of total branches in Palestine. It worth mentioning here that the number of foreign banks was reduced due to the withdrawal of the Grindlays bank. By the end of this period, the West Bank or Northern Governorates had (90) branches i.e. (70.9%) of total branches, whereas, (37) branches i.e. (29.1%) of total branches were operating in Gaza Strip or Southern Governorates.

By the end of year 2003 there were (22) banks operating through a network of branches and offices totaling (133). Ten of these banks were classified as national banks i.e. (45.45%) of total banks with (60) branches or (45.11%) of total branches and offices. Twelve were foreign

banks i.e. (54.55%) of total banks with (73) branches and offices i.e. (54.89%) of total branches.

By the end of this period, Northern Governorates had (95) branches and offices i.e. (71.43%) of total branches. Southern Governorates, on the other hand, had (38) branches and offices i.e. (28.57%) of total branches and offices.

This period was characterized by the expanding of the branches network in Palestine . Four new branches were licensed to operate, which increased the total number of branches to (137), while the total number of banks remained the same with (22) banks.

The number of national banks remained the same, that is (10) banks, which represents (45.45%) of total operating banks with (63) branches, which represent (45.99%) of the total branches and offices . On the other hand the number of foreign banks remained (12) banks, which represents (54.55%) of total banks with (74) branches and offices, that represent (54%) of the total branches and offices operating in Palestine.

By the end of this period, we notice that northern Governorates of Palestine had (98) branches and offices, which represent (71.53%) of total branches. southern Governorates on the other hand had (39) branches and offices, that is (28.47%) of total branches and offices the table below shows the development of banks and its branches during the period (1995-2005)

***Development of Banks and its branches during (1995-2003)***

The below table shows the continuous increase in the number of banks and branches over time, which reflects PMA's concern of providing banking services to most of the Palestinian territories, particularly, the most populated areas with the highest economic activities. We list below the banks operating in Palestine classified according to their nationality:



## Development of Number of Banks and its branches during (1995-2005)

**Table 1 - A: Number of Banks / Governorates During the Period 1995 - 2005**

Year	Northern Governorates			Southern Governorates			Total in Palestine		
	National	Foreign	Total	National	Foreign	Total	National	Foreign	Total
1995	4	10	14	2	0	2	6	10	16
1996	6	11	17	2	1	3	8	12	20
1997	7	11	18	2	1	3	9	12	21
1998	7	12	19	2	1	3	9	13	22
1999	7	12	19	2	1	3	9	13	22
2000	7	11	18	2	1	3	9	12	21
2001	8	11	19	2	1	3	10	12	22
2002	8	10	18	2	1	3	10	11	21
2003	8	11	19	2	1	3	10	12	22
2004	8	11	19	2	1	3	10	12	22
2005	8	11	19	2	1	3	10	12	22

**Table 2 – B: Number of Banks' Branches and Offices during the Period 1995 - 2005**

Year	Northern Governorates			Southern Governorates			Total in Palestine		
	National	Foreign	Total	National	Foreign	Total	National	Foreign	Total
1995	5	33	38	9	10	19	14	43	57
1996	10	39	49	10	12	22	20	51	71
1997	16	45	61	13	15	28	29	60	89
1998	24	50	74	16	15	31	40	65	105
1999	31	52	83	19	15	34	50	67	117
2000	33	52	85	19	16	35	52	68	120
2001	38	52	90	20	16	36	58	68	126
2002	38	52	90	21	16	37	59	68	127
2003	39	56	95	21	17	38	60	73	133
2004	40	56	96	21	17	38	61	73	134
2005	41	57	98	22	17	39	63	74	137

- National Banks: there are (10) national banks operating in Palestine. These banks are Palestine Limited Bank, Palestine Commercial Bank, Palestine Investment Bank, Arab Islamic Bank, Alquds for Development and Investment Bank, Arab Palestinian Investment Bank, Palestine International Bank, Palestine Islamic Bank, Alaqsa Islamic Bank and Palestinian Banking corporation. National banks operate (63) branches and offices i.e. (45.45%) of total banks and (45.99%) of total branches and offices. It worth mentioning here that before the establishment of the PMA there were only (2) banks with (9) branches.
- Jordanian Banks: nine Jordanian banks are, currently, operating in Palestine. These banks are Arab Bank, Cairo-Amman Bank, Bank of Jordan, Jordan commercial Bank, Jordan-National Bank, Housing Bank for Trade and Finance, Jordan-Kuwait Bank and Union Bank for Savings and Investments.
- Egyptian Banks: the two Egyptian banks operating in Palestine are the Egyptian Arab Land Bank and the Principal Bank for Development and Agricultural Credit.
- Foreign Banks: HSBC Middle East.

The above preview shows the substantial changes done by the PMA to the structure of the banking sector in Palestine. Particularly, the PMA had played a major role in increasing the number of national banks and its branches. Under PMA supervision, national banks jumped to (10) banks operating (63) branches and offices by the end of year 2005.

### **Corporate Governance in Palestinian Banking Sector**

Macey and O'Hara (2003) argue that commercial banks pose unique corporate governance problems for managers and regulators, as well as investors and depositors. They observe that the intellectual debate in corporate governance has focused on two very different issues:

Whether corporate governance should focus exclusively on protecting the interests of equity claimants in the corporation or whether corporate governance should instead expand its focus to deal with problems of other groups – stakeholders – or non-stakeholder constituencies.

Corporate governance should concern itself exclusively with the challenge of protecting equity claimants and attempts to specify ways in which the corporation can better safeguard those interests.

In addition, they state that the dominant model of corporate governance in law and economics is that the corporation is a “complex set of explicit and implicit contracts” meaning one should view the corporation as nothing than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants include not only shareholders, but also creditors, employee-managers, the local communities in which the firm operates, suppliers and customers. They contend that in the case of banks, these claimants also include the regulators in their role as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.

According to PMA (2002), corporate governance in the banking sector largely relates to the responsibility conferred to and discharged by the various entities and persons responsible for and concerned with the prudent management of the financial sector. The corporate governance stakeholders in the banking sector include the following:

- The board of directors,
- The management,
- The shareholders,
- PMA

- External auditors,

The customers and the general public also play a critical role in fostering corporate governance in the financial sector. In the late 980s and early 1990s, corporate governance issues were low priority in the Palestinian's banking sector. Directors were never vetted, shareholders could start banks almost at will, the role of the external auditors was not well defined, the prudential regulations were scanty and at some stage banks supervision was not playing a major role in ensuring prudence in the financial sector. The effect was imprudent lending practices, excessive investment in fixed assets, inadequate systems to measure, identify and control risks. Subsequently, the PMA undertook several measures to enhance corporate governance in the sector. The following measures were undertaken:

- introduction of an effective legal and regulatory framework
- development of prudential regulations,
- increased interaction with other regulatory authorities, directors and external auditors,

Other issues that touch on governance issues in banking include risk management. The PMA (2001) observe that the ever changing business environment characterized by globalization and deregulation has presented the banking sector with great challenges, which call for sound management systems capable of early identification, measuring, monitoring and controlling the various banking risks which include credit, currency, liquidity, interest rate and operational risks. The Bank observes that effective management of risks in banks requires risk management processes that cover the following:

- Management oversight,
- Policies and procedures,

- Risk measurements and;
- Internal controls.

Several challenges to sound risk management in the banking sector in Palestine have been observed to include:

- Lack of appropriate systems that can monitor compliance with internal control policies and limits on timely basis.
- Risk control functions and business operations are not well segregated, leading to conflict of interest in risk management,
- The presence of Board members who do not possess sufficient skills and knowledge to understand banking risks, renders the Board less effective in risk management,
- Limited source of good information on credit, From the foregoing discussion the study
- will adopt the following conceptual framework :

### **Principles of Good Corporate Governance**

Indeed, good corporate governance principles and practices aim to align as nearly as possible the interests of individuals, corporations, and society, which are critical to economic efficiency and social progress. A sound and robust corporate governance system is able to provide business competitive advantage, to strengthen the economy, to broaden capital markets, to attract long term capital, to promote sustained growth, and to discourage fraud and mismanagement. Regardless the development level of the country, the importance of corporate governance for improving economic efficiency is widely acknowledged. Good corporate governance is alleged to provide proper incentives for the board and management to

pursue objectives aligned to the interests of the suppliers of the capital and to encourage firms to use resources more efficiently (OECD, 1999).

### **The OECD Principles of Corporate Governance**

Since the first publication of the OECD principles of corporate governance in 1999, those principles have become the most widely accepted corporate governance benchmark and have inspired the drafting of other codes issued by international organizations, countries, companies and stock exchanges. The corporate governance framework devised by the OECD comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition as a way to cover the crucial elements for effective corporate governance practices.

In 2004, the OECD divulged a revised version of those principles covering the following areas:

1. ensuring the basis for effective corporate governance framework;
2. the right of shareholders and key ownership functions;
3. the equitable treatment of shareholders;
4. the role of stakeholders in corporate governance;
5. disclosure and transparency; and
6. the responsibilities of the board.

## **The Basel Committee Recommendations**

As highlighted on the paper Enhancing Corporate Governance for Banking Organizations issued in 1999 by Basel Committee, corporate governance involves the manner in which the business and affairs of institutions are governed affecting how banks:

1. set corporate objectives;
2. run the day-to-day operations of the business;
3. consider the interests of their stakeholders;
4. align corporate activities and behaviors with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
5. protect the interest of depositors.

From 1982, the Committee has proposed a vast collection of best practices that address several issues in the corporate governance sphere including the need for banks to set strategies and establish accountability, the importance of transparency, internal control requirements, and risk management, not to mention a special report on corporate governance (1999).

The most relevant publications addressing corporate governance are:

### **A. The compliance function in bank**

This consultative document was released in October 2003 for comment by 31 January 2004. It brings up eleven principles regarding three themes: (i) responsibilities of the board of directors for compliance, (ii) responsibilities of the senior management for compliance, and (iii) compliance function. Banking supervisors must be sure that effective compliance policies and procedures are consistently followed and that managers take appropriate corrective action

when laws, rules and standards are infringed. Compliance risk management may succeed when (i) culture emphasizes high standards of ethical behavior at all levels of the bank; (ii) the role and responsibilities of the compliance function is clearly defined, and (iii) the compliance function and the business activities are independent from each other.

#### **B. Sound practices for the management and supervision of operational risk**

This paper was issued in February 2003 to provide a framework for the effective management and supervision of operational risk. It raises ten principles covering four interconnected topics: (i) developing an appropriate risk management environment, (ii) identification, assessment, monitoring, and mitigation/control of operational risk- risk management, (iii) role of supervisors, and (iv) role of disclosure. Among other crucial elements, the Committee draws attention for importance of clear strategies and oversight by the board and senior management, effective internal reporting, contingency planning, and strong culture on both operational risk and internal control.

#### **C. Principles for the management and supervision of interest rate risk**

This consultative paper was issued in September 2003 for comment by 31 October 2003 compiling important issues on the management and supervision of interest rate risk. Although it was originally published as a supporting document to the Second Consultative Paper on the New Basel Capital Accord in January 2001, the Committee has decided to release a revised version for a second, short period of consultation particularly due to the important issues addressed. The paper presents fifteen principles including themes that are crucial to the corporate governance discussion such as : ( i) the development of a business strategy, (ii) the importance of internal control system, (iii) the need for effective interest rate risk management, monitoring and control, (iv) board and senior management oversight of the risk management process, (v) and disclosure.



**D. Principles for the management of credit risk**

This document was published in September 2000 with the purpose of encouraging supervisors to promote sound practices for managing credit risk. The recommended sound practices are arranged into seventeen principles covering several areas including: (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit-granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (v) ensuring adequate controls over credit risk.

**E. Internal audit in banks and the supervisor's relationship with auditors**

This paper was published in August 2001 to address bank supervisory issues and encourages sound practices regarding internal auditing in banking organizations. The Committee emphasizes that adequate internal controls within banking organizations must be supplemented by an effective internal audit function that independently evaluates the control systems within the bank. Internal auditing represents a valuable source of information for both bank management and supervisors about the quality of the internal control system.

**F. Sound practices for managing liquidity in banking organizations**

The Basel Committee published this document in February 2000 as part of its ongoing effort to strengthen procedures for risk management in bank organizations. Liquidity is critical to the viability of every bank and most of all the system as a whole. A shortfall in liquidity might have systemic repercussions and hence is one of the most important issues in the banking business. The paper presents fourteen principles around the following central topics: (i) developing a structure for managing liquidity; (ii) measuring and monitoring net funding requirement; (iii) managing market access; (iv) contingency planning; (v) foreign

currency liquidity management; (vi) internal controls for liquidity risk; (vii) role of public disclosure in improving liquidity; and (viii) role of supervisors.

### **G. Enhancing corporate governance for banking organizations**

This document was issued in September 1999 to reinforce the importance for the banks of the OECD corporate governance principles, to draw attention to governance issues addressed in previous papers, and to present some new topics related to the theme. Although the Committee recognizes that sound governance can be practiced regardless of the structure used by a single bank, it outlines four important forms of oversight that should be present in order to ensure adequate checks and balances:

- Oversight by the board of directors or supervisory board;
- oversight by individuals not involved in the day - to day operations;
- Direct line supervision of different areas of the business;
- Independent risk management and audit functions.

The Committee also suggests sound practices for corporate governance which are quoted below.

**Table 3 : Practices for corporate governance**

Practice 1:	Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organizations.
Practice 2:	Setting and enforcing clear lines of responsibility throughout the organization.

Practice 3:	Ensuring the board members are qualified for their positions, have a clear understanding of their role in corporate governance and not are subject to undue influence from management or outside concern.
Practice 4:	Ensuring that there is appropriate oversight by senior management.
Practice 5:	Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide.
Practice 6:	Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment.
Practice 7:	Conducting corporate governance in a transparent manner.

## **Chapter Three: Methodology**

### **Research Methodology**

The methodology that was utilized to achieve the thesis objectives comprises the following procedures:

- Conduct a comprehensive literature review to develop conceptual frame work for the empirical analysis of the thesis.
- Conduct both structured and informal interviews with senior bank officials, to explore thesis views and attendants towards corporate governance and to assess the degree of adherence to corporate governance principles practices.- Appendix I
- In-depth interviews with 47 people whom they have position in senior management in the sampled banks.

### **Sampling Design**

#### *Sample size*

The thesis sets the sample size of 17 respondents. Given an effect size for this sample, the results of the thesis are true 90% of the time using information with a margin of error of plus or minus 5%.

#### *Respondents*

Respondents are members of senior management of the selected banks in Ramalla there are some of (17) banks or 12.5% of total banks in Palestine. All bank directors of target banks who were available at the time of the study were intervened.

#### *Data Gathering*

Well – trained and experienced interviewers using a highly structured questionnaire conducted personal interviews. The questionnaire is shown in Appendix A. The interviewers followed the standard routine for conducting executive interviews, as follows:

- Letter was sent to Chairman of the Board.
- Confirmed receipt of such letter through telephone.
- On confirmation, copies of questionnaire of all Board members were sent through fax.
- Appointments were set for me.

The study set a maximum of three call backs, after which the target respondent was dropped from the list.

### **Survey Instrument**

The study made use of a six – page highly structured questionnaire. It was designed in such a way that it could be self – administrated. The first part of the questionnaire is an introduction and the other two parts comprise the survey proper.

### **Analytical Techniques**

The study used both the descriptive and causal methods of analysis. Where practical, nominations by respondents were transformed to numerical values or scaled using standard techniques for data transformation. The following were the techniques used for analysis.

#### *Descriptive Analysis*

Summary statistics using totals were used for qualitative information while measures of central location and dispersion were used in describing data with continuous scale.

### *Test of Proportion*

The Binomial Test procedure compares the observed frequencies of the two categories of a dichotomous variable to the frequencies expected under a binomial distribution with a specified probability parameter. By default, the probability parameter for both groups is 0.5. To change the probabilities, a test of proportion for the first group is attempted. The probability for the second group will be 1 minus the specified probability for the first group.

### *T-Test*

The Paired-Samples T Test procedure compares the means of two variables for a single group. It computes the differences between values of the two variables for each case and tests whether the average differs from 0.

### *Bivariate Correlation*

The Bivariate Correlations procedure computes Pearson's correlation coefficient, Spearman's tau-b with their significance levels. Correlations measure how variables or rank orders are related.

### *Linear Regression*

Linear Regression estimates the coefficients of the linear equation, involving one or more independent variables that best predict the value of the dependent variable. It is used in exploratory analysis and descriptive in nature.

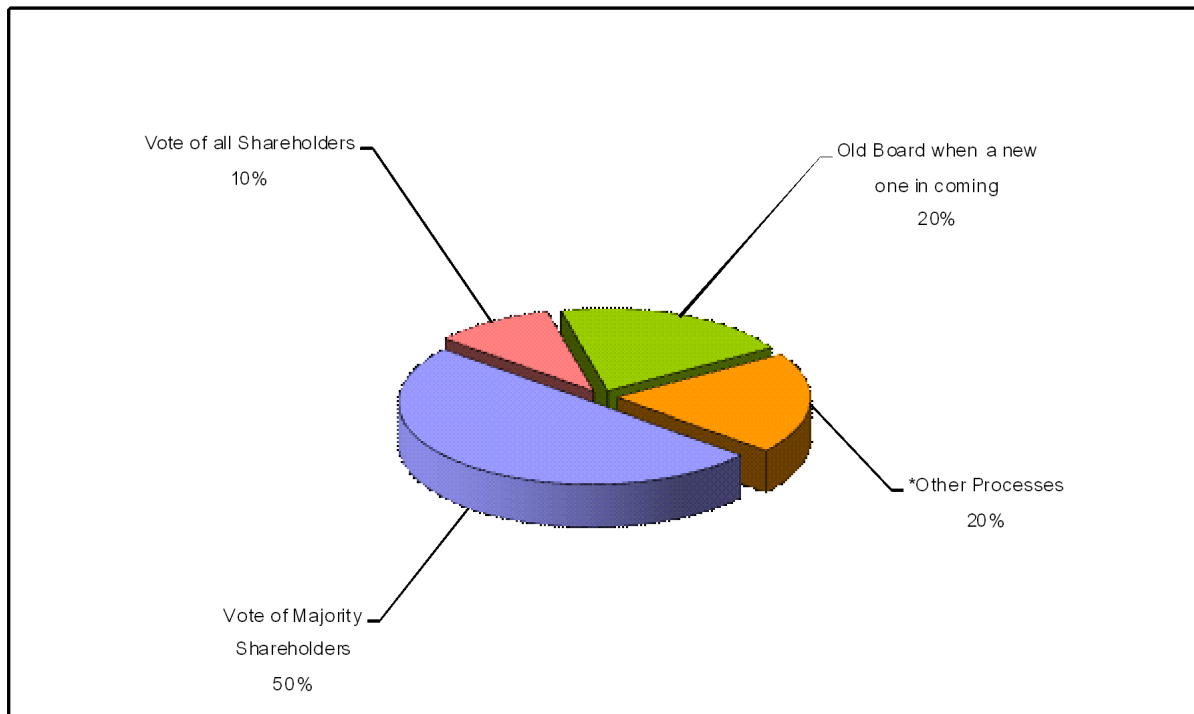
### *F. Respondent Profile*

A total of 43 bank directors from 17 banks were interviewed, an average of five respondents per bank. On the average, these directors are affiliated with banks that have been in operation for 35 years with two branches, has seven board members, and around 170 employees.

## Chapter Four: Findings and Discussion

### Findings

One half (50%) of the banks appointed their Board Members by vote of majority shareholders see figure 4.1.



**Figure 3 : How the Board of Directors is Appointed**

\* The other processes taking 20% include:

Nomination by the Board and the approval of appointment is done by the Shareholders.

Appointment by the Government in the case of Government Banks.

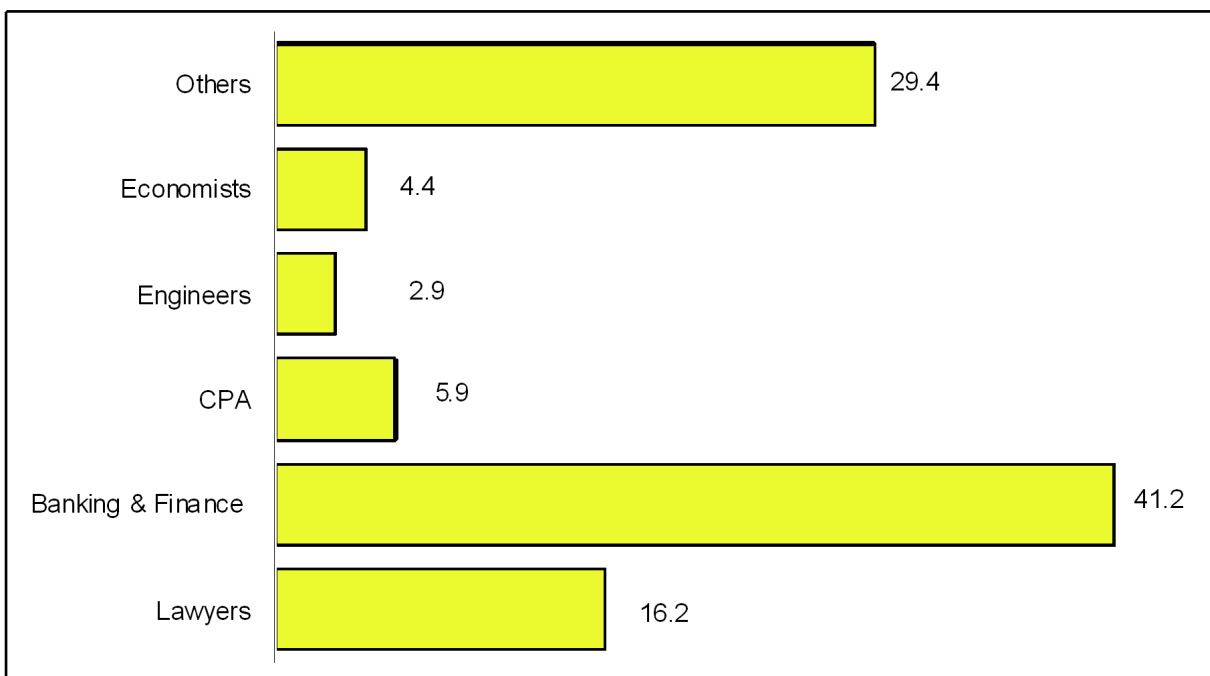
In all the cases except one, the number of executive non-executive directors was always more than that of executive directors. The average number of Executive Directors being 2 (with a range of 0 to 6) and Non- Executive being 5 (with a range of 0 to 9) respectively for every bank.



Regarding the composition of the Boards in terms of professional qualifications, there exists a professional mix which includes Lawyers, Banking and finance specialists, Certified Public Accountants, Engineers, Architects, Economists, Management and Insurance specialists.

Figure 4.2 details this breakdown in proportions.

**Figure 4 : Professional Qualifications of Board Members**



\* The others as mentioned include: Architects, Management and Insurance specialists.

From figure 4.2 it is noted that majority of Board members of various banks are professionals in the areas of banking and Finance followed by Law.

Men form the majority of Board members of most banks. The number of male Board members range from 6 to 11 while female members range from 0 to 3 with 50% of the banks have no female Board members at all.

The powers of the Board

The powers of the Board that were mentioned included:

Policy making and decisions.

Regulation of issuance and management of shares.

Performance reviews

Compliance audits

Corporate governance

Responsibilities of the Board

Policy formulation in accordance with the relevant Acts.

Keeping proper books of accounts.

Prepare financial statement while:

Selecting suitable accounting policies and then apply them consistently.

Making judgment and estimates that are reasonable and prudent.

Stating whether applicable accounting standards have been followed

Preparing the financial statements on the going concern basis.

Provision of leadership.

Formulate strategies.

Receive and approve reports of committees.

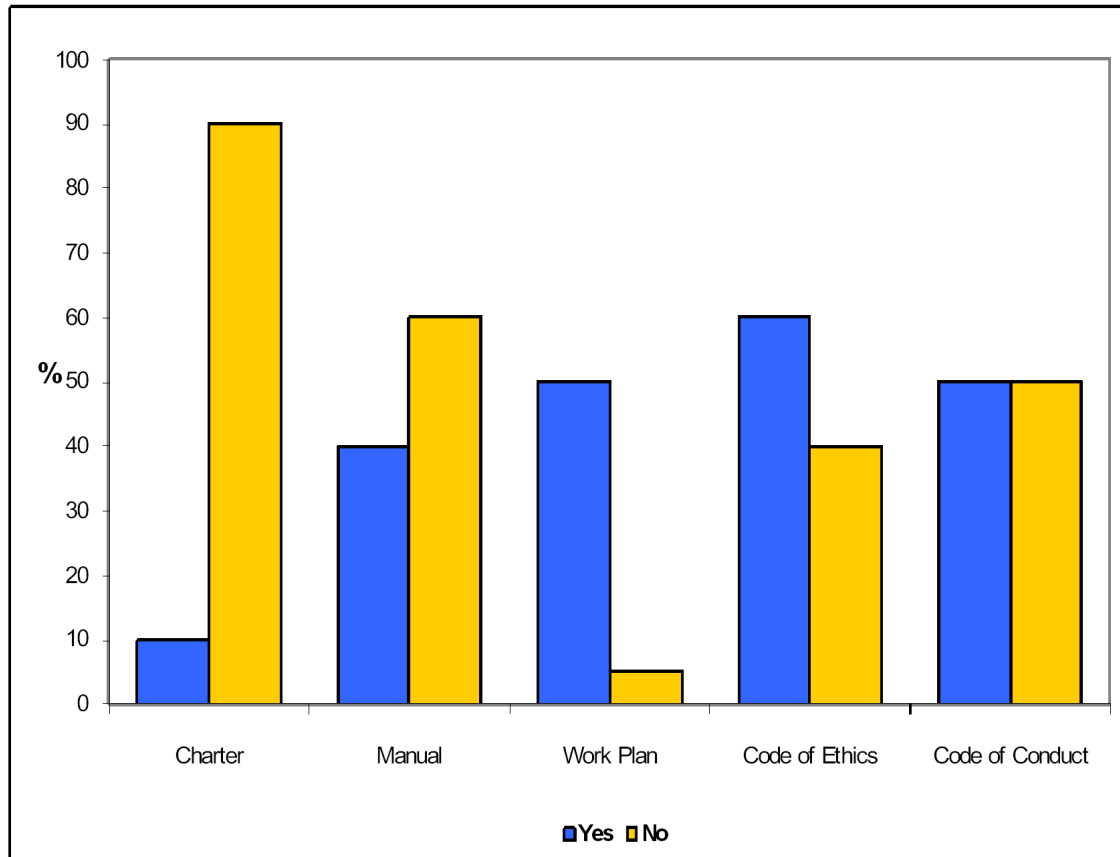
Approve key financial objectives, budgets and business reports.

Good corporate governance

Approval of loans

Approval of expenditures.

**Figure 5 : Existing Board Operating Documents**



All the banks under the study reported that the responsibilities of the Board are clear to both the Directors and the management.

At least one of the banks reported that there are areas of conflict or overlap between the responsibilities of the board and management.

These areas of conflict include:

All the Board Members being managers

The Chairman of the Board being the General Manager.

Regarding the Board's effectiveness in terms of leadership, integrity, enterprise, judgment and decision making, majority rated their Boards to be very effective as shown in table 4.1:

**Table 3: Senior Management Effectiveness**

Quality	Very Effective	Not Very Effective	Effective	Total
<b>Leadership</b>	9	0	1	10
<b>Integrity</b>	8	0	2	10
<b>Enterprise</b>	7	1	2	10
<b>Judgment</b>	8	0	2	10
<b>Decision making</b>	7	0	3	10

From the table it is noted that most Board's show very effective leadership qualities compared to enterprising and decision making.

### **Board meetings**

Most Boards (30%) have 4 meetings in a year. An average of 7 meetings per years with a range of 4 to 12 meetings was recorded for all the banks. In all the cases, the directors receive board papers at least 1 week before Board meetings. In 7 banks, the directors receive the papers 1 week in advance while in the remaining 3 they receive the papers 2 weeks before the meetings. Several ways through which the Board's deliberations are communicated to shareholders and stakeholders were indicated. These include:

### **Circulation of minutes**

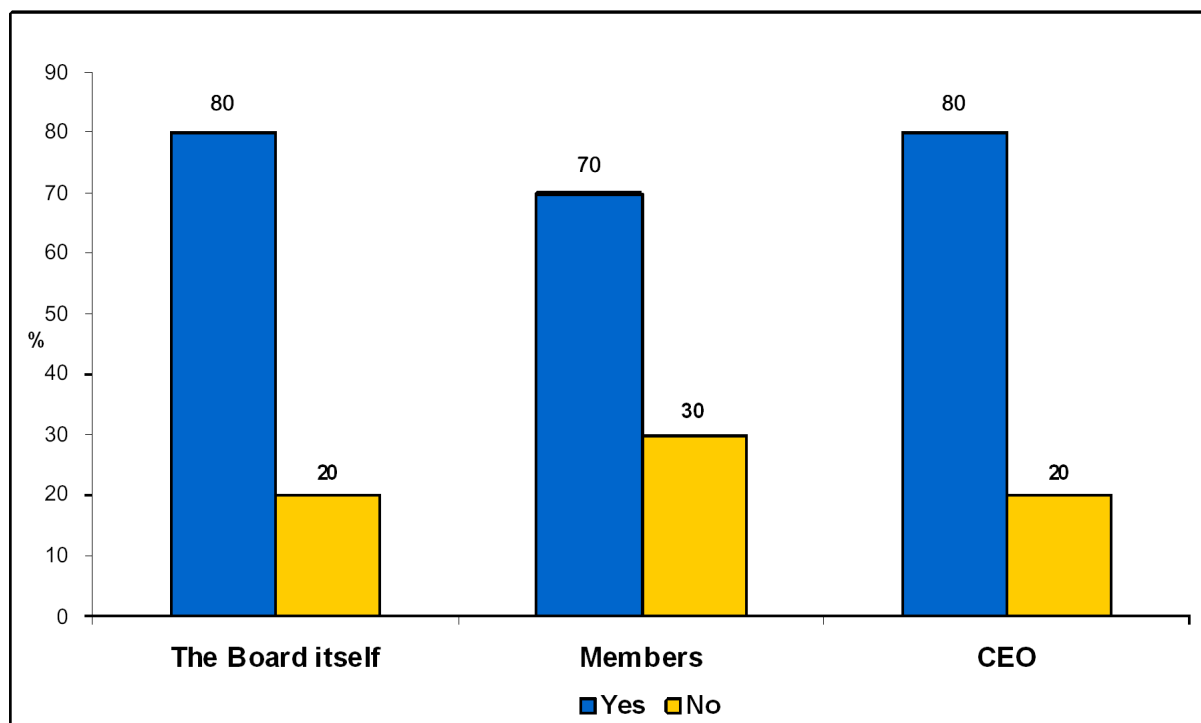
At the Annual General Meetings

### Quarterly publications

The most commonly used mode of decision making by the Boards is consensus (70%) followed by a combination of both consensus and vote depending on the magnitude of the matter (30%). In all the banks except one, the Board acts as a freely independent decision making organ without interference from any individual.

Figure 4.4. Summarizes the extent of the assessment of performance and effectiveness of the Boards, individual board members and the Chief Executive officers.

These assessments are normally done annually except for two banks which do them quarterly. Only 40% of the banks do make reports from these assessments 80% of which are discussed at the Board meetings and the other 20% at the Annual General Meetings.



## **Figure 6 : Whether Session Plan Exists**

### **Board Committees**

More than one half (80%) of the Banks have various Committees. The following Committees were recorded:

Audit

Credit and Advances.

Human Resources.

Investment.

External Relations.

Asset and Liabilities.

Nominations.

Management.

In terms of membership composition, each Committee is headed by a different director.

Each Committee has at least one Board member and Senior management of the bank.

### **Induction and training**

Only 40% of the banks have induction programs for new Board members.

70% have training or development programs for directors.

80% have training or development programs for executive management.

## **Conflict of interest**

Of all the banks, 20% conceded that there exists conflict of interest among the directors.

The most striking one being that some board members provide contractual services to the bank. The solution prescribed being that they disqualify themselves from deliberations of the tender awards.

In all the cases, the directors receive compensation for their services on the board. These compensations include:

Directors fees (basic pay.)

Bonus at the end of term.

Sitting allowance

Loans at subsidized rates.

In all cases except in two banks (where the allowances are determined by the board itself), these allowances are determined by the shareholders at the Annual General Meetings.

## **Appointment and tenure of office**

In one bank majority shareholders in conjunction with the Chairman appoint the Chief Executive Officer. For all the banks the appointment is done by the Board. Only 3 banks out of 10 have fixed tenure of office for the directors and the chairman.

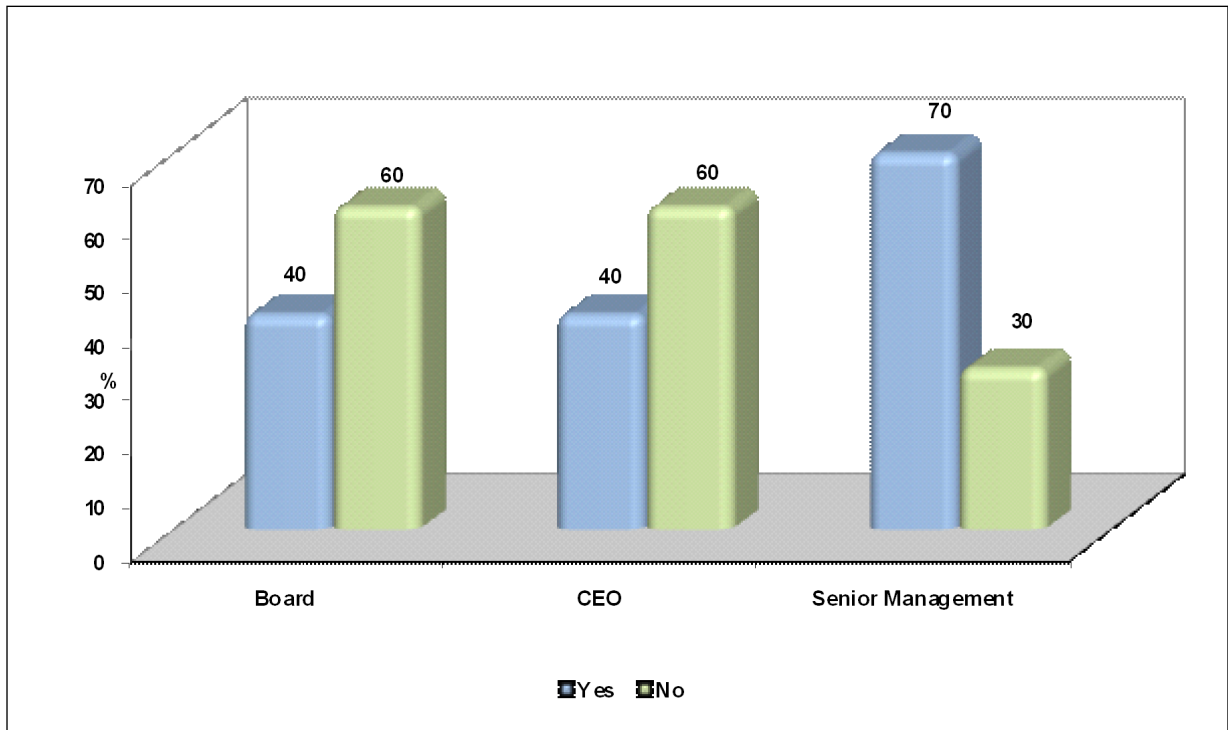
In 80% of the banks, the position of the Chairman and CEO are occupied by separate persons.

In the other 20% the positions are held by one person. In all the cases, the CEO is a member of the board. In all the banks except two, there is a clear distinction of the responsibilities of the Chairperson of the Board and the CEO.

## Succession plans

The succession plans for the Board, CEO and senior management do exist in varied scenarios in different banks as shown in figure 4.5.

**Figure 7 : Whether Succession Plan Exists**



It is apparent that most banks have succession plans for senior management compared to that of the Board and the CEO.

Some of the succession plans recorded include:

External and internal training for management

An arrangement where every head of a department has a deputy

Existing executive under the CEO.



In one bank, the succession plan for the Board is that the next of kin of each member is nominated by the member in readiness to take over.

### **Shareholding**

In two banks, the share holders are not able to exercise the authority to ensure that only competent and reliable persons are elected or appointed to the board of directors. Neither do they have the power to ensure that the board is held accountable for the effective running of the bank, so as to achieve its objectives nor to change the composition of the board that does not perform to expectations or in accordance with the mandate of the bank. In terms of accountability to shareholders, there exist board committees (in most cases the audit committee) to ensure this.

30% of the banks reported that the customers are “very satisfied”. Another 40% reported that the customers are “satisfied”.

50% of the banks reported that they have policies which guide how the banks operate with both internal and external stakeholders.

60% of the banks reported that some of their directors are shareholders in the bank.

### **Strategy, values, performance and compliance**

In all cases, the Board of Directors in 60% of the banks determines the purpose and values of the banks and also the strategies of the banks. Table 4.2 gives a summary of this.

**Table 4 : Strategy, Value, Performance and Compliance**

<b>Indicator</b>	<b>In all cases</b>	<b>Sometimes</b>	<b>Not at all</b>	<b>Total</b>
<b>The purpose and values</b>	6	2	1	9

<b>The strategy</b>	6	3	0	9
<b>Implementation of the strategy</b>	5	4	0	9

In ensuring that the procedures and values that protect the assets and reputation of the bank are put in place, 67% of the banks reported that this is the responsibility of everybody in the management position including the board and the CEO, 22% said it is the CEO while 11% said it is the Board.

For the responsibility of monitoring and evaluation of the implementation of the bank's strategies, policy and management performance, another 67% reported it is everybody in the management position including the board and the CEO, 22% said it is the Board while 11% said it is the CEO.

Regarding who reviews the viability and financial sustainability of the banks, 56% reported that is the responsibility of everybody in the management position including the board and the CEO and 22% each for the board and the Chief Executive.

All the banks reported that they have measures in place to ensure that the bank complies with all relevant laws, regulations, governance practices, accounting and auditing standards. Some of these measures include Annual Audit PMA inspections and governance and control committee functions. Less than one half (44%) of the banks reported that these measures are enforced by everybody in the management position including the board and the CEO. The board (22%), all departmental heads (22%) and the Chief Executive (11%). All the banks reported that their boards have risk management on the agenda. Again in all the cases the directors are allowed to seek professional advice. These include legal, regulation and audit advise,

### **Corporate Social responsibility**

Only three of the banks have corporate social responsibility programmes which include:

Support of charitable events, Community service and Conservation programmes.

### **Legal framework**

All the banks operate under the following legal frameworks:

- The Banking Act.
- The Palestinian Minority Authority .
- The Companies Act.
- Finance Act

### **Discussion of Findings**

#### **A. *The corporate governance procedures applied in the banking sector.***

In the pursuit of good corporate governance in Palestine, PMA exercise some guidelines in order to enhance corporate governance practices by such companies. It is upon these guidelines that some banks have set up corporate governance procedures.

### **The Board**

Every bank should be headed by *an effective* board to offer strategic guidance, lead and control the company and be accountable to its shareholders. The study has established that in terms of leadership, integrity, enterprise, judgment and decision making, majority the Boards in the study were reported to be effective.

### **Appointments to the Board**

It is expected that a formal and transparent procedure in the appointment of directors to the board and all persons offering themselves for appointment, as directors should disclose any potential area of conflict that may undermine their position or service as director. The appointment procedures recorded include:

- Vote of majority shareholders,
- Nomination by the old Board,
- Vote of all share holders,
- Nomination by the Board and the approval of appointment is done by the Shareholders, and;
- Appointment by the Government in the case of Government Banks.

Of all the banks, 20% conceded that there exist conflict of interest among the directors.

The most striking one being that some board members provide contractual services to the bank. The solution prescribed being that they disqualify themselves from deliberations of the tender awards.

### **Tenure of office**

It is recommended that Executive directors should have a fixed service contract not exceeding five years with a provision to renew subject to regular performance appraisal; and shareholders approval. The study has established that in one bank majority shareholders in conjunction with the Chairman appoint the Chief Executive Officer. For state owned banks, the government does the appointment while for all the rest the appointment is done by the Board. Only 3 banks out of 17 have fixed tenure of office for the directors and the chairman.

The succession plans for the Board, CEO and Senior management do exist in varied scenarios in different banks. It is apparent that Most banks have succession plans for senior management compared to that of the Board and the CEO. Some of the secession plans recorded include, external and internal training for management, an arrangement where every head of a department has a deputy, existing executive under the CEO. In one bank, however, the succession plan for the Board is that the next of kin of each member is nominated by the member in readiness to take over.

### **Roles and responsibilities of the Board**

According to the corporate governance regulations, the board of directors are expected to assume a primary responsibility of fostering the long-term business of the banks consistent with their fiduciary responsibility to the shareholders. The study has established that the core responsibilities of the Boards in the banks in the study include:

- Policy formulation in accordance with the relevant Acts.
- Keeping proper books of accounts.
- Prepare financial statement while:
  - Selecting suitable accounting policies and then apply them consistently.
  - Making judgment and estimates that are reasonable and prudent.
  - Stating whether applicable accounting standards have been followed
  - Preparing the financial statements on the going concern basis.
- Provision of leadership.

- Formulate strategies.
- Receive and approve reports of committees.
- Approve key financial objectives, budgets and business reports.
- Good corporate governance
- Approval of loans
- Approval of expenditures.
- Ensuring compliance to Statutory and regulatory frameworks.
- Banking projections.
- Safeguarding the assets of the bank.

In all cases, the Board of Directors in 60% of the banks determines the purpose and values of the banks and also the strategies of the banks. In ensuring that the procedures and values that protect the assets and reputation of the bank are put in place, 67% of the banks reported that this is the responsibility of everybody in the management position including the board and the CEO, 22% said it is the CEO while 11% said it is the Board.

For the responsibility of monitoring and evaluation of the implementation of the bank's strategies, policy and management performance, another 67% reported it is everybody in the management position including the board and the CEO, 22% said it is the Board while 11% said it is the CEO. Regarding who reviews the viability and financial sustainability of the banks, 56% reported that is the responsibility of everybody in the management position including the board and the CEO and 22% each for the board and the Chief Executive. All the banks reported that they have measures in place to ensure that the bank complies with all

relevant laws, regulations, governance practices, accounting and auditing standards. All the banks reported that their boards have risk management on the agenda. Again in all the cases the directors are allowed to seek professional advice. These include legal, regulation and audit advice.

These responsibilities as stated relate well to those which are stipulated by the PMA guidelines which include:

- Defining the bank's mission, its strategy, goals, risk policy plans and objectives including approval of its annual budgets;
- Overseeing the corporate management and operations, management accounts, major capital expenditures and review corporate performance and strategies at least on a quarterly basis;
- Identifying the corporate business opportunities as well as principal risks in its operating environment including the implementation of appropriate measures to manage such risks or anticipated changes impacting on the corporate business;
- Developing appropriate staffing and remuneration policy including the appointment of chief executive and the senior staff, particularly the finance director, operations director and the company secretary as may be applicable;
- Reviewing on a regular basis the adequacy and integrity of the bank's internal control, acquisition and divestitures and management information systems including compliance with applicable laws, regulations, rules and guidelines; and
- Establishing and implementing a system that provides necessary information to the shareholders including shareholder communication policy for the bank.

- Monitoring the effectiveness of the corporate governance practices under which the bank operates and propose revisions as may be required from time to time.
- Taking into consideration the interests of the bank's stakeholders in its decision making process.

### **Committees of the Board**

In a good corporate governance scenario, the boards are expected to establish relevant committees and delegate specific mandates to such committees as may be necessary. The study found out that 15 banks out of 17 have board committees which include Audit, Credit and Advances, Human Resources, Investment, External Relations, Asset and Liabilities, Nominations, Tender and Management Committees. These committees have various delegated responsibilities from the boards as per their specific functions.

### **Remuneration**

The banks are expected to establish a formal and transparent procedure for remuneration of directors, which should be approved by the shareholders. In all the banks, the directors receive compensation for their services on the board. These compensations include, Directors fees (basic pay), Bonuses at the end of term, Sitting allowances, Loans at subsidized rates, Car mileage, Housing, Entertainment allowances and Transport allowances.

### **Supply and disclosure of information**

In all the banks the boards are supplied with relevant, accurate and timely information to enable them discharge their duties. The study established that the directors receive board papers at least 1 week before Board meetings. In 10 banks, the directors receive the papers 1 week in advance while in the remaining 7 they receive the papers 2 weeks before the



meetings. The information is relevant and given the timeframe of 2 to 1 week, the study considers it to be timely. However the study was not able to establish the accuracy of this information. There are also several ways through which the Board's deliberations are communicated to shareholders and stakeholders which include, Circulation of minutes, at the Annual General Meetings and Quarterly publications.

Within the legal frame work which the banks operate, every board is expected to annually disclose in its annual report, its policies for remuneration including incentives for the board and senior management, particularly the quantum and component of remuneration for directors including non executive directors on a consolidated basis in the categories of executive directors fees, executive directors emoluments, non executive directors fees, non executive directors emoluments. When all the annual reports were perused, none of the banks has complied to this governance practice. Most banks simply state: director's remuneration or staff cost, but they do not give a break down as required, others do not state it at all.

## **Shareholders**

### **Approval of Major Decisions by Shareholders**

It is expected that there should be shareholders' participation in major decisions of the Bank. The board should provide the shareholders with information on matters that include but are not limited to major disposal of the Company's assets, restructuring, takeovers, mergers, acquisitions or reorganization.

According to the findings of this study, in two banks, the share holders are not able to exercise the authority to ensure that only competent and reliable persons are elected or appointed to the board of directors. Neither do they have the power to ensure that the board is held accountable for the effective running of the bank, so as to achieve its objectives nor to change the composition of the board that does not perform to expectations or in accordance with the mandate of the bank. In terms of accountability to shareholders, there exist board committees (in most cases the audit committee) to ensure this. At least 70% of the banks reported that the customers are satisfied with the accountability system of the bank. At least 50% of the banks reported that they have policies which guide how the banks operate with both internal and external stakeholders with another 60% reporting that some of their directors are shareholders in the bank.

### **Corporate Social responsibility**

Only three of the banks have corporate social responsibility programs which include:

Support of charitable events, Community service and Conservation programs.

The existing legal framework includes:

#### **B. *Existing legal framework***

- The Banking Act.
- The PMA Act.
- The Companies Act.

- Regulations (Corporate Governance Guidelines, Securities, Public offers and disclosures, Collective Investment Scheme, Takeovers and Mergers, Rating Agency Approval Guidelines).
- Income Tax Act.

### **Strengths**

- Ensures good accounting systems.
- Provides for efficient and sustainable banking systems and procedures.
- Ensure efficiency and supervision.
- As measure to ensure prudent fiduciary management

### **Weaknesses**

- Promotes delays in decision making.
- Enhances duplication of supervisory and regulatory procedures.
- Promotes bureaucracy.
- Enforcement is not streamlined
- Some are confusing.

### **C. *Existing corporate governance procedures***

The existing corporate governance procedures within the banks as established by this study are:

- Responsibility of the boards that exists in a framework which ensures the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.
- Enhancement of accountability and integrity systems.
- Promoting and protecting the rights of shareholders.
- Equitable treatment of all shareholders, including minority and foreign shareholders.
- Recognition of the positive role of stakeholders.
- Disclosure and transparency- ensuring that timely and accurate disclosure is made on all material matters regarding the banks, including the financial situation, performance, ownership, and governance of the bank.

**D. *Effectiveness of the regulatory and supervisory systems***

The regulatory and supervision systems have been issued by the PMA. Some banks have also developed own in-house systems to ensure this.

These systems have effectively promoted a sound and stable market based banking system in Palestine by:

- Fostering liquidity and solvency of banking institutions,
- Ensuring efficiency in banking operations, and:
- Encouraging high standards of customer service.

This has been achieved through the enforcement of the Banking Act and the prudential regulations by the PMA of Palestine.

## **Chapter Five: Conclusions and Recommendations:**

This section sets out recommendations to improve Palestinian listed banks' compliance with the OECD and Basel II Principles.

The management team as a whole, and each member of it, should have clearly defined responsibilities and necessary authority to manage the bank in a manner consistent with the strategic direction approved by the supervising board. All members of the management team should be required to perform their duties with due care and diligence, and for the purpose of maintaining the long – term soundness of the bank. Members of the management team should be free of material conflicts of interest that could unduly influence their judgment. Where management is constituted as a management board, no non- executives should be part of the management board.

Management should have sufficient skills and experience in relation to bank, finance and other disciplines relevant to management of the bank. All members of the management team should have access to sufficient resources and receive sufficient training to assist in the performance of their roles. Members of management team should be fully accountable to the supervising board. The accountability should be clearly specified in the bank status.

The bank risk management system should be subject to regular internal review, and periodic review by suitable, independent experts, to ensure that the system is appropriate for nature of its business activities and risks.

### **Management**

*This section deals with the required expertise, responsibilities and duties of the top and middle level management.*

**Management** should:

- Be fit and proper people for the roles they play.
- Promote a culture of trust, honesty and integrity within the organization.
- Be responsible to the Board for protecting stakeholder interests and for implementing the plans and goals set by the Board.
- Ensure that the organization is efficiently structured and that duties of the staff are clearly defined and that competent people are assigned to these duties, and ensure clear and transparent delegations to competent people.
- Ensure the implementation of best practices in risk management, including policies, procedures, as well as risk rating and allocation of economic capital.
- Fully understand the risk tolerance of the Board, and define risk areas and oversee the application of specific risk measurement and management tools.
- Provide a structured procedure for capital management and planning ahead for future growth.
- Consider the implementation of Basel 2 as a priority. ( It is important to establish project teams or task forces to prepare for Basel 2)
- Communicate the processes involved in implementing Basel 2 to relevant staff.
- Understand that the implementation of Basel 2 is unlikely to be the sole project in a bank and ensure that resources are spread effectively over all the bank's activities.
- Be remunerated on the basis of the achievement of company goals, including meeting performance targets and satisfactory risk-based returns.

- Ensure that middle level managers under its supervision are fit and proper. Capacity building programs should be arranged for managers where skill inadequacies are detected.

## **Staff**

*This section deals with the desirable skills, duties and rights of bank staff.*

**Staff** should:

- Possess the skills and experience appropriate for the roles they play. (Appropriate programs should be in place to encourage and support skills development). New recruits need to be educated in the bank's risk culture and approach)
- Be provided with clearly defined job descriptions, delegations and arrangements for accountability.
- Be motivated by appropriate performance enhancing schemes and their performance measured against key performance indicators.
- Have an appreciation of the cost of capital, be aware of the need for adequate risk control and be provided with a work environment in which they feel comfortable in communicating any concerns over fraudulent activities and inadequate management practices and procedures. (There is a need for awareness programs on Basel 2 in banks as part of initiating a change in culture that Basel 2 is likely to entail)
- Comply with the bank's code of conduct and exercise due diligence and integrity in performing their duties.

- Know a bank's strategy but not disclose information directly or indirectly to outsiders without management approval.

### **Systems and reporting**

*This section deals with rules required in designing management systems, in complying with regulatory requirements and in reporting and public disclosure.*

- Rules and procedures need to clearly define responsibilities, decision-making authority, and accountability. There should be proper and adequate checks and balances in the approval and reviewing processes of loan-making and timely adjustment in these processes to reflect changes to the environment. Front and back office control activities should be separated.
- Banks need to develop credit rating models and review them on a periodic basis. Advanced risk measurement and performance evaluation techniques warrant attention by management. Best practices such as stress testing and back testing of models should also be implemented.
- There is a critical need for strong financial risk management functions and strong internal control. Risks in each business line should be clearly identified, and banks should have a business continuity plan to deal with unexpected operational risks. Risk management areas must be adequately staffed.
- Computer information systems to collect data should be developed, and procedures to safeguard security of information established. The information system should be reviewed regularly to keep pace with technology development. Adequate funding in budgets is required for these activities and for an information system that is able to support timely and accurate reporting.



- Documentation should be adequate to inform customers and to meet public disclosure requirements. A bank's website could be one of the major channels to disclose information to the public.
- Care is needed to ensure effective and timely reporting. Auditing should play a very important role in checking results. Internal auditors should have the authority to report directly to the Board, to ensure the independence of internal auditing.
- Disclosure of risk profiles and risk management practices is anticipated under Pillar 3 of Basel 2. Banks should disclose relevant information.
- Incidences of fraud should be promptly investigated.

### **Regulatory interactions**

*This section deals with the rules and responsibilities of the Board, the management and staff in cooperating with supervisory authorities.*

- Top management should be evaluated and approved by bank regulators. Changes in bank ownership structure should be reported to and approved by regulators. For the establishment of a foreign or joint venture bank, recommendations from home authorities in which the bank's head office is domiciled should be obtained.
- On-site supervision over banks by regulators should include credit policies, internal control practices and procedures, investment portfolios as well as capital adequacy. Off-site supervision should focus, inter alia, on the examination of consolidated bank reports. Supervisors should provide an early warning to a bank considered to be in difficulties in meeting regulatory requirements and sound standards. Regulators may determine to involve external auditors in carrying out its supervisory duties.

- Bank management should cooperate closely with supervisory agencies on regulatory issues, and exchange information on a regular basis. Banks' risk profile evaluations and self-assessment of capital adequacy should be reported and discussed with regulators. Regulators' opinions should be reflected in the way a bank conducts its business. Bank regulators should fully inform banks of the regulatory arrangements and procedures for the implementation of Basel 2 and they should provide clear guidelines on calibrations between international credit ratings and domestic credit ratings.
- Banks should respond positively to regulators and both banks and regulators need to drive the cultural changes needed to facilitate implementation of good risk management practices as embodied in Basel 2.
- Banks should have clear internal procedures and specially designated staff to be responsible for external reporting. Results of supervisory examinations should be published to ensure transparency.
- Banks with international operations should make available to supervisors their consolidated financial accounts drawn up with consistent accounting policies.

#### Rights of Shareholders and Stakeholders

***This section deals with rules required in designing systems that deals with shareholders and stakeholders.***

- The Bank should ensure that shareholders are treated fairly and appropriately in accordance with the law.
- The Bank should treat its customers as its business partners to strive for mutual prosperity.

- The Bank should contribute to community services with the spirit of friendship and cooperation.
- The Bank should treat all stakeholders in keeping with the principles of honesty and integrity.
- The Bank should realize the importance of establishing and enforcing practices that will prevent the illegal or inequitable pursuit of benefits such as the prohibition of insider' trading.
- The Bank should realize the importance of establishing and enforcing practices that will oversee and manage potential conflicts of interest in accordance with the rules and regulations as laid down by the Monetary Authority.

**In general, the study recommends that:**

1. The corporate governance procedures applied in the banking sector in Palestine have been effective to some extent in achieving the goals and objectives upon which they were set, but it is still in its infancy. On a scale of 1 to 5, this study has graded the general corporate governance of banks in Palestine at 3 and that of none listed together with state owned banks at 1.
- It is therefore recommended that strategic training for board members and senior bank managers be intensified by stakeholders in corporate governance to promote good corporate governance in these institutions. They should be guided to understand that “to remain competitive in a changing world, banks must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities and the government has an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function

effectively and to respond to expectations of shareholders and other stakeholders” – OECD.

- Banks should be assisted to develop principles of corporate governance that cut across all the functions of the banks.
2. The strengths of the existing legal framework outweigh the weaknesses, however the following recommendations are provided:
    - Issues of delays in decision making due to the existing legal framework should be addressed.
    - Duplication of supervisory and regulatory procedures arising from the same should also be addressed.
  3. The existing corporate governance procedures within the banks as established by this study are still not effectively implemented. There is need for stakeholders to play an effective role in assisting the banks with necessary professional and technical assistance towards the implementation of these.
  4. The regulatory and supervision systems have been issued by the PMA. Some banks have also developed own in-house systems to ensure this. More in-house systems are further recommended so that those systems that have been introduced through statutes can be supplemented by the in-house systems and enforcement.

## REFERENCES

- Anderson, C. and T. Campbell II (2000). “Restructuring the Japanese Banking System: Has Japan Gone Far Enough?” *International Review of Financial Analysis*, vol. 9, no. 2.
- Arun, T. G. and Turner, J. D. (2002e) “*Corporate Governance of Banks in Developing*”. Advisory Group on Corporate Governance (AGCG) (2001), *Report on Corporate Governance and International Standards*, Reserve Bank of India.
- Arun, T.G and Turner, J. D. (2002d), “Corporate Governance of Banking Institutions in Developing Economies: The Indian Experience”, Paper presented in the conference on ‘Finance and Development’ organized by IDPM, The University of Manchester.
- Arun, T.G and Turner, J. D. (2002c), “Financial Liberalization in India”, *Journal of International Banking Regulation* (Forthcoming)
- Arun, T.G and Turner, J. D. (2002b), “Financial Sector Reform in Developing Countries: The Indian Experience”, *The World Economy*, Vol.25, No.3, pp.429-445.
- Arun, T.G and Turner, J. D. (2002a), “Public Sector Banks in India: Rationale and Prerequisites for Reform”, *Annals of Public and Cooperative Economics*, Vol.73, No.1.
- Barro, J and Barro, R.J. (1990). “Pay, performance and turnover of bank CEOs”. *Journal of Labor Economics* 8.
- Basel Committee on Banking Supervision (BCBS) (1999) “Enhancing Corporate Governance for Banking Organizations”, Bank for International Settlements, Switzerland. King and Levine (1993a and b)

Barth, J., Caprio, G. and Levine, R. (2001), "The Regulation and Supervision of Banks Around the World", World Bank, *Working Paper*.

Caprio, G, Jr and Levine, R (2002), "Corporate Governance of Banks: Concepts and International Observations", paper presented in the Global Corporate Governance Forum research Network Meeting, April 5.

Palestinian Monetary Authority (2003) Annual Report

Palestinian Monetary Authority (2003)

Crespi, R., Garcia-Cestona, M. A. and Salas, V. (2002) Governance Mechanisms in Spanish Financial Intermediaries. Universitat Autònoma de Barcelona.

El-Kharouf, F. W. (2000) Strategy Corporate Governance and the Future of the Arab Banking Industry. *The Arab Bank Review, Volume 2 Number 2 October, 2000*.

Franks, J., C. Mayer and L. Renneboog (2001). "Who disciplines management in poorly performing companies?" *Journal of Financial Intermediation* 10.

Fries, S., Neven, D. and Seabright, P (2002) Bank Performance in Transition Economies. European Bank for Reconstruction and Development.

Gispert, C. (1998). "Board turnover and firm performance in Spanish companies", *Investigaciones Económicas*, vol. 22(3).

Goswami, O. (2001), "The Tide Rises, Gradually: Corporate Governance in India", OECD Development Centre discussion paper.

Grifell-Tatjé, E. and Lovell, C. (1997). "The Sources of Productivity Change in Spanish Banking", *European Journal of Operational Research*, 98.

- Hampden-Turner, C. (1990) *Charting the Corporate Mind: From Dilemma to Strategy*, Oxford: Blackwells.
- Hansmann, H. (1996): "The ownership of enterprise". Harvard University Press. Cambridge, MA.
- Herman, R. and Van Til, J. (1989) (eds) *Nonprofit Boards of Directors: Analyses and Applications*, New Brunswick: Transaction Books.
- Hung, H. (1998) 'A typology or theories of the roles of governing boards', *Corporate Governance*, 6, 2, 101-111.
- Hetteš, F. (2002) Corporate Governance in the Banking Act. In BIATEC Volume X, 5/2002, National bank of Slovakia.
- Kaplan, S. (1994). "Top executives, turnover, and firm performance in Germany", *Journal of Law, Economics and Organization* 10.
- Kaplan, S. and B. Minton (1994). "Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers", *Journal of Financial Economics* 36.
- La Porta, R, F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1998a). "Law and Finance", *Journal of Finance*.
- La Porta, R, F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1998b). "Ownership Around the World", *Journal of Political Economy*.
- Lozano, A. (1998). "Efficiency and Technical Change for Spanish Banks", *Applied Financial Economics*, 8.

Macey, J. R. and O'Hara, M. (2001) "The Corporate Governance of Banks", *Federal Reserve Bank of New York Economic Policy Review*. Financial Stability Forum (2001).

Mork, R.; Shleifer, A. and Vishny, R. (1989). "Alternative mechanism for corporate control". *American Economic Review*. Vol 79, 4.

Oman, C. P. (2001), "Corporate Governance and National Development", *OECD Development Centre Technical Papers*, Number 180.

Prowse, S. (1995). "Alternative methods of corporate control in commercial banks". *Federal Reserve Bank of Dallas Economic Review*, Third quarter.

Prowse, S. (1997). "The Corporate Governance System in Banking: What do We Know?", *BNL Quarterly Review*, March.

Shleifer A. and R. Vishny (1997). "A Survey of Corporate Governance" *Journal of Finance*, vol. 52, 2.

Tirole, J. (2001). "Corporate Governance," *Econometrica*, 69 (1).

Warner, J.; Wats, R.L. and Wruck, K. (1988): "Stock prices and top management changes". *Journal of Financial Economics*, 20.



### Appendix 1 : The Questionnaire

#### STUDY OF CORPORATE GOVERNANCE IN THE COMMERCIAL BANKING SECTOR IN PALESTINE

Date: ..... / ..... / .....

Name of Bank: .....

#### A: Introduction

QA 1. For how long has this bank in operation in Palestine? [\_\_\_\_\_ Years]

[1] Yes

[2] No

QA 2. Is this bank:

[1] entirely privately owned

QA 3. How would you classify this bank?

[1] Commercial bank

[2] Non-bank financial institution [other than mortgage or building]

[3] Mortgage finance company

[4] Building society

QA 4. What is the range of services that the banks offer?

.....

.....

## **B: Management and the Board**

QB 1. What is the total number of the Board of Directors [.....]

QB 2. How is the board appointed?

[1] By the vote of majority shareholders

[2] By the vote of all shareholders

[3] By the old board when a new one is coming into office

[4] A head hunt by the chairman

[5] Other process [please state] .....

QB 3. What is the composition of the board in terms of professional qualification?

[1] Lawyers [give number.....]

[2] Banking and finance specialists [.....]

[3] CPA [.....]

[4] Engineers [.....]

[5] Economists [.....]

[6] Other professions [list and give numbers] .....

QB 4. What is the composition of the board in terms of gender?

[1] Male

[2] Female

QB 5. How effective do you consider the Board to be in exercising the following so as to achieve the banks objectives:

[1] Very effective

[2] Not very effective

[3] Effective

[4] Below average

i. Leadership [.....]

ii. Integrity [.....]

iii. Enterprise [.....]

iv. Judgment [.....]

v. Decision making [.....]

QB 6. How frequently does the Board meet?

.....

QB 7. How is there deliberations communicated to shareholders and other stakeholders?

.....

.....

QB 8. Does the board assess the performance and effectiveness of:

[1] Itself? [1. yes 2. no]

[2] Individual's members? [1. yes 2. no]

[3] The Chief Executive? [1. yes 2. no]

QB 9. If Yes how frequently is this done?

[1] for itself .....

[2] for individuals members .....

[3] for the Chief Executive .....

QB 10. Are reports made from these assessments?

[1] Yes

[2] No

QB 11. At what level are the reports discussed?

[1] Board meeting

[2] AGM

[3] Special meetings

[4] Other [indicate] .....

QB 12. Are there any induction programs in place for new Board members?

[1] Yes

[2] No

QB 13. Are there continuous members' skill development programs for the Board?

[1] Yes

[2] No

QB 14. Is there any training program for the management and other staff?

[1] Yes

[2] No

QB 15. Does the bank have a succession plan for the senior management?

[1] Yes

[2] No

QB 16. If yes, briefly explain how it works .....

**C: Shareholders and stakeholders**

QC 1. What is the approximate total number of shareholders? [.....]

QC 2. To what extent do the shareholders exercise the authority to ensure that only competent and reliable persons are elected or appointed to the Board of Directors? .....

.....  
.....

QC 3. To extent do the share holders ensure that the Board is held accountable for the effective running of the bank – so as to achieve its objectives?

.....  
.....

QC 4. QC4. Do the shareholders have the power to change the composition of the Board that does not perform to expectations or in accordance with the mandate of the bank?

[1] Yes

[2] No

QC 5. How does the bank communicate with its shareholders and stakeholders?

.....  
.....

QC 6. To what extent is the bank accountable to its members?

.....

QC 7. What accounting procedures are there in place to effect this?

.....  
.....

QC 8. Do you think the members are satisfied with this?

[1] Very satisfied

[2] Satisfied

[3] Not satisfied at all

QC 9. Who are the internal stakeholders of the bank?

.....

QC 10. Who are the external stakeholders of the bank? .....

QC 11. Is there a policy which guides how the bank should relate with them?

[1] Yes

[2] No

**D: Strategy, values performance and compliance**

QD 1. Would you say the Board of Directors do determine the following:

[1] In all cases

[2] Sometimes

[3] Not at all

i. The purpose and values of the bank [.....]

ii. The strategy to achieve the bank's purpose [.....]

iii. Implementation of the banks values [.....]

QD 2. Who ensures that the procedures and values that protect the assets and reputation of the bank are put in place?

[1] The board

[2] The chief executive

[3] The share holders

[4] All departmental heads

[5] Everybody in the management position including the board and the CEO

QD 3. Who monitors and evaluates the implementation of the bank's strategies, policies, plans and management performance?

[1] The board

[2] The chief executive

[3] The share holders

[4] All departmental heads

[5] Everybody in the management position including the board and the CEO

QD 4. Who reviews the viability and financial sustainability of the bank?

[1] The board

[2] The chief executive

[3] The share holders

[4] All departmental heads

[5] Everybody in the management position including the board and the CEO

QD 5. How frequently is this done? .....

QD 6. Is there any measure in place to ensure that the bank complies with all relevant laws, regulations, governance practices, accounting and auditing standards?

[1] Yes

[2] No

QD 7. Please the measures

.....

QD 8. Who enforces these measures?

[1] The board



[2] The chief executive

[3] The share holders

[4] All departmental heads

[5] Everybody in the management position including the board and the CEO

**E: Management of corporate risk and social responsibility**

QE 1. What are some of the key risk areas that the board has so far identified?

.....  
.....

QE 2. What are some of the key performance indicators that the bank has in place?\_

.....  
.....

QE 3. In what circumstances does the bank seek professional advise?

.....  
.....

QE 4. What are some of the banks social responsibility?

.....  
.....

**F: Bank performance**

QF 1. Please could you provide the figures for the following for the year ending December 2003:

- [1] Yield on earning assets .....
- [2] Cost of funding earning assets .....
- [3] Interest margin on earning assets .....
- [4] Yield on Advances .....
- [5] Cost of deposits .....
- [6] Return on assets (including contingents) .....
- [7] Return on shareholders funds .....
- [8] Overheads to earnings .....

QF 2. Briefly comment on the status of the banks:

[1] Capital adequacy  
.....  
.....

[2] Earnings and liquidity  
.....

[3] Market share.  
.....  
.....

[4] Lending behavior  
.....

.....  
[5] Distribution of bank profitability.

.....  
.....  
[6] Credit distribution

.....  
.....  
[7] Composition and changes in assets.

.....  
.....  
[8] Liabilities.

.....  
.....  
[9] Capital and reserve.

.....  
[10] Profit and Loss.

## **Research Questions**

The following research questions will guide the study:

1. To what extent the bank protect the rights of all of its shareholders, including its ability to prevent majority shareholders from diluting the value and interests of minority shareholders?
2. To what extent the bank provide independent oversight of management performance?
3. To what extent the bank hold management accountable to shareholders and other relevant stakeholders?
4. To what extent the bank disclose the accuracy and timeliness of their financial position, condition and prospects, and other non- financial information, and also the ability of existing and prospective investors to access this information?
5. To what extent the bank understand the importance of audit committee?

**Appendix 2 – Data as of December 31 2005 [Source: PMA of Palestine]****List of all Financial Institutions in Palestine**

Bank Of Palestine

Cairo-Amman Bank

The Commercial Bank Of Palestine

Bank Of Jordan

Jordan Commercial Bank

Arab Bank

Egyptian Arab Land Bank

The Palestine Investment Bank

Jordan National Bank

Jordan Kuwait Bank

Housing Bank Of Trade And Finance

Union Bank for Saving and Investment

Arab Islamic Bank

The Principle Bank Of Development and Agriculture Credit

Jerusalem Development and Investment Bank

Palestine Islamic Bank

Arab Palestinian Investment Bank

HSBC Bank Middle East

Palestine International Bank

Al-Aqsa Islamic Bank

Palestinian Banking Corporation

### **Appendix 3 : The Sampled Banks**

1. Arab Bank
2. Cairo-Amman Bank
3. The Palestine Investment Bank
4. Bank Of Palestine
5. Bank Of Jordan
6. Egyptian Arab Land Bank.
7. Housing Bank Of Trade And Finance
8. Arab Islamic Bank
9. Al-Aqsa Islamic Bank
10. Jerusalem Development and Investment Bank
11. Jordan Commercial Bank
12. Jordan Kuwait Bank
13. Union Bank for Saving and Investment

14. Palestine International Bank
15. Palestine Islamic Bank
16. Jordan National Bank
17. The Commercial Bank Of Palestine