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The Role of Corporate Governance in Jordanian Banking Sector

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Abstract

Corporate governance is a way of ensuring that the interests of all the stakeholders in a business are considered before taking any management or investment decisions. Banks are typically entities in which there are many small stakeholders, but because of their insignificant presence in the overall bank management process, their interests in the decision making process are not taken into account. The shareholders and the top management in banks hold absolute power in making the strategic and investment decisions. As the individual downside for the financial managers are almost negligible, they tend to take huge risks with the depositors' money. Due to the complexity of operations in the bank, it is not easy for the common stakeholders or even regulators understand the extent of the risks involved in an investment. The recent subprime depression in the USA was caused mainly by the unnecessary huge risks that the shareholders and the financial managers took with the investors' money. With the presence of proper corporate governance measures, part of this depression could have been avoided. Corporate governance not only increases the confidence of the depositors to deposit their money in the government and commercial banks, but also boosts up the confidence of the creditors in the banking system, thereby helping the overall economy. This paper establishes that corporate governance is an essential component in increasing the confidence of the depositors and creditors in the banking system and through the implementation of proper corporate governance measures, the growth of the deposits in Jordanian banks and investment in the country's economy can be significantly improved.

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1. Introduction

Banks are an essential part of any economy. A sound banking system not only ensures a robust deposit growth, but also helps attract outside investors. On the other hand, banking crises and poor infrastructure have huge consequences for the economy. As we have seen in the 2008 subprime recession that the economies like the USA and the UK were shaken by the poor banking control mechanisms and corporate governance structure (Anginer, Huizinga and Ma, 2013). Poor banking governance structure and regulations can cripple an economy, destabilize the government and can hugely intensify poverty by collapsing the overall financial system. Therefore, more than any other sector, the banking sector needs to be regulated and transparent. The implementation of corporate governance can ensure that the banks function in a regulated, ethical and risk-averse way. Corporate governance can not only improve the transparency inside the banking organizations, but also can improve the confidence of the external parties like the depositors and creditors. If the depositors feel more confident in the banking system, they are more likely to keep their savings in the local banking system without looking for better options outside their countries (Anginer, Huizinga and Ma, 2013). As the banks receive more number of deposits, the overall financial health of the banks improves, thereby increasing the credit scores of the countries as well as the individual banks. This essay will discuss corporate governance in detail describing why it is more essential for banks than any non-financial firm. This essay will then explain the relationship of deposit and credit scores with corporate governance with the help of different literatures and then taking into account all the views, it will suggest a suitable corporate governance implementation for the Jordanian banks.

1.1 What is Corporate Governance?

Corporate governance refers to the rules, processes, mechanisms and practices by which organizations are controlled and directed. Recognizing the rights and responsibilities of different stakeholders in an organization, including shareholders, customers, management, government, suppliers, financiers, and the community, it balances their interests by providing a framework for all the rules and procedures that need to be followed in corporate affairs (Shailer, 2004). Corporate governance also provides guidelines for organizational goals and objectives, and it encompasses almost every aspect of the management, right from the action plans to the performance appraisal and internal controls.

In the early 2000s, a number of high-profile accounting fraud scandals led to the bankruptcy of a large number of companies like Enron, Adelphia, Peregrine Systems, Tyco International and WorldCom, shaking the confidence of the investors and the public in corporate governance (Shailer, 2004). These scandals drew a considerable public interest to corporate governance because of its linkage to the economic health of organizations and the society as a whole. Since the time these scandals have taken place making investors lose billions of dollars, countries around the world have suddenly taken to amending their legislation and stock exchange listing requirements to stick to corporate governance principles and developing new sets of best practices. For instance, in the wake of these scandals, the US government enacted the Sarbanes–Oxley Act or SOX in 2002 by imposing a few rules and regulations on the publicly held companies and the accounting firms for the better management of corporate governance (Investopedia, 2014).

1.2 How Corporate Governance in Banks is Different?

The three key differences that distinguish the corporate governance of banks from that of non-financial organizations are 1) banks have a greater number of stakeholders involved than non-financial organizations holding maximum power, 2) the banking business is opaque and more complex, and 3) no incentive to reduce risks for the managers (Mehran, Morrison and Shapiro, 2011).

1.3 Maximum Power to the Shareholders

Banks, comprised of over 90% debt in comparison with an average 40% debt for non-financial firms, have a greater number of stakeholders than non-financial organizations. Aside from the shareholders, the stakeholders of banks include debt holders, most of whom are the depositors as well as the holders of subordinated debt. The insurance company for deposit also takes an interest in the bank's health as it needs to pay insurance in the case of insolvency. The government is also a stakeholder in the bank because in the case of a bank's insolvency, the entire financial system will come under threat, and therefore, the government needs to regulate and bail out these externalities at a considerable cost to the taxpayers (Mehran, Morrison and Shapiro, 2011). Despite the involvement of a great many stakeholders, only the views of shareholders are considered by the banking board. The interests of the shareholders differ substantially from that of the other stakeholders, especially in relation to risks, in which shareholders prefer volatility and possess short-term views, whereas the regulators and debt holders prefer low volatility and take long term perspectives (Mehran, Morrison and Shapiro, 2011).

1.4 Opacity in the Banking Sector

Opacity in the banking business is another problem that makes it difficult to monitor banks. Banks can quickly alter the risk profile of their assets and readily hide problems by giving loans to a borrower, thereby incrementing the interest income. Depositors, who are one of the main financiers, are often kept in the dark about the investments banks make with their money. Even if banks declare information as regards the investment, it is presented in such a complex and incomplete way that it becomes difficult for a common depositor to understand the depth of risks involved in the investments. Even large institutional investors cannot understand the complex financial instruments used by the banks to invest and reinvest their money (Levine, 2003). Often regulators also have very little idea about the new financial instruments put into practice by the banks.

1.5 No Incentive to Reduce Risk for the Management

Like most of the other organizations, the performance of the top management of the banking sector is measured by the amount of returns they receive from the banks. Often the remunerations of the executives are directly tied to the returns they get from the investments. As the expected value of percentage returns increases in an investment portfolio, the risk involved in that portfolio also goes up. The safest and the risk-free financial instruments always have the lowest rate of returns. Therefore, the managers have every incentive to increase the risks to improve their chances of getting higher remuneration (Levine, 2003). This exposes the bank to a huge risk. Over a period of time, this leads to a cascading effect, if it remains unchecked.

1.6 Relationship between Corporate Governance and Bank Performance

Since the subprime depression of 2008, the world economy has seen a significant decline in the confidence of the investors, depositors, and creditors in the banking system. The subprime recession was so massive in effect that it touched almost all the countries in the world including

Jordan. Jordan has relatively a small banking sector as opposed to its European and Middle Eastern neighbors. Most of the Jordanian banks are controlled by a few shareholders and politically influential people, making the banking system very inefficient and prone to corruption. The economic growth as well as the per capita income of the country is average (Bawaneh, 2011). Therefore, when the commercial banking sector got affected by the subprime crisis followed by the sovereign debt crisis in Europe, the confidence of the Jordanian depositors and the creditors plummeted. Unlike other Middle Eastern countries such as Saudi Arabia and the UAE where the banking sector is highly regulated and controlled by the government, Jordan’s banking sector is more open. The exposure of the financial system of Jordan is linked to big commercial banking organizations present in Jordan. Hence, it is more important for the Jordanian banking sector to implement different parameters of corporate governance to ensure and protect its local interests. Before getting deeper into the discussion, I will try to establish that different governance parameters have a positive relationship with the creditors as well as the depositors.

1.7 Ownership Concentration

Ownership concentration means more presence of the shareholders of an organization in the board of directors. In a non-financial firm, typically, the board of directors are people expert in that particular business segment. Shareholders may be present in the board of directors, but their influence in the decision making is minimal. Thus, the shareholders do not interrupt the day to day decision making process of the business and let it be run by the experts. This model works well for non-banking organizations. However, banks are completely different in this respect. In a banking sector, if the participation of the shareholders in the board of directors is less, then the performance of banks is seen to be inferior to those that have larger percentage of shareholders present in the board of directors (Obeten, Ocheni, and John, 2014).

A study by Perrini et al (2008) found a positive correlation between the ownership concentration and corporate performance. In other words, the study found a positive relationship between depositors’ confidence and corporate governance (Bawaneh, 2011). Similarly, in 2010, a study conducted by Al-Farooque et al found that ownership concentration in banks decreases the management, monitoring costs and improves the performance and productivity of the managers. However, there are a lot of studies that have found a negative correlation between ownership concentration and bank performance (Bawaneh, 2011). For instance, Boon et al (2011) in their study concluded that there is a negative correlation between ownership concentration and corporate performance (Obeten, Ocheni, and John, 2014). Their study, conducted on the US banking sector, came up with the finding that if the interference of the stakeholders is less, then banks perform better. There are several other studies, especially conducted in the 1980s, 1990s and the early 2000s, found no correlation between ownership concentration and bank performance. For example, McConnell and Servaes, who conducted a study in 1990 on the UK banking sector, could not find any correlation between the two (Durukan et al, 2005). However, most of the studies conducted after the 2008 subprime crisis showed a positive correlation between the ownership concentration and corporate performance. This primarily happened because the higher ownership concentration eliminated agency conflicts between the management and owners. Managers continued to take decisions that will maximize returns, whereas owners by the virtue of being in the board of directors ensured that the risks taken in such investment are kept within check.

1.8 Institutional Investors

In a banking system, institutional investors are those stakeholders who invest their money in the banks for more returns and profitability. As they invest large sums of money in the banks, they have a greater influence on the decision making process of the banks. If the institutional ownership in the banks increases, the investment process will become more transparent (Obeten, Ocheni, and John, 2014). If institutional investors force the management to publish risk information and investment decisions, then it will significantly improve the transparency of the bank investments to other small stakeholders like the depositors, thereby improving the overall corporate governance structure. However, it is interesting to see if this institutional involvement can help the performance of the bank. In 1996, Shleifer and Vishny found in their study that there is a positive correlation between institutional ownership and bank performance because more involvement of the institutional investors reduces the agency problem (Durukan et al, 2005). This, in the long run, helps banks make a greater amount of profit by mitigating the overall risks.

On the contrary, a study conducted by Barnhart and Rosenstein in 1998 showed that institutional ownership can significantly decrease the bank performance by creating more conflict of interests and strategic misalignment. However, other studies like the ones conducted by McConnell and Servaes in 1990 and Filatotchev in 2005 have found that institutional ownership not only improves the bank performance but also increases the confidence of other small stakeholders like the depositors (Durukan et al, 2005). Therefore, it can be concluded that there is a positive correlation between institutional ownership and the depositors' confidence. These studies also show that as the confidence of the depositors increases, the bank credit scores also improve substantially.

1.9 Foreign Ownership

As a benchmark shareholding practice, some banks often employ the strategy of partial foreign ownership, which helps the banks in multiple ways. First, the foreign owners bring a fresh new perspective to the banking system of the country. Secondly, if those foreign individuals hail from a country in which there is an established banking sector, then they also bring better expertise and knowledge in the banking practices and corporate governance. Therefore, many banks nowadays are using a diversified ownership structure to understand and manage the banking process and risks better. Finally, having a foreign owner in a bank provides confidence to the local depositors and investors because it is a common perception that if a foreigner shows interest in a bank, then that must be doing well (Obeten, Ocheni, and John, 2014). Not many studies were conducted to find out the relationship between foreign ownership and bank performance. However, a few studies conducted in the last 10 years found a positive correlation between the two. Kangis and Kareklis (2011) in their study have found that the reasons of this positive correlation are a higher confidence of the local investors on foreign ownership, better valuation of the company in the international market, and more regulation requirements to disclose the information related to banking investments to all the stakeholders, which collectively have boosted up the confidence of the depositors and institutional investors (Bawaneh, 2011).

1.10 Board Size

Board size has recently become a part of the corporate governance discussion. Often in the traditional companies, board sizes are very small, consisting of five or less number of members. In recent times, there is a trend of increasing the board size as it not only helps in the advisory process of the organization, but also, as part of the corporate governance, monitors the functioning of the top management (Obeten, Ocheni, and John, 2014). The influence of the board size on the bank performance is a fairly new subject because of which there is minimal empirical evidence in support of a positive relationship between a higher board size and bank performance. One study conducted by Adams and Mehran (2011) has found that with the increase of board size, the risk taking ability of the bank decreases. Therefore, the performance of the bank suffers in the short term (Obeten, Ocheni, and John, 2014). However, in the long run, those banks with a large board size tend to do better in crisis situations such as recession, depression and economic turmoil.

1.11 Country Evidences

Over the years, the world economy has seen several financial meltdowns. Some of the recent ones include Asian debt crisis, the US subprime recession, and the European sovereign debt crisis. In all of these cases, some countries seem to perform better than others. For instance, during the Asian crisis of 1997 and also during the 2008 subprime depression, Indian banking segments suffered much less than all other big economies. This was primarily because the banking segment of India was highly regulated, and Central Bank implemented some stringent risk minimization guidelines for the banks in the case of offering loans and investments. In 1997, Hong Kong suffered badly in the Asian crisis. However, in subsequent depressions, the Hong Kong financial system performed relatively well because Hong Kong financial regulators forced the banking sector to implement strict corporate governance policies (Christopher, 2009). This helped minimize the risks for the banks. In recent years, another study conducted by Obeten, Ocheni, and John in Nigeria (2014) found that depositors' confidence in the foreign banks in Nigeria is higher than that of the government banks. This is because most of the foreign banks have implemented strict corporate governance policies and show more transparency in their financial transaction. Finally, another study conducted in Kenya shows that the confidence of the depositors is more in the government banks than in the foreign commercial banks, because the government acts as the insurer of deposit in the case of bank insolvency (Wambua, 2011). Therefore, it can be concluded that there is no single corporate governance factor influencing the confidence of the depositors. Rather, several factors lead to the boosting of the confidence of the depositors.

1.12 Corporate Governance Policies to be implemented in the Jordanian Banking Sector

As per the conventional corporate governance philosophy, the management of an organization is only responsible for balancing the interests of several stakeholders. In the case of banks, the top management thinks that by declaring the way they are investing the depositors' and creditors' money in the annual statement in an incomplete way, their responsibility towards these stakeholders gets fulfilled. However, the implementation of corporate governance as only a tool of transparency through annual statement and newsletters cannot solve the conflicts of interests of different stakeholders of the banks. This way, the shareholders will continue to have greater authority over the decision making process than the other stakeholders. Therefore, the implementation of corporate governance policies in the case of the banking sector should be more comprehensive and elaborate.

The banking sector in Jordan consists of government, cooperative, local commercial and international banks. The level of implementation in these different kinds of banks is very different. For instance, the majority of the foreign banks has implemented the basic corporate governance policies in their organizations, whereas most of the cooperative and government banks do not have any corporate governance policies implemented. Still, a large section of Jordanians prefers domestic banks over the international banks as their deposits are partially insured by the government (Bawaneh, 2011). Therefore, it is not very easy to formulate a framework for corporate governance in Jordan.

As seen above that the inclusion of comprehensive information about investment in the annual statement with proper risk categorization should be made mandatory by the Jordanian government for all types of banks. Currently, some banks may follow certain risk disclosure policies, but there is no strict government regulation around this. Banks should include these regulations as part of their corporate governance framework implementation.

Representations of multiple types of stakeholders in the board should be made a part of the corporate governance framework. At present, shareholders, institutional investors, and the top management form the board of directors. However, the inclusion of regulators and some representation of small depositors in the board will help monitor the management operations of the banks.

Currently, there are no rules around the minimum board size and the percentage of shareholders present in the banks. The banks can implement corporate governance policies around these to increase the board size of the banks and increase the percentage of shareholder representation in the board over 50% (Obeten, Ocheni, and John, 2014).. These measures will definitely help boost the confidence of the institutional investors and the small depositors.

Other corporate governance parameters like diversification of shareholder ownership and more involvement of the institutional investors in the management decision making process of the bank will certainly go a long way in improving the depositors' confidence and the credit scores of the banks in the long run.

2. Conclusion

As we have seen in this paper that several research studies over the years have shown that many corporate governance parameters like ownership concentration, declaration of risk categorization in annual statements, board size, institutional ownership and foreign ownership have positive correlations with corporate governance. Furthermore, we have seen that some studies show that the confidence of the depositors increases significantly, if their savings are insured by the government or other parties fully or partially. If the policy of government insurance can be implemented in the Jordanian sector, then that will boost up the confidence of the depositors quickly. However, in the long run, it is not possible for the government to insure 100% of the depositors' money. It is, therefore, crucial to implement other corporate governance policies like risk categorization disclosure, minimum board size requirement, diversification of ownerships, and the involvement of the creditors in the banking policies, process and the investment decisions. In Jordan, the main problem is that most of the banks are controlled by some highly influential political families. Therefore, the chances of corruption are very high. The implementation of strict corporate governance policies like the above will definitely help support the rights of all the stakeholders including depositors and creditors.

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