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EVALUATION OF THE IMPACT OF INTERNATIONAL
STANDARDS SET BY "THE BASLE COMMITTEE ON
BANKING SUPERVISION" ON JORDANIAN LAW

A thesis submitted to the University of Durham for the degree of Doctor of
Philosophy in the Faculty of Social Sciences and Health

2009

Nadia A. Al-Anani

Durham Law School

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ABSTRACT

Author: Nadia Ahmad Abdul-Muhsin Al-Anani

Title: Evaluation of the Impact of International Standards set by "the Basle Committee on Banking Supervision" on Jordanian Law.

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Abstract:

Formulating international standards on banking supervision is one of the most important topics of international financial law. The recent international financial crisis is another striking example on the significance and relevance of this subject. This thesis attempts to evaluate the impact of international standards of banking supervision aimed at the creation of a "safe and sound" banking system on Jordanian legislation at two levels: to what extent international standards set out by the Basel Committee on Banking Supervision ("BCBS") have influenced Jordanian law; and how these standards can assist in improving the Jordanian law as well as direct new policy reforms.

The first finding of the thesis is that Jordanian law is significantly compliant with international standards. The second main finding is that soft law, as opposed to hard law, is the optimal form of setting international banking supervisory standards. The thesis also finds that the BCBS standards do not provide adequate guidance on the structure of the banking supervisory authority. The thesis concludes with recommendations on how to enhance international banking supervisory standards as well as the structure and substantive law of banking supervision in Jordan in light of international standards and with occasional reference to the UK Law.

THE AUTHOR

The author, Mrs. Nadia A. Al-Anani, was born in Amman in 1966. She holds a Bachelor of Law degree from the University of Jordan, where she was awarded the top graduate for the year 1988. She also holds an LLM in Commercial Law from the University of Bristol, UK, which she obtained in 1990.

She currently works as an attorney on corporate and financial law in Amman, Jordan. She was formerly a legal researcher for the Central Bank of Jordan.

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DEDICATION

*In Memory of my Father
And Brother Azzam*

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- Vienna Convention on the Law of Treaties.1980.

LIST OF ABBREVIATIONS

ABCP	Asset-Backed Commercial Paper
ACBS	Arab Committee on Banking Supervision
AJIL	American Journal Of International Law
AMA	Advance Measurement Approach
AMF	Arab Monetary Fund
ASE	Amman Stock Exchange
B.E.Q.B	Bank of England Quarterly Bulletin
BB&Co.	Baring Brothers and Co. Ltd.
BCBS	Basel Committee on Banking Supervision.
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
BSD	Banking Supervision Department (at the CBJ)
BSF	Baring Futures (Singapore) Pte Ltd.
BSL	Baring Securities Ltd.
CBJ	Central Bank of Jordan
CDO	Collateralised Debt Obligation
CDS	Credit Default Swaps
DIC	Deposit Insurance Corporation
CRT	Credit Risk Transfer
E.B.L. Rev.	European Business Law Review
EEA	European Economic Area
EAD	Exposure at default
ESC	Economic Security Council
EU	European Union
FATF	Financial Action Task Force

FMG	Financial Markets Group
FSA	Financial Services Authority
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Programme
FSF	Financial Stability Forum
FSI	Financial Stability Institute
FSMA	Financial Services and Markets Act
FSSAs	Financial System Stability Assessments
FX	Foreign exchange
G-10	Group of Ten
G-7	Group of Seven
GATS	General Agreement of Trade in Services
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariffs
Geo.Wash.J.Int'l L.& Econ.	George Washington Journal of International Law and Economics
GYIL	German Yearbook of International Law
HLIs	Highly leveraged institutions
ICLQ	International & Comparative Law Quarterly
IFSB	Islamic Financial Services Board
I.F.L.Rev.	International Financial Law Review
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAAP	Internal Capital Adequacy Assessment Process
ICBS	International Conference of Banking Supervision

ICJ	International Court of Justice
IDB	Islamic Development Bank
IEF	Institute for European Finance
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IRB	Internal ratings-based approach
J.B.R	Journal of Banking Regulation
J.F.R.&C.	Journal of Financial Regulation and Compliance
J.I.B.L.	Journal of International Banking Law
J.I.B.L.R.	Journal of International Banking Law and Regulation
JCB	Jordanian Currency Board
JD	Jordan Dinar
JIBFL	Butterworths Journal of International Banking and Financial Law
JIBR	Journal of International Banking Regulation
JMB	Johnson Matthey Bankers
JSC	Jordan Securities Commission
L.Q.R.	Law Quarterly Review
LGD	Loss given default
LSE	London School of Economics
LTCM	Long-Term Capital Management
McGill L.J.	McGill Law Journal
MoU	Memorandum of Understanding
OECD	Organisation for Economic Cooperation and Development
OJ	Official Journal of the European Communities
OTC	Over the Counter

PD	Probability of Default
PSEs	Public sector entities
ROSCs	Reports on the Observance of Standards and Codes
SDC	Securities Depository Centre
SEC	Securities Exchange Commission
SIB	Securities and Investment Board
SIVs	Structured Investment Vehicles
SMEs	Small and medium-sized entities
SPE	Special purpose entity
Spear, Leeds and Kellogg	Spear, Leeds and Kellogg
UNCTAD	United Nations Conference on Trade and Development
VaR	Value at Risk
World Bank	International Bank for Reconstruction and Development
WTO	World Trade Organisation
World Bank	International Bank for Reconstruction and Development
YEL	Yearbook of European Law

INTRODUCTION

I. Scope and Aims of the Thesis

The main purposes of this thesis are to evaluate the influence of international standards, banking supervision, legislation and institutional structure designed to achieve the safety and soundness of the banking system of Jordan, as well as, evaluate how these standards can assist policies and practices of banking supervision in Jordan. Yet a subordinate goal of the thesis emerged during research. The rather voluntary compliance of the Jordanian legislator with the set international standards on banking supervision provides insights into the current international supervisory infrastructure and why some countries comply with international standards while others do not.

Banks assume a substantial role in the economy by promoting savings, extending credit and providing payment services. Therefore, maintaining the financial soundness of banks is a major policy goal for the Hashemite Kingdom of Jordan ("Jordan"). Furthermore, Jordan is a country which seeks a policy of openness and deregulation and accordingly the significance of promoting its practice and image of adhering to internationally recognised standards on banking supervision is essential. However, each country has its unique regulatory framework and banking structure. Therefore this thesis calls for establishing the right balance between the need for maintaining the robustness of the local banking systems, on one hand, and the need for setting out flexible international banking supervisory standards, on the other hand.

The recent international financial crisis have put the international financial regulation as top priority for public policy on a domestic, regional and an international levels, and on an unprecedented scale since the Great Depression. Calls for tight or big bang type of regulation as a response to the crisis are not necessarily valid. The financial turmoil of 2007-08 should be a driving force for re-regulation not over-regulation. Any call for substituting the current soft international standards on banking supervision with hard law would stifle the development of banking supervision and would not necessarily improve compliance therewith. Likewise, the emerging recent calls in Jordan for adopting the UK model represented by the Financial Services Authority ("FSA") as a result of the pseudo effect of the financial turmoil on Jordan and other domestic

problems is also invalid. Supervisory structures are not always determined by prudential consideration. Legal tradition and the size and complexity of the banking market are other crucial factors.

II. Methodology and Research Questions

The evaluation is undertaken throughout the following three successive stages.

- 1. What is the optimal form of banking supervision in terms of selecting supervisory tools and methods, organising the institutional structure and handling cross-border supervisory issues?*

Answering this question is dependent on three elements. The first element requires an in-depth understanding of the nature and role of the banking system, as well as, the policy goals of banking supervision. The second element is found in the international norms of banking supervision. These norms are mainly determined by the 'Basle Committee on Banking Supervision' ("BCBS"), which sets down, by itself or in co-operation with other international supervisory institutions, widely accepted standards of banking supervision. The legislation of the European Union ("EU") and other important jurisdiction legislation have grown in tandem with that of the BCBS. The international standards are comprised of minimal core principles while flexibly allowing each jurisdiction to adopt its detailed banking supervisory methods and institutional structures. This leads to the final element being that banking supervision should be responsive to the market structure and underlying legal tradition of each country.

- 2. What are international standards for banking supervision? And what is the status quo of banking supervision in Jordan?*

The description and analysis of international standards and the Jordanian legislation show that Jordan is largely compliant with international standards and has adopted extensive banking supervision legislation and organisation, yet, banking problems still exist. This has drawn to public attention questions related to the comprehensiveness, sufficiency and efficiency of banking supervision.

3. *How can the banking legislation in Jordan be improved to reach the optimal model?*

This question is answered in light of international standards and with occasional reference to UK Law. UK Law is selected due to the significance of the City as well as the shortcomings in the adopted financial supervisory structure which failed to coordinate between supervisors and authorities responsible for bailing out troubled banks.

Finally, there are three further important points to explain here. First, the thesis aim is to provide recommendations on questions of law and policy. It the technical nature of banking regulation is inevitable. Secondly, the thesis does not cover the particular difficulties arising from the implementation of the BCBS standards to Islamic banking. Thirdly, it does not seek to provide a thesis on the sources of international law.

III. Banking Supervision in Legal Research

This thesis has drawn on economic references and aims at accuracy in employing economic jargon, while remaining within the boundaries of legal research. One author has justly described the relationship between economic analysts and lawyers when he states that the former identifies regulatory objects, and determines market imperfections as well as the cost of regulations (including rule-making, enforcement and compliance costs),¹ while the lawyers' role is to lay down such outlines in specific legislation. However, this is not meant to negate the fact that the two issues are inseparable. This is because it is essential that the supervision must be compatible with the regulatory goals as set out by policy makers. Two results stem from this: first, the law and practice of supervisory authorities should have a sound and effective legal basis in order to fulfil the regulatory ends. Secondly, such laws and practices should not explicitly or implicitly impede the fulfilment of the policy goals. Furthermore, lawyers' research should focus on the assurance of fairness and justice to all of the concerned parties. Consequently, lawyers must consider the outcome of any suggested reform to

¹ Cento Veljanovski, The Economies of Law, (Hobart Economic Paper No. 157. Institute of Economic Affairs, 2006), pp. 156.

financial legislation both legally and economically, though they do not have to formulate a distinctive opinion on questions such as costs and benefits.²

IV. Sources on Jordanian Law

There are a number of difficulties related to the various types of source materials on Jordanian law. As regards legislation, it has suffered until very recently from weak drafting and occasionally poor listing. The subject of banking supervision has also been grossly neglected in legal research. None of the articles referred to in the thesis were published in academic journals applying stringent academic requirements. The articles, nevertheless, cover several of the practical problems in banking supervision in Jordan. They also contain useful information regarding the opinions of bankers and banking supervisors, while also covering the discussions of related panels and conferences. Searching for articles was a time-consuming effort taking into consideration the lack of on-line services. Furthermore, there is no major legal reference book on banking supervision and regulation in Jordanian law.

In addition, the evaluation of Jordanian law in the thesis is not confined to published materials. Numerous informal discussions with junior staff at the Banking Supervision and Banking Inspection departments at the Central Bank of Jordan (“CBJ”) were undertaken in order to help analyse the CBJ regulations and notices, as well as to determine practical efforts. An interview with a senior official was also conducted in order to better understand CBJ’s regulatory policies. It is humbly hoped that this thesis will be a useful addition to the Jordanian legal library.

V. Structure of the Thesis

The thesis is comprised of an introduction and eleven chapters divided into three parts. Each of the first ten chapters begins with a short introduction. The thesis is also supplemented with an annex on Core Principles.

Chapter 1 aims at providing a sound conceptual framework on which to build the thesis. Section 1 defines banking and explains the nature and the importance of the

² Anthony Ogus, ‘Economics and Law Reform: Thirty Years of Law Commission Endeavour’ 1995 L.Q.R. Vol. 111(July), pp. 420.

banking system. It further explains that the distinctive features of banks are their functions of intermediation coupled with their particular form of credit transformation. Section 2 defines banking supervision for the purposes of the thesis and in accordance with its objectives. It illustrates that avoiding systemic risks is the major economic rationale for banking supervision. Section 3 describes the common tools of banking supervision. Section 4 looks into the major developments in banking. It explains why it is increasingly difficult to distinguish between banks and other financial institutions, particularly in industrial countries where the phenomenon of large and complex banking institutions exists. It then explains how these developments influence the methods of banking supervision. Section 5 looks into the importance of building the capacity of the supervisory authority and the relevance of the supervisory structure in maintaining a sound banking system. Section 6 deals with the international dimension of banking supervision. It explains the necessity for the co-ordination of efforts in allocating supervisory duties between home and host authorities and the need for common prudential rules.

Part I covers international standards and is comprised of six chapters.

Chapter 2 describes the establishment of the BCBS and its early efforts in setting out international standards of banking supervision. Section one illustrates the establishment of the BCBS as an international standard setter forum for banking. Section 2 looks into the BCBS early standards in promoting cross-border cooperation between banking supervisory authorities. Section 3 looks into the BCBS early role in setting out internationally recognised capital adequacy requirements, while Section 4 looks into the remaining early standards.

Chapter 3 is a descriptive chapter of the BCBS standards on capital adequacy from the mid-1990s onwards. Section 1 illustrates how the BCBS amended the Capital Accord in 1996 to incorporate market risk in capital adequacy measurement, as well as, permit banks to choose between either the standardised approach or the internal risk based approach. Section 2 illustrates the BCBS proposals to replace the Capital Accord. Section 3 reflects on the responsiveness of the BCBS to market developments by issuing the new capital adequacy standards known as 'Basel II', which widens the scope of risks covered as well as the set of choices given to banks. It also looks into the new proposals to amend Basel II after the late credit crisis.

Chapter 4 illustrates the evolution of the BCBS other substantive supervisory standards during the same era (mid-1990s onwards). Section 1 explains the standards on risk management by banks and the related supervisory role. Section 2 analyses international standards which support the partnership between the supervisor and the private sector based on market discipline, the relationship between each of the supervisors, external audits and internal audits, as well as, sound corporate governance, and the internal audit and internal control functions.

Chapter 5 looks into the standards issued from the mid-1990s onwards to strengthen international cooperation. Section 1 explains the developments in international standards on supervisory cooperation, and which reflects important market developments such as the expansion of electronic banking. Section 2 illustrates cross-sectoral cooperation between international fora on financial conglomerates. Section 3 looks into the Core Principles for Effective Banking Supervision and their Methodology and how they support the duality of approaches in banking supervision as well as serve as a benchmark against which supervisors can be assessed.

Chapter 6 examines the BCBS standards related to the institutional aspects of banking supervision. Section 1 shows how the BCBS set out standards only on the institutional capacity of banking supervisory authorities. Section 2 looks specifically into the limited influence of the BCBS on the techniques and structure of banking supervisors and the concurrent wide variety of structures across jurisdictions. Section 3 looks on the UK structure and examines the Banking Act 1987, which provides an example on a semi-independent banking supervisory authority. It also focuses on the UK Financial Supervisory Authority (“FSA”), a unified financial authority independent from the central bank and one which is provided with a framework of wide statutory objectives. This Section attempts to draw lessons from the adverse effects of the UK model on handling banking crisis.

Chapter 7 analyses the legal nature of the BCBS standards and its significance. Section 1 explains why they are considered to be “soft international law”, but does not attempt to provide a discussion on the sources of international law. Section 2 examines the role of regional organisations in transposing international standards into domestic legislation. Section 3 analyses the wide influence of the BCBS standards particularly on non-member countries and seeks to draw preliminary conclusions therefrom.

Part II covers Jordanian law and is comprised of chapters 8, 9 and 10.

Chapter 8 describes the evolution of the Jordanian banking supervision legislation in three chronologically organised sections. It shows how banking supervision has developed as a result of three major contributory factors: changes in the market structure, local supervisory experiences and more recently the influence of international supervisory standards. Section 1 covers the development of banking supervision from the infancy of the banking system at mid-twentieth century until 1971. Section 2 illustrates the major developments during the period from 1971 to 1989. It focuses on how a multi-tier financial system evolved during the mentioned era. Section 3 examines the financial crisis of the late eighties and its effects, while Section 4 covers the late 1990s onwards.

Chapter 9 provides description and analysis of current Jordanian banking substantive legislation in light of international banking standards through four sections. Section 1 covers the implementation of standards on licensing, branching, permissible activities, investment criteria and ownership. Section 2 examines the rules on risk management, while Section 3 examines conformity with complementary regulation on corporate governance, internal controls as well as the supervisor's relationship with the internal and external auditors. Finally, Section 4 looks into the implementation of international supervisory standards on capital adequacy

Chapter 10 evaluates the current banking supervisory structure in Jordan in light of the BCBS standards and the lessons learned from the UK financial troubles in 2007-08. Section 1 examines the legal framework of the CBJ which covers its objectives, responsibilities, powers and legal protection issues. Section 2 looks into the coordination between the CBJ and other domestic authorities related to its banking supervisory roles such as the Deposit Insurance Corporation. Section 3 looks into the CBJ's institutional qualities operational independence, transparency, sound governance, adequacy of resources, and accountability. Finally, it examines the cross border coordination between the CBJ and other supervisors.

The last chapter is Chapter 11, which provides a summary of the thesis and sets out its recommendations.

Finally, the law is stated as at the end of February, 2009.

CHAPTER I

A CONCEPTUAL FRAMEWORK FOR INTERNATIONAL BANKING SUPERVISION

1.0 Introduction

The aim of this chapter is to provide a sound conceptual basis for the whole thesis. First, it defines banking and explains the nature of the banking system. “Banks” are one of the terms that can be intuitively understood, but can prove to be problematic for academic precision between banking and non-banking institutions (Section 1). The chapter then seeks to define and explain the meaning and rationale of banking supervision (Section 2). Having described why banks are supervised, the chapter proceeds to describe the types and tools of banking supervision (Section 3). It then goes on to explain the market developments in the field of banking and their influence on the types and tools of banking supervision (Section 4). The following section explains the importance of the institutional capacity of the banking supervisory authority and the relevance of the structure of such authorities (Section 5). These sections are necessary to understand and assess policies underpinning cross-border banking supervision. To put it another way, how domestic considerations are to be met in an international context (Section 6).

1.1 Definition of Banks and the Nature of the Business of Banking

Banks have two features, which distinguish them from other financial companies: intermediation and maturity transformation.

The key task of banks is the intermediation between depositors and borrowers; i.e. banks transfer liquidity from depositors to borrowers be they investment companies, household purchasers or any other group. At the risk of over simplification, researchers explain that economies of scale are attained through intermediation. “Banks can pool risk and diversify portfolios more cheaply than individual investors, given fixed costs of acquiring investments. Risk itself is reduced in turn by such diversification which

should entail a lower cost of funds.”¹ Information costs (the cost of searching for suitable transactions; verifying proposals made by potential borrowers; monitoring the performance of the borrowers’ obligations; and costs of enforcement in case of borrowers default) will be lowered.² Banks also provide a payment agency for domestic and international clients such as cheques, guarantees and letters of credit. This is in addition to a variety of other services such as holding safety deposits.

The other distinctive feature of banks is maturity transformation of liquid liabilities to illiquid and long-term assets. Banking intermediation solves the liquidity problem between investors who need to borrow for a long time without interruption, and risk averse depositors who wish to maintain control on when to recall their deposits, yet prefer the higher returns of investment to that of hoarding cash. Banks, therefore, have an asset-liability mismatch problem: they have on the assets side of their balance sheets recallable deposits while on the liabilities side they have loans with fixed maturity dates. The very nature of the asset/liability structure of banks, their credit transformation function, in addition to their high leverage ratio (i.e. a high ratio of debt to equity capital), mean that banks are only “conditionally solvent”, as any depositors run on a bank’s assets can lead to its collapse.³ Banks therefore differ from insurance companies, which are more likely to have problems on the liabilities side of the balance sheet (due to the uncertainty of premiums). A major difference between banks and securities companies, is that the latter’s assets are readily marketable. Mutual funds also compete with banks as repositories of liquid assets and can provide payment services. They nevertheless differ from banks in two important aspects: deposits therein are not “money certain” and they do not engage in maturity transformation.⁴ Furthermore, a bank’s value as a “going concern” is worth much more than its value when it is liquidated,⁵ comparable to other financial institutions.

¹ E. Davis, Theories of Intermediation: Implications for Regulation, (LSE FMG, Special Paper No. 50, November 1992), pp. 3.

² Mervin Lewis, ‘Theory and Practice of the Banking Firm’ in C. Green, and D. Llewellyn (eds), Surveys in Monetary Economic: Financial Markets and Institutions, Vol. 2 (1991), pp. 120.

³ Richard Dale, The Regulation of International Banking, (1984), pp. 54.

⁴ Eddie George, ‘Are Banks Still Special?’ 1997 B.E.Q.B. Vol. 37(1)(February), pp. 116.

⁵ J. Guttentag, and R. Herring, The Lender-of-Last-Resort Function in an International Context, (Essays in International Finance, No. 151. Princeton University. New Jersey, 1983), pp. 8.

The separation between banking and non-banking deposit taking institutions in one jurisdiction depends on complex factors in the evolution of that financial system. Since this is an important point, it deserves to be illustrated in a detailed example of building societies in the UK.⁶ Building societies were first established in Britain in the last quarter of the 18th Century. They were comprised of people who used to pay fixed contributions in order to buy land and thereafter build houses. Building societies, therefore, had two distinctive features: first, they were truly mutual which, at its simplest definition, means that customers are also the owners. The major distinction between a mutual institution and a Public Shareholding Company is the absence of equity shareholders in the former type. This means that building societies are more capable of providing pricing policies to the advantage of members, than a Public Shareholding Company, which has to maximise its profits in order to remunerate shareholders.⁷ Secondly, the activities of building societies were confined to home ownership and, therefore, they used to terminate once the houses were provided. Building societies initially operated in a segmented market between building societies and banks and the former enjoyed a virtual monopoly over the credit mortgage market. Banks, unlike building societies, were at the time subject to credit controls (known as 'the corset') and other monetary controls. Activities of building societies could therefore be restricted. The 1962 Building Societies Act (largely based on a previous Act laid in 1874) confined building societies activities to raising funds for home ownership.

By lifting the controls on banks in the early eighties, banks entered the mortgage market to an unusual extent, and consequently building societies lost a considerable share of the market to banks. The response of the British government was issued in a Green Paper in 1984.⁸ The British government expressed its intention to retain the traditional role of building societies of credit mortgage, but at the same time it realised that building societies should be enabled to become more competitive in the

⁶ See: Mark Boléat, The Building Society Industry, (1982); Mark Boléat, Ronald Armstrong, Christopher French and Micheal Coogan; Building Societies: the Regulatory Framework, (1992); Steve Crowther, 'Analysing the New Powers Given to Building Societies' 1995, J.F.R.&C. Vol. 3(3), pp. 275-279; and Maximillian Hall, 'The Regulation of Building Societies and the Issue of Conversion' 1988 J.I.B.L.R. Vol. 3(6), pp. 260-265.

⁷ Treasury and Civil Service Committee, Financial Services Regulation: Minutes of Evidence: Strafordshire Building Society and the Building Societies Association, HC (1994-1995) 26-III, (23 November, 1994), pp. 72-73.

⁸ HM Treasury, Building Societies: a New Framework, (Cmnd 9316, July 1984).

savings market by allowing them to become “one stop” centres for investment as well as financial services. The Building Societies Act (1986) accordingly allowed building societies to have more than a single purpose. Section 5(1) stated that the “purpose” or the “principal purpose” of a building society was raising loans secured on residential property. Building societies were permitted in Schedule 8 of the Act to undertake new activities such as insurance, money transmission and house building. The following Building Societies Act (1997) further widened the scope of permissible activities with the principal prohibited activities being the dealing in derivatives and taking positions in the commodities and currencies markets.

The principle of mutuality was likewise eroded. Building societies eventually became permanent saving institutions as they accepted funds from savers who did not intend to own houses and paid them interest in return, this also meant that borrowers had to pay interest. The Building Societies Act (1986) and the subsequent Building Societies Act (1997) allowed and facilitated building societies attempts to demutualise to banks. A number of building societies made this decision led by the Abbey National. Experience showed, nevertheless that building societies did not convert for competitive reasons as envisaged by the legislator, and have not implemented all the new powers they are entitled to use.⁹ The spur of demutualisation was largely attributed to the “windfall”; i.e. were distributed profits or shares to original customers upon the transfer to the status of a bank.¹⁰ The ensuing legislative debate and legislation are not of concern here.¹¹ Banks and buildings societies exist in the UK financial market. They

⁹ Treasury and Civil Service Committee. Second Report. Financial Services Regulation: the Building Society Sector: Report together with the Proceedings of the Committee, HC (1994-95) 26 (21 December, 1994), pp. viii.

¹⁰ Treasury Committee, Ninth Report: Vol. 1, Demutualisation: Report and Proceedings of the Committee, HC (1998-99) 605-I, (27 July, 1999), para 8.

¹¹ A report conducted later on by the Treasury Committee of the House of Commons showed that there was little evidence to support that close links with customers cannot be attained by none-mutuals. It however found that mutuals have lower overheads and are consequently more capable of providing better rates for customers.

The UK Government, however, had concerns about the possible disappearance of building societies which could reduce the diversity of the British financial system. Smaller societies in particular provide regional focus and high quality work opportunities outside the City. Mutuals also understand their markets and are highly appreciated in their local markets. The Government therefore took the view that regulatory hurdles imposed on building societies seeking demutualisation should persist due to the comparative advantages of mutuality.

have become subject to the same supervisory authority the FSA and subject to regulation largely similar to banks.¹²

The other question, which imposes itself here, is whether “Islamic banks” are banks? Modern Islamic banks are a relatively new phenomena (the first modern Islamic bank was established in Egypt as recently as 1963), but with a vibrant growth rate. Islamic banks are simply companies, which aim at profit through investment like any other company. They provide their services to general customers and many of them are now established by western institutions such as Stanley Morgan. The name “Islamic” is used because these banks are founded on basis of the *shari’ah* (Islamic law)¹³ and Islamic economic principles.¹⁴ The main principle of Islamic banking and finance which give it its distinctive feature is the prohibition of *riba*¹⁵ usually defined as positive fixed increase of income for no consideration other than the lapse of time.¹⁶ Consequently, the traditional deposit taking activity, which involves the payment of an agreed fixed interest is considered *riba* and as such is prohibited. The relationship between a depositor and an Islamic bank is equity based whereby the depositors share losses and profits. As one scholar explains,¹⁷ by definition Islamic banks are not “banks” as they do not guarantee the principal, i.e. the deposits, and therefore should be more accurately

Source: Treasury Committee, Ninth Report, Demutualisation: Report and Proceedings of the Committee, Vol. 1, HC (1998-99) 605-I, (27 July, 1999); and Treasury Committee, Ninth Special Report, Demutualisation: the Government’s Response to the Committee’s Ninth Report of Session 1998-99, HC (1998-99) 880 (4 November, 1999).

¹² Michael Blair, ‘Mortgage Lending and Mortgage Intermediation’ in Michael Blair and George Walker (eds), Financial Services Law, (2006), pp.564-566.

¹³ The primary sources of Islamic Law are four; the *Quran*, which is believed to be an authentic word of God, the *Sunna*, which refers to the sayings, actions and silences of the Prophet Muhammed, the *Ijma’ As-Sahabah* the consensus of the Prophet’s companions and *Qiyas*, which involves the science of Islamic jurisprudence and aims at applying the prime *Shari’ah* resources in every day life legal situations by *Fuqaha or Ulama* scholars who can be described as lawyers.

¹⁴ For an explanation of how Islamic economy paradigm and methods may differ from conventional economy, see: U. Chapra, The Present State of Islamic Economics, presented in the Fifth Intensive Orientation Course on Islamic Economics, Banking and Finance, the Islamic Foundation in co-operation with the Islamic Development Bank and Loughborough University. Leicester, September, 1997.

¹⁵ القرآن الكريم سورة البقرة: 275-276 وآل عمران 3: 130.

¹⁶ For further details on *riba*, see for example: S.H. Homoud. Islamic Banking: the Adaptation of Banking Practice to Conform with Islamic Law. (1985), pp. 138-140.

¹⁷ M. Iqbal, Islamic Banking in Theory and Practice, presented in the Fifth Intensive Orientation Course on Islamic Economics, Banking and Finance, the Islamic Foundation, in co-operation with the Islamic Development Bank and Loughborough University. Leicester, September, 1997. pp.9.

described as financial intermediaries. Likewise, the traditional bank loan with pre-fixed interest is considered *riba*. Therefore, Islamic banks in their paradigm form will depend mainly on utilising profit and loss sharing arrangements. Islamic banks also employ a wide range of complex Islamic financing modes, which can be difficult to classify with certainty in English legal terms.¹⁸ Profit and loss modes most importantly cover *Mudaraba* being a form of trustee finance contract, *Musharakah* being a form of equity participation contract and direct investment. Non-profit and loss modes cover *Murabaha* or mark-up, whereby the seller determines the cost of producing or acquiring the underlying product, then a mark-up is negotiated between the seller and the buyer.

1.2 Definition and Rationale of Banking Regulation and Supervision

There is no conformity in the literature either regarding the definition of the term “supervision”, or on the difference between “supervision” and “regulation”. Regulation, at its simplest definition, “refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically a public agency, for monitoring and promoting compliance with these rules”.¹⁹ There are three generic types of banking regulation and supervision. First, there is regulation that is concerned with the safety and soundness of the banking system. Secondly, is the conduct of business regulation that is concerned with the treatment of customers by such banks. Finally, there is economic regulation that addresses market failures in the allocation of resources.

Some sources draw a distinction between the two terms “regulation” and “supervision” on the basis that regulation is completely based on the rule of law while supervision is bureaucratic.²⁰ Other authors refer to supervision as the functional and practical aspects of monitoring banks by competent authorities,²¹ while others add the complementary element of control or enforcement as necessary to make supervision

¹⁸ For a synoptic description of Islamic modes of finance, see: Luca Errico and Mitra Farrahbaksh, Islamic Banking: Issues in Prudential Regulation and Supervision, (IMF Working Paper No. 98/30, 1998), pp. 7-8.

¹⁹ R. Baldwin, C. Scott and Christopher Hood, ‘Introduction’ in Baldwin, C. Scott and Christopher Hood (eds), A Reader on Regulation, (1998), pp. 3.

²⁰ C. Goodhart, P. Hartmann, D. Llewellyn, L. Rojas-Suárez and S. Weisbord. 1997. Financial Regulation: Why, How and Where Now?, pp. xvii.

²¹ J. Norton, Devising International Bank Supervisory Standards, (1995), pp.xxvii.

truly effective.²² The terms “supervision” and “regulation” are used inter-changeably and are defined for the purpose of this thesis to mean all the rules and measures adopted for the purpose of maintaining the “safety and soundness” of banks.

This thesis starts with two presumptions, that supervision is applied in a “market” system where individuals are left to achieve their own welfare and that regulation ought to be undertaken for the public interest. Some banking theorists take the opposite view by supporting the free banking or the *laissez-fair* banking model. This argues that banks should prove their solvency to customers through competition for clients, and that the market should be left alone to rid itself of incompetent and obsolete banks. Other theorists are sceptical about the public interest view in financial regulation.²³ Still others believe that regulatory authorities gradually become “captured” by the interests of the regulated institutions. Benston believes that financial regulation in general benefits the regulatory authorities, politicians and other regulated institutions (as far as anti-competitive measures are concerned). Benston, however, refers only to restrictions on market entry and permissible activities but agrees that deposit-taking institutions should be subject to capital requirements, submit periodical prudential reports, and ‘structured early intervention and resolution’.²⁴ Kane, (another American author, who is concerned that the influence of interest groups will subject the regulatory process to the benefit of government officials), is concerned that regulation might forcefully preserve undercapitalised and technologically outdated banks.²⁵ Other authors, while accepting the principle of financial regulation in general, warn that the public treats financial regulation as a “free good” which puts regulators under pressure to over-regulate beyond the cost-efficiency point, which is then passed on to the

²² B. Steil, ‘Introduction: Effective Public Policy in a World of Footloose Finance’ in B. Steil (ed), International Financial Market Regulation, (1994), pp.1.

²³ For a review of various theories of financial regulation, see the opinions of K. Dowd, ‘The Case for Financial *Laissez-Fair*’; G. Benston and G. Kaufman, ‘The Appropriate Role of Financial Regulation’ and S. Dow, ‘Why the Banking System Should be Regulated’; all from 1996 The Economic Journal. Vol. 106(436)(May), pp. 679-707; and Charles Goodhart, The Evolution of Central Banks: A Natural Development?, (1985) pp. 13-22.

²⁴ G. Benston, Regulating Financial Markets: a Critique and Some Proposals. (Hobart Paper No. 135, the Institute of Economic Affairs, London, 1998), particularly pages 19-23, 99-109 and 121.

²⁵ E. Kane, ‘Government Officials as a Source of Systemic Risk in International Financial Markets’ in F. Edwards and H. Patrick (eds), Regulating International Financial Markets: Issues and Policies. (1992), pp. 257-265.

regulated institutions (or taxpayers).²⁶ Another undesired effect attributed to regulation is that it can create the wrong incentive for banks. A high capital ratio, for example, might hinder investment.

The author believes that these critical views of financial regulation should be considered seriously and should be seen as demonstrations of the difficulties or problems associated with regulation. Despite these problems, banking regulation is applied worldwide. The reasons could be political convenience or public demand, but this does not negate the fact that there is an economic rationale for regulation.²⁷ It is the correction of market imperfections and failures: negative externalities arising from banking failures (systemic risk) and asymmetry of information.

1.2.1 Systemic Risk

Since the financial crisis in the United States during the great depression in the early thirties, the major reason for banking supervision has been systemic risk i.e. the spread of failure to other institutions and even sectors of the economy. The aim is explained as the avoidance of externalities or knock-on effects, whereby the social cost of a banking failure is greater than the private cost born by the economic unit: which in our case is the failing bank.

Once a bank fails, there is a potentially systemic danger that this will have a “contagion” effect on other institutions. Banks are central to the payment system and are major providers of liquidity for a large base of clientele. Other banking institutions are particularly eligible to fail because of the large exposure of banks to one another through the inter-bank market, as well as because of the increased possibility of runs against other banks once depositors lose their confidence in the banking system as a whole in that country.

Despite the doubts some theorists try to shed on the need for an external regulator to avoid systemic risk,²⁸ financial crises occur recurrently and have serious

²⁶ C. Goodhart, P. Hartmann, D. Llewellyn, L. Rojas-Suárez and S. Weisbord, *Ibid* (n 20), pp. 61-72.

²⁷ For a detailed review on the economic rationale for banking supervision, see: D. Llewellyn, The Economic Rationale for Financial Regulation, (FSA, Occasional Paper No. 1, April 1999).

²⁸ Some authors argue that many of the events described, (as financial crises are merely pseudo-financial crises rather than real financial crises), can be dealt with by the extension of sound economic and

effects on the whole financial system. The International Monetary Fund (“IMF”) reported 41 incidents of financial crisis in the period between 1980 and the spring of 1996.²⁹ The crises covered both developed and emerging countries and in both cases proved to be contagious and costly for industrial countries.³⁰ The Asian crisis of 1997-98 is another financial crisis of a major scale, and the contagion effect proved that it could even cross borders. The credit crunch crisis of 2007-08 started in the US sub-prime market crossed then to other banks and money markets. Even banks became reluctant to lend to each other in the Interbank market. The casualties included the Switzerland's UBS Bank, French bank BNP Paribas, IKB and Sachsen banks in Germany, the UK Northern Rock Bank and the Lehman Brothers Bank in the USA. It also spread to the US Dollar, Sterling pound and Euro money markets

Finally, there are three important points to stress here. First, the purpose of safety and soundness does not refer to any particular bank. Small banks can also endanger the safety of the banking system. One author explains that banks are divided to two groups. The “core banks”, usually the large old banks, which tend to adopt low risks and return policy. “Other” banks which are small banks have a tendency towards “growth oriented policies” of high risk and high return.³¹ An evident example is the fringe-banking crisis in the UK during 1973-75, which spread from small banks to large ones.³² As to large banks, supervisory authorities quite often remind us that there is no institution, which can be described as “too big to fail.” This expression refers to the concern of supervisory authorities regarding the substantial negative externalities, which arise when a large bank fails, and which leads to an implicit guarantee that supervisory authorities will save large banks from failure. This implicit guarantee is widely

monetary policies. See: A. Schwartz, ‘Real and Pseudo-Financial Crises’ in Forrest Capie, and Geoffrey Wood (eds), Financial Crisis and the World Banking System, (1986), pp. 11-31. Other authors argue that incidents of bank failures have not even brought about loss of confidence problems. See: J. Macey and G. Miller, ‘Bank Failures, Risk Monitoring and the Market for Bank Control’ 1988 Columbia Law Review. Vol. 88(6)(October), pp. 1158.

²⁹ C. Lindgren, G. Garcia and, M. Saal (eds), Bank Soundness and Macroeconomic Policy, (1996), pp.1.

³⁰ Morris Goldstein and Philip Turner, Banking Crises in Emerging Economies: Origins and Policy Options, (BIS Economic Paper No. 46, October 1996), pp.7.

³¹ Jeffrey C. Marquardt, Financial Market Supervision: Some Conceptual Issues, (BIS. Economic Paper No. 19, May 1987), pp. 15-16.

³² For further explanation, see M. Reid, The Secondary Banking Crisis, 1973-75: Its Causes and Course, (1982).

criticised for creating a pervasive incentive for large banks to take more excessive risk than the smaller banks in the market, known as the “moral hazard” problem. However, the practicality of this statement remains doubtful as the larger a banking institution is, the more likely it will affect other institutions through their wide connections and large base of clientele. Secondly, the conditions of the market determine largely its vulnerability to systemic risk. The effects of a single bank failure can be particularly felt where there is a concentrated banking system.³³ Thirdly, and as illustrated by the case of Bear Sterns bank in the USA, the authorities intervened to rescue the bank because it was ‘too inter-connected’ to fail though it was not a relatively big bank.³⁴

1.2.2 Asymmetry of Information

One of the major inefficiencies in the financial market relates to the problem of asymmetry of information. This problem exists simply where one of the contracting parties has more information than the other party. Borrowers for example can better estimate the returns and risks of the investment underpinning the loan contract. Two problems stem from the asymmetry of information: adverse selection and the moral hazard problem.³⁵ Adverse selection takes place before the conclusion of the financial contract, whereby potentially bad deals are the ones most eagerly seeking credit and consequently they are most likely to be selected by an adverse decision of a financial institution. The moral hazard problem occurs after the conclusion of a financial contract whereby the institution granting credit is susceptible to the danger that the borrower has a motivation to undertake activities to the detriment of the interest of the lender.

Asymmetry of information gives rise to two regulatory concerns. The first is how to protect consumers from the misconduct of regulated firms. The second is how to ensure the proper functioning of banks’ management despite the existence of an asymmetry of information between them and their customers.

³³ R. P. Kinsella, Some Regulatory and Supervisory Lessons of the BCCI Collapse, (Research Paper in Banking and Finance No. 10, IEF, Bangor University, 1992), pp.3.

³⁴ Rosa M. Lastra, ‘Northern Rock, UK Bank Insolvency and Cross-Border Bank Insolvency’ 2008 Journal of Banking Regulation, Vol. 9(3), pp. 172.

³⁵ F. Mishkin, The Causes and Propagation of Financial Instability: Lessons for Policymakers, Maintaining Financial Stability in a Global Economy, paper delivered during a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming 28-30 August, 1997. pp. 56-57.

1.3 Tools of Banking Supervision

Supervisory authorities usually adopt, according to Dale,³⁶ measures falling under two categories: protective supervision, which concerns actions taken by supervisory authorities when banks actually fall into trouble, as well as preventive supervision, which aims at controlling risk taking by banks. As regards protective supervisory measures, they vary from one country to another and can be used to deal with individual banking cases or to deal with a financial crisis facing a domestic banking system. These measures cover the role of the Lender of Last Resort facilities provided by central banks³⁷ in order to cover a liquidity shortage³⁸ such as discount windows and open market operations as well as government emergency lending. There are also deposit insurance schemes or deposit guarantee schemes, which aim to refund a certain percentage of bank depositors who suffered from the insolvency of their banks. The difference between the two of them is that deposit insurance is funded from premiums from participating banks, while the guarantee schemes are funded ex-post.³⁹ These measures boost market confidence in the banking system and assure consumer protection. They, nevertheless, give rise to a moral hazard problem, as banks' shareholders and depositors may not exercise sufficient diligence when making a choice between institutions, as they depend on the fact that there are safety net schemes to bail them out if their perspective banks face financial trouble.

As regards preventive supervision, it relates to banking licensing and ongoing supervision. Banking licensing is a cornerstone of banking supervision, because it is supposed to prevent weak banks from entering the market whether established locally or foreign banks seeking to establish a presence as subsidiaries or branches. Supervisors usually ensure that the licensed bank has fit and proper management and sound financial basis. Likewise, supervisors should monitor major shareholders which include mergers and acquisitions. Supervisors also spell out the activities permissible to banks or puts

³⁶ R. Dale, The Regulation of International Banking, (1984), pp. 55-68.

³⁷ The role of the Central Bank to intervene in a credit crisis is largely attributed to Sir Walter Bagehot's work, *Lombard Street* (1802). An excerpt is reproduced in Walter Bagehot, 'A General View of Lombard Street (excerpts)' in C. Goodhart and G. Illing (eds), Financial Crisis, Contagion, and the Lender of Last Resort: a Reader, (2002), pp. 67-72.

³⁸ D. Schoemaker, Home Country Deposit Insurance, (LSE Special Paper No. 43, June 1992), pp. 3.

³⁹ *Ibid*, pp.8.

conditions and limits thereon, e.g. they may only allow banks to undertake insurance by establishing subsidiary. There are a number of reasons why regulators might want to restrict banking activities. One reason is the assumption that bank depositors, unlike customers in investment companies, are unwilling to accept to be subject to risks. However, a major reason is the fear that competition increases failure probabilities.⁴⁰

Preventive supervision also covers prudential or quantitative requirements imposed on balance sheets. These controls take the form of ratios, meaning laying down percentages of thresholds and ceilings restricting the size of banking activities. The capital adequacy (or solvency) ratio is considered the most important of these supervisory tools. Liquidity has also attracted supervisory attention to its importance particularly since the credit crunch of 2007-08.

The nature of bank capital had been initially understood as the “net worth” representing the books value of the shareholders’ interests in the banking institution. The major ratios applied to test banks’ solvency were capital to deposits and capital to assets. This ‘accountancy’ understanding of capital was found to be inadequate mainly due to the differences between the economic value and the book value, particularly when a bank faced failure. Capital was now understood rather as a ‘cushion’ against unexpected losses and therefore a protection from bank failures, which would increase the confidence of the market in banks. Another benefit of regulatory capital is that a higher capital ratio than the firm would hold willingly, shifts the cost of failure from banks and their customers towards the owners (equity holders and subordinated equity holders). This should stimulate equity holders to monitor the behaviour of their respective banks’ management.⁴¹

There are three basic issues that supervisory authorities have to deal with when determining the capital ratio. First, they have to decide on which elements of capital should be eligible to be counted as capital. Some elements such as cash are universally agreed upon as a component of capital. However, the situation is less clear for example,

⁴⁰ Sarah A. Wagman, ‘Laws Separating Commercial Banking and Securities Activities as an Impediment to Free Trade in Financial Services: A Comparative Study of Competitiveness in the International Market for Financial Services’ 1994 *Michigan Journal of International Law* Vol. 15(Spring), pp. 1019-1021.

⁴¹ J. Richardson, and M. Stephenson, *Some Aspects of Regulatory Capital*, (FSA, Occasional Paper No. 7, March 2000), pp.17.

with reserves. The second issue is how to measure capital. It has already been explained that assets to deposits and loans to deposits are useful but inadequate indicators. Another common method is to impose limits on large exposures. The aim of such ratios is to limit the exposure of banks to a certain type of risk or related risks as well as excessive exposures to a single borrower and related persons such as companies in the same group. It is believed that diversification of risk is a safety measure against losses that might occur in a certain type of risk.⁴² A more recent method is the risk weighting of on-balance and off-balance sheet assets. The third issue is the sufficiency and compatibility of accountancy standards. Inadequate accountancy standards render capital adequacy measurement insufficient.

Loan assessments and provisioning are other essential benchmarks for banking supervisory authorities.⁴³ Loan assessment is based on the classification of loans according to their performance (e.g. standard, special mention, substandard, doubtful, and loss). The evaluation generally concentrates on the original source of repayment as well as the quality of collateral and guarantees. It also leads to the adjustment of loan values by “provisioning” against loan loss value. Loans might be e.g. over-valued at the outset or the condition of the borrower might have deteriorated afterwards. Provisions are divided into two types: “general provisions” to cover against expected losses in portfolios of loans; and “specific provisions” made against actual losses in individual loans.⁴⁴ Banks that fail to properly assess their credit or do not set aside adequate provisions undermine their capital adequacy and become more susceptible to failure.

One of the most important measures of preventive supervision is monitoring banking risk management. Banks can be exposed to:⁴⁵ credit risk, which refers to the risk of non-repayment and includes the counterparty (borrower) default; liquidity risk,

⁴² R. Pecchioli, Prudential Supervision in Banking, (1987), pp.71.

⁴³ See generally: Luis Cortavarria, Claudia Dziobek, Akihiro Kanaya and Inwon Song, ‘Loan Review, Provisioning and Macroeconomic Linkages’ in Charles Enoch, David Marston and Michael Taylor (eds), Building Strong Banks through Surveillance and Resolution, (2002), pp. 11-39.

⁴⁴ Claudio Borio and Philip Lowe, ‘To Provision or not to Provision’ 2001 BIS Quarterly Review, (September), pp. 37.

⁴⁵ For more detailed discussion of the various types of risks, see for example: R.M. Lastra, Central Banking and Banking Regulation, (1996), pp. 98-104; and Hennie van Greuning and Sonja Bratanovic, Analyzing Banking Risk: a Framework for Assessing Corporate Governance and Financial Risk Management, (2000).

which is related to the inability of a bank to raise cash to comply with obligations by maturity dates, and without having to lessen its net worth;⁴⁶ foreign exchange rate risk, which stems from speculations in the foreign exchange markets; interest rate risk, which is related to the adverse changes in the interest rates, i.e. when the interest rates the bank have to pay are higher than the interest rates it earns from loans; and operational risk, which arises from weak internal controls, mismanagement and failure of the internal controls of a banking institution.

Another important supervisory tool is the early intervention to solve a banking problem. This includes imposing remedial actions and sanctions on troubled banks including banking closure when deemed necessary.

1.4 Developments in Banking and their Influence on Banking Supervision

The gap between banks and other financial intermediaries has been narrowing. There has been a trend since the seventies, particularly in the industrial countries, towards “deregulation” and “despecialisation”.⁴⁷ Modern banks have increasingly resorted to non-traditional activities for profitability; this is due to the fierce competition, not only from other banks, but also from other financial institutions. These include securities companies, mutual funds, and insurance companies. These institutions started to provide credit and attract savings from customers, which caused what is known as the “disintermediation” problem for banks, i.e. customers resorted to obtain funds from other financial institutions instead of banks. The seventies also witnessed the increase of a financial “liberalisation” of market entry and “internationalisation”. A substantial proportion of international banking was wholesale banking, in the form of either large international banking loans or that which aimed at serving large institutional investors, who would like to invest their savings abroad in the securities markets. Financial markets have also become more integrated due to technological advancement,

⁴⁶ R. Dale, The Regulation of International Banking, (1984), pp. 60.

⁴⁷ For further reading on new trends in international banking, see for example: BIS, Euro-Currency Standing Committee, prepared by a Study Group established by the Central Banks of the Group of Ten (“G-10”) Countries, Recent Innovations in International Banking, also known as the “Cross Report” after the Chairman of the Committee, (April, 1986); C. Borio and Ro Filosa, The Changing Borders of Banking: Trends and Implications, (BIS Economic Paper No. 43, December 1994); and I. Swary, Itzhak and Topf, Barry, Global Financial Deregulation: Commercial Banking at the Crossroads, (1992).

which facilitates and accelerates dealings in securities and the movement of capital. Another motivation for deregulation is the attempted “diversification” of risk exposures.

These combined factors led to the affiliation of banking institutions with other financial institutions (known as “Allfinanz”, “Bancassurance” and “Conglomerates”) as well as a wide expansion of the banks’ off-balance sheet activities, such as derivatives and securitisation followed by an expansion into the insurance business. The significant increase in structured finance and banks’ adoption of “originate-to-distribute” model was yet another essential change in banking particularly in the last decade. These developments are interrelated but will be illustrated under separate headings for organisational purposes.

1.4.1 Derivatives

Derivatives⁴⁸ are financial instruments, which have witnessed a rapid growth in the financial market. The term derivatives denotes a wide range of complex instruments such as options, forwards, futures, and swaps which can be based on interest rates, equities, currency rates or commodities. Derivatives can be either Exchange-traded or Over the Counter (“OTC”) derivatives. The difference between the two is that exchange traded derivatives are traded in regulated markets where most of the terms are standardised and accepted before a dealing takes place. The clearinghouse is a counterpart in the dealing and, consequently, it is important for dealers to maintain its solvency and stability. OTC derivatives are traded without a formal market where contractual terms can be negotiated between parties

Derivatives expose banks to the same types of risks related to the banking business: market risk, credit risk, liquidity risk, operational risks as well as concentration risk. Derivatives, however, raise supervisory concerns for a number of reasons. First, they have a particularly high concentration risk, as derivative trading is concentrated in a limited number of large institutions. Secondly, financial statements of

⁴⁸ John Board, Charles Goodhart, Michael Power, and Dirk Schoenmaker, Derivatives Regulation, (Special Paper, No. 70, LSE FMG, March 1995); R. Dale, ‘Derivatives: the New Regulatory Challenge’ 1995 JIBFL, Vol. 10(January), pp. 11-17; R. Dale, ‘How Risky Are Derivatives’ 1993 JIBL, Vol. 8(9), pp. 345-348; C. Goodhart, Financial Globalisation, Derivatives, Volatility and the Challenge for the Policies of Central Banks, (Special Paper No. 74, LSE FMG, October 1995); B. Quinn, Derivatives - A Central Banker’s View, Lecture delivered on 15 September, 1994 at Clifford Chance, London; and William White, Clifford Smout, Christian de Boissieu and Richard Dale, The Implications of Derivatives for Regulation, (Special Paper No. 66, LSE FMG, January 1995).

banks dealing in derivatives are also quickly exchanging, perhaps every minute, which makes it difficult for supervisory authorities to monitor changes in risk exposure and capital adequacy. Thirdly, contagion risk is feared to increase between securities markets and banks that are major dealers in derivatives. Finally, there are highly complex contracts involved and banks may not understand how they function.

Another development in derivatives is credit derivatives whose value is based on the credit worthiness of a third party known as the reference entity.⁴⁹ The most important type of credit derivatives is the credit default swap (“CDS”), whereby counterparty risk of default is insured. Credit derivatives have revolutionised banking. They aided banks to transfer credit risk to another party and reduce their capital adequacy requirements.⁵⁰

1.4.2 Conglomeration

Conglomerates raise a number of concerns for supervisors:⁵¹ different cultural approaches between supervisors of various functions; capital assessment; contagion; intra group exposures; and conflict of interest. Multiple supervisory authorities can supervise conglomerates. As banks have distinctive features that make them different from other financial institutions, the objectives and practices of banking supervisory authorities might differ from supervisory authorities of other functions within the conglomerate. This problem manifests itself particularly in the capital assessment. Banks differ from securities houses in that they have a high percentage of illiquid assets in their balance sheets and are worth, as going concerns, more than when liquidated. Banking supervisory authorities also focus on the assets side of the banks’ balance sheets, (because this is where banks are most likely to be exposed to problems and given the difficulties in the evaluation of loans and other assets) whereas insurance supervisory authorities focus on the liabilities side (due to the uncertainty of premiums). Another problem in capital assessment is referred to as “double gearing” where the same capital is used for supervisory capital requirements in more than one company

⁴⁹ Schuyler K. Henderson, Henderson on Derivatives, (2003), pp. 105.

⁵⁰ *Ibid*, pp. 120.

⁵¹ IOSCO, Principles for the Supervision of Financial Conglomerates, (October, 1992); Tripartite Group of Bank, Securities and Insurance Regulators, The Supervision of Financial Conglomerates, (July, 1995).

within the conglomerate. This means that it becomes possible for each separate company to cover its capital requirements while the group, as a whole cannot.⁵²

Supervisory authorities also fear the “contagion” effect of a failing securities or insurance subsidiary on banking institutions in the same group. Contagion can become an imminent danger where there are intra-group exposures. They can take the form of credit extended from one company in the group to another. They can also be related to less transparent ways such as, intra-group cross shareholdings; guarantees given by one company to another or providing services such as pension schemes.⁵³ Finally, supervisory authorities are also concerned about potential conflict of interest whereby bank management might manipulate the interests of customers or affiliated institutions in order to benefit themselves or to benefit their banks.⁵⁴ Excessive risks can also be taken through other consolidated companies, as banks might attempt to shield themselves behind the limited liability of the separate subsidiaries or affiliates.⁵⁵

Barings Bank is a significant example on the effects of the failure of a well-founded international conglomerate as a consequence of its involvement in investment services. In 1995, Barings plc, the parent company of the Barings Group and a number of subsidiaries of the group, was put under joint administration and subsequently purchased by the Dutch financial services group Internationale Nederlanden Group. Barings Bank was established two centuries ago. It started its engagement in investment services in 1984, but conducted banking and investment services separately. These two activities were merged in 1992.⁵⁶ The Group, which was comprised of over 100 companies, incurred massive losses by the indirect subsidiary Baring Futures (Singapore) Pte Ltd. (“BFS”) in derivatives trading activities in the Far East. An inquiry conducted by the then UK Board of Banking Supervision into the circumstances of the

⁵² Tripartite Group of Bank, Securities and Insurance Regulators, *Ibid*, pp. 17-18.

⁵³ *Ibid*, pp. 20.

⁵⁴ C. Borio and R. Filosa, *Ibid* (n 47), pp. 16.

⁵⁵ J. Guttentag and R. Herring, *Disaster Myopia in International Banking*, (Essays in International Finance, No. 164, Princeton University, New Jersey, 1986), pp. 31.

⁵⁶ Treasury Committee, First Report, Barings Bank and International Regulation: Report together with the Proceedings of the Committee, Vol. 1 HC (1996-97) 65-I, par. 5.

collapse of Barings in 1995⁵⁷ concluded that Barings was brought down as a result of the unauthorised and concealed trading activities of the manager and a senior floor trader at BFS, the infamous Nick Leeson. He exceeded his authorities by maintaining overnight open positions, exceeding limits on intra-day trading and house trading in options. Losses were concealed in account “88888”, which accumulated to £830 million by 27 February 1995. Unauthorised trading was hidden by the suppression of account “88888” from the headquarters in London, submitting false reports and misrepresenting BFS profits and a number of false entries.

The Inquiry also concluded that losses were not detected earlier on due to control failures and management confusion in the Barings Group. A significant failure of control was the lack of segregation of duties between the front office and the back office at BFS. Furthermore, management monitoring of BFS trading activities and funding was weak. BFS was funded by Barings in London of more than £300 million by way of “top up”, i.e. margin deposits on exchanges, without knowing on whose behalf the monies were paid. Management did not know particularly whether money was paid for house trading or client trading. “Top up” accounts also could not be reconciled with client accounts by Barings’ Settlements Department. Control problems were intensified by the solo consolidation of Baring Brothers and Co. Ltd. (“BB&Co.”), an investment bank, and Baring Securities Ltd. (“BSL”), an investment company, in 1994. This effectively meant that no limit was imposed on the amounts of money advanced by BSL through BB&Co to BFS. Another significant failure relates to the Spear, Leeds and Kellogg (“SLK”) receivable incident. Mr. Leeson created a fictitious receivable of £50 million from SLK, which should have indicated either that Mr. Leeson was engaged in unauthorised OTC trading or that there was a large sum paid by error to a third party. The matter, however, was not investigated by management as thoroughly and seriously as it should have been. Barings’ management generally did not follow-up recommendations of internal audit reports. It also failed to react to a number of serious warning signs, which even raised market concerns in 1995 and drew the attention of the BIS.⁵⁸

⁵⁷ Board of Banking Supervision, Inquiry into the Circumstances of the Collapse of Barings, HC (1994-1995) 763.

⁵⁸ For a definition of the BIS, see following Chapter 2, page 43, footnote 8.

The Inquiry generally concluded that the Bank of England did not detect the true situation of Barings prior to its collapse. The Bank of England was the home supervisory authority of the Barings Group as well as the lead regulator for BB&Co. The report noticed that the Bank of England had confidence in Barings' management and, consequently, relied on its statements and did not undertake reviews of its overseas subsidiaries. Furthermore, the report also concluded that the Bank of England reasonably relied on information supplied by overseas regulators and explanations furnished by management. This is despite the fact the Bank of England was not cognisant of Barings' breach of inaccurate reporting and connected lending limits.

The Singaporean Minister for Finance also conducted inspectors to investigate into the affairs of BFS. The report, which was issued in September 1995,⁵⁹ came broadly to similar conclusions. The collapse of Barings was mainly attributed to failure of controls including lack of segregation of duties, confusion in reporting lines and defining responsibilities after merging the investment and banking activities of BB&Co. and BSL. It was concluded that had there been adequate organisational management, Mr. Leeson could not have produce huge remittances to fund 88888 account at BFS.⁶⁰

It is noteworthy that a number of differences exist between the UK and Singaporean inquiry reports. Most importantly, the Singaporean report concluded that until February 1995, it was probable that the collapse of Barings Group could have been avoided due to a number of factors, including that the SLK receivable could have been resolved had a full investigation been conducted. Another difference is that the Singaporean report found that Mr. Leeson was not alone and that other personnel at Barings were engaged in a cover up.⁶¹ Different conclusions were reached because the British inquiry had limited access to personnel and information in other jurisdiction, which denotes to the importance of cross border cooperation.

⁵⁹ Singapore Ministry of Finance (September, 1995), Barings Futures (Singapore) Pte Ltd.: Investigation Pursuant to Section 231 of the Companies Act (Chapter 50) – The Report of the Inspectors appointed by the Minister For Finance, Singapore.

⁶⁰ Ibid, pp.39, par. 4.34.

⁶¹ Ibid, the Executive Summary pp. Bi-Bxi, particularly par. 11, 31,32 and 36.

See also: Maximilian Hall, 'A Review of the Singapore Inspectors' Report on Baring Futures (Singapore) Pte Ltd' 1995 JIBFL Vol. 10(December), pp. 525-529; and Memorandum submitted by the Bank of England in Treasury Committee, First Report, Barings Bank and International Regulation: Minutes of Evidence and Appendices, Vol. II, HC (1996-97) 65-II (12 December, 1996), pp. 148-151.

The lessons to be learned from the failure of Barings require deep attention. Considering the analysis on the failure of Barings it is only natural to expect these lessons to be centred on internal controls and management as well as the Bank of England's supervisory practice. As to the Bank of England, a significant lesson to learn, and hence for other supervisory authorities, is the need to understand the supervised business and associated risks.⁶²

1.4.3. Originate-to-Distribute Model

Developments in the securitisation market and structured finance led banks to adopting the originate-to-distribute model.

Securitisation is a technique of transforming relatively illiquid assets (such as residential mortgages) to securities that can be unbundled and sold on the market.⁶³ There are three major parties to a securitisation: (1) the originating bank which pools and transfers high quality receivables such as home mortgage loans to (2) a special purpose entity or vehicle ("SPE") and the investors who buy the securities issued by the special purpose entity. Historically, banks originated loans taking responsibility for credit risk. Securitisation therefore breaks the direct intermediation between depositors and borrowers as different institutions take responsibility for debt origination (the bank), placement, issuance and service. (3) The investors who buy the receivables from the SPE.

SPEs are separate legal entities established by the originating bank usually in tax havens such as the Cayman, for the purpose of selling the receivables thereto in return for the purchase price. The SPE then finances the price by issuing bonds. Banks gain three benefits from securitisation. First, the receivables' credit ratings are higher than the underlying assets. Secondly, the SPEs are separate entities and they do not need to have their balance sheets consolidated with the banks, which makes SPEs more attractive to banks than subsidiaries. Thirdly securitisation allows banks to transfer riskier assets from their balance sheets to the SPEs and hence improve their capital adequacy ratios.

⁶² Board of Banking Supervision, *Ibid* (n 57), para. 14.35.

⁶³ For further details see: Philip Wood, Project Finance, Securitisations, Subordinated Debt, (2007), pp. 120-155.

The conventional transfer of credit can also be substituted with the “synthetic securitisation”, whereby the SPE agrees to cover the losses of the originator should a determined default occur. The originator effectively guarantees his risk and does not receive his funds.⁶⁴ Synthetic securitisation covers collateralised debt obligations (“CDOs”) whereby bonds or loans are bundled in tranches of various risk ratings and sold to investors seeking higher investment yields. Another type of instruments is credit default swaps (“CDS”), whereby counterparty risk of default is insured.

Another important development is using structured finance as a means of transferring credit risk. Structured finance is similar to securitisation in that it entails the pooling of assets and selling the claims of their cash flows which are backed by these assets, to investors. A major difference is that structured finance involves the tranching of claims,⁶⁵ whereby claims are divided into senior claims (Super-Senior AAA and AAA), mezzanine claims (AA, A, and BBB) and equity (lower than investments grade or unrated).⁶⁶ The lower or subordinated tranches absorb the first losses then the mezzanine tranches followed by more senior tranches.⁶⁷

The period from 2005-2007 witnessed important developments in the structured finance market.⁶⁸ The growth of securitisation of Asset Backed Securities and derivatives referencing highly leveraged loans; The increase of the originate-to-distribute model by banks have become more interested in issuing, pooling, tranching and distributing securities rather than the earlier “originate-to-hold” model; And finally, the widening of market participants in the structured market to include banks, securities, insurers, hedge funds, assets managers, as well as, Asset-Backed Commercial Paper Conduits (“ABCP Conduits”) and Structured Investment Vehicles (“SIVs.”), which buy long term to maturity tranches of structured products and refinance themselves by issuing medium or short-term debt and selling notes respectively.

⁶⁴ Schuyler K Henderson, Henderson on Derivatives, (2003), pp. 222.

⁶⁵ Ingo Fender and Janet Mitchell, ‘Structured Finance: Complexity, Risk and the Use of Ratings’ 2005 BIS Quarterly Review, (June), pp. 67.

⁶⁶ Joint Forum, Credit Risk Transfer: Developments from 2005 to 2007, (July, 2008), pp. 9.

⁶⁷ Ingo Fender and Janet Mitchell, *Ibid* (n 65), pp. 69.

⁶⁸ Joint Forum, *Ibid* (n 66), pp. 4-8.

The originate-to-distribute model helps banks manage their risks. It facilitates the removal of riskier assets from banks' balance sheets and consequently increases their ability of extending loans. However, it has the disadvantage of making banks dependent on the demand for credit instruments in the capital market. Another disadvantage is the shifting of credit risk towards less regulated markets including hedge funds and private equity firms. Sponsoring banks provide liquidity lines which makes them exposed to the liquidity problems of the SPEs. Another disadvantage is reducing market transparency as to where risks ultimately lie. These weaknesses were evident during the global financial market turmoil in 2007.⁶⁹

These shortcomings were evidently illustrated by the credit crunch of 2007,⁷⁰ which occurred against a backdrop of strong global growth. In early 2004, interest rates were very low in the U.S, U.K and the Euro zone, while borrowing demand soared. The increase in the mortgage arrears and the decline in the housing market outlook in the U.S resulted in substantial mark-to-market losses on residential mortgage-backed securities of U.S sub-prime loans. The surge in the delinquency rates of mortgages lead to the deterioration in the value of asset backed mortgaged securities as well as related CDS and CDOs backed by pools of sub-prime mortgages. As market participants become uncertain about the value of SPEs, funding become costly and less available. Banks have reacted in some cases by moving the assets of SPEs back to their balance sheets, a second group of banks provided liquidity support, while other banks winded them down. This problem had a contagious effect on highly rated tranches of mortgage backed securities due to investors' uncertainty about the volume of risks and where they ultimately lie, due to the opacity of structured finance, the complexity of financial instruments and inadequacy of disclosure.

1.4.4 Influence of Developments on Banking Supervision

The growing complexity of many of the banking institutions' functions and structures and their adoption of their own models of internal risks have influenced

⁶⁹ Hermann Remsperger, 'Financial Stability Issues – A View from the Bundesbank' 2007 BIS Review (129), (2007), pp 2-3,7.

⁷⁰ For details on the 2007 financial turmoil, see for example: Bank of England, 2007 Financial Stability Report (October); Ingo Fender and Peter Hördahl, 'Overview: Credit Retrenchment Triggers Liquidity Squeeze' 2007 BIS Quarterly Review, (September), pp.1-16; and IIF, Interim Report of IIF Committee on Market Best Practices, (April, 2008).

banking supervision in various aspects. First, risk management by banks and the supervision of bank management of risk gained tantamount importance. Banks exposure to risks has widened and deepened. The more banks are involved in the securities markets in industrial countries; they naturally become more susceptible to loss. These developments raised also the question whether the supervisory authorities should rely on banks' internal models of risk assessment. A related issue is the scope of application of the capital ratios: should it apply to banks or extend to competitive financial institutions? Should the same capital adequacy rules apply to all banking institutions despite their various degrees of size and sophistication? Or should the supervisors allow only large banks to implement their internal models, and if so, how would that affect smaller banks?

Secondly, the growing reliance of large banks on their internal models and the increased importance of risk management have highlighted the need for cooperation between banking supervisory authorities and the private sector as well as a shift towards risk-focused supervision.⁷¹ Accordingly, greater emphasis is put on management and sound corporate governance. There is no universal definition of corporate governance; it simply refers to the interrelationship amongst management, the board of directors, shareholders and stakeholders. Shareholders and boards of directors should be active and vigilant in monitoring bank executives, while the board of directors monitors the banks' management, officials, and internal auditors. Therefore, supervisory authorities should focus on management independence, strength, integrity and their active involvement in the bank. A complementary measure is to examine internal controls as well as the external auditing of reports, which are supposed to be the first line of defence against any mismanagement in banks. Another element in cooperation with the private sector is the need to ensure stock market transparency and the reliability of its released data as well-informed investors can play complementary role in ensuring the sound management of banks.

Thirdly, supervisors need to ensure themselves of the adequacy and professionalism of other financial supervisors particularly supervisors of insurance and investment companies.

⁷¹ Joseph Norton, "Qualified Self-Regulation" in the New International Financial Architecture' 2000 *JIBR*, Vol. 2(2), pp. 11.

Finally, market developments raise concerns about the institutional coverage of the supervisory authority and whether the supervision of all financial institutions should be internalised in a single supervisory authority. This consideration, amongst others, will be further examined in the following section.

1.5 The Institutional Framework

1.5.1 The Structure of Banking Supervisory Authorities

The structure of the supervisory authority refers in this thesis to the particular form the supervisor may take as a response to the three questions: what should be the basis of supervisory structure? What should the relationship between the supervisory authority and the central bank be? Should there be a single supervisory authority of all financial institutions?

Theoretically speaking, there are three possible alternative bases to the supervisory structure: purely “institutional”, purely “functional” and “objectives-based”.⁷²

As to the institutional-based approach, it applies to all banking institutions despite the variety and diversity of their function. Authors attribute three major shortcomings, to the institutional approach. The first shortcoming is that it has become redundant considering recent market developments. Traditionally it has been institutions, which are supervised. Only in the last four decades that there has been a separation between institutions and their functions.⁷³ As explained earlier in this chapter, the international scene of the banking sector, particularly in industrial countries, shows a distinctive narrowing down between banks and other financial institutions, which is illustrated by the following five symptoms:⁷⁴

First, the inter-links between banks and other financial institutions through derivatives markets and other new markets, making systemic risk relative to non-

⁷² This section depends on: C. Goodhart, P. Hartmann, D. Llewellyn, L. Rojas-Suárez and S. Weisbord. *Ibid* (n 20), pp. 142-188.

⁷³ P. Molyneux, *Competitive Equality and Regulatory Balance*, (Research Paper in Banking and Finance No. 19, IEF, University College of North Wales, Bangor), pp.4.

⁷⁴ M. Taylor, ‘Redrawing the Regulatory Map: A Proposal for Reform’ 1997 *J.F.R.& C.* Vol. 5(1), pp. 50.

banking institutions. Secondly, the application of the principle of competitive equality between banks and other financial institutions. Thirdly, deregulation which increased competition between banks and other financial institutions. Fourthly, the emergence of financial conglomerates demanding an all embracing group-wide supervision. Fifthly, the formation of new financial products, which do not fit into the usual institutional distinctions between various financial institutions. Finally, new technology employed in financial markets suggests that banks will suffer from further disintermediation. This point can be further understood by examining the historical development of many banking institutions, which, started originally as non-banks but gradually moved in to the banking arena. Evident examples are Chase Manhattan in the United States and Lloyds bank in England, which commenced as non-financial institutions. Therefore, the more the distinction between the various types of financial institution narrows, the less appropriate the institutional approach becomes. Another attributed shortcoming of the institutional approach is its “wasteful duplication” as one banking institution or a group of banks can be subject to various supervisory authorities. A bancassurance, for example, will be subject to the insurance supervisory authority for its insurance activity in addition to the banking supervisory authority for its banking activities. A third attributed shortcoming is “competitive neutrality” as different supervisory authorities might have different approaches towards the same function.

The functional approach focuses on the business undertaken by institutions. It would therefore apply the same rules to mortgage credit whether provided by banks, building societies or indeed any other financial institutions. An exclusively functional supervisory system would mean, however, that supervisory rules would not be applied on a group-wide basis unless each function is separately capitalised, and this is highly inefficient. Furthermore, it is institutions and not functions, which ultimately become insolvent or fail.⁷⁵

The objectives-based approach means that there should exist separate supervisory authorities divided alongside the various objectives of supervision such as avoiding systemic risk and consumer protection. It subjects the same institution to the supervision of two or more supervisory authorities each responsible for the attainments

⁷⁵ Governor (Governor of the Bank of England), ‘Some Thoughts on Financial Regulation’ 1996 *B.E.Q.B.* Vol. 36(2)(May), pp. 215.

of a certain regulatory objective(s). One prominent supporter of this approach is Michael Taylor who called for the application of the “Twin Peak” approach in the UK.⁷⁶ He proposed that there should be a division drawn between two commissions:⁷⁷ the “Financial Stability Commission” which undertakes prudential supervision of various types of financial institutions, and the “Consumer Protection Commission” which monitors the conduct of dealings between financial institutions and retail customers. Other authors call for the “matrix structure” whereby an institutional approach is applied for safety and soundness purposes and a functional approach is applied for consumer protection purposes.

As to the second question of segregating central banks and banking supervisory authorities, it should be borne in mind the strong link between the primary objective of central banks to achieve price and monetary stability, and the supervisory objective of maintaining a safe and sound banking system. Banks’ liabilities are constituted of money, and the preserving of a stable value of money is inseparable from maintaining public confidence in money deposited at banks. Banks are also the channels through which central banks transmit their monetary policies. In addition, banking crises have serious adverse effects on the real economy.⁷⁸ Furthermore, central banks are looked-upon as the providers of Lender of Last Resort facilities to bail out banking failures and are expected to continue to perform this role even when segregated from the supervisory authority.⁷⁹ In addition, supervisory authorities are concerned with the influence of the central bank’s macro-economic policies on the stability of the banking system. The developments in structured finance have increased the linkages between banking and monetary market. The credit crisis of 2007-8 was a conspicuous evidence of the spill over effect of money markets on banking institutions.

⁷⁶ M. Taylor, Peak Practice: How to Reform the UK’s Regulatory System, (Centre for the Study of Financial Innovation, 1996), pp. 6.

⁷⁷ These proposals were aimed for the UK before the establishment of the Financial Services Authority as will be further discussed in Chapter 6.

⁷⁸ Pierre Duquesne, ‘The Supervisory Role of the Central Bank’ in Charles Enoch and John Green (eds) Banking Soundness and Monetary Stability, (1997), pp. 399.

⁷⁹ C. Goodhart (with D. Schoemaker), ‘Institutional Separation between Supervisory and Monetary Agencies’ in C. Goodhart, The Central Bank and the Financial System, (1995), pp. 359.

Consequently, a total segregation between the supervisory authority or authorities, on one hand, and the monetary authority or the central bank on the other hand is not possible. In practical terms, governments have to choose from three possible alternatives: to create a unified supervisor of all financial institutions while financial stability would remain the responsibility of the central bank, providing there is adequate co-ordination between them; to locate the supervisory authority within the central bank; or confer a semi-independent status on the supervisory authority within a central bank.

The following question is whether there should be a single supervisory authority for all financial institutions or a separate institution for banks (accompanied by rules of co-ordination). Unified or single financial supervisory authorities have the advantages of attaining economies of scale and scope, increasing efficiency in resource allocation, as well as, better capability of solving conflicts between different objectives of regulation and competitive equality.⁸⁰ The key question is whether opting for this structure is more likely to attain the supervisory goal of maintaining the safety and soundness of banks. The answer varies relatively to the stage of development of banking systems. In industrialised countries where conglomerates exist strongly and banks are vigorously involved in risky and innovative transactions and markets, there is a stronger need to have a single financial supervisor in order to avoid gaps in the supervisory coverage. This concern is less relevant for countries where a smaller banking system prevails. Another major consideration for developing countries is that the unified supervisory authority should not be placed on central banks.⁸¹ Goodhart has explained this point clearly:

“The logic of placing all supervision under one roof would then require the Central Bank to take responsibility for supervision over activities which lay outside its historical sphere of expertise and responsibility. An even more serious problem, than already exists, would arise of how to demarcate the boundaries between those sub-sets of depositors/institutions which would be covered by the “safety-net” (explicit or implicit), deposit insurance, Lender of Last Resort facilities, etc., and those not so covered. Would the Central Bank really want to take under its wing the responsibility for customer protection in fund management? ... Would a Central Bank really want to extend its operational remit to dealing with financial markets and institution where issues relating to systemic stability were limited, and customer protection of much

⁸⁰ Clive Briault, The Rationale for a Single National Financial Services Regulator. (FSA, Occasional Paper No. 2, May 1999), pp. 18-22.

⁸¹ Some countries in practice opted for this option such as Bahrain.

greater importance, e.g. the pension mis-selling scandal in the UK? So if efficiency and cost saving implied the unification of financial supervision, this suggested placing such a unified body outside the Central Bank."⁸²

To sum up, there are two aspects to the choice of structure: one is the economic aspect, which is relevant to the size and complexity of the banking system; and the prudential aspect, which main concern is that the form of the institution does not compromise the efficiency and coverage of banking supervision. Particular attention should be given in the situations where the banking authority is or will be segregated from the central bank as well as to the coverage of supervision where separate institutions have jurisdiction on inter-related financial institutions.

1.5.2 Institutional Requirements

Whatever the structure a supervisory authority adopts, it should meet a minimal list of requirements. The first requirement is that the supervisory authority should be empowered by a clear mandate of law to undertake its supervisory functions, monitor, encourage, and where necessary, enforce compliance.

The second requirement is the independence from the intervention of political interference. This is because supervisory authorities take decisions during the course of their daily business, which might affect the fiscal and monetary policies of the government. One example is where the government considers loan provisioning and asset classification as contributors to a credit crunch in the economy. The situation is most delicate when supervisory authorities have to deal with a bank or banks facing financial closure by imposing corrective measures or taking a decision of licence withdrawal.⁸³

The third requirement is that there should be well-trained, efficient and trustworthy personnel. The Venezuelan banking crisis of 1994 illustrates that regulatory requirements become meaningless if the supervisors are unable or unwilling to analyse

⁸² C. Goodhart, The Organisational Structure of Banking Supervision, (FSI, Occasional Paper No. 1, November 2000), pp. 10-11.

⁸³ J. Tuya and L. Zamalloa, 'Issues on Placing Banking Supervision in the Central Bank' in T. Balino and C. Cottarelli (eds), Frameworks for Monetary Stability: Policy Issues and Country Experiences, (1994), pp. 673.

the prudential returns.⁸⁴

The fourth requirement is the adequacy of resources to cover supervisory costs. Rapid innovation in the banking sector means that supervisory authorities have to increase their expenditure on staff remuneration and training to make sure that they keep abreast of market developments. This is particularly relevant in advanced markets and where a new liberalisation policy is applied. Outsourcing has become an alternative solution to many supervisory authorities, despite the fact that it is an expensive solution. This leads us to the fourth requirement of designing the most efficient supervisory structure. In industrialised countries where a large number of conglomerates exist, there are economies of scope and scale to be attained where financial supervision falls under the auspices of a single supervisory authority.

The fifth requirement is accountability. Supervisory authorities should be accountable for their actions before Parliament. This should be the case even if they are located at central banks, which tend to be powerful non-elected institutions. Related to accountability is the concept of transparency, which relates to the degree of information a supervisory authority makes accessible to others concerning its functions.⁸⁵

The sixth requirement is to determine institutional objectives and the scope of the supervisory authority. Clearly delineated objectives increase the efficiency and effectiveness of regulatory authorities, enhance its transparency and accountability as well as more likely to create a well-focused internal management. Furthermore, clear objectives minimise the problems of regulatory competition and regulatory neutrality.

Once objectives are determined, the seventh requirement is to provide for institutional co-ordination at least at four levels: (1) between supervisory and monetary authorities, if separated; (2) supervisory authorities and the regulatory competition authority; (3) between bank supervisors and supervisors of other financial institutions if separated; (4) and between various banking supervisory authorities e.g. where both the central bank and a deposit insurance institution assume inspection and/or supervision

⁸⁴ Ruth De Krivoy, *Collapse: the Venezuelan Banking Crisis of 1994*, (2000), pp. 25.

⁸⁵ For further discussion, see: Rosa M. Lastra and Heba Shams, 'Public Accountability in the Financial Sector' in Ellis Ferran and Charles Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century*, (2001), pp. 165-188.

roles. This requirement is essential particularly considering the confidentiality restrictions on supervisory authorities. Should the author be allowed to draw on her own experience, it was found that it is very difficult to legally approve on passing information by supervisory authorities without a clear mandate. This refers to straightforward Acts of Parliament, clearly spelt out in detailed regulations and/or orders, as well as Memoranda of Understanding. Otherwise the legal duty of confidentiality will supersede the politically convenient concepts of transparency and co-operation.

1.6 The International Dimension

Banking supervision is justifiable for domestic purposes and consequently for international banking.⁸⁶ When a bank establishes a presence abroad in the form of a branch or a subsidiary, the domestic supervisory concerns become international. The supervisory authorities of host countries fear that a foreign bank might destabilise the safety of its financial system or harm the reputation of the local financial market. Likewise, home authorities need the co-operation of the host supervisory authorities in case the parent banking institution is adversely affected by the insolvency of its branches and subsidiaries in other jurisdictions. Safety considerations of international banks started to rise during the 1970s, when adverse economic situations motivated banks from developed countries to resort to internationalisation and to dangerous innovative financial activities.⁸⁷ Many authorities responded by racing towards the

⁸⁶ Benston contests the contribution of domestic regulation in preventing systemic risk and maintaining the safety and soundness of domestic banks. Therefore, he concludes that there is no justification for international regulation as a general rule. Benston, however, believes that international regulation is useful for dealing with foreign branches because their capital can be moved across jurisdictions.

See: G. 'Benston, International Regulatory Co-ordination of Banking' in J. Fingleton, and D. Schoenmaker (eds), The Internationalisation of Capital Markets and the Regulatory Response. (1992), pp. 197-209.

Proponents for the 'Theory of Regulatory Competition' (who support the duality in banking regulation between federal and state regulators as well as interstate competition for charters in the United States) also advocate diversity and competition amongst international supervisory authorities as a tool to enhance regulatory efficiency. For a critical view of the latter theory, see: J. Coffee, 'Competition Versus Consolidation: the Significance of Organizational Structure in Financial and Securities Regulation' 1994/5 The Business Lawyer. Vol. 50(2)(February), pp. 447-484.

⁸⁷ E. Kapstein, Supervising International Banks: Origins and Implications of the Basle Accord. (Essays in International Finance No.185, Princeton University, 1991), pp. 3.

adaptation of more permissible regulations in order to gain competitive advantages over each other.

While the need for co-operation to ensure the safety of cross-border banking is evident, it is more difficult to decide on the distribution of roles. There are three theoretical possibilities: “home country control” where the home country takes the primary role of authorisation and on-going supervision, “host country control” or “centralised supervision” practised by a supra national body. Supervisory concerns, nevertheless, are not the only determinate factors in allocating responsibilities. Home authorities might fear supervisory measures are being employed as a disguise for anti-competitive purposes.⁸⁸ The second complication arises where the host country takes the decision to close a bank, as the consequences of the closure will be faced in other jurisdictions.⁸⁹ One solution is to impose the duty to exercise protective supervision on the authority responsible for preventive supervision, though it is very unlikely to find the support of the taxpayer in the home country.⁹⁰ A third difficulty is the global trend of modern banks to diversify their activities beyond the traditional fields of accepting deposits and the extension of credit. Banks in many jurisdictions are permitted to offer a wide range of securities, insurance and other financial services as well as commercial activities directly. A bank can also be related to a non-banking group of companies where the bank can be the parent company, a sister company or a subsidiary.⁹¹ A fourth difficulty arises where the host authority imposes measures on foreign banks for monetary policy purposes. A common practice is to require and compulsory reserves as well as liquidity ratios, which relate to the capability of a bank to raise cash to comply with obligations by maturity dates without having to reduce its net worth. Fifthly, there is the question of control: how to ensure compliance with supervisory rules on a cross-border level.

⁸⁸ For further explanation, see generally, Raj. Bhala, ‘Tragedy, Irony and Protectionism After BCCI: A Three-Act Play Starring Maharajah Bank’ 1994 South Methodist University Law Review Vol. 48(Fall), pp. 11-62.

⁸⁹ For a critical view of the closure of BCCI, see: United Nations Centre on Transnational Corporations, New Issues for International Co-operation in Transnational Banking, (UNCTC/DOC/PIC/1992/1).

⁹⁰ D. Schoemaker, *Ibid* (n 38), pp. 9.

⁹¹ For further details see for example: Symposium: Global Trends toward Universal Banking, as reproduced in 1993 Brooklyn Journal of International Law Vol.19(1).

Cooperation between home and host banking supervisory authorities and other related domestic authorities is essential. Bank supervisors need to coordinate with supervisors of other financial institutions where the need arises. Likewise, where the banking supervisory authority is segregated from the central bank there is a need for cross-border coordination with both institutions. This becomes evident at times of liquidity crisis in the financial and or money markets.

This leads to the following question: how can international standards cover issues of structure without undermining country specific issues, mainly, the question of economic efficiency without compromising cross border prudential issues.

Another critical issue is how can supervisors coordinate their efforts without agreement on the basic prudential requirements that are considered essential for fair competition such as market entry requirements and solvency ratios. Practically there cannot be effective cooperation without agreeing on such requirements. This leads to the next question of how can the international community harmonise international standards flexibly in order to achieve the right balance between the soundness of international banks, on one hand, and catering for the needs of supervising fast developing banks and the differences amongst jurisdictions in the stage of market development, on the other hand.

The following part I will look into the international community's approach to meeting these challenges of banking supervision.

PART I

INTERNATIONAL STANDARDS

CHAPTER 2

THE ESTABLISHMENT OF THE BASEL COMMITTEE ON BANKING SUPERVISION AND ITS EARLY STANDARD-SETTING EFFORTS

2.0 Introduction

In Chapter 1, the nature of the business of banking and the meaning of banking supervision was discussed. The pivotal importance of maintaining a sound supervisory structure was identified. Finally, the challenges of meeting supervisory goals on an international level were examined. This Chapter examines extensively how these challenges were met on an international level through an examination of the organisation primarily responsible for setting international standards, the BCBS.

This Chapter first explains the establishment of the BCBS in the mid 1970s (Section 1). It then examines the banking supervisory standards set out by the BCBS in its first two decades. It illustrates how the BCBS concentrated its efforts on two major issues. The first one was the setting of minimum standards of co-operation and the co-ordination of supervisory efforts between various jurisdictions (Section 2). The second concern was setting internationally agreeable minimum standards on banks' minimum capital adequacy (Section 3). Finally, the Chapter looks into other initiatives of the BCBS in relation to market risk, off-balance-sheet exposures, as well as, credit risk including international lending risk which responds to the 1980s debt crisis resulting from over-lending to sovereigns (Section 4).

2.1. The Establishment of the BCBS

The roots of international banking supervision can be traced back to the 1970s. As a result of the adverse economic situations of the time, banks in developed countries resorted to internationalisation and to dangerous innovative financial activities.¹ Many authorities responded by a race towards more lenient regulations in order to gain

¹ E. Kapstein, Supervising International Banks: Origins and Implications of the Basle Accord, (Essays in International Finance, No.185, Princeton University, New Jersey, December 1991), pp. 3.

competitive advantages over each other. These facts attracted the attention of supervisors who realised the differences between the domestic supervisory schemes and the dangers that might stem from a bank's operations abroad.² Bank supervision, however, remained a national concern:³ a review of the efforts of international economic organisations shows that they had not assumed any role in relation to banking supervision. The IMF and its sister organisation, the International Bank for Reconstruction and Development ("World Bank") were oriented towards macro-economic policies.⁴ The General Agreement on Trade and Tariffs ("GATT") was also in existence but it was not concerned with trade in services in general until the Uruguay Round in 1986.⁵ The Organisation for European Co-operation and Development ("OECD")⁶ had similarly not assumed any responsibility. The central banks of the industrialised countries, the G-10⁷ had been meeting monthly at the Bank for

² Andrew J. Cornford, The Role of the Basle Committee on Banking Supervision in the Regulation of International Banking, (Discussion Paper No. 68, UNCTAD, 1993), pp. 1.

³ John Edelman Spero, The Failure of the Franklin National Bank: Challenge to the International Banking System, (1980), pp. 153.

⁴ The purposes of these two organisations are cited in Article 1 of the Articles of Agreement of the International Monetary Fund and Article 1 of the Articles of Agreement of the International Bank for Reconstruction and Development.

⁵ Mary Footer, 'GATT and the Multilateral Regulation of Banking Services' 1993 The International Lawyer, Vol. 27(2)(Summer), pp. 346.

⁶ The OECD was established under the Convention on the Organisation for Economic Co-operation and Development in Paris on 14 December 1960.

⁷ The Group of Ten is a political body composed of the ten industrialised countries, which entered into the General Arrangements to Borrow with the IMF in 1951. The ten countries include: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. Switzerland joined later on but the G-10 has maintained its original name.

Source: G-10, 1964, Statement by Ministers of the Group of Ten: and Annex Prepared by the Deputies, pp. 1; and IMF, A Brief Guide to Committees, Groups, and Clubs: A Fact Sheet, (April, 2008).

International Settlements (“BIS”),⁸ but they confined their meetings to discussions on economic and monetary policies.⁹

International banking co-operation was not triggered until the failure of three international banks in 1974. The response to the bank failures of 1974 came initially from the G-10. They first agreed in September 1974 to intensify exchange of information between central banks on international banks as well as strengthen, whenever deemed appropriate, regulations on foreign exchange positions, while consider it impractical to agree on procedures for providing liquidity.¹⁰ Then they agreed on establishing a standing committee under the auspices of the BIS which aim was to “assist the Governors in their continuing work of surveillance and exchange of information”.¹¹ It was initially named the Basle Committee on Banking Regulations and Supervisory Practices,¹² and then renamed to become the Basel Committee on Banking Supervision. The membership was initially confined to the original countries i.e. the G-10 countries, including Luxembourg, Spain was invited to join on February 1 2001. It usually holds four meetings every year, attended by representatives from the central banks and the banking supervisory authorities of member countries.¹³ The BCBS has various task forces and technical working groups holding regular meetings.

The declared aims of the BCBS are to ensure banking liquidity and solvency by providing a forum for discussion and co-operation among member states.¹⁴ The

⁸ The Bank was founded in 1930 in relation to the Young Plan for the settlements of German repatriations. Despite its name, the BIS functions are not limited to the agency for international settlements as it also performs as a central bank’s bank and is a forum for international monetary co-operation. The members and principal shareholders of the BIS are central banks.

Source: Mario Giovanoli, ‘The Role of the BIS in International Monetary Cooperation and its Tasks Relating to the ECU’ in R C. Effros (ed), Current Legal Issues Affecting Central Banks, Vol. (1992), pp. 39.

⁹ John Edelman Spero, The Failure of the Franklin National Bank: Challenge to the International Banking System, (1980), pp. 153.

¹⁰ BIS, Press Communiqué issued on 10.9.1974.

¹¹ BIS, Press Communiqué issued on 12.2.1975.

¹² Committee on Banking Regulation and Supervision, Report on International Developments in Banking Supervision, Basel, (1982), pp. 1.

¹³ BCBS, History of the Basel Committee and its Membership, (March, 2001). pp. 1

¹⁴ BIS, The Bank for International Settlements and the Basle Meetings, (1980), pp. 56.

members agreed from the beginning that it would provide “an early warning system” against troubled banks and that such a system should be derived from national practices rather than creating an international organisation for this purpose.¹⁵ There were no rules to govern voting practices. The decisions themselves took the deliberate form of “broad supervisory standards and guidelines” and “statements of best practice”, while details were left to national supervisors rather than attempting to reach a harmonisation of laws.¹⁶ This was to affect the legal form of the BCBS decisions as will be discussed in section 3 below.

2.2. Earlier Standards of the BCBS

2.2.1 The 1975 Concordat

The first work of the BCBS came shortly after its establishment in 1975, when it issued the ‘Report to the Governors on the Supervision of Banks’ Foreign Establishments’ which later became known as the “Concordat”. This work was only made public in 1981.¹⁷ The Concordat was a response to the three banking failures, and emphasised the need for international co-operation. The first bank, Bankhaus Herstatt was closed after wide losses in the foreign exchange market were discovered, and which had been disguised by fraudulent book-keeping. This bank mainly operated through its German head office and, therefore, it was the responsibility of West German authorities to handle the situation.¹⁸ In addition, this case brought attention to the need for supervisory co-operation, because the bank was closed before the settlement of exchange transactions leaving other banks with capital losses.¹⁹ The dissatisfaction of foreign creditors’ claims also indicated a need for regulating international banking crises.²⁰

¹⁵ Ibid. pp. 57.

¹⁶ BCBS, Ibid (n 13), pp. 1.

¹⁷ The Concordat was first published in the International Capital Markets: Recent Developments and Short-Term Prospects, (IMF, Occasional Paper No. 7, September 1981), pp. 29-31.

¹⁸ Richard Dale, The Regulation of International Banking, (1984), pp. 156.

¹⁹ P. Allsop, ‘Why Settlement Risk Does Matter’, CIB News, (November, 1995), pp. 9.

²⁰ D. Alford, ‘Basle Committee Minimum Standards: International Regulatory Response to the Failure of BCCI’ 1992 Geo.Wash.J.Int’l L.& Econ Vol. 26(2), pp. 246.

The failure of the Israel-British Bank of Tel-Aviv showed that “cross border contagion effect” was not limited to a bank's interwoven relations in the international payment system. This case showed that contagion risk could spread to other separately incorporated companies, which belonged to same group of companies. The Israeli authorities seized the assets of the parent bank and consequently the wholly owned London subsidiary of Israeli-British Bank of Tel Aviv closed its doors. This case also shed light on the differences between supervisor’s attitudes towards the responsibility of the Lender of Last Resort. The Bank of Israel denied any responsibility to guarantee depositors of the London subsidiary, (even though they guaranteed all deposits held in the parent bank’s eight branches in Israel); while the Bank of England insisted that this was the responsibility of Israeli authorities.²¹

Intra-group contagion and the need for international supervisory co-operation were raised again with the failure of the US Franklin National Bank. This time, the bank was large and very active in the international market.²² The major cause of the banks’ failure was related to losses in the foreign exchange markets which were concealed by false transactions between the bank on the one hand, and the affiliates of the holding company, Fasco, on the other.²³ Fasco was not declared as a banking holding company and, therefore, there were no investigations undertaken by the American federal authorities into the merits of the owner, consequently Franklin National Bank was able to make loans to affiliate companies within Fasco above the regulatory limits. Though as early as 1972 the Italian authorities had information concerning irregularities in the Italian banks belonging to the owner of Fasco, it failed to pass the information on to the American authorities.²⁴ In the end, the bank failed despite the prolonged liquidity assistance from the Federal Reserve Bank.

The Concordat provided the national authorities with two general “guidelines”: first, that no foreign bank establishment should escape supervision and secondly that

²¹ Richard Dale, *Ibid* (n 18), pp. 164.

²² John Edelman Spero, *The Failure of the Franklin National Bank: Challenge to the International Banking System*, (1980), pp. 11.

²³ *Ibid*, pp. 95-96.

²⁴ *Ibid*, pp. 62-63.

such supervision is the joint responsibility of the parent²⁵ country and the host country authorities. In order to fulfil these two guidelines, the Concordat allocated the supervisory duties of solvency and liquidity between home and host supervisory authorities.²⁶ It also called for co-operation between supervisory authorities.

As to the allocation of supervisory duties, the Concordat allocated supervisory roles according to the type of the supervised entity: branches, “which are integral parts of a foreign parent bank”; subsidiaries, “which are legally independent institutions incorporated in the country of operation and controlled by one foreign parent bank” and joint ventures, “which are legally independent banks incorporated in the country of operation and controlled by two or more parent institutions, most of which are foreign and not all of which are necessarily banks”.²⁷

The Concordat stressed the need for co-operation between supervisory authorities and provided for rules for the allocation of supervisory roles according to the types of banking establishments. The Concordat, like the later documents, allocated the supervision of liquidity to the host authorities in the first instance, mainly because foreign banks apply local monetary legislation. The parent authority regulations are, however, relevant to the management of foreign currencies especially the currency of the parent authority. Other reasons for the involvement of the parent authority are that the liquidity of a branch must be connected to the situation of the whole bank. Branches may have deposits with the parent and may also call for liquid resources. Although subsidiaries have separate legal personalities, parent companies still feel there is a “moral responsibility” towards them, and may also provide them with stand-by facilities. Therefore, the Concordat stated that the liquidity of the subsidiary should not be judged in isolation from its parent. As regards solvency, the emphasis was on the host authority in relation to subsidiaries and joint ventures though the report admitted that the parent authorities must also play a role because of the moral commitment of parents towards foreign establishments. Solvency of branches, on the other hand, was

²⁵ The terms home and parent authorities are used interchangeably.

²⁶ There were no definitions of host and parent authorities given, but it is obvious that the former is the place where the establishment is undertaking business, while the latter is where its parent was established.

²⁷ Some of the latter documents mentioned joint ventures occasionally without providing for distinctive supervisory standards to be applied on them.

the primary responsibility of the parent authorities, because they do not have separate legal personalities. The fact that certain host authorities require a “dotation de capital”²⁸ was not reason enough to change this rule.

Finally, the Concordat emphasised the need for supervisory co-operation between the home and host supervisory authorities. It encouraged them both to allow the exchange of information on banks, while it also encouraged home authorities to inspect their banks. As these recommendations might contradict national laws on confidentiality (or secrecy laws), the document stated that such laws “should” be modified and stressed that the purpose would be for supervisory purposes and would not be directly related to individual customers.

2.2.2 The 1979 Consolidated Supervision

In 1979 the BCBS issued a brief document entitled ‘Consolidated Supervision of Bank’s international Activities’. This document first clarifies that the authority responsible for supervision of international banks should be fully assured of the soundness of individual banks only if they can examine the totality of each bank i.e. the parent supervisory authority should exercise its supervision on the worldwide business of the bank. This is in addition to the supervision of each bank on a non-consolidated basis. The document further illustrates that supervising branches on a consolidated basis should be unproblematic since branches do not have separate legal identities. The situation, by contrast, is more difficult in relation to foreign subsidiaries, participations and joint ventures, which are legally independent and are subject to different solvency requirements in host jurisdictions. The document therefore recommended that wholly and majority owned subsidiaries should be subject to consolidated supervision. By contrast, the parent supervisory authority is recommended to ensure that the capital of the parent bank can meet its commitments to minority interests and joint ventures.

²⁸ “Dotation de capital” requirements of some host countries exist to oblige foreign branches that set up business in these countries to make and sustain a certain minimum investment in them, as well as to equalise competitive conditions between foreign branches and domestic banks.

2.2.3. The 1983 Accord

Practice revealed defects in the Concordat.²⁹ First, it did not deal directly with the question of the responsibility of Lender of Last Resort despite the confusion of supervisory authorities towards this duty in 1974. Secondly, the division of responsibilities in general was not clear and consequently supervisors were unsure as to who was responsible for the different duties laid down in the Concordat. Thirdly, an important shortcoming was the lack of criteria for what constitutes adequate supervisory standards upon which the supervisory authorities could base their judgments. A fourth difficulty arose from the endorsement of the BCBS recommendations in 1978 stating that banking supervision should be practised on a consolidated basis.³⁰ According to this document, the parent supervisory authority was responsible for the supervision of banks' solvency. Consolidated supervision therefore was in contradiction with the Concordat, which, as seen above, had designated the primary role of supervision of banking solvency to the host supervisory authority.

The above facts gained emphasis with the increasing problems of international sovereign debt in the eighties, culminating by the failure of Banco Ambrosiano Bank in 1982, which failed as a result of imprudent lending to Latin American companies through its intermediate subsidiary in Luxembourg, Banco Ambrosiano Holdings.³¹ The Italian authorities denied any responsibility towards BAH and its subsidiaries in Latin America. The Luxembourg authorities, on the other hand, took the view that Banco Ambrosiano Holdings should fall under the responsibility of the supervisory authority of the ultimate parent, namely Italy.³² This pointed to the lack of a rule to cover the situation of intermediate holding companies in the Concordat.³³

²⁹ Richard Dale, The Regulation of International Banking, (1984), pp. 173-178.

³⁰ BCBS, Principles for the Supervision of Banks' Foreign Establishments, Basle Report, (May, 1983), pp. 4.

³¹ D. Alford, *Ibid* (n 20), pp. 251.

³² Andrew Cornford, *Ibid* (n 2), pp. 4.

³³ BCBS, *Ibid* (n 30), pp. 4.

The BCBS' response came in 1983 with the endorsement of the 'Principles for the Supervision of Banks' Foreign Establishments' better known as the "Accord".³⁴ The Accord sets "recommended guidelines of best practices" in the area of the supervision of international banks, which, upon their issuance, replaced the Concordat. The Accord is certainly an important development in the history of international banking standards. It emphasises effective co-operation between home and host supervisory authorities which should be based on two major principles: first, "that no foreign banking establishment should escape supervision" and secondly, that the supervision be adequate. This means that the host supervisory authority should be satisfied that the concerned banking establishment is adequately supervised by the home supervisory authority and *vice versa*. Furthermore, each authority should inform the other when problems arise. If the host supervisory authority does not adequately supervise the foreign establishment, the home supervisory authority should either extend its supervisory duties to such establishments or discourage the parent institution from conducting business in the host country. If it is the host authority, which is not satisfied with the home authority's supervision, it should at a minimum discourage or ultimately forbid the foreign establishment from conducting business on its territory. In particular, the Accord points out the possible supervisory gaps that could arise, and how these should be dealt with. For example, it addresses the situation of intermediary holding companies (such as Ambrosiano Luxembourg) stating that the home supervisory authority should ensure that such companies are adequately supervised, otherwise the home authority should forbid its operation.

The Accord also emphasises the principle of consolidated supervision. It illustrates that the parent (i.e. home) supervisory authority should monitor the risk exposure and the capital adequacy of the bank or banking group on an overall basis. It explains, however, that this should not lessen the responsibilities of the host supervisory authority. Furthermore, the Accord explains the allocation of three supervisory responsibilities namely, solvency, liquidity and foreign exchange operations and positions. The allocation of these responsibilities depends upon the type of the establishments i.e. whether they are branches, subsidiaries, joint ventures or consortia.

³⁴ The BCBS also issued in 1983 the document, Authorisation Procedures for Banks' Foreign Establishments (March, 1983), which recommended guidelines for internal and external authorisation of banks. However, the standards set out in this paper were incorporated later on in the Supplement to the Concordat. See: BCBS, below (n 37).

The BCBS, however, does not provide for any rules of substance, for example it does not set the solvency ratio.

Furthermore, the Accord confirms the allocation of supervisory responsibilities based on consolidated supervision. The parent supervisory authority should accordingly monitor the risk exposure and the capital adequacy for the banks and banking groups under their supervision based on the totality of their business in all jurisdictions. The Accord also confirms that consolidated supervision is to be applied in addition to the unconsolidated supervision basis (i.e. supervision of each banking institution separately by the relevant supervisory authorities). Furthermore, the Accord notices the gaps in supervising banks operating within international groups of companies, such as where holding companies exist at the top or in the middle. It called for co-operation between the relevant supervisors where there are separately incorporated banks headed by a banking company. In situations similar to those in the Ambrosiano case, the Accord stated that the parent authority (Italy) should supervise intermediate companies and their intermediaries or, alternatively, prohibit this intermediation. Furthermore, for the first time the Accord called for the co-operation between “supervisors of different functions” where a non-banking holding company has considerable liabilities to the international banking system. The report also stated that if such co-operation cannot be achieved, then supervisors should aim at minimising the consequential risks of such activities.

2.2.4 The 1990 Supplement on Exchange of Information

The application of the previous documents faced difficulties in relation to the exchange of information and the need for supervisory authorities to know about supervisory practices in other countries. International banking supervision cannot be performed without effective exchange of information. There are two major elements here: how to determine the scope of needed information and how to have access to it. It is important to determine the scope of information because the passing on of information demands large resources, especially experienced personnel. This is particularly significant where a bank’s foreign establishment is small in relation to the world-wide activities of the parent bank or the banking group. Banking confidentiality is another major legal problem to parent and home supervisory authorities. Parent authorities in particular are more reserved about divulging sensitive information that might affect their banks. If a bank was endorsed by a host authority after obtaining

delicate information from parent authorities, the parent authority might be accused of breach of confidentiality.³⁵

In order to deal with the need for transparency, supervisors agreed in the 1984 International Conference on Banking Supervision (“ICBS”) to exchange information on their supervisory practices on basis of a questionnaire prepared by the BCBS.³⁶ There had also been a number of complaints regarding the excessive reporting requirements of the United States prior to the Revised Concordat.³⁷ The Offshore Group of Banking Supervisors³⁸ complained also about the allocation of responsibilities.³⁹ The BCBS showed interest in the difficulties surrounding the flow of information to the Offshore Group and a working party was established in order to make practical recommendations.⁴⁰ A joint report was issued and circulated in 1986 and later on discussed in the fourth ICBS in Amsterdam,⁴¹ followed by another recommendation report issued in 1987⁴² on the basis of which a “Supplement to the Concordat” was made in 1990 (“Supplement”).⁴³

The Supplement included recommendations which were described as “not designed as minimum legal requirements” but rather “statements of best practices” that

³⁵ BCBS, Report on International Developments in Banking Supervision, Report No. (5), (1986), pp. 52-54.

³⁶ BCBS, Report on International Developments in Banking Supervision: 1984, (1985), pp. 2.

³⁷ BCBS, Information Flows between Banking Supervisory Authorities, (1990).

³⁸ The Offshore Group of Banking Supervisors formed in 1980 was comprised of fifteen offshore centres, Bahamas, Bahrain, Barbados, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Netherlands Antilles, Panama, Singapore and Vanuatu. The Group’s aim was to further international co-operation in banking supervision.

³⁹ BCBS, *Ibid* (n 36), pp. 26.

⁴⁰ BCBS, *Ibid* (n 35), pp. 50.

⁴¹ BCBS, Report on International Developments in Banking Supervision, Report No. (6), (1988), pp. 18.

⁴² Conclusions and summary of recommendations of the Joint Report on practical aspects of international collaboration between banking supervisory authorities were reproduced in: BCBS, *Ibid*, pp. 20-23.

⁴³ Although this report is often referred to as the ‘Supplement to the Concordat’, its official name is: ‘Information Flows between Banking Supervisory Authorities (Supplement to the Concordat).

members will attempt to implement them "according to the means available to them".⁴⁴ An official report summarised the Supplement into the following points:⁴⁵

- the purpose for which the information is sought should be specific and supervisory in nature;
- information received should be restricted solely to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent;
- there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;
- there should be a two way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded;
- before taking consequential action, those receiving information will undertake to consult with those supplying it".

Finally, the Supplement recommended that sufficient provision for an external audit should be a condition for authorisation. It was also preferred that the foreign bank's auditor be the same as that of the parent bank or at least that the parent's auditor should have access to their papers. It was also recommended that supervisors should have direct access to external auditors and be empowered to criticise and substitute them. Lastly, it was required that auditors should have international qualifications as well as sufficient experience in bank auditing in the relevant country.⁴⁶

2.2.5. The BCCI Failure and the 1992 Statement

The failure of the Bank of Credit and Commerce International ("BCCI") and its closure in July 1991 had a marked influence on the development of international banking supervisory standards.⁴⁷ At its peak, BCCI was one of the largest private banks and operated in more than seventy countries. Official investigations in the UK and the

⁴⁴ BCBS, *Ibid* (n 37), pp. 2.

⁴⁵ BCBS and Offshore Group of Banking Supervisors, below (n 70), pp. 10.

⁴⁶ BCBS, Report on International Developments in Banking Supervision, Report No. (7), (1990), pp. 42.

⁴⁷ The circumstances leading to the failure of the BCCI were examined in the following UK official reports: Bingham L.J., Inquiry into the Supervision of the Bank of Credit and Commerce International, HC 198, (October, 1992) (known as the "Bingham Report"); and Treasury and Civil Service Committee,

USA found that the BCCI failed due to its involvement in money laundering and massive worldwide fraud. Furthermore, a number of problems were identified as to how the BCCI managed to escape from the supervisory net, despite its presence in many important financial centres particularly London.

First, there is the, possibly deliberate, choice of a complex banking structure. The BCCI had the same structure as the Ambrosiano Bank, which the Accord dealt with specifically: the Bank had a holding company in Luxembourg and two main subsidiaries in Luxembourg and the Cayman Islands.⁴⁸ Luxembourg was also a particularly convenient location because it did not subject holding companies to consolidated supervision.⁴⁹

Secondly, the BCCI was not subject to a home supervisory authority. According to the Concordat, Luxembourg was the parent authority and should have supervised the bank on the basis of the principle of consolidation. The Luxembourg supervisory authority, however, admitted in 1987 that it was impossible for them to undertake such a role while 98% of the BCCI activities were concluded outside their jurisdiction.⁵⁰ As there was no recommendation in the Concordat for this situation, an alternative solution was the appointment of a "college of regulators" in the same year. The formulation of a group of regulators was within the borderline of the principle of co-operation in the Concordat; however, it proved to be an unsuccessful measure because it diluted the assignment of responsibilities amongst supervisors.⁵¹ They did not take action to close the bank until July 1991, despite the fact that regulators in the United States and the

Fourth Report, Banking Supervision and BCCI: International and National Regulation, HC (1991-1992) 177, (4 March, 1992).

For further discussion, see: Richard Dale, 'Regulatory Consequences of the BCCI Collapse: US, UK, EC, Basle Committee - Current Issues in International Bank Supervision' in, Joseph Norton, Chia-Jui Cheng, and I. Fletcher (eds) International Banking Regulation and Supervision: Change and Transformation in the 1990s, (1994), pp.377-397; D. Laifer, 'Putting the Super Back in the Supervision of International Banking, Post BCCI' 1992 Fordham Law Review, Vol. 60 (6)(May), pp. S467-500; and Joseph Norton, 'Projecting Trends in International Bank Supervision: After BCCI' in Joseph Norton and Raymond Auerback (eds), International Finance in the 1990's, (1993), pp. 64-84.

⁴⁸ Treasury and Civil Service Committee, *Ibid*, par 5.

⁴⁹ Philippe Vigneron, Philippe Steinfeld and Delphine Couyne. 'European Regulatory Lessons of the BCCI Collapse-The Case for Strengthening Financial Supervision' 1993 YEL, Vol. 13, pp. 264.

⁵⁰ Treasury and Civil Service Committee, *Ibid* (n 47), par 7.

⁵¹ Andrew J. Cornford, *Ibid* (n 2) pp. 13.

United Kingdom had been concerned for many years about the situation of the Bank, including a guilty plea regarding accusations of money laundering in Tampa, Florida in 1988.⁵²

Thirdly, the BCCI had two auditors until 1987 who could not have had a complete understanding of the Banks' wide-spread activities, a matter which helped the management to hide the situation of the bank.⁵³ The statement had been addressed by the BCBS, but the BCCI case highlighted once again the need to consider their role.

The BCBS was engaged in a rapid evaluation of the BCCI case late in 1991. The major conclusion was that the "college of regulators" method ought not to be a substitute for the appointment of a "lead regulator" who could supervise the worldwide activities of banks.⁵⁴ The principle of consolidated supervision was also preserved and even strengthened. The results were issued in July 1992 in a document entitled 'Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments' ("Minimum Standards").⁵⁵ It was clearly stated that "The Committee... reinforced the Concordat, which has a "best-efforts" character, with a document setting out minimum standards".⁵⁶ The report emphasises that the representatives "will be taking the necessary steps to ensure that their own supervisory arrangements meet the standards as soon as possible". The BCBS is also to play a monitoring role in the future over the implementation of the standards and further amendments.⁵⁷ In addition, the Statement distinguishes between two types of 'home country authorities': 'immediate' and 'higher level' home authorities.⁵⁸ Host authorities are called to decide whether both types of home authorities are capable to meet the following minimum standards:

⁵² D. Alford, *Ibid* (n 20) pp. 258-260.

⁵³ Treasury and Civil Service Committee, *Ibid* (n 47), para. 14.

⁵⁴ BCBS, Report on International Developments in Banking Supervision, Report No. (8), (1992), pp. 4-5.

⁵⁵ The Minimum Standards were reproduced in: BCBS, Report on International Developments in Banking Supervision, Report No. (8), (1992), pp. 11-18.

⁵⁶ BCBS, Report on International Developments in Banking Supervision, Report No. (8), (1992), pp.10.

⁵⁷ *Ibid*, pp. 11.

⁵⁸ *Ibid*, pp. 13.

The first standard is that a foreign bank or banking group should be supervised on a consolidated basis by a capable home country. In order to satisfy this standard, the home country should obtain consolidated information from their banks and verify the information by conducting on-site visits or by other means. They also should hinder their banks from developing non-transparent structures and to prevent them from establishing existence in “particular jurisdictions”.⁵⁹ There is, however, no explanation of what is meant by “particular jurisdictions”.

The second standard is that home and host supervisory authorities must both consent to the creation of a new foreign establishment. The strength of capital and the effectiveness of the risk management of the bank should be particularly taken into consideration.⁶⁰ The report further illustrates that the host authority should be “particularly concerned with the level of *support* that the parent is capable of providing to the proposed establishment (italics added)”.⁶¹ The requirement of mutual consent is better than the previous lax measures of the 1990 Statement. Furthermore, the authorities should decide on the allocation of responsibilities amongst themselves before authorisation. If they remain silent, it will be assumed that they accept the allocation of responsibilities in the Concordat. The purpose is to emphasise the idea that each international bank or banking group must have a primary home regulator whatever the structure of the group.

The third standard is that the home supervisory authority is entitled to gather information from cross border establishments. Inward and outward authorisations should be contingent on a mutual understanding on the exchange of information. The fourth and final standard is that the host authority has the right to restrict or totally prohibit a foreign establishment if any of the above standards is not satisfied because the home authority is unable or unwilling to meet them. Host authorities, nevertheless, may permit a conditional authorisation on their own discretion providing that they supervise the bank on a consolidated basis.⁶²

⁵⁹ Ibid, pp. 14.

⁶⁰ Ibid, pp. 14-15.

⁶¹ Ibid, pp. 15

⁶² Ibid. pp. 17.

2.2.6. Exchange of Information with Securities Supervisory Authorities

The deregulation trend, which started in the mid-eighties, raised concerns amongst supervisory authorities. Banks were increasingly active in securities dealings and consequently increasingly exposed to market risks. Banking and securities authorities felt that there was a need to co-ordinate the exchange of information on a cross-sector basis. The BCBS consequently launched meetings with securities' regulators from industrial countries.⁶³ The outcome was the release of the joint paper in 1990 entitled the 'Exchange of Information between Banking and Securities Supervisors'.⁶⁴ This document was in many ways similar to other documents on the exchange of information between supervisory authorities of international banking: it focused on the mutual need of banking and securities supervisory authorities to exchange prudential information, the ability to consult supervisors abroad and the need to be able to rely on other supervisors taking the initiative to inform their international colleagues of necessary information.⁶⁵ This was to include information on the financial standing of the institutions as well as on management and internal controls. However, confidential information related to customers was still excluded from the scope of the definition of prudential information.⁶⁶ Furthermore, it was agreed that any exchanged information should only be used for supervisory purposes and would not be divulged to authorities who were not responsible for financial supervision. This was even to include governmental officials who worked for the same institution.⁶⁷ In addition, the report stressed on the confidentiality of information received as well as recommended that the question of whether the relevant supervisor could or should provide the requested information must remain discretionary. Strict reciprocity was also discouraged as it was viewed that this could lead to a halt in information exchanges altogether. The report stressed that the recipient should not take a decisive action, such as bank closure, based

⁶³ BCBS, *Ibid* (n 46), pp. 7.

⁶⁴ BCBS, Exchanges of Information between Banking and Securities Supervisors, (April, 1990), reproduced in the Report on International Developments in Banking Supervision, Report No. (7), (1990), pp. 43-50.

⁶⁵ *Ibid*, Section I, pp.43-44.

⁶⁶ *Ibid*, pp. 43, Footnote 13.

⁶⁷ *Ibid*, pp. 44-45.

upon received prudential information without prior consultation with the supplier.⁶⁸ Finally, the report examined the legal restraints on the flow of prudential information from a securities regulator to a foreign bank's supervisor and *vice versa*. It recommended alternatives such as the appointment of a fellow supervisory authority to act as a medium between the cross border authorities or obtaining the concerned bank consent.⁶⁹

2.2.7. Cross-Border Banking

The BCBS report 'Supervision of Cross-border Banking' was produced in 1996 by a working group comprised of members of the BCBS as well as the Offshore Group of Banking Supervisors ("Offshore Group"). The Offshore Group was established in order to move towards an effective implementation of the Minimum Standards with the view of overcoming obstacles to its implementation.⁷⁰ Discussions of the report concentrated on the difficulties associated with offshore banking though its outcome was applicable to all banking supervisory authorities.⁷¹ The principles set by the Report were later "endorsed" by the one hundred and forty countries, whose representatives took part in the ninth ICBS in Stockholm, they "undertook to work towards their implementation in national centres".⁷²

The report identifies two major categories of impediments to the application of the Minimum Standards: information access by home and host supervisory authorities and the meaning of effective host and home supervision in line with earlier documents issued by the BCBS on cross border cooperation and exchange of information.

2.3. The Capital Accord

The first international effort to converge capital adequacy requirements was the BCBS 'International Convergence of Capital Measures and Capital Standards' of 1988

⁶⁸ Ibid, pp. 46-47.

⁶⁹ Ibid, pp. 48-49.

⁷⁰ BCBS and Offshore Group, The Supervision of Cross-Border Banking, (1996) Section I, pp. 1.

⁷¹ Ibid.

⁷² Ibid, Preface.

known as the (“Capital Accord” and later on as “Basel I”). The Capital Accord applied the method of risk-weighted assets. The aim of this method was to encourage banks to act prudently in an industry characterised by high leverage or low capital-to-liabilities ratio. It was intended that the Capital Accord would be applied on internationally active banks, though there no definition of such banks was given. The Capital Accord had two fundamental objectives: to support the stability and soundness of international banking and to provide a fair and consistent framework to eradicate competitive inequalities. It is important to point out that in general the BCBS Capital Accord is similar to the ‘US/UK Agreed Proposal on Primary Capital Adequacy Assessment’, which had been issued in 1987.⁷³ Consultations also took place with the European Community to apply similar solvency ratios.

The Capital Accord first addressed the issue of the composition of capital. The first type of capital was named “core capital” (or Tier 1 capital) comprised of paid up capital and disclosed reserves. There had been a common practice to disclose core capital in published financial statements; it had a substantial influence on banks’ profit margins and their competitive ability, and it was the focus of the market’s judgement on the firm. Core capital was comprised only of permanent shareholder’s equity, which referred to two types of shares. The first one was issued and completely paid ordinary shares/common stock. The second one was non-cumulative perpetual preferred stock. Preferred stocks entitle their holders to extra contractual preferences in relation to their rights of voting, dividend and liquidation. Payment of dividend, nevertheless, is not decided by a decision of the board of directors (as it is the case with common stock) but according to their respective contractual terms and applicable legislation. Payment, for example, could be deferred and cumulative and therefore there remain contingent claims of arrears. Payment could also be limited or in perpetuity i.e. for perpetual life.⁷⁴ Therefore, preferred stock had to be perpetual and non-cumulative to possess the attributes of permanence and subordination necessary for inclusion in the capital base.

⁷³ For further details, see the two part article by A. Murray-Jones, and D. Spencer, ‘The US/UK Proposal on Capital Adequacy’, 1987 I.F.L.Rev Vol.(8)(August) pp. 20-23 and 1987 I.F.L.Rev Vol. 6(9)(September), pp. 27-30.

⁷⁴ Joseph J. Norton, Devising International Bank Supervisory Standards, (1995), pp. 8-9.

As to disclosed reserves these were described as those reserves “created or increased by appropriations of retained earnings or other surplus, e.g. share premiums”.⁷⁵

There were other elements of capital, which the Capital Accord admitted into the category of “supplementary capital” (Tier 2 capital). They mostly refer to certain types of reserves and to certain debt instruments that are treated differently by the various supervisory authorities and therefore, their inclusion into the capital base were left to the discretion of the respective countries. Tier 2 capital should not exceed the amount of core capital; it should also meet certain conditions and be subject to a number of deductions. It encompassed five elements: first, “undisclosed reserves” or “hidden reserves” which referred to unpublished reserves that passed through the profit and loss account, i.e. they had the same quality as published retained profits but they lacked transparency. Secondly, “revaluation reserves” allocated because of changes in the market value of assets. They rise in relation to the revaluation of fixed assets (usually banks’ own premises) or because of ‘latent’ revaluation of holdings of securities in the balance sheet valued at the historic cost of acquisition. Thirdly, “general provisions/general loan loss reserves” that are held, and made readily available against presently unidentifiable future losses. They should not relate to a specified asset or reflect a devaluation of a certain asset. This is as opposed to specified reserves put aside against the likely reduction of the value of a certain asset. Fourthly, “hybrid debt capital instruments,” this category covered certain capital instruments, such as cumulative preference shares, which have some of the characteristics of both debt and equity. The Capital Accord accepted the inclusion of these documents into the capital base providing that they were very similar to equity in their ability to absorb losses without having to resort to liquidation. Therefore, they should meet certain minimum requirements: they must be subordinated, unsecured and completely paid-up; they should not be redeemable at the holder’s request; service obligations should be allowed to be deferred; and they should be made available for participation in losses without having to force the respective bank to cease its trading activities. Fifthly, there were the “subordinated debt capital instruments”; the BCBS recognised that these instruments have shortcomings to be included in capital due to their fixed maturity and lack of ability to absorb losses in a situation other than liquidation. Therefore, the Capital

⁷⁵ BCBS, Capital Accord, (1988), Annex 1, para. d (i).

Accord provided that the “subordinated term debt” should have a minimum original fixed term to maturity exceeding five years, a sufficient amortisation agreement and should not exceed fifty percent of Tier 1 capital.

The Capital Accord also specified two elements, which should be deducted from capital. The first one was goodwill (an intangible asset), and the second one covered the investments of banks in unconsolidated subsidiaries engaged in banking and financial activities. The Capital Accord explained that the correct procedure was to consolidate subsidiaries for the purposes of measuring capital adequacy. Deduction, however, was a recommended alternative approach to avoid “double gearing” or using the same capital twice. The committee left the possibility of introducing further constraints to future initiatives. As to banks’ holdings of capital issued by other banks of a deposit-taking institution, it was left to the discretion of the various countries to apply policies of deduction. Meanwhile, it was provided that where no deduction takes place, holdings’ in the capital of other banks have a weighting risk of 100 percent. Supervisory authorities were also directed to prohibit cross-ownership for the purpose of inflating the capital position of their respective banks.

As to the measurement method, the Capital Accord allocated all claims (on balance sheet as well as off balance sheet and credit equivalent amounts of the latter) to five risk categories 0, 10, 20, 50 and 100 percent.⁷⁶ It assigned, for example, a 50 percent risk weight for loans completely secured by residential mortgage. As to off-balance-sheet items, their nominal principal amounts were multiplied by a conversion factor. The amount resulting would then be risk-weighted according to the category of the respective counterparties. Standby letters of credit and other off-balance-sheet claims considered as substitutes of loans were assigned a 100 percent conversion risk factor, while a nil weight was assigned to commitments which could be cancelled unconditionally. The Capital Accord covered all off-balance-sheet items and classified them into five categories according to their level of risk. The divisions were broad and discretionary. For example, claims on the central governments, central banks as well as claims on banks or guaranteed by banks from the OECD countries attracted a zero weight.

⁷⁶ Annex (2) of the 1988 Capital Accord provides for risk weights by category of on-balance-sheet assets.

Risk weights were accordingly assigned to the level of perceived risk that each type of obligor. The higher the estimation of risk of loss associated with an investment, the higher the risk weighting. A 100 per cent risk loss implied that the whole of an investment can be lost and a zero per cent risk-weight (basically holdings in Government Treasury Bills and bonds) implied that the asset concerned is risk-free. Claims on the non-bank private sector carried a flat 8 percent rate. The capital measurement was accordingly as follows:

$$\text{Capital Ratio according to the Capital Accord} = \frac{\text{Capital}}{\text{Risk Weighted Assets}} \quad (1)$$

The risk weighted assets were then to be multiplied by the solvency ratio of 8 percent (or its inverse 12.5 percent).

The Capital Accord was subject to continuous amendments.⁷⁷ The following Chapter 3 will look into this issue specifically.

2.4. Other Early Standards

The BCBS issued a number of other reports, which spelled out supervisory standards of substance, besides the standards on capital adequacy, asset quality and loan-loss reserves, as the need arose. Below is an explanation of documents still of relevance and which fall under three categories market risk, credit risk, and the management of banks' off-balance-sheet exposures.

2.4.1 Market Risk

The late seventies witnessed an increase of banking risk in foreign exchange positions due to the instability of the exchange rates at the time. During 1980, the BCBS issued a report setting three major guidelines for supervisory authorities in this regard.⁷⁸

⁷⁷ The BCBS issued the following amendments: Amendment to the Basle Capital Accord in Respect of the Inclusion of General Provisions/ General Loan-Loss Reserves in Capital, (November, 1991); Treatment of Potential Exposure for Off-Balance-Sheet Items, (April, 1995); (July, 1994); The Treatment of the Credit Risk Associated with Certain Off-balance-sheet Items, (July, 1994); Interpretation of the Capital Accord for the Multilateral Netting of Forward Value Foreign Exchange Transactions (April, 1996) and Instruments Eligible for Inclusion in Tier I Capital (Press Release, October, 1998).

⁷⁸ BCBS, Supervision of Banks' Foreign Exchange Position, (August, 1980), I, Section I.

The first recommendation was that supervisory authorities check that banks have adequate internal controls to monitor their foreign exchange exposures. The same report set out standards for the role of such an internal control. First, that there should be a clearly defined role as well as a clear division of responsibility between each of (i) foreign exchange dealers, (ii) accountants and (iii) internal supervisors. The second recommendation was that supervisory authorities should set limits on foreign exchange exposures of banks. The report particularly found it desirable to distinguish between banks' dealing positions and banks' own positions in foreign exchange. It also suggested a system of "dual limits," placing one on banks' overall exposure and the other on its exposure to each single currency. The third recommendation related to the supervisory role of monitoring banks' foreign exchange exposures. The report has also explained that supervisory authorities need to be satisfied that banks adopt and apply rational policies to limit open exchange positions and, desirably, to relate the limits of exposure to the size of the bank's balance sheet.

2.4.2. Credit Risk

In the field of credit risk management, the BCBS issued two important reports on concentration limits as well as exposures arising in international lending.

As to concentration limits, the BCBS issued in 1991 a document on measuring and controlling large exposures.⁷⁹ This document seeks to attain a degree of convergence in national treatment of large exposures. It addresses five issues within this context. First, it looks into the issue of the definition of credit exposure, which involves the answering the question of extent of coverage of credit exposures. It determines that large exposures should cover all forms of actual, potential and contingent liabilities. It therefore covers credit substitutes such as acceptances and securitised assets. Furthermore, it recommends that large exposures should be measured on a consolidated basis at group-wide level. Secondly, the document defines the counterparty to encompass single counterparties as well as related counterparties, which cover all economically and legally related parties that constitute a single legal risk (though ostensibly they might have separate identities). A related party can be determined by considering common ownership, management or control as well as cross-guarantees.

⁷⁹ BCBS, Measuring and Controlling Large Credit Exposures, (January, 1991).

Thirdly, the document sets the appropriate level of credit exposure as 25 percent of the total capital base (as defined by the BCBS standards), and suggests reporting of a lower threshold, for example 10 percent. It also calls for careful attention to connected lending, i.e. counterparties with connections to the creditor bank. Fourthly, the document emphasises the need to monitor “clustered” (i.e. over-concentrated) loan books. Finally, it also stresses on paying careful attention to extensive exposure in certain geographic or economic sectors or from extensive exposure in loans. The document, however, did not set out precise definitions of geographic and economic sectors but highlighted the importance of credit risk diversification in this regard to avoid the risks of over-exposure.

A particular type of counterparty risk, which raised a serious concern of the international supervisory community in early 1980s, was country risk. Many developing countries borrowed heavily in the 1970s and early 1980s from developed commercial banks, which lead to an international debt crisis including Mexico's default in 1982.⁸⁰ In 1982, the BCBS issued a document on the management of risks associated with international lending i.e. country risk.⁸¹ Country risk is defined with reference to “[T]he possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfil their foreign obligations for reasons beyond the usual risks which arise in relation to all lending”.⁸² It illustrates that there are many varying causes for country risk such as natural disasters and external shocks, which makes country risk significantly difficult to predict. It is also a difficult risk to measure as its effects may vary from time to time.⁸³

The report recommends guidelines that all banks, despite their size, should apply to their country risk management.⁸⁴ The document stresses on the importance of banks' awareness of potential exposure to country risk and their need to establish a system for country risk assessment that is integrated with their overall risk management processes.

⁸⁰ J. Norton, Financial Sector Law Reform in Emerging Economies, (2000), pp. 264-267.

⁸¹ BCBS, The Management of Banks' International Lending (Country Risk Analysis and Country Exposure Measurement and Control), (March, 1982).

⁸² Ibid. Section I., pp. 1.

⁸³ Ibid. Section I, pp. 1-7.

⁸⁴ Ibid. Section II, pp. 3-8.

The document also emphasises the importance of the measurement of country exposures according to each bank's size and degree of complexity. The measurement should be based on three elements: first, that country exposure should be determined according to where the final risk is, and that there should be allowance for risk reallocation. An example is where there is available liquid collateral from a resident in a jurisdiction other than that of the borrower's. In this case, a bank can usefully make a dual exposure measurement. Secondly, country exposure should be measured on a consolidated basis to allow the bank's management an overall look at the bank's country risk. Thirdly, the document recommends a breakdown of country exposures by borrower country. It should also cover all on and off balance sheet claims. The document also calls for claims to be recorded despite the currency of repayment. Furthermore, the document draws attention to the limitations on offsetting deposits from a certain country against deposits from the same country, as well as, risks raised by off-balance sheet items.

After assessing and measuring country exposures, the document recommends that banks should set a limit on individual country exposures. Although the document does not suggest a specific limit, it recommends that banks should diversify their risks, set safeguards measures such as segregating functions as well as establish monitoring procedures.

The document also addresses four recommendations to banking supervisory authorities. The first one is that supervisors should see whether banks operate a risk assessment system for country risk, devote sufficient resources for this system and ensure that it is efficiently managed. The following recommendation is that supervisors should examine the bank's country exposure management. Banks should have a system, which captures their country exposures with adequate details and allows sufficient diversification of each bank's exposure. Furthermore, supervisors should ensure that banks continuously maintain adequate controls on such exposures. Finally, macro-economic statistics are considered a very useful tool for assessing country risk, and therefore, the report recommends that supervisory authorities should make sure that banks engaged in international lending should have access to these reports.

There were two subsequent country risk crisis. The first one was the crisis which hit the banking sectors in Latin American countries including Mexico, as a result of the high debts combined with the increase of interest rates as well as other political and

monetary factors.⁸⁵ The second one was that the Asian Crisis 1997-8 which hit a number of emerging East Asian countries. It started in 1996 with banking problems in Thailand, which had a contagious effect in the region as foreign investors overreacted to the Thai problem and local economies were vulnerable to sudden changes to capital outflows.⁸⁶

In both the 1994 Mexican Crisis and the Asian Crisis 1997 which, G10 banks incurred significant losses from short-term claims on cross-border counterparties which were denominated in a currency other than the local one. In the Mexico crisis, exposures were dominated by sovereigns and country risk was related to transfer risk, while in the Asian crisis there were public and private counterparties adversely affected by their regional economic conditions. The study issued by the BCBS however⁸⁷ found that there was no reason to impose limits on Interbank exposures, introducing limits on geographical exposures or any other amendment on its above guidelines on large exposures. Likewise, the BCBS found that its guidelines on country risk remain valid.

2.4.3. The Management of Off-Balance Sheet Exposures

In March 1986, the BCBS issued the document 'The Management of Banks' Off-Balance-Sheet Exposures'. This paper examined the then new banking trend of increased exposures in the off-balance sheet, examined the various risks banks are exposed to consequently, and factors banks need to take into account to keep these exposures under control. Finally, and most importantly, the report set three guidelines for supervisory authorities in this regard to make sure that banks are keeping their off-balance-sheet exposures under control.⁸⁸ First, supervisory authorities should keep themselves informed of market developments through open dialogue with banks. Secondly, supervisory authorities should review their supervisory returns' requirement

⁸⁵ Claudio Loser, 'Recent Financial Crisis- Comments from the International Monetary Fund: Recent Financial crisis in Latin America' in IMF (ed), Current Developments in Monetary and Financial Law, Vol. 1 (1999), pp. 99-108.

⁸⁶ Bijan Aghevi, 'Recent Financial Crisis- Comments from the International Monetary Fund: Asian Crisis, Causes and Remedies' in IMF (ed), Current Developments in Monetary and Financial Law, Vol. 1 (1999), pp. 109-114.

⁸⁷ BCBS, Supervisory Lessons to be Drawn from the Asian Crisis, Working Paper No. (2) (June, 1999), by a working group led by Rudi Bonte and participation from Joseph Bisignano and others.

⁸⁸ BCBS, The Management of Banks' Off-Balance-Sheet Exposures, Section V (March, 1986) pp. 14 and 15.

so that all types of financial instruments are captured. Thirdly, supervisory policies should also be put under constant review so that developments in off-balance-sheet business would be taken into account.

The following chapter looks into the substantial development in the BCBS standards on capital adequacy.

CHAPTER 3

CAPITAL ADEQUACY RULES: THE EMERGENCE OF THE DUALITY APPROACH

3.0. Introduction

The previous Chapter covered the establishment of the BCBS and its early endeavours on establishing international banking supervisory standards. It showed that the BCBS set out international standards on the cooperation between supervisory authorities based on the rules of home country control, consolidated supervision and active exchange of information. The BCBS also set out international minimum capital adequacy standards against credit risk in the Capital Accord.

In the 1980s and onwards, banks, particularly in industrialised countries, increased their wholesale and capital markets' activities and became more engaged in complex transactions such as OTC derivatives and securitisation. These developments increased large banks' exposure to market, credit and other risks, and prompted banks to develop their own internal risk based measurement models. Internal models are expensive and require advanced technology and well-trained staff which makes them a more likely choice of large banks. The BCBS flexibly responded to market development by amending the Capital Accord in 1996 to incorporate market risk in capital adequacy measurement, and to allow the application of a dual approach whereby banks are entitled to choose between the application of the traditional standardised approach, and the more advanced internal risk based approach (Section 1). The BCBS later on issued three sets of proposals to change the Capital Accord in order to avoid many of the shortcomings revealed as a result of market developments and the experience of the Asian Crisis 1997-98 (Section 2). The proposals resulted lead to the issuance of new capital adequacy standards known as Basel II. Basel II focuses simultaneously on the measurement and management of capital adequacy and is based on the three reinforcing pillars of capital adequacy, the supervisory process and market discipline. It encompasses operational risk and allows banks a set of options for each of market, credit and operational risks (Section 3).

3.1 Amendments to the Capital Accord

The BCBS introduced in January 1996 three documents for the purpose of incorporating market risk into capital adequacy measurement.¹ The BCBS document ‘Overview of the Amendment to the Capital Accord to Incorporate Market Risks (“1996 Capital Accord Amendment”)’ prescribed capital adequacy rules, to be applied worldwide on a consolidated basis, for market risks arising from open positions in traded equities, commodities and options, traded debt securities as well as in foreign exchange markets. The capital adequacy relation was accordingly amended to accommodate for Tier 3 of regulatory capital to meet market risk to become as follows:²

Capital Ratio According to the Capital Accord Amendment =

$$\frac{\text{Capital}}{\text{Risk Weighted Assets} + [12.5 \times \text{Market Risk Capital Charge}]} \quad (2)$$

Banks were allowed to choose between two methods. The first one was relevant to larger banks which could apply for the first time their own internal models, in our case Value at Risk (“VaR”) models. Internal models can generally be defined as “statistical, computer-based models that calculate the potential change in the value of an instrument or a portfolio from historical changes in market price factors”.³ VaR can be defined at the risk of oversimplification as a representation of the probability of the maximum amount to be lost over a certain holding period. The second one was the standardised approach which applied to less sophisticated banks.

¹ BCBS, Overview of the Amendment to the Capital Accord to Incorporate Market Risks, (January, 1996); BCBS, Amendment to the Capital Accord to Incorporate Market Risks, (January, 1996); BCBS, Supervisory Framework for the Use of “Backtesting” in Conjunction with the Internal Models Approach to Market Risk Capital Requirements, (January, 1996).

² This equation is modelled on: Maximilian Hall, ‘Basel II: Panacea or a Missed Opportunity?’ 2006 Journal of Banking Regulation, Vol. 7 (1/2), pp. 108.

³ BCBS, Report on International Developments in Banking Supervision Report No. 9. (September, 1994), pp. 5.

The standardised method adopted the “building-block” approach, whereby each item of the market risk is calculated separately and then summed arithmetically. This methodology also distinguished between risk stemming from “movements in broad risk factors” on one hand, and “specific risk associated with individual securities positions” on the other hand. Risk categories were; interest rate position risk (for debt instruments), equity position risk (for equity instruments) as well as foreign exchange risk and commodities risk (throughout the bank). A separate section on the treatment of options also provided for possible methods for measuring their risks. This differed from the VaR approach whereby a bank was permitted to produce a single figure as the maximum possible loss on a financial portfolio resulting from market risks. The outcome of VaR measurement is less than the sum of different parts, because in VaR the correlation between risks and currencies is acceptable.⁴

For banks to be entitled to apply internal models, they should satisfy quantitative and qualitative requirements. As to quantitative standards, the Capital Accord amendment required⁵ the following: VaR must be calculated on a daily basis; a 99th percentile and one tailed “confidence interval” should be used in VaR calculation; there should be a minimum “holding period” of ten days, i.e. instantaneous prices shock equivalent to ten days; the choice of ‘historical observation period’ (sample period) for calculating value-at-risk will be restricted to a minimum length of one year; “data sets” should be updated at least once every three months; there was no mandatory “type of model”, providing that the model captured specified risks; it was left to the discretion of competent supervisory authorities to decide whether or not to authorise “correlations” within broad risk categories; internal models must capture the particular risks associated with options; and the daily capital measure should be the higher of either the VaR of the previous day, or the average of the preceding sixty working days, multiplied by at least three. The reason for the minimum three-time “multiplication factor” was to “account for potential weaknesses” in models.⁶

⁴ Matthew Elderfield, ‘Basle Publishes Final Market Risk Capital Standards’ 1996 JIBFL Vol. 11(March), pp. 126.

⁵ BCBS, Amendment to the Capital Accord to Incorporate Market Risks, Ibid (n1) pp. 44-45.

⁶ BCBS, Overview of the Amendment to the Capital Accord to Incorporate Market Risks, Ibid (n1), para. 2.

Another obligatory requirement was “Backtesting,” which is simply a technique for the evaluation of the risk measurement model of banks by comparing actual trading results with those generated by the model, was also made obligatory. A separate document was issued simultaneously by the BCBS setting out the requirements of backtesting and the subsequent procedures.⁷ Most importantly, banks were obliged to add to the multiplication factor, a “plus” factor ranging from zero (where all the results of backtesting were satisfactory and all quantitative and qualitative requirements were met) up to one depending upon the results of the backtesting.

The BCBS was not entirely satisfied with the modelled treatment of “specific risks,” as essential elements of specific risk (such as default or event risk) were generally not captured.⁸ Therefore, these were only allowed if subject to a “floor” of 50 percent of the specific charge applied by the standardised approach for specific risks. The BCBS, however, modified the market risk amendment in 1997.⁹ The 50 percent floor was removed, but only as far as idiosyncratic variations (day-to-day variations not justified by the general market) was concerned. The rationale given for this amendment was the development and innovation in modelling techniques, and adequate similarities in the internal modelling methodologies applied to idiosyncratic variations. The BCBS also took the stand that until a bank demonstrated that its internal model captured event and default risk, it would be subject to a multiplication factor of four (instead of three).

The amendment also specified qualitative requirements for the purpose of permitting banks to apply internal models or become eligible for the minimum multiplication factor. The relevant bank should accordingly have a specialised unit on risk control independent from business trading units.¹⁰ There should also be adequate internal controls and risk management standards. Furthermore, the amendment provided that a programme for “stress testing”¹¹ should be applied routinely and rigorously. The

⁷ This requirement was elaborated in the BCBS, Supervisory Framework for the Use of “Backtesting” in Conjunction with the Internal Models Approach to Market Risk Capital Requirements, Ibid (n1).

⁸ BCBS, Communiqué (12 December, 1995), para. 11.

⁹ BCBS, Explanatory Note: Modification of the Basle Capital Accord of July 1988, as Amended in January 1996, (September, 1997).

¹⁰ BCBS, Amendment to the Capital Accord to Incorporate Market Risks, Ibid (n1) pp. 39-41.

¹¹ Ibid (n1) pp.46-47.

purpose of stress testing is the identification of events and influences, which have a great impact on banks. Its scenarios cover extraordinary portfolios' losses and gains and low probability events in general. This entails subjecting the bank's trading book to hypothetical market shocks such as 200 basis points shift interest rate or the consequences of a coup.¹² Furthermore, there should be routine checks for the compliance of internal controls and an independent review of the risk measurement system.

Finally, as to the definition of capital, the 1996 Capital Accord Amendment authorised banks, upon the discretionary agreement of their supervisory authorities, to issue short-term subordinated debt to meet market risks under what became Tier 3 capital.¹³ Tier 3 capital was subject to four conditions: an original maturity period of at least two years and limited to 250 percent of the Tier 1 capital; it was approved for market risks only; there was a "lock-in" clause that interest and principal may not be paid should this lead to less than the minimum capital ratio; and Tier 2 capital may be substituted for Tier 3 within the same 250 percent limit provided that the 1988 Capital Accord was adhered to. As to the calculation of a bank's overall capital ratio, the amendment created a numerical link between market and credit risk by multiplying market risk by 12.5, (which was the reciprocal of the 8 percent capital ratio in the Capital Accord). The resulting sum would then be added to the figure of risk-weighted assets for credit risk purposes.¹⁴

3.2 Initiatives to Replace the Capital Accord

The implementation of the Capital Accord revealed its shortcomings. Globalization and financial innovation which have taken place since the adoption of Capital Accord multiplied and diversified the risks of the banking system. Yet the Capital Accord provided a fixed measure of capital without recognising the changes in risk profiles or creditors, e.g. it did not differentiate in the assessment of credit risk between variable maturities. The non-differentiation between various types of risk gave

¹² M. Elderfield, *Ibid* (n 4) pp. 126.

¹³ BCBS, Overview of the Amendment to the Capital Accord to Incorporate Market Risks, *Ibid* (n1) para. 26.

¹⁴ *Ibid*, para. 27.

banks an incentive to lend riskier business in their pursuit of higher yield. Meanwhile, the flat rate on the private sector was an incentive to move high quality assets off the balance sheet through securitisation and other methods (capital arbitrage) leaving banks with lower quality loans. The Capital Accord also provided incentives for banks to invest in OECD bonds at the expense of lending to business.¹⁵ The Asian Crisis also highlighted the dangers of correlation between market and credit risks.¹⁶ Calls were accordingly raised to modernise the existing capital framework and make it more comprehensive and risk-sensitive. Furthermore, the Capital Accord did not cover operational risk although it became an increasingly important risk in banking. It did not provide for risk mitigation techniques such as guarantees and collateral as well.

The BCBS realised that the Capital Accord suffered from a number of weaknesses.¹⁷ In the spring of 1999, the 'BCBS Models Task Force' embarked on studying banks' internal rating systems in relation to credit risk. It issued in the same year a report on practices and applications of credit risk modelling, which raised the issue of whether such models could be a basis for measuring regulatory capital.¹⁸ The BCBS found that internal credit models align the regulatory capital more closely to the risks faced by banks. The BCBS, nevertheless, found that there were hurdles to the application of credit rating compared with the application of market risk. First, market instruments are marked to markets and a few days' holding-period is typically used in market risk models. Conversely, credit instruments are not usually marked to market and therefore they rely heavily on historical data to project potential risks. However, there is a problem of scarcity of data on the historical performance variables such as loans, which might eventually impair the model's ability to capture default probability. This problem is heightened by the infrequency of default, which leads to a need for longer time horizons covering a number of cycles. Therefore, model-builders rely more on proxy data and simplified assumptions. Secondly, the longer time horizons (a year at least) creates a problem of model validation, i.e. the assessment of the precision of these

¹⁵ Jan H. Dalhuisen, Dalhuisen on Transnational and Comparative Commercial, Financial and Trade Law, (2007), pp. 1262.

¹⁶ BCBS, Supervisory Lessons to be Drawn from the Asian Crisis, Working Paper No. (2) June 1999, by a working group led by Rudi Bonte and participation from Joseph Bisignano and others. pp. 14.

¹⁷ BCBS, A New Capital Adequacy Framework, Consultative Paper, (June, 1999), paras. 6-8.

¹⁸ BCBS, Credit Risk Modelling: Current Practices and Applications, (April, 1999).

models in delineating credit risk. It is noteworthy to refer here to the banking industry views on the BCBS assessment.¹⁹ The industry agreed that data problems make model estimates more difficult to attain accuracy. Some respondents opposed the implicit hint that there can be an equivalent to backtesting of market risk models to be applied on credit risk models.

The BCBS launched successive proposals to amend the Capital Accord, which were reviewed in light of qualitative impact studies.²⁰ The first proposal was launched in 1999.²¹ The second proposal was envisaged that it would be finalised by 2002, and implemented by 2005.²² However, a third round of consultation took place in 2003 and the ultimate date for implementation is scheduled to take place by end 2006.²³

3.3. Basel II

On 26 June 2004, the BCBS released its new capital adequacy framework for banks, 'International Convergence of Capital Measurement and Capital Standards', better known as ("Basel II").²⁴ Whereas the Capital Accord focused on the amount of capital, Basel II focuses on the measurement and management of capital. The Capital Accord covered only credit and market risks by providing a flat 8 percent rate of risk

¹⁹ BCBS, Summary of Responses Received on the Report Credit Risk Modelling: Current Practices and Applications, (May, 2000).

²⁰ This package covers the following BCBS documents: The New Basel Capital Accord, January 2001, and seven further explanatory documents: The Standardised Approach to Credit Risk, January 2001; The Internal Ratings-Based Approach, January 2001; Asset Securitisation, January 2001; Operational Risk, January 2001; Pillar 2 (Supervisory Review Process), January 2001; Principles for the Management and Supervision of Interest Rate Risk, January 2001; Pillar 3: Market Discipline, January 2000 and Overview of the New Basel Capital Accord, January 2001.

²¹ BCBS, A New Capital Adequacy Framework, Consultative Paper, (June, 1999).

²² BCBS, Press Release, Update on the New Basle Capital Accord, (25 June, 2001).

²³ The source of information on the third consultative paper depends heavily on: BCBS, Overview of the New Basel Capital Accord, (April, 2003).

²⁴ References to Basel II in this Thesis are made to the Comprehensive Version issued by the BCBS in June 2006. This document is a compilation of the June 2004 Basel II Framework, the elements of the former 1988 Capital Accord that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to Incorporate Market Risks, and the November 2005 paper on Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework.

It is noteworthy that the BCBS is undertaking consultations to improve Basel II. See: BCBS, Proposed Enhancements to the Basel II Framework, (January, 2009).

weighted assets according to broad categories of borrowers. Basel II, by contrast, covers credit, market and operational risks. Basel II also seeks to better align capital adequacy requirements to actual risks. In order to do so, it defines risks according to credit rating bureaus or alternatively it gives greater freedom to individual banks to assess their own capital after taking account of risks. Under Basel I banks could choose between two market risk methodologies, while under Basel II banks are given options, with the supervisor's approval, for methodologies employed for the calculation of capital adequacy against the three types of risks. This provides institutions with the opportunity to adopt the approaches most appropriate to their situation and to the sophistication of their risk management leading to a degree of self regulation. (*Table 1* illustrates the continuum of approaches permitted to banks under the three types of risks). Furthermore, Basel II permits wider recognition of risk mitigation methods such as collateral, guarantees, credit derivatives and securitisation. The aim of capital reduction for these risk mitigants was to provide an incentive for banks to improve their risk management,²⁵ while stressing on the imposition of operational standards.

Unlike the Capital Accord which covered only regulatory capital, Basel II is comprised of three pillars; namely, minimum capital requirements, supervisory review and market discipline. The second pillar is concerned with the supervisory review process by national regulators for ensuring comprehensive assessment of the risks and capital adequacy of their banking institutions. The third pillar provides international norms for disclosure by banks of key information regarding their risk exposures and capital positions and aims at improving market discipline.

Basel II is therefore a more complex document comprised of 333 pages. Its complexity demands resources from countries seeking to understand and appropriately transpose it into their regulation. To make this task easier, the Basel II document contains the annex on the "Simplified Standardised Approach" which is a collection of the simplest approaches for calculating capital adequacy (and not an alternative approach for the calculation of capital adequacy).²⁶ The BCBS initially decided that the

²⁵ BCBS, Overview of the New Basel Capital Accord, Ibid (n 20), executive summary para. 13.

²⁶ BCBS, Basel II, pp. 322-333 particularly footnote number 256 on page 322.

standardised and foundation approaches would be implemented from year-end 2006 then extended the date another year.²⁷

3.3.1 Scope of Application

Basel II applies on a fully consolidated basis to international banks "to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing".²⁸ Its scope of application is extended on a consolidated basis to cover any parent holding company of a banking group (i.e. any group which mainly undertakes banking activities), and on sub-consolidated basis to international banks at every Tier within the banking group.²⁹ Basel II should also be applied, as a general rule and to the extent possible, to banking and other financial activities undertaken within a group containing an internationally active bank. The definition of financial activities within this context covers portfolio management, financial leasing, issuing credit cards, investment advisory, and other activities ancillary to banking excluding insurance. The majority owned or controlled financial companies and banks within a group will be consolidated for capital adequacy requirements as a general rule.³⁰

Three items should be deducted from capital: majority-owned securities and other financial subsidiaries which are not consolidated for capital purposes;³¹ significant minority investments in banking, securities and other financial entities (as a general rule.);³² and any cross-shareholdings used for the purpose of artificially improving the capital position of the bank.³³

²⁷ BCBS, Consensus Achieved on Basel II Proposals, Press Release (11 May, 2004).

²⁸ BCBS, Basel II, main text para. 20.

²⁹ Ibid, main text para. 21-22.

³⁰ Ibid, main text para. 23 – 25 and footnotes.

³¹ Ibid, main text para. 27.

³² Ibid, main text para. 28.

³³ Ibid, main text para. 29.

3.3.2 The Three Pillars of Basel II

Basel II is comprised of three pillars: capital adequacy, the supervisory review process and market discipline.

3.3.2.1 Pillar 1: Capital Adequacy

Capital adequacy charges cover the three types of credit, operational and market risks. The overall minimum capital adequacy measurement covers: (1) the credit risk requirements including the credit counterparty risk on OTC derivatives both in the banking and trading books, but with the exclusion positions in commodities and debt and equity securities in the trading book; (2) capital charges for operational risk; and (3) capital charges for market risk.³⁴

Basel II measures the capital adequacy ratio according to the following relation:³⁵

$$\text{Capital Ratio under Basel II} = \frac{\text{Capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}} \quad (3)$$

Basel II retains major elements of the Capital Accord including the requirement for banks to hold total capital equivalent to at least 8 percent of their risk-weighted assets. The definition of eligible regulatory capital is determined by large according to the Capital Accord, and as clarified by the BCBS 1998 press release on 'Instruments Eligible for Inclusion in Tier 1 Capital'.³⁶

Capital is comprised of the following tiers:

- Tier 1 (core capital).

³⁴ Ibid, main text para. 701(v).

³⁵ Maher Hasan, 'The Significance of Basel 1 and Basel 2 for the Future of the Banking Industry with Special Emphasis on Credit Information' 2002 *اتحاد المصارف العربية*, pp. 87.

³⁶ BCBS, *Basel II*, main text para. 41 and Annex Ia.

- Tier 2 (supplementary capital)³⁷ with the latter component not exceeding 100 percent of the former.
- Tier 3 capital: Banks are also entitled, at the discretion of their national authority, to use short-term subordinated debt covering market risk. They have in this case to meet certain conditions including that Tier 3 capital will be confined to 250 percent of a bank's Tier 1 capital. In addition, Tier 2 capital may not exceed total Tier 1 capital while long-term subordinated debt must at a maximum be 50 percent of Tier 1 capital.³⁸

Finally, Basel II provides for three types of deductions from the capital base for the purpose of calculating the risk-weighted capital ratio; namely goodwill, increase in equity capital ensuing from a securitisation exposure, and investments in subsidiaries which are engaged in banking and financial activities and are not consolidated.³⁹ The holdings of other banks' capital instruments can be deducted provided that they will bear a risk weight of 100 percent.⁴⁰

1. Credit Risk

Basel II introduces fundamental changes to credit risk assessment. It allows banks to choose between different approaches. The first approach is the Standardised Approach where banks assess their own risk with the support of external credit assessment institutions recognised as eligible by national supervisors in accordance with the criteria defined in Basel II.⁴¹ The eligibility criteria cover the objectivity of the assessment methods; the independence of the credit institution and the assessment process; availability and transparency of assessments and assessments methodology to domestic and international markets; disclosure of the assessment methodology, and the sufficiency of the bank's resources to carry out high standard assessments, as well as the

³⁷ Tier 2 capital is comprised of undisclosed reserves; evaluation reserves; general provisions or general loan-loss reserves; hybrid debt capital instruments; and subordinated term debt

³⁸ BCBS, Basel II, main text para. 49(xiii).

³⁹ *Ibid*, main text para. 49(xv).

⁴⁰ *Ibid*, main text para. 49(xvi) and (xvii).

⁴¹ *Ibid*, main text para. 50 and 52.

credibility of the credit institutions.⁴² The other approach is the Internal Risk-Based Approach (“IRB”) where banks' assessments are employed in the calculation of capital with the *explicit* approval of their supervisory authority.⁴³

Table 1: Menu of Approaches Adopted By Basel II

Credit risk

- √ Standardised Approach (a modified version of the existing approach)
- √ Foundation Internal Based Approach
- √ Advanced Internal Rating Based Approach

Market risk

- √ Standardised Approach
- √ Internal Models Approach

Operational risk

- √ Main Indicator Approach
- √ Standardised Approach
- √ Internal Measurement Approach

A. The Standardised Approach

The standardised approach is an amplification of the Capital Accord in that it categorises risks according to the borrower type: sovereigns and their central banks, non-central government public sector entities (“PSEs”), multilateral development banks, banks, securities firms, corporates, retail portfolios, claims secured by residential

⁴² Ibid, main text para. 90.

⁴³ Ibid, main text para. 51.

property, claims secured by commercial real estate, past due loans, higher-risk categories, other assets such as securitised exposures, and off-balance sheet items. A significant development in Basel II is that risk weights are determined by external ratings. Standard & Poor's ratings are applied by Basel II (though an equivalent rating might also be used by banks).⁴⁴ In the case of corporate exposures, banks may exceptionally refrain from using credit ratings, but they need to assign a 100 percent risk weighting to unrated loans. Afterwards, banks determine the eligibility and effect of credit risk mitigation techniques (such as collateral and guarantees). The exposure amount (after risk mitigation and net of specific provision)⁴⁵ should be multiplied by specified risk weights. Claims related to securitisation exposures are dealt with under a separate section.⁴⁶

Claims on sovereigns and their central banks: The credit risk will be weighted as follows:⁴⁷

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

Supervisors may by way of exception allow their sovereign a lower risk rating for credit exposures denominated in the domestic currency.⁴⁸ Furthermore, supervisors may identify the country risk scores according to the credit ratings of eligible Export Credit Agencies (instead of applying rigid pre-determined categories),⁴⁹ which correspond to the following categories:

⁴⁴ Ibid, main text para. 50 and accompanying footnote 14.

⁴⁵ Ibid, main text para. 52.

⁴⁶ Transactions exposing banks to counterparty credit risk (i.e. the risk of counterparty default before the final settlement of the underlying transaction cash flow). These transactions are OTC and securities financing transactions such as repurchase agreements, reverse repurchase agreements, and margin lending and borrowing.

See: Main text para. 52 and accompanying footnotes 15 and 16.

⁴⁷ Ibid, main text para. 53.

⁴⁸ Ibid, main text para. 54.

⁴⁹ Ibid, main text para. 55.

Risk Scores	0-1	2	3	4-6	7
Risk Weight	0%	20%	50%	100%	150%

In addition, claims on the Bank for International Settlements, the European Central Bank and the European Community and the International Monetary Fund may receive a 0% credit risk weight⁵⁰

PSEs: The BCBS applies a flexible approach as it allows the regulatory authority to apply either of the options applicable to banks as illustrated below, or the risk weighting applicable to the Central Governments.⁵¹ The simplified standardised approach proposes the following optional classification for PSE:

"-Regional governments and local authorities could qualify for the same treatment as claims on their sovereign or central government if these governments and local authorities have specific revenue-raising powers and have specific institutional arrangements the effect of which is to reduce their risks of default.

- Administrative bodies responsible to central governments, regional governments or to local authorities and other non-commercial undertakings owned by the governments or local authorities may not warrant the same treatment as claims on their sovereign if the entities do not have revenue raising powers or other arrangements as described above. If strict lending rules apply to these entities and a declaration of bankruptcy is not possible because of their special public status, it may be appropriate to treat these claims in the same manner as claims on banks.

- Commercial undertakings owned by central governments, regional governments or by local authorities might be treated as normal commercial enterprises. However, if these entities function as a corporate in competitive markets even though the state, a regional authority or a local authority is the major shareholder of these entities, supervisors should decide to consider them as corporates and therefore attach to them the applicable risk weights".⁵²

Multilateral development banks: Their ratings are, in general, based on external credit assessments according to the second option for claims on banks. Highly

⁵⁰ Ibid, main text para. 56.

⁵¹ Ibid, main text para. 56-58.

⁵² Ibid, Annex 11: The Simplified Standardised Approach, pp. 323 footnote 260.

rated banks are assigned a zero risk weight, such as the European Investment Bank, for example.⁵³

Corporates: The following risk weights are applied to the credit risk assessment of claims on corporates:⁵⁴

Credit Assessment	AAA to AA-	A+ to A-	BBB+ To BB-	Below BB-	Unrated
Risk Weight	20%	50%	100%	150%	100%

Banks and securities companies: Basel II provides the supervisory authorities with two alternative options. One option is that all banks are given one category less than the one assigned to claims on their sovereign. The other option is to adopt the credit rating assessment of the bank itself, while assigning a 50 percent credit weighting to unrated banks. Short-term claims (original maturity of three months or less) of banks weighted below 150 percent are given preferential treatment of one higher category, subject to a floor of 20 percent.⁵⁵ Securities companies are treated like banks if they are subject to regulatory arrangements comparable to Basel II, otherwise they are treated similarly to corporates in general.⁵⁶

Claims included in the regulatory retail portfolios: They are assessed on a portfolio basis. They must meet four criteria in order to be eligible under this criterion and carry a risk weight of 75 percent.⁵⁷ Claims should be extended to individuals or to a small business (the orientation criterion); be of a certain type such as student loans, auto loans and credit cards but excluding securities and residential mortgages (client criterion); be well diversified (granularity criterion) and be of low value whereby the aggregate individual exposure does not exceed €1m.

⁵³ Ibid, main text para. 59 and footnote 24.

⁵⁴ Ibid, main text para. 66.

⁵⁵ Ibid, main text para. 60-64.

⁵⁶ Ibid, main text para. 65.

⁵⁷ Ibid, main text para. 69-70.

Claims secured by real estate: They have a risk weight of 100 percent of secured loans, while claims fully secured by residential property are more favourably risk weighted at 35 percent.⁵⁸

Past due loans: Basel II differentiates between the risk weightings of residential mortgage loans and other types.⁵⁹ Unsecured past due residential mortgage loans for 90 days or more have a risk weighting of 100 percent net of specific provisions. The latter risk weighting becomes 50 percent if specific provisions amount to 20 percent or more of the outstanding loan. By contrast, unsecured past due non-residential mortgage loans for 90 days or more have a higher risk weighting of 150 percent of its risk weight if less than 20 percent of the outstanding loans are covered by specific provisions. The risk weight is reduced to 100 percent if the specific provisions cover 20-50 percent of the outstanding loan and 50 percent if the specific provisions cover 50 percent or more of the outstanding loan.

Higher risk categories: Basel II numerates four types of higher risk categories.⁶⁰ First, claims on sovereigns, PSEs, banks and securities firms rated below B-. Secondly, claims on corporates rated below BB-. Thirdly, unsecured past due non residential mortgage loans for 90 days or more. Fourthly, securitisation tranches which are rated between BB+ and BB-. All of the mentioned categories are rated at 150 percent except the mentioned securitisation tranches, which are risk weighted at 350 percent. Finally, supervisory authorities have the discretion to apply higher risks to other assets.

Other assets: Cash carries only a zero percent risk weight. Gold, at national supervisors' discretion, may carry the same weighting. Cash in the process of collection is weighted at 20 percent. The standard risk weight for all other assets (without securitization exposure) is 100 percent.⁶¹

⁵⁸ Ibid, main text para. 72 and 74.

⁵⁹ Ibid, main text para. 75-78.

⁶⁰ Ibid, main text para. 79-80.

⁶¹ Ibid, main text para. 81 and footnote 32.

Off-balance-sheet items: These items are categorised then transformed into their credit exposure equivalents by multiplying them by the credit factors illustrated in (Table 2).⁶²

Table 2: Treatment of Off-balance Sheet Items under Basel II

Item	Credit Conversion factor (%)
Commitments with a maximum original maturity of one year.	(20%)
Commitments with an original maturity exceeding one year.	(50%)
Commitments which are unconditionally cancellable by the bank without prior notification, or which effectively provide for automatic cancellation because the borrower's credit worthiness has deteriorated.	(0%)
Direct credit substitutes such as acceptances and general guarantees of indebtedness (including standby letters of credit which provide financial guarantees for securities and loans).	(100%)
Asset sales with recourse and sale and repurchase agreements, whereby the bank bears the credit risk.	(100%)
The lending of banks' securities or banks' posting of securities as collateral.	(100%)
Forward deposits, forward asset purchases, as well as, well as partly-paid shares and securities.	(100%)
Specific transaction-related contingent items (such as performance bonds, warranties and bid bonds).	(50%)
Revolving underwriting facilities (RUFs) and Note issuance facilities (NIFs).	(50%)
Self-liquidating short-term trade letters of credit arising from the movement of goods such as documentary credits collateralised by the underlying shipment.	(20%)

B. The IRB Approach

The purpose of the IRB approach is to resolve banks' credit loss distribution, which combines probabilities and losses. It is based on the measurement of banks' expected and unexpected losses.⁶³ It identifies first the expected losses, which determine

⁶² Ibid, main text paras. 82-85.

⁶³ Ibid, main text para. 212.

the amount of provisions to be set aside by banks. Meanwhile, the inclusion of general provisions (or general loan-loss reserves) in Tier 2 capital under the Capital Accord does not exist under the IRB approach specifically (not the standardised approach).⁶⁴ Banks using the IRB approach compare the two elements of ‘total eligible provisions’ and ‘total expected losses’. In cases where expected losses surpass provisions, the difference may be deducted from capital equally distributed between Tier 1 and Tier 2. If the provisions are more than the expected losses, banks may recognise the difference under Tier 2 capital subject to an upper limit of 0.6 percent of risk-weighted assets⁶⁵. The method finally adopted by the BCBS is illustrated in the following relation:⁶⁶

$$\text{Capital Ratio (IRB)} = \frac{\text{Capital} + (\text{provisions} - \text{Expected Losses})}{\text{Unexpected Losses} \times 12.5} \geq 8\% \quad (4)$$

The IRB approach determines exposures by capitalising on the advancement of large banks’ internal risk management systems.⁶⁷ It is based on three inter-related risk components. The first component is the probability of default (“PD”), i.e. the possibility that a debt will not be paid back. Default is defined as the occurrence of at least one of two events. The first event is a subjective one as it refers to the bank’s opinion on the obligor’s ability to fully pay its credit obligations without the bank having to resort to actions such as realising security. The other event is that the obligor is in default or past due for more than 90 days.⁶⁸ The second component is loss given default (“LGD”), which is an estimate of how much a bank will lose in case of borrower’s default, expressed as a percentage of its exposure. The third component is exposure at default (“EAD”), which represents the money owed at the time of default. An additional possible element is Maturity.⁶⁹ Effective maturity is generally determined under the

⁶⁴ Ibid, main text paras. 42-43.

⁶⁵ Ibid, main text para. 43.

⁶⁶ Ryozo Himino, ‘Basel II – Towards a New Common Language’ 2004 BIS Quarterly Review, (September), pp. 45.

⁶⁷ Nout Wellink, ‘Basel II and Financial Institution Resiliency: Remarks by Dr Nout Wellink’ delivered at the Risk Capital 2007 Conference, Paris, 27 June. 2007, pp. 1.

⁶⁸ BCBS, Basel II, main text para. 452.

⁶⁹ Ibid, main text 318-319.

foundation approach and assumed under the IRB approach to be 2.5 years. Expected losses are expressed according to the under relation:⁷⁰

$$EL = PD \times LGD \times EAD \quad (5)$$

The IRB approach is divided into two categories. First, the Foundation Approach, where the PD is provided by banks while the supervisory authority provides the other elements of LGD, EAD and probably Maturity. PD can be estimated by using external credit rating agencies such as Moody's Investors Service, or Standard and Poor's for estimating PDs from historical default experience. Secondly, the Advanced Approach, whereby banks supply not only PD but also LGD, EAD and Maturities, which is an expensive and onerous task, but has the potential benefit of reducing capital requirements. Therefore, the Advanced Approach is the expected choice and advantage of large complex banks over smaller ones.

Exposures of the banking-book (i.e. loaning book) under both IRB approaches are categorised into broad classes of assets, namely corporate, sovereign, bank, retail, and equity.⁷¹ Basel II determines the credit risk for the unexpected losses of each of the mentioned categories.

There are two major differences between the standardised approach and the IRB approach in the treatment of corporates. First, concessionary treatment is given to small and medium-sized entities ("SMEs") under the IRB approach.⁷² SMEs are defined as "corporate exposures where the reported rates for the consolidated group of which the firm is a part is less than €50 million."⁷³ Secondly, the IRB approach creates a sub-category for "specialised lending", to mainly address exposures to Special Purpose Entities ("SPEs"). SPEs are created as financing vehicles, which buy bank's exposures in return for cash or debt originated thereby. Therefore, SPEs differ from commercial

⁷⁰ Hugh Thomas and Zhiqiang Wang, 'Interpreting the Internal Ratings-Based Capital Requirements in Basel II' 2005 *Journal of Banking Regulation* Vol. 6(3), pp. 285.

⁷¹ BCBS, *Basel II*, main text para. 215.

⁷² *Ibid*, Annex 5, and main text paras. 278-279.

⁷³ *Ibid*, main text para. 273.

corporate, which have the wider capacity to generate income.⁷⁴ Specialised lending itself is subdivided into five categories.⁷⁵

1. Project finance, which is usually used for mines, power plants and other expensive transactions, whereby the lender depends mainly on the project revenues for repayment and security.
2. Object finance is used for financing acquisition of assets such as aircrafts where the generated cash flows are usually assigned or pledged to the lender.
3. Commodities finance, which is structured short term lending for the purpose of funding inventories, receivables, or reserves of crude oil and other exchange-traded commodities.
4. Income-producing real estate, which differs from collateralised real estate in that the prospect of repayment depends on the income generated by funded real estate.
5. High-volatility commercial real estate, which exhibits higher asset price volatility compared with the other types of specialised lending.

Banks may apply their foundation or IRB estimates to all categories of specialised lending with the exception of high volatility commercial real estate. Banks which cannot apply their own estimation of PD must map their risk grades into five criteria (strong, good, satisfactory, weak and default).⁷⁶ A risk weighting is assigned to each category with a higher weight assigned to the category of high volatility commercial real estate.⁷⁷

⁷⁴ Ibid, main text para. 219 read together with para. 552.

⁷⁵ Ibid, main text paras. 220-228.

⁷⁶ Ibid, Annex 6, pp. 280-297.

⁷⁷ Ibid, main text paras. 249-251.

Capital charge for equity⁷⁸ exposures held in the banking book for long term (as opposed to short term holdings in the trading book) is treated differently under the IRB approach⁷⁹. IRB banks may follow one of two different approaches. The first one is the PD/LGD approach, which is similar to the general IRB foundation approach, but banks are subject to 90 percent LGD and a risk weight of 100 percent. The second approach provides banks with the opportunity to use their internal models to measure the market value of their equity over a quarterly holding period. A simplified version of the latter approach is also permitted, where the risk weight of 300 percent is applied to equities traded in recognised securities markets and a higher 400 percent rating is applied to other equity.

Retail exposures under the IRB approach are also treated on a pooled basis, but need to be divided into three risk weight functions of residential mortgage exposures, qualifying revolving retail exposures and other exposures.⁸⁰

C. Operational Requirements for the IRB Approach

Basel II sets out minimum operational requirements for banks applying the IRB approach upon authorisation and on-going basis. The underlying goal of these principles is to ensure that bank's internal ratings are applied to properly assess risks and not to minimise regulatory capital. This entails providing meaningful assessments of borrowers, meaningful differentiation of risks as well as consistency and reasonable accuracy of risk estimates.⁸¹

First, banks must demonstrate their compliance with the minimum requirements of Basel II and subsequent relevant requirements issued by the BCBS,⁸² including the design of each "rating system" it uses for its internal ratings.⁸³

⁷⁸ Equity includes direct and indirect ownership interest in the assets and income of an enterprise. It should be irredeemable before liquidation, does not impose an obligation on the issuer and conveys a residual claim on the holder.

Source: *Ibid.*, main text para. 235.

⁷⁹ *Ibid.*, main text paras. 340-361.

⁸⁰ *Ibid.*, main text para. 326.

⁸¹ *Ibid.*, paras. 388-389.

⁸² *Ibid.*, para. 392.

The design of the rating system encompasses six elements. First, the rating dimensions. For example, the corporate, sovereign, and bank exposure should have two dimensions; one for borrower default and one for transaction-specific factors such as seniority and product type.⁸⁴ As for retail exposures, they are grouped into pools of exposures. The rating system here should also encompass borrower and transaction risks, and demonstrate that the group is homogenous to ensure that it is an accurate estimation of losses at a pool level.⁸⁵ Secondly, the rating structures, whereby banks should have borrower grades for corporate, sovereign, and bank exposures, which are based on the specific criteria of their risks. Exposures then should be meaningfully distributed across grades on both its facility-rating scales and its borrower ratings. Similarly, there should be distribution of borrowers and exposures for pooled retail exposures.⁸⁶

Thirdly, there is the issue of the rating criteria. Banks should have specific criteria for assigning exposures to grades within the rating system. The criteria must be intuitive, plausible and lead to meaningful differentiation of risk.⁸⁷ Fourthly, banks are expected to use more than one year as their time horizon for the assessment of their ratings (despite that the time used in PD estimation is one year).⁸⁸ Fifthly, statistical models and other mechanical methods, such as credit scoring, are permissible for assigning rates to exposures and may be utilised for the estimation of loss, provided that there is also human judgment and supervision.⁸⁹ Finally, banks need to document their

⁸³ Basel II defines the term "rating system" as one that "comprises all of the methods, processes, controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates".

Source: *Ibid*, para. 394.

⁸⁴ *Ibid*, main text para. 396.

⁸⁵ *Ibid*, main text para. 401.

⁸⁶ *Ibid*, main text paras. 403-409.

⁸⁷ *Ibid*, main text para. 410.

⁸⁸ *Ibid*, main text para. 414.

⁸⁹ *Ibid*, main text para. 417.

rating systems' design and operational details. These documents should prove that banks comply with the BCBS minimum requirements for the IRB approach.⁹⁰

The following IRB criterion concerns the risk rating system operations. The rating system should cover exposures and possess integrity. Ratings assigned to corporates, for example, should cover borrowers, guarantors and associate exposures with a facility rating, as well as regularly refreshed and reviewed by an independent party. Banks should also have guidelines for the procedures where the human judgment may override the outputs of a rating process. Furthermore, banks should maintain data on facility characteristics and key borrowers to support their credit risk management. Finally, IRB banks should implement stress testing processes for their capital adequacy assessments. Stress testing encompasses the identification of general future economic conditions, which might adversely affect the banks' credit exposures as well as specific conditions.⁹¹

Another operational criterion is the use of internal ratings. Basel II stresses that rating systems should not be used by banks merely as a tool to qualify for the IRB approach, but rather become an indispensable ingredient in the risk management, credit approval, corporate governance and internal capital allocations functions of qualified banks.⁹²

There are also detailed operational requirements for risk quantification. The general rule is that internal estimates of PD, LGD, and EAD should incorporate all relevant information, data and methods. They also need to be based on empirical evidence and historical experience and subject to regular review at least annually. In order to avoid unpredictable erroneous over-estimates, banks must introduce to its estimates a margin of conservatism.⁹³ Banks should also implement a system to validate

⁹⁰ Ibid, main text para. 418.

⁹¹ Ibid, main text paras. 422-437.

⁹² Ibid, main text para. 444.

⁹³ Ibid, main text paras. 446-451.

the consistency and accuracy of its internal rating and risk estimation systems. They should also compare their realised default rates with their estimation of PD.⁹⁴

D. Credit Risk Mitigation (“CRM”)

Basel II has increased the range of credit risk mitigation techniques eligible for deduction from credit risk. It covers collateral, netting as well as guarantees extended by third parties and their equivalents such as credit derivatives. Before embarking on discussing each CRM, Basel II makes important general remarks. First, a transaction using a CRM technique cannot have a risk weighting higher than a similar transaction in which no CRM is used. Secondly, the effects of CRM should not be double counted for capital adequacy purposes. Thirdly, Basel II draws the attention of the supervisory authority to the potential of CRM techniques to raise operational and other risks although they reduce credit risk.⁹⁵

I. Collateral

Basel II allows the application of two methods to measure the risk weight of collateral under the standardised approach, the simple approach and the comprehensive approach in the banking book, while the comprehensive approach is only permitted in the trading book. Maturity mismatch between the exposure and collateral is permissible only under the comprehensive approach, while partial collateralisation is allowed in both approaches.⁹⁶

All collateral must meet a minimum list of requirements. First, legal certainty i.e. collateralised documents must be binding on their parties and enforceable.⁹⁷ Secondly, the bank must be able to liquidate the collateral upon default, insolvency or bankruptcy. Thirdly, banks must follow all procedures needed to maintain the collateral.⁹⁸ Fourthly, the value of the collateral and the credit quality of the counterparty must not have a material positive correlation (e.g. collateral must not be

⁹⁴ Ibid, main text para. 500-501.

⁹⁵ Ibid, main text paras. 113-118.

⁹⁶ Ibid, main text para. 121.

⁹⁷ Ibid, main text para. 123, read in conjunction with paras., 117-118.

⁹⁸ Ibid, main text para. 123.

securities issued by the debtor).⁹⁹ Finally, banks should have well established procedures for timely liquidation of collateral.¹⁰⁰

The instruments eligible for treatment as collateral are cash, including certificates of deposits; gold; debt securities rated at least BB- if issued by sovereigns, at least BBB- when issued by other entities or A-3/P-3 for short term instruments; senior debt securities issued by banks and listed on a recognised exchange whether related or not, provided that they are not rated below or believed to justify a rating below A-3/P-3; equity included in a main index; and units in mutual funds or collective investments in transferable securities where prices are publicly quoted on a daily basis, and their investments are themselves eligible as collateral.¹⁰¹ Equities which are not included in the main index but are listed on recognised exchanges as well as funds and collective investments in such equities are eligible as collateral only under the comprehensive approach.¹⁰²

Under the simple approach, a claim is divided into a collateralised part (by one or more types of collateral) and the unsecured part. For the collateralised part, the value of the collateral is multiplied by the risk weight of the issuer e.g. the risk weight of the company issuing the security used as collateral.¹⁰³ In most cases a 20 percent floor is imperative because risk may still persist despite collateral and due to possible difficulties with enforcing collateral.¹⁰⁴ Under this approach the collateral must be pledged during the life of the exposure, revalued biannually and be marked to market.¹⁰⁵

As to the comprehensive approach, the value of the exposure to counterparty and the value of the posted collateral are both adjusted so as to reflect possible fluctuations in their values. Here the risk weighted assets represent the difference between the

⁹⁹ Ibid, main text para. 124.

¹⁰⁰ Ibid, main text para. 125.

¹⁰¹ Ibid, main text para. 145.

¹⁰² Ibid, main text para. 146.

¹⁰³ Ibid, main text para. 121.

¹⁰⁴ Philip Wood, Regulation of International Finance, (2007), pp. 639.

¹⁰⁵ BCBS, Basel II, main text para. 182.

volatility-adjusted exposure amount and the adjusted collateral amount multiplied by the risk weight of the counterparty.¹⁰⁶ The haircuts under the comprehensive approach can be calculated either by imposing standard supervisory haircuts laid down by Basel II or implementing the banks' own estimates of haircuts. A bank may apply either method whether it is following the standardised or foundation IRB approach to credit risk.¹⁰⁷

Banks applying the foundation IRB approach may reduce their credit risk with the same financial collateral eligible under the standardised approach in addition to other precise forms such as specified commercial real estate. Similar operational requirements are also applied to both of the foundation IRB and the standardised approaches. The risk weight of IRB collateral is however similar to that of the comprehensive approach to collateral, and banks applying the IRB approach may not use the simple approach.¹⁰⁸

II. Netting

Basel II recognises netting¹⁰⁹ as a means of mitigating banks' credit risk. Accordingly, the net exposure of loans and deposits is the basis for measuring capital charges. These charges must be measured similarly to collateral, whereby liabilities (deposits) are treated as collateral and assets (deposits) are treated as exposures. Basel II, however, sets out that on-balance sheet netting should have a sound legal basis to ensure the enforceability of netting in relevant jurisdictions irrespective of whether the counterparty is insolvent or bankrupt. Therefore, banks should be aware of the differences in jurisdictions in this regard. The bank must be able to determine clearly assets and liabilities with the same counterparty and which are subject to the netting agreement. Finally, the bank must monitor the related risks and the net exposures robustly.¹¹⁰

¹⁰⁶ Ibid, main text paras. 130,132.

¹⁰⁷ Ibid, main text para. 134.

¹⁰⁸ Ibid, main text paras. 289-290.

¹⁰⁹ The term netting is used widely here to encompass both netting and offsetting despite technical legal difference. For more details on netting generally, see Philip Wood, Set-off and Netting, Derivatives, Clearing Systems. (2007). pp. 3-23.

¹¹⁰ BCBS, Basel II, main text para. 188.

III. Guarantees

There are two methods of measuring the effect of guarantees: the standardised approach and the internal rating based approach. Under the standardised method,¹¹¹ a guarantee must satisfy a minimal list of requirements and the guarantor must be of a particular type in order to qualify as a risk mitigant: it must have legal certainty so as to be binding on all parties and be enforced in all relevant jurisdictions;¹¹² it should represent a direct claim on the guarantor and the extent of the cover must be clearly defined and incontrovertible; it must be unconditional as well as irrevocable (i.e. the guarantor cannot unilaterally cancel the guarantee or increase the cost of the cover); in case of counterparty default, the bank must be able to pursue the guarantor for outstanding amounts without having first to take legal action against the obligor; it needs to be explicitly documented, therefore, oral commitments and comfort letters do not count as eligible guarantees;¹¹³ it must cover principle and other payments of the obligor such as margins and interest. If the guarantee is confined to the principle, uncovered payments should be considered unsecured; and eligible guarantors are sovereigns, PSEs, securities firms and banks which risk weights are lower than the counterparty as well as other entities rated at least A- including sister companies, which have lower risk weights than the counterparty.¹¹⁴

The risk weights of exposures in this approach are counted similarly to collateral, i.e. by splitting the exposure to, first, guaranteed portion where the risk weight of the guarantor replaces the risk weight of the counterparty; and, secondly, the unsecured part which retains the risk weight of the counterparty.¹¹⁵

As to the internal based approach, it is subdivided into two types: the foundation approach, which mirrors the standardised approach for credit risk in that all inputs are supplied by the bank except LGD, and the advanced approach, which includes banks' own estimation of LGD.

¹¹¹ Ibid, main text paras. 189-190.

¹¹² Ibid, main text para. 190 read with main text paras. 117-118.

¹¹³ Philip Wood, Regulation of International Finance, (2007) pp. 633.

¹¹⁴ BCBS, Basel II, main text para. 195.

¹¹⁵ Ibid, main text paras. 196-198.

The foundation approach requires the same conditions of eligible guarantees and qualified guarantors under the standardised approach for guarantees, though it permits other guarantors rated A- or above according to internally-generated ratings of banks.¹¹⁶ The risk weight of the guaranteed exposure is determined according to the risk weight of the type of guarantor and the PD appropriate to the guarantor's borrower (or a grading between the obligor and the guarantor's borrower when deemed necessary by the relevant bank). Meanwhile, the unsecured portion retains the risk weight of the obligor.¹¹⁷ Under the advanced internal based approach the bank may calculate guaranteed capital exposures by adjusting the estimates of either the PD or LGD as long as this is done consistently.¹¹⁸

IV. Credit Derivatives

Credit derivatives emerged after the Capital Accord and have grown to reach \$20 trillion in 2006 due to their quality of transferring risk without underlying credit.¹¹⁹ Credit derivatives are similar to guarantees because they involve a third party (protection provider) agreeing to make a payment (underlying obligation) to the creditor bank in case of default on the part of the obligor (default event) to pay its obligation (reference obligation).

Protection providers must meet the requirements of an eligible guarantor.¹²⁰ Credit derivations must also represent a direct claim on the protection provider so that the underlying cover is incontrovertible and clearly specified. Credit protection must be irrevocable and unconditional as well. There are, however, the various additional regulatory requirements for the eligibility of credit derivatives for risk mitigation purposes.¹²¹ First, the credit event must at least cover three elements. The first one is non-payment of amounts due at the time of failure. The grace period of the credit

¹¹⁶ Ibid, main text para. 302.

¹¹⁷ Ibid, main text paras. 303-304.

¹¹⁸ Ibid, main text para. 306.

¹¹⁹ Irina Molostova, 'Credit Derivatives as Credit Risk Mitigation under Basel II' 2007 JIBFL, Vol. 22(September), pp. 465.

¹²⁰ BCBS, Basel II, main text para. 195.

¹²¹ Ibid, main text paras. 191-194.

derivative must be close to that of the underlying obligation. Secondly, the credit event must cover the inability of the obligor to pay its debts, insolvency, bankruptcy or any other similar event. Thirdly, restructuring of the underlying obligation is considered a credit event if it entails relinquishing or postponement of all or part of the underlying obligation. If the restructuring meets mentioned requirements, but is not covered by the credit derivative, (1) the maximum limit of the eligible hedge may not exceed 60 percent of the underlying obligation; (2) the underlying obligation and the reference obligation must match. A mismatch of assets may be permitted if (a) the reference obligation is junior or *pari passu* with the underlying obligation, and (b) they have cross-default or cross-acceleration clauses and the same obligor;¹²² (3) the credit derivative must not terminate before the expiration of the grace period for default of the underlying obligation; (4) the protection buyer must have the right to determine whether a credit event has occurred; (5) robust valuation processes for cash settlements are imperative; and, finally, credit derivatives that do not provide protection equivalent to guarantees are not eligible for recognition.

E. Securitisation

There are various types of securitisation. Under traditional securitisation, the securitised exposure of the originating bank is transformed. Payments to the investors are derived from the performance of the specified underlying exposures not the originating bank. In synthetic securitisation, the payment is by contrast secured by the originating bank by using credit risk mitigation techniques such as collateral.¹²³ Clean-up calls are also options that allow securitisation exposures to be called before the full repayment of underlying exposures.¹²⁴

The cornerstone in securitisation is to find out the reference capital level of the securitised position, i.e. how much capital a bank should hold if its exposure is not securitised (referred to as " K_{IRB} "). If the exposure is equal to or less than K_{IRB} under a "first loss position," it should be deducted. In other words, the general rule under Basel

¹²² For an explanation of why these requirements are important, please see: Irina Molostova, *Ibid* (n 119), pp. 468.

¹²³ Basel II, main text paras. 539-540.

¹²⁴ *Ibid*, main text para. 545.

II is that originating banks should "hold regulatory capital against all of their securitisation exposures,"¹²⁵ though banks may exceptionally deduct securitised exposures from their risk-weighted assets if certain operational requirements are met.¹²⁶ These requirements include requirements for the recognition of risk transfer from the originating bank.¹²⁷ The originating bank should transfer "significant" risk to third parties, do not retain control over transferred exposures nor hold obligations towards the investors. Credit risk mitigation techniques, when used should meet the prudential requirement of Basel II. Call up calls should not be mandatory, as well. In addition, when a bank provides implicit support, i.e. "provides support to a securitisation in excess of its predetermined contractual obligation"¹²⁸ it should maintain capital against exposures that has not been securitised.

2. Operational Risk

Basel II defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk".¹²⁹ Basel II also proposes three models for calculating operational risk; namely, the Basic Indicator, Standardised Approach and Advanced Measurement Approach ("AMA").¹³⁰ Moving up through these three consecutive approaches should provide banks with an incentive to improve their operational risk management.¹³¹

Income is used as the proxy for the scale of a bank's operation and hence the degree of its operational risk. Under the Basic Indicator approach, operational risk is calculated according to a basic formula, whereby the gross income of the bank for the preceding three years is multiplied by 15 percent. Under the Standardised Approach the

¹²⁵ Ibid, main text para. 560.

¹²⁶ Ibid, main text para. 554.

¹²⁷ Ibid, main text paras. 554-559.

¹²⁸ Ibid, main text para. 551.

¹²⁹ Ibid, main text para. 644.

¹³⁰ Ibid, main text para. 645.

¹³¹ Richard Bethell-Jones, 'Basle Committee Tries to Come to Terms with Operational Risk' 2001 *IFLR*, Vol. 20(March), pp. 12.

operational risk of the bank's business lines is measured separately by following the same formula then summed up. By contrast banks are allowed to use their internal operational risk models under the AMA. Risk mitigants are also recognised under the AMA.

3. Market risk

A. Outline

Basel II introduces less significant changes to the treatment of market risk for capital adequacy purposes. Like its predecessor (1996 Capital Accord Amendment), market risk is defined as "the risk of losses in on and off-balance-sheet positions arising from movements in market prices."¹³² The risks subject to this requirement are also interest rate risk and equity position risk in the trading book as well as commodities risk and foreign exchange risk throughout the bank.¹³³ The definition of the trading book is widened to cover all positions in financial instruments held either for trading purposes or for hedging other instruments in the trading book.¹³⁴

Financial instruments and positions are defined as follows:

"A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both primary financial instruments (or cash instruments) and derivative financial instruments. A financial asset is any asset that is cash, the right to receive cash or another financial asset; or the contractual right to exchange financial assets on potentially favourable terms, or an equity instrument. A financial liability is the contractual obligation to deliver cash or another financial asset or to exchange financial liabilities under conditions that are potentially unfavourable.

Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include for example proprietary positions, positions arising from client servicing (e.g. matched principal broking) and market making."¹³⁵

¹³² BCBS, Basel II, main text para. 683(i).

¹³³ Ibid, main text para. 683(i).

¹³⁴ Ibid, main text para. 685.

¹³⁵ Ibid, main text paras. 686 and 687.

Banks are provided with guidance on prudent valuation of positions in the trading book, because it usually contains less liquid positions.¹³⁶ They should first have adequate systems and controls to ensure the prudence and reliability of the valuation estimates. This includes the adoption of documented policies on evaluation and the existence of an independent reporting line from the front office. Basel II also emphasises that positions should be marked-to-market, and if not possible, they may be marked-to-model. Marking-to-market should be at least undertaken on a daily basis at available close-out prices from independent sources such as exchange prices. Marking-to-model is permitted only if certain conditions are met. Models and their embedded assessments should be evaluated and periodically reviewed. Inputs should also be externally obtained. Furthermore, valuation adjustments or haircuts (i.e. percentages of capital set aside to cover against a possible risk) must be established. In addition, haircuts must cover at least close-out costs, unearned credit spreads, operational risks, future administrative costs, early termination, investing and funding costs as well as model risk where appropriate.

Instruments in the trading book are subject to capital charges against market risk as a general rule. OTC derivatives, repo style and unsettled trades are exceptionally charged against counterparty credit risk. The methodology applied for calculating credit risk in the banking book (be it the standardised or the IRB approach) shall also be employed to the trading book, when applicable.

Basel II also entitles banks to hold Tier 3 capital to cover against market risk only provided that three conditions are met. First, credit and market capital requirements must be met forehead. Secondly, Tier 3 capital should not exceed 250 percent of Tier 1 Capital. Thirdly, Tier 2 capital may substitute Tier 3 capital provided that it does not exceed the 250 percent ratio.

Banks may choose between the standardised methodology using determined measurement, or the internal model based methodology, with the approval of their supervisory authorities.

¹³⁶ Ibid, main text paras. 690-701.

B. The Standardised Method of Measuring Market Risk

The standardised method covers the four types of market risk as well as provides separate rules for options' risks. Accordingly, capital charges are calculated separately for interest rate risk, equity position risk, commodities risk, foreign exchange risk and options. Then, the sums are added arithmetically.¹³⁷ The standardised methodology also employs the “building block” approach, whereby ‘specific risks’ related to the issuer as well as ‘general market risks’ emanating from equity and debt positions are calculated separately.¹³⁸

I. Interest Rate Risk

Measurement of interest rate risk under Basel II covers fixed-rate and floating rate debit securities and instruments of similar effect such as non-convertible preference shares.¹³⁹ It determines capital requirements by calculating charges for ‘specific risk’ and ‘general market risk’ separately then summing the results. It also provides independent rules on dealing with derivative instruments with the exception of options. Specific risk here refers to unfavourable movements in the price of securities related to the issuer itself. Risk weights are assigned for government and other issuers, e.g. governments rated AAA to AA- are assigned a risk weight of zero percent.¹⁴⁰ The general market risk, by contrast, is designed to capture the risk of loss pertaining to general market movements.

Basel II permits a choice between the ‘maturity method’, and the ‘duration method’ to capture interest rate risk in the trading book. Required capital under both methods is the summation of four elements: the net position in the trading book; ‘vertical disallowance’, being the small proportion of the matched positions in each time band; ‘horizontal disallowance’, being the larger proportion of the matched positions across time bands; and finally the net charge for positions in options.¹⁴¹

¹³⁷ Ibid, main text para. 701(i).

¹³⁸ Ibid, main text para. 701(iii).

¹³⁹ Ibid, main text para. 709(i).

¹⁴⁰ Ibid, main text paras. 709(iii)-710.

¹⁴¹ Ibid, main text para. 718(i).

As to banks employing the maturity method, short or long positions are slotted into a maturity ladder divided into thirteen time bands at least. Floating rate instruments are classified according to the remaining term to next repricing date, while fixed rate instruments are classified according to residual term to maturity.¹⁴² The first stage in this method is to weight positions within each time band according to a specific table,¹⁴³ comprised of three time zones (zero-one year, one year to three years and four years and above). In order to avoid basis risk (defined as “the risk that the relationship between the prices of similar commodities alters through time”) as well as gap risk (defined as the risk that “price may change for reasons other than a change in interest rates”).¹⁴⁴ Basel II levies a 10 percent capital charge for the smaller (short or long) position, known as ‘vertical disallowance’.¹⁴⁵ Then banks will be permitted to conduct two rounds of ‘horizontal offsetting’ between net positions within the same zone (30 percent for the first time zone and 40 percent for zones 2 and 3) and then between the different zones. The last offsetting is subject to a scale of horizontal disallowances within the same time zone and between adjacent zones (40 percent). Finally, the residual net position of each zone may be offset against opposite residual positions of other zones, subject again to a disallowance factor.¹⁴⁶

As to the duration method, banks with the approval of their respective supervisory authorities should measure their general market risk by calculating the price sensitivity for each position on its own. Then they will slot the results into a duration based ladder comprised of 15 time bands. Positions in time bands will afterwards be subject to a 5 percent vertical disallowance, in order to capture basis risk. Finally, net positions of each time zone will be carried forward to be offset horizontally subject to scaling disallowances.¹⁴⁷

¹⁴² Ibid. main text para. 718(iii).

¹⁴³ Ibid. main text para. 718(iv).

¹⁴⁴ Ibid. main text para. 718(xLv).

¹⁴⁵ Ibid. main text para. 718(v).

¹⁴⁶ Ibid. main text para. 718(vi).

¹⁴⁷ Ibid. main text para. 718(vii).

Capital charges also cover interest rate derivatives. The measurement should cover all interest rate derivatives and off-balance sheet instruments in the trading book with the exception of options. They should be converted into positions and become subject to general and specific market risk charges.¹⁴⁸

II. Equity Position Risk

Banks should hold capital charges against equity positions in the trading book. Instruments include common shares instruments which behave like equity and commitments to buy or sell equity. Similarly to debt securities, the capital charges are the summation of 'specific risk' and 'general market risk' calculated for each market separately. Specific risk is the sum of all short and long positions in an individual equity, while the general market risk refers to overall net position i.e. the difference between the sum of long and short positions.¹⁴⁹

The capital charge for the general market and specific risks will be 8 percent however; the ratio for specific risk may be reduced to 4 percent in case of well-diversified and liquid portfolios.¹⁵⁰ Equity derivatives and off-balance-sheet positions influenced by equity prices, with the exception of options, should be converted into notional positions then be subject to capital charges.¹⁵¹

III. Foreign Exchange Risk

Banks should hold capital to capture risks of taking or holding positions in foreign exchange including gold.¹⁵² The calculation is undertaken by following two processes, first, measuring the exposure in a single currency position and, secondly, measuring foreign exchange risk in a portfolio of foreign currency positions and gold.¹⁵³ The second process allows the application of two alternative methods, with the

¹⁴⁸ Ibid, main text para. 718(ix)(x).

¹⁴⁹ Ibid, main text para. 718(xx).

¹⁵⁰ Ibid, main text para. 718(xxi).

¹⁵¹ Ibid, main text para. 718(xxix).

¹⁵² Ibid, main text para. 718(xxx).

¹⁵³ Ibid, main text para. 718(xxxi).

supervisor's approval. The first method is the internal model approach, which should reflect the risk according to the composition of the portfolio. The other method is the 'short method,' which treats all the currencies on an equal basis. The capital charge is the higher of net positions (net long or net short) plus the net position in gold multiplied by 8 percent.¹⁵⁴

Banks that do not hold foreign exchange positions for their own and do insignificant business in foreign exchange are excluded from this requirement.

IV. Commodity Risk

Basel II establishes minimum capital requirements against taking or holding positions in commodities. It defines commodity as "a physical product which is or can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals."¹⁵⁵ Precious metals do not include gold, which is captured by capital foreign exchange.¹⁵⁶

Commodities markets are less liquid than the debt and equity markets, more volatile and less transparent. It is also less likely to hedge positions in commodities. Therefore, they expose banks to wider risks including basis risk and interest rate risk.¹⁵⁷ Basel II provides banks with three alternatives for the calculation of commodities risk. It allows the application of banks internal models, the standardised method comprised of the maturity ladder approach or the simplified approach, whereby the net long and short positions for each commodity are calculated.¹⁵⁸

All positions affected by commodity prices are included and subject to a 15 percent capital charge for net positions in each commodity. Each commodity is also subject to a 3 percent capital charge of the bank's gross position valued at the current spot price.

¹⁵⁴ Ibid, main text para. 718(xli).

¹⁵⁵ Ibid, main text para. 718(xLii)(xLiii).

¹⁵⁶ Ibid, main text para. 718(xLiii).

¹⁵⁷ Ibid, main text para. 718(xLv).

¹⁵⁸ Ibid, main text para. 718 (xLvii).

V. Options Risks

Banks are offered various approaches for the calculation of capital charges against holding positions in options. Banking institution involved in writing options should apply the more sophisticated methods.¹⁵⁹ The capital charge is 8 percent for general market risk plus 8 percent for specific risk.¹⁶⁰

C. The Internal Models Method of Measuring Market Risk

Banks must obtain the prior approval of their supervisors on applying the internal models approach for measuring capital requirements against market risk. The approval shall be granted only if the respective bank has, at a minimum, an appropriate risk management system, adequate staff, track record of accurate internal models, and conducts stress testing.¹⁶¹ Stress testing is *ante post* testing of internal models to “identify events of influences that could greatly impact banks”.¹⁶²

Banks employing the internal model approach should also meet a list of quantitative and qualitative requirements.¹⁶³ An essential requirement is that the measurement system should capture all the on and off-balance-sheet market risks, whether related to interest rate, equity position, foreign exchange or commodities’ risks. While banks may devise their internal models, they are bound to observe a minimal list of quantitative requirements. First, VaR must be calculated on a daily basis, with 99th percentile, one tailed ‘confidence interval,’ minimum ‘holding period’ of ten days, and at least one year of ‘historical observance.’ Banks should also update ‘data sets’ used for their models at least every three months and when material changes in market prices occur. Each bank must meet a minimum capital requirement being the higher of (i) the preceding day’s VaR and (ii) an average of the daily VaR of the previous sixty business days, multiplied by a multiplication factor of at least 3.

¹⁵⁹ Ibid, main text para. 701(iv).

¹⁶⁰ Ibid, main text para. 701(iv).

¹⁶¹ Ibid, main text para. 718(Lxxi).

¹⁶² Ibid, main text para. 718(Lxxvii).

¹⁶³ Ibid, main text para. 718(Lxxiv)-(xcix).

Qualitative requirements refer to the role of the boards of directors and senior executives in active risk monitoring. They include the existence of an effective risk control unit, adequate internal audit review and compliance of internal models with set out policies, controls and precedence. They also cover conducting backtesting i.e. *ex post* comparison between model-generated results and actual market movements, as well as conducting stress testing, which should include factors that can cause extraordinary losses (such as low probability incidents). Internal models should also be subject to initial and periodic validation reviews by well qualified and independent parties.

In situations where a bank applies VaR measures to specific risks, it must capture all components of price risk, including event risks that are not reflected in its VaR such as risks beyond the ten days internal and severity events and low probability risk. It should also cover credit risk in the trading book known as ‘incremental default risk.’ The latter type of risk was introduced into Basel II in 2005,¹⁶⁴ in order to cover banks against default risks emanating from their increased exposures to credit risk particularly illiquid products. It was designed to capture 99 percent 10 day VaR over one year.

Finally, banks are allowed to combine internal models with the standardised approach for different broad types of risk. They may not use the two methodologies for the same category of risk. Also, once a bank is permitted to apply its internal models, it may not revert back to the standardised approach.¹⁶⁵

D. New Proposals

The credit risk crisis of 2007-2008 highlighted that most losses occurred in the trading book and mainly as a result of over-exposure to SPEs. It showed that the VaR treatment of banks’ assets in the trading book cannot capture extraordinary events (migration risk combined with loss of liquidity) and losses that occurred less frequently than 10 days in a year. Therefore, the BCBS is currently reviewing the treatment of

¹⁶⁴ BCBS, The Application of Basel II to Trading Activities and the Treatment of Double Default Effects, (July, 2005).

¹⁶⁵ BCBS, Basel II, main text para. 718(Lxxxvi).

incremental default risk to cover both types of risks.¹⁶⁶ In addition, Basel II is proposing amendments to its market risk framework in general.¹⁶⁷ The proposed amendment is designed to capture both risks in the banking book for unsecuritised products. Securitised products will also be treated equally in the banking and trading books to ensure the avoidance of arbitrage. Furthermore, the preferential treatment provided for well diversified portfolios is proposed to be eliminated. In addition, the BCBS is proposing various measures to enhance the stress testing of banks and improve the external validation of stress testing.

3.3.2.2. Pillar 2: The Supervisory Review Process

The declared purpose of the supervisory review process is to stimulate banks to improve their risk management techniques not merely to monitor banks' capital adequacy.¹⁶⁸ Basel II therefore stresses that increasing capital is neither an alternative to adequate risk management nor the sole solution for dealing with increased risks. Other solutions are improving internal control systems and strengthening provisions.¹⁶⁹ Within this context, Basel II sets out four supervisory principles, as well as elaborates on issues to be addressed under the review process.

The first supervisory principle focuses on the bank's duty to adopt *rigorous* Internal Capital Adequacy Assessment Process ("ICAAP").¹⁷⁰ First, board members and senior management should understand and monitor the risk management process. Secondly, banks need to undertake sound capital assessment, which relates capital to the level of the bank's risks, as well as determines measures for the identification, measurement and reporting of material risks. Thirdly, the assessment should be a comprehensive one, including credit risk, operational risk, market risk, interest rate risk

¹⁶⁶ BCBS, Guidelines for Computing Capital for Incremental Default Risk in the Trading Book Consultative Document. (January, 2009).

¹⁶⁷ BCBS, Revisions to the Basel II Market Risk Framework, Consultative document (January, 2009).

¹⁶⁸ *Ibid*, main text para. 720.

¹⁶⁹ *Ibid*, main text para. 723.

¹⁷⁰ It is noteworthy that Basel II employs the term "internal capital adequacy assessment process" only in paragraph 55 without acronym 'ICAAP' and uses the term "internal capital adequacy process" in other paragraphs, although the term is more common in academic literature and later BCBS publication such as BCBS, 'Progress on Basel II Implementation: New Workstreams and Outreach' 2007 Basel Committee Newsletter, (11) (May).

in the banking book, liquidity risk and other risks. It explains that "other risks" are not easily measurable, and expects the industry to further develop techniques for managing all aspects of these risks.¹⁷¹ Fourthly, the establishment of a system for monitoring and reporting risk and demonstrating how change in the risk profile may affect the need for capital. Finally, banks should review their internal control systems to ensure the accuracy, integrity and reasonableness of the risk management process.

The second principle of the supervisory review process concerns the role of the supervisory authorities to review and evaluate the ICAAP in order to identify deficiencies and intervene promptly to reduce banking risks.¹⁷² The focus of the review should be on the quality of risk management. The review should also examine in detail banks' internal analysis, because of the huge adverse impact that errors in methodology and assumption can have on capital requirements. Banks' supervisors, nevertheless, should not attempt to assume the duties of banks' management, who are ultimately responsible for sound risk management.

The third principle is that supervisors should expect regulated banks to maintain capital ratio and be empowered to require banks to do so. Basel II document offers the following explanation:¹⁷³

"Pillar 1 capital requirements will include a buffer for uncertainties surrounding the Pillar 1 regime that affect the banking population as a whole. Bank-specific uncertainties will be treated under Pillar 2. It is anticipated that such buffers under Pillar 1 will be set to provide reasonable assurance that a bank with good internal systems and controls, a well-diversified risk profile and a business profile well covered by the Pillar 1 regime, and which operates with capital equal to Pillar 1 requirements, will meet the minimum goals for soundness embodied in Pillar 1. However, supervisors will need to consider whether the particular features of the markets for which they are responsible are adequately covered. Supervisors will typically require (or encourage) banks to operate with a buffer, over and above the Pillar 1 standard."

The fourth principle concerns the duty of supervisors to intervene in a timely fashion to prevent the bank's capital from falling below the minimum capital adequacy requirements. Supervisors need to impose remedial measures such as increasing capital.

¹⁷¹ Ibid, main text para. 742.

¹⁷² Ibid, main text paras. 746-756.

¹⁷³ Ibid, main text para. 757.

More permanent solutions such as improving systems and controls are also recommended.¹⁷⁴

The specific issues that Basel II recommends that supervisors should be mindful of, can be grouped under three categories:¹⁷⁵ risks that are not captured by Pillar I capital adequacy (such as interest rate risk in the banking book and credit concentration risk); elements of risk which are not captured by Pillar I (such as the influence of the business cycle); and specific areas within Pillar II that might not be sufficiently and adequately covered against risk, such as stress testing, definition of default and residual risks of risk mitigation techniques. Furthermore, Basel II stresses the importance of supervisory transparency and accountability, as well as the importance of enhanced cross border exchange of information and coordination.¹⁷⁶

Finally, Pillar II particularly stresses on the importance of the supervisory review of securitization although already captured by Pillar I. Pillar II first emphasises that, considering the various forms of securitisation transactions, banks should determine the regulatory capital on the basis of the economic substance of the transaction, rather than its legal form.¹⁷⁷ Consequently, a higher capital assessment might be required of banks if the general rules on capital are not found adequate and sufficient against securitisation exposure or reducing capital relief in case of originated assets.¹⁷⁸

3.3.2.3. Pillar 3: Market Discipline

Pillar III provides for complex and well detailed disclosure requirements for banks. It calls banks to disclose information on their risk management systems to allow market participants to evaluate their risk profile and capital adequacy, as well as provide the market with consistent, understandable and comparable information.¹⁷⁹

¹⁷⁴ Ibid, main text paras. 759-760.

¹⁷⁵ Ibid, main text paras. 724 and 761-778.

¹⁷⁶ Ibid, main text paras. 779-783.

¹⁷⁷ Ibid, main text para. 784.

¹⁷⁸ Ibid, main text para. 785.

¹⁷⁹ Ibid, main text paras. 809-900.

The recent international financial crisis has raised attention for the need to strengthen certain aspects of the BCBS standards on capital adequacy, particularly stress testing.¹⁸⁰ Under all circumstances, an effective implementation of Basel II highlights the importance of risk management and the partnership with banks' management and auditors. These issues will be examined in the following chapter.

¹⁸⁰ The most recent initiative in this regard is the BCBS Consultative Document, Principles for Sound Stress Testing Practices and Supervision, (January, 2009). This document is issued for comment by 13 March, 2009.

CHAPTER 4

RISK ASSESSMENT AND MANAGEMNT, AND PUBLIC-PRIVATE PARTNERSHIP

4.0. Introduction

The previous chapter illustrated how Basel II focuses on the measurement and management of capital and provides for prudential rules on market discipline, while the earlier standards were concerned only with the calculation of capital adequacy. This chapter examines the BCBS extensive efforts to lay standards on the identification, assessment, monitoring and controlling of banking risks as well as related supervisory rules. In doing so, the BCBS analysed and flexibly responded to international crises and market developments by issuing new supervisory standards or replacing existing ones, when deemed necessary. Most significantly, the Asian crisis of 1997-8 highlighted the importance of the management of country, liquidity and foreign exchange risks as well as sound accounting and sound loan assessment. Weak risk management control is a major cause of banking failures. Therefore, the BCBS emphasised in a document issued in 1997 on the critical role of risk management by banks. It also issued many documents which set out standards on various types of risk management and the supervisory role in monitoring banks' implementation of these standards. Furthermore, the financial difficulties of Long-Term Capital Management ("LTCM"), underscored the particular risks of exposure to highly leveraged institutions ("HLIs") as opposed to ordinary credit risk. Most recently, the Credit Crunch of 2008-8 also highlighted the significance of liquidity risk management amongst others (Section 1).

The growing emphasis on risk management denotes to the need for enhanced public private partnership. Public private partnership in the case of banking supervision comprises three basic elements: sound corporate governance, internal audit function and internal control; secondly, effective external auditing as well as the existence of a tripartite relationship between the external auditors, the internal auditors and bank supervisors; and finally market discipline (Section 2).

4.1 Risk Management

4.1.1 Credit Risk

4.1.1.1 Principles for the Management of Credit Risk, 1999

The BCBS document, 'Principles for the Management of Credit Risk' 1999 established four major principles for the assessment of banks' credit risk management: (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 (iv) ensuring adequate controls over credit risk.¹

The document recommended that supervisory authorities should "conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio".² Where internal risk-rating and/ or credit rating models are applied, the supervisors or external auditors should evaluate the quality of such models and assess internal reviews of credit administration and credit granting functions of the bank. When weaknesses in credit management control are spotted during evaluation, such as excessive concentration and problem asset classification, supervisory authorities should adopt appropriate measures to enhance the credit management control process. Finally, "supervisors should consider setting prudential limits to restrict banks exposures to single borrowers or groups of connected counterparties".³

There were three important points to be emphasised concerning credit risk control. First, these principles should be applied despite banks' stage of sophistication. Secondly, the inter-relationship between credit risk and other risks should be taken into consideration. For example, settlement arrangements influence credit risk. Thirdly, the four principles, mentioned above, should be read in conjunction with other BCBS

¹ BCBS. Principles for the Management of Credit Risk. (September, 2000), pp.1, para. 5.

² Ibid.

³ Ibid, pp. 4, Section E, Principle 17.

complementary principles on concentration limits, exposures arising in international lending disclosure, as well as asset quality and loan-loss reserves.

4.1.1.2 Sound Credit Risk Assessment and Valuation of Loans 2006

The BCBS issued its comprehensive document 'Sound Credit Risk Assessment and Valuation for Loans' in 2006. The document provides for two sets of rules, first, "supervisory expectations concerning sound credit risk assessment and valuation for loans", and secondly, "supervisory evaluation of credit risk assessment for loans, controls, and capital adequacy". The document does not cover the particularities of loans carried on a fair value basis.

The first set of rules is composed of seven principles. The first principle explains the role of banks' directors and senior management responsibilities in maintaining and monitoring credit risk assessment procedures and effective internal control systems. The internal control system should particularly cover the integrity and reliability of their loan review information. Internal controls should also ensure compliance with applicable legislation and accountancy frameworks. Furthermore, banks should have a loan review process independent from the lending function that includes a credit risk grading system, a process that ensures that collected information is properly used for the estimation of loss. In addition, banks should set up an adequate communication system amongst relevant functions in the bank.

The second principle is that banks should classify their loans according to credit risk. The classification of large loans should be based on a credit grading system, while smaller loans can be either classified according to either a grading system or their payment delinquency status. The grading system should also typically cover information on the borrower, realisability of collateral and specific information on the credit facility. The grading system should be subject to regular review as well. The third principle stresses that banks that apply the IRB approach (which entails the use of judgment in credit risk assessments) should ensure the validation of their assessment. Validation includes stress testing, back testing, and tolerance limits between actual losses and expected losses. The fourth principle is that banks should monitor the quality of their loan portfolios, and accordingly determine their loan loss or provisioning methodology. The fifth principle illustrates that banks should review the collectibility of

individual and collective loans at least annually taking into consideration all-important relevant factors such as probability of liquidation and concessions granted by banks. The sixth principle calls banks not to rely on standard formulae alone in their loan classification but they should also use their credit experience judgment. The judgment, however, should be subject to written policies within determined limits set out by the bank. It also recommends that banks consider current factors such as changes in local and international markets rather than being limited to historical loss experience. This principle, however, does not cover the important issue of training staff. The seventh principle recommends that the aforementioned basic requirements of credit risk assessment should be applied for the purposes of accounting and capital adequacy as well. This commonality should ensure the reliability and consistency of resulting figures as well as sound provisioning practices.

The document provides three principles on the supervisory evaluation of credit risk assessments. The eighth principle is that supervisors should evaluate banks' internal loan review processes periodically and recommend necessary amendments thereto. The following principle is that supervisors should ensure that loan loss provisions' methods result in prudent and reasonable measurement of credit losses estimated in the loan portfolio. The last principle illustrates that supervisors should take into consideration banks' credit risk assessment practices in their capital adequacy assessments.

4.1.1.3 Exposure to Highly Leveraged Institutions

A particular type of credit risk, which has caught the attention of the BCBS, is exposure to HLIs. HLIs, including hedge funds, have three features: they are large financial institutions; they fall completely, or to a large extent, out of the realm of supervision and disclosure requirements, and have a significant leverage (defined as the risk to capital ratio). The failure of LTCM, a highly privileged hedge fund or mutual fund in the US market is a significant example of the adverse effects of banks' exposures to HLIs. In its search for high yields, LTCM resorted to leverage its capital in risky derivatives market and securities repurchase contracts.⁴ Domestic banks incurred large exposures towards LTCM either as a result of extending loans or through

⁴ Alan Greenspan, 'Mr. Greenspan Testifies on Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management', 1988 *BIS Review* (77), pp. 1.

derivatives contracts, and it is believed that had the authorities allowed LTCM to fail banks would have incurred significant difficulties.⁵

The BCBS responded in 1999 by issuing its first document on banks' interactions with HLIs.⁶ The document evaluated banks' credit risk management towards credit extended to HLIs and related supervisory matters, and identified significant weaknesses. Most notably, banks did not have clear policies on management of exposures to HLIs, in line with their overall credit management strategies. Another deficiency was that banks' evaluation of the creditworthiness of HLIs was considerably limited.

The BCBS issued a simultaneous document 'Sound Practices for Banks' Interactions with Highly Leveraged Institutions', which provides guidance on sound banking practices in this regard.⁷ The aim of this document is to address the mentioned weaknesses and to improve banks' management of credit risk exposures to HLIs. These techniques are similar to general credit risk management standards but are adopted for the particular nature of credit risk identified with HLIs. The document, therefore, emphasises, *inter alia*, that banks should develop clear policies regarding their relation with HLIs that remain within the context of their credit risk strategy and that remain compatible to their exposures to HLIs. Banks should also have sound credit risk standards designed to address specifically the problems of HLIs. As a result, the document emphasises the importance of due diligence, credit analysis and collecting sufficient information of HLIs for the credit approval process and on-going basis. Banks should also have structured exposures' limits to HLIs and constantly monitor their implementation.

⁵ Ibid, pp. 5.

⁶ BCBS, Bank's Interactions with Highly Leveraged Institutions, (January, 1999).

⁷ BCBS, Sound Practices for Banks' Interactions with Highly Leveraged Institutions, (January, 1999.) BCBS Compendium Vol. 1.

4.1.2 Liquidity risk

Before explaining the BCBS standards on liquidity risk management, it is first important to understand the context of liquidity risk.⁸ Chapter 1 illustrated that one of the major activities of banks is to create liquidity and that the liquidity mismatch problem is one of the most serious banking problems. Chapter 1 also explained that a bank, which is critically facing a shortage of liquidity, is usually given access to the central bank's funds as a Lender of Last Resort. Therefore, it is important for supervisory authorities to monitor banks' liquidity. The traditional method was to impose statutory requirements of liquidity ratios on banks. The growth in banking size, complexity and sophistication of activities led to a new supervisory trend, which focuses on the assets and liabilities maturity structure. This is done by constructing what is termed as 'maturity ladders' for assets and liabilities during a certain period, whereby expected flows are calculated.⁹ A bank is seen to have sufficient liquidity if it has adequate funds to cover potential obligations either by increasing their liabilities or liquidating their assets. Accordingly, in order to examine a bank's liquidity management, supervisory authorities need to look first at its funding structure to check whether the bank has a sufficiently large and diverse deposits base to minimise its exposure to liquidity risk. Another essential element in funding structure is market accessibility; i.e. the bank's ability to borrow from the market rapidly and with suitable costs, to meet liquidity demand.

4.1.2.1 Sound Practices for Managing Liquidity in Banking Organisations, 2000

The BCBS document 'Sound Practices for Managing Liquidity in Banking Organisations' issued in February, 2000 took the same general view on liquidity risk management. It stated that each bank should set out a management structure¹⁰ for liquidity risk, which suits its size, and they should then regularly review and monitor it. This included setting limits on banks' liquidity positions. Alternatively, the supervisory

⁸ See generally: Hennie van Greuning and Sonja Bratanovic, Analyzing Banking Risk: a Framework for Assessing Corporate Governance and Financial Risk Management, (2000), pp.157-176.

⁹ Ibid, pp. 158.

¹⁰ BCBS, Sound Practices for Managing Liquidity in Banking Organisations, (February, 2000), paras. 1-22, pp. 1-6.

authority may set down these limits. Furthermore, banks should have adequate information systems, the purpose of which are to measure, monitor and control liquidity risk, as well as to provide reports to senior management and concerned personnel on a timely basis. In line with the new risk-based approach to banking supervision, the document emphasised the need for adequate internal control systems,¹¹ and the role of disclosure in order to improve liquidity.¹² Meanwhile, the role of supervisors was viewed mainly as undertaking independent evaluations of banks' policies and practices of liquidity risk.¹³

4.1.2.2 The New Standard on Liquidity risk

The market turmoil which commenced in mid 2007 has raised the attention towards the importance of banking liquidity management. The BSBS Working Group on Liquidity consequently reviewed banking supervisory practices in relation to liquidity management and published a summary of its findings in February 2008.¹⁴

The document illustrates that banks have become more dependent on the capital market for funding; though the capital market is much more volatile than the traditional retail deposits. During the credit crunch period, risk-averse investors required higher compensation for risk and banks could only roll over to short term money market or even refrain from extending credit facilities. Another challenge is the growth of the securitisation market and the "originate-to-distribute" model of banking. The lengthy securitisation process of pooling and distributing assets can lead to excessive warehousing of assets in stressed markets. The wide-spread form of securitisation of "asset-backed commercial paper" in particular gives rise to contingent liquidity risk, e.g. where banks need to support conduits.

The growth of complex financial instruments (which might not be actively traded, include embedded optionality, or have a short data history) has complicated liquidity risk assessments and management. In addition, the substantial increase in

¹¹ Ibid, pp.18-19, paras. 81-85.

¹² Ibid, pp.19, paras. 86-87.

¹³ Ibid, pp.20-21, paras. 88-94.

¹⁴ BCBS, Liquidity Risk: Management and Supervisory Challenges. (February, 2008).

collateral renders banks more susceptible to funding liquidity risk, because parties might request additional collateral in adverse market conditions. Furthermore, banks have to meet intra-day liquidity requirements due to developments in the settlement and payment systems, such as real-time gross settlement, which introduces intra-day finality and the unwinding effect of transactions. Finally, the increase in cross-border flows across currencies means that market liquidity problems might have contagious effect on other markets. European banks, for example, were affected by the US sub-prime mortgage markets.

The document identifies liquidity lessons learnt from the 2007/8 market turmoil. First, the scope of stress testing was limited during the crisis to firm-specific and idiosyncratic shocks, which is not wide enough to capture global financial disruptions. Secondly, banks proved to be over-reliant on Asset-Backed Commercial Papers (“ABCP”) and did not anticipate problems with the inter-bank market. The conclusion is that banks’ liquidity risk contingency plans should be enhanced. Thirdly, liquidity management failed to capture risks resulting from off-balance-sheet activities and contingent commitments coming up to bank’s balance sheets. Fourthly, events illustrated that many of banks’ treasury functions were not aware of the liquidity risks, which means that there should be coordination between treasury and business lines. Fifthly, the crisis highlights that liquidity problems may affect even well capitalised banks, and hence brings to attention the paramount importance of sound liquidity risk management. Sixthly, the turmoil focused supervisors’ attention on the importance of gathering information once the market is stressed in addition to routine information. Seventh, the crisis showed that there is a stigma of banks’ using central banking lending facilities, causing other banks to cut their exposure to the borrowing bank and eventually worsening funding pressure. Finally, the crisis emphasised the importance of cross-border supervisory co-ordination on liquidity risk.

In light of the findings of the latter study, the BCBS issued in mid 2008 a new consultative document, which updates and augments its earlier 2000 standards on liquidity.¹⁵ The recommendation crystallised into the new BCBS document ‘Principles

¹⁵ BCBS, Principles for Sound Liquidity Risk Management and Supervision, Draft for Consultation, (June, 2008).

for Sound Liquidity Risk Management and Supervision' issued last September. The document set out six principles.

First, it stressed on the importance of sound management and supervision of liquidity risk describing it as the fundamental principle. The primary objective of liquidity risk management is to address and withstand liquidity stress. Meanwhile, supervisors should supervise liquidity risk to reduce the severity and recurrence liquidity problems.¹⁶

Secondly, the document stresses on the governance of liquidity risk management. This entails the establishment of a liquidity risk tolerance i.e. the level of liquidity risk the bank is willing to take, commensurate with the bank's strategy, complexity and risk profile.¹⁷ Furthermore, the bank's senior management should develop and monitor liquidity strategy, policies and practices and monitor its implementation according to its risk tolerance. The strategy should contain extensive details on the liquidity policy, such as the diversification and stability of funding sources, composition of assets and liabilities, managing intra-day liquidity, management of liquidity in various currencies, across borders, business lines and legal entities. The strategy should also cover both normal and stressed market conditions on market-wide, firm specific, as well as a combination of both market and firm scopes.¹⁸ Senior management should also monitor the implementation of the liquidity strategy. In addition, banks should also incorporate liquidity risk in their product pricing, product approval and performance measurements.¹⁹

Thirdly, the document sets out detailed guidance on the measurement of liquidity risk to cover all important business activities and all types of liquidity risk. The scope of the measurement should cover liquidity risk positions for four bank items.²⁰ The first item is future cash flows of assets and liabilities both long-term and short-term.

¹⁶ BCBS, Principles for Sound Liquidity Risk Management and Supervision, (September, 2008), paras. 8-9.

¹⁷ Ibid, para. 10.

¹⁸ Ibid, para.11.

¹⁹ Ibid, para. 19.

²⁰ Ibid, paras. 22-46.

The second item is contingent liquidity demand. Banks should take into consideration any recourse provisions in asset sales and funding risks related to non contractual obligations particularly securitisations and conduits. They should also be aware of undrawn loan guarantees because they can drain liquidity from banks as well as potential credit risk of derivatives. The third item is that all currencies in which the bank is active should be included. The fourth element is that the effect of correspondent, custodian and settlement risks on the management of liquidity risk should be assessed and managed.

In addition, the document sets out recommendations on liquidity measurement tools. It illustrates that banks should apply various metric tools to obtain forward-looking assessments, impose liquidity risk exposure limits and design early warning systems.²¹ Finally, liquidity management should cover the bank's institutions in each jurisdiction, separately on an aggregate group basis as well as cover all types of liquidity risk on intra-day, day-to-day, and longer time horizons.²²

Fourthly, the measurement of liquidity risk is supplemented with seven principles.²³ (1) Liquidity risk should be managed on a group wide basis across business lines, currencies and legal entities. (2) Banks should set out a funding strategy that ascertains the diversification of the tenor and sources of funding. The document stresses here on the significance of maintaining market access. (3) Banks should manage their intra-day liquidity risk so that they can meet their settlement and payment obligations and should be reflected in contingency funding plans and stress testing. (4) Banks should manage their collateral so that it would be able to meet various collateral needs. (5) Another recommendation is that banks should conduct stress tests on market-wide and firm specific bases both separately and in combination. The purpose of the test is to ensure that the bank is complying with tolerance limits and accordingly amend their liquidity risk strategies. (6) The document underscores the importance of adopting a funding contingency plan appropriate for the bank's risk profile, complexity and operations. (7) Finally, the document proposes that banks should maintain a 'liquidity cushion' comprised of unencumbered liquidity assets of high quality. The size of the

²¹ Ibid, paras. 47-55.

²² Ibid, paras. 47-56.

²³ Ibid, Principles 6-12, which are illustrated in paras. 58-127.

cushion should be determined according to the complexity and risk profile of the bank. Within this context, banks should ensure that there are no legal or operational requirements preventing using these assets when needed.

Fifthly, the document reaffirms the importance of regular public disclosure of banking liquidity.²⁴ Finally, the document expands its guidance to supervisors' role in monitoring liquidity risk. While the BCBS 2000 liquidity standards were comprised of a single guidance, this document contains four principles on this regard.²⁵ It affirms the general principle that supervisors should require banks to maintain adequate liquidity and have sound liquidity risk management in line with the BCBS standards. Another principle calls supervisors to supplement their assessments with information available to the public, internal reports and prudential reports. The following principle is that supervisors should be empowered by legislation to enforce remedial measures against banks revealing deficiencies in their liquidity management or liquidity position. The final principle addresses the significance of timely and adequate information sharing between relevant domestic authorities including central banks, securities regulators, and banking supervisory authorities, as well as, on a cross border level.

4.1.3 Settlement Risk in Foreign Exchange Transactions

The BCBS emphasises the new risk-based approach in relation to foreign exchange ("FX") settlement risk²⁶ in a document issued in 2000.²⁷ FX settlement risk is defined as "the risk of loss when a bank in exchange transaction pays the currency it sold, but does not receive the currency it bought".²⁸ Settlement risk exists in all traded products, but the significant increase in banks' exposure to currency settlement risk has prompted the BCBS to set out supervisory standards.²⁹

²⁴ Ibid, para. 128.

²⁵ Ibid, paras. 132-147.

²⁶ Settlement risk is but one aspect of risks associated with currency. For further details see: Hennie van Greuning and Sonja Bratanovic, Ibid (n 8), pp. 211-230.

²⁷ BCBS, Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions, (September, 2000).

²⁸ Ibid. pp.1. para. 1.

²⁹ Ibid.

Settlement risk has many risk dimensions to it.³⁰ First, it has a credit risk ambit, as the bank might lose the whole principal value in case of its counterparty's default. Therefore, it should be treated as an equivalent credit risk exposure in terms of its size and exposure.³¹ Secondly, it has a liquidity risk dimension, as large unsettled payments can cause the receiving bank a liquidity squeeze if it has to meet other due obligations out of the unsettled amount. Thirdly, it has a legal risk, as settlements often take place across jurisdictions. Finally, there is the possibility of facing systemic risk, taking into consideration the large size of settled amounts.

In line with other BCBS documents on risk management, this document stresses on banks' senior management's role of monitoring settlement risk.³² Banks should have a clear policy on settlement risk as an indivisible part of its counterparty risk and proportionate with the size and scope of the bank's activities. The supervisory authorities' main duty is to ensure that banks have adequate procedures to measure, monitor and review risk exposures and policies related to settlement risk appropriately.³³

4.1.4 Management of Interest Rate Risk

In 2004, the BCBS issued its document 'Principles for the Management and Supervision of Interest Rate Risk' to replace the earlier 1997 document as well as support Pillar II under Basel II³⁴. The document defines interest rate risk as "the exposure of a bank's financial condition to adverse movements in interest rates"³⁵ and provides a brief explanation of the four sources of interest rate risk: "repricing risk", which is the most common type of risk and it arises from differences in term to maturity

³⁰ Ibid, pp.2, paras. 5–8.

³¹ Two points are worth mentioning here. First, settlement risk was not assigned a *minimum* capital adequacy requirement, as is the case with other risks such as credit and market risk. However, the Capital Accord, as amended, recognised this within the context of "netting," a mitigation technique often resorted to in settlements. For further details, see: the BCBS report, Interpretation of the Capital Accord for the Multilateral Netting of Forward Value Foreign Exchange Transactions, (April, 1996.)

³² BCBS, Ibid (n 27), pp.3, paras. 9-11.

³³ Ibid, pp.12, para. 47.

³⁴ BCBS, Principles for the Management and Supervision of Interest Rate Risk (July, 2004), pp. 1.

³⁵ Ibid, pp. 8-20.

for fixed interest rate or the repricing of float interest rate; “yield curve risk”, which takes place when unexpected shifts in the banks’ yield curve reduces the income of the bank or its economic value; “basis risk”, which results from unexpected differences in the rates earned and paid on financial instruments which are otherwise expected to have similar repricing features; and “optionality risk”, which stems from holding explicit or embedded options (i.e. the right of the holder to buy or sell an instrument). Options can expose banks to serious interest rate risk if asymmetrical payoffs occur.

The general principles on the management of interest rate risk apply to both the banking and trading books as well as principles applicable only to the banking book. As with the other risk categories, the BCBS general principles stress on the implementation of sound interest rate risk management practices commensurate with the bank’s size and level of diversification.

The BCBS sets out the following four basic elements for sound interest rate management.³⁶ The first element is that the bank’s board of directors and senior management should appropriately monitor the implementation policies for interest rate management. Banks should also define personnel and or committees responsible for interest risk management as well as segregate the function of position taking from key control functions to avoid conflict of interest situations. The second element concerns the essential responsibility of banks to define interest rates and policies and procedures to be applied on a consolidated basis. The procedures and policies should clearly define lines of responsibilities, authorised instruments, hedging policies, position opportunities, as well as, acceptable level of interest risk. Banks should also identify interest rate risk inherent in new instruments and activities and ensure beforehand that they are subject to adequate controls. The third element is that banks must have adequate internal controls to ensure the integrity of the interest rate risk management.

The fourth element is the appropriateness of risk measurement, monitoring and control functions. This element itself is based on four components:

The first component is interest rate measurement, which should identify the level of interest rate risk of the bank and any possible excessive exposure. The measurements should also assess all types of interest rate risk (repricing, yield curve, basis and

³⁶ Ibid, pp. 8-20.

optionality) associated with the bank's assets, liabilities and off-balance-sheet obligations as well as the affects of interest rate on the earnings and economic value of the bank.

Furthermore, the document recognises various techniques of interest rate measurements provided that they are in tandem with the complexity of the interest risk profile of the bank. It makes specific reference to the simple technique of "gap analysis", where various types of interest rate risk exposures are divided along time bands according to the next repricing (for fixed-rates) or term to maturity (for floating rates). The interest risk exposure is deducted from the gap in a time-band. The other technique is the "duration" techniques, which applies additional interest rate sensitivity weights for each time bank. And finally, for more sophisticated banks, there is the "simulation" technique which assesses the effect of interest rates by detailed simulation of the future trend of interest rates and their influence on the bank's cash flow. All techniques should be based on valid assumption and accurate methodologies. Underlying data on current positions should also be supplied accurately and in a timely fashion. The document also stresses that bank risk managers thoroughly understand the techniques.

The second component of sound interest risk measurement is the establishment and enforcement of a system of interest rate limits, which assists the bank's risk managers to control and monitor risk exposures. The third component is stress testing. Banks should test their possible vulnerability to stressed market condition and take the results into consideration when formulating their interest rate policies. Finally, the fourth component is the possession if timely and accurate reporting system of interest rate exposure.

The document makes three other recommendations generally applicable to banks interest rate risk management³⁷. First, supervisors should regularly obtain information from banks regarding their interest rate risk management. They should at a minimum, receive information adequate to spotting significant mismatches in repricing. Information should take account of exposures in various currencies and different maturities across the banking and trading books. Secondly, the banks' holding of capital

³⁷ Ibid, pp. 21-23.

should be commensurate with their level of exposure to interest rate risk. Finally, banks should disclose adequate information on their interest rate risk profile and risk management.

The document provides two guiding principles applied only to the interest risk in the banking book (i.e. the trading book is excluded³⁸). The first principle is that supervisors must ensure that banks capture their interest rate risk exposure in the banking book adequately. Banks should specifically supply their supervisors with information on their internal measurements including the results of a standardised interest rate shock measurement (or equivalent test). The other principle calls supervisors who find out that banks do not hold adequate capital in the banking book to require the concerned bank to hold additional capital, reduce its risk, or apply a combination of both remedial activities.

4.1.5. Operational Risk

4.1.5.1 General Principles

The BCBS issued in 1998 a paper on operational risk, which set out the results of an earlier survey conducted by the BCBS on the participating banks' techniques of operational risk management.³⁹ The paper illustrated that the breakdown of internal controls and corporate governance expose banks to operational risk.⁴⁰ Financial losses would be incurred because of banks' management and staff's neglect of their duties, committing faults, errors, delays or any other acts that jeopardise the bank's interests. Other causes are the failure of IT systems and disastrous events. The survey also recognised that banks' senior management's awareness of the importance of internal management had certainly increased, but operational management and monitoring system were in their infancy stage and many necessary conceptual frameworks and data

³⁸ Ibid, pp. 24-26.

³⁹ BCBS, Operational Risk Management, (September, 1998).

⁴⁰ Ibid, pp.1.

were also lacking.⁴¹ It further stated that it would be working on developing standards for the measurement, management and control of operational risk.⁴²

Banks operational risk has increased sharply in the decades as a result of advancement in banking technologies, globalisation and deregulation. Information technology, for example, has transformed the risk of manual error to IT system failures. Risk mitigation techniques such as collateral and netting also increased banks' exposure to legal risks, while reduced their market and credit risks.⁴³ Banks therefore sustained substantial losses including losses resulting from external and internal fraud, systemic failures and business disruption,⁴⁴ causing at times serious banking failures. Banks and supervisory authorities consequently started to treat operational risk management as a distinctive risk comparable to credit and market risks.⁴⁵

The BCBS responded to last-mentioned market developments by issuing in 2003 a new document on 'Sound Practices for the Management and Supervision of Operational Risk'. It defines operational risk as the risk of loss emanating from the inadequacy or failure of internal processes, people and systems as well as external events. The definition includes legal risk but excludes strategic and reputational risk.⁴⁶ It also spells out principles on sound operational risk management practices applicable to all banks, despite their sizes and complexity. First, it states that banks should develop their own operational risk framework.⁴⁷ The board of directors should approve and be familiar with such framework, regularly monitor its application and ensure that it is subject to adequate internal audit. Senior management should also be responsible for the implementation of the framework as well as developing needed policies and procedures for operational risk management. Secondly, banks should develop viable operational

⁴¹ *Ibid*, pp.1.

⁴² *Ibid*, pp. 7.

⁴³ BCBS, Sound Practices for the Management and Supervision of Operational Risk, (February, 2003), pp.3, para. 3.

⁴⁴ *Ibid*, pp.2, para.5.

⁴⁵ *Ibid*, pp.3, para. 7-8.

⁴⁶ *Ibid*, pp.2, para. 4.

⁴⁷ *Ibid*, pp. 6-8, paras.11-22.

risk management programmes covering the stages of risk identification, assessment, monitoring and control or mitigation.⁴⁸ Identification and assessment of operational risk should cover all substantial products, activities, systems and processes undertaken or to be introduced. Operational risk should also be regularly monitored and reported thereon to senior management. Banks also need to regularly review their risk control strategies and adjust their risk profile accordingly, as well as, adopt risk contingency and continuity plans. Thirdly, banks should disclose adequate information about their operational risks.⁴⁹

As to the role of banking supervisory authorities, the document sets out two important principles:⁵⁰

“Banking supervisors should require that all banks, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management”.

“Supervisors should conduct, directly or indirectly, regular independent evaluation of a bank’s policies, procedures and practices related to operational risks. Supervisors should ensure that there are appropriate mechanisms in place which allow them to remain apprised of developments at banks”.

4.1.5.2 High Level Principles on Business Continuity

One of the most significant issues in operational risk management is to ensure effective business continuity management during major disruptions such as earthquakes, outbreak of Avian Flu, and terrorist attacks. The BCBS and other members of the Joint Forum issued their specialised guidance ‘High-level Principles for Business Continuity’ in 2006. This document provides the following definition for business continuity management:⁵¹

“A whole-of-business approach that includes policies, standards, and procedures for ensuring that specified operations can be maintained or recovered in a timely fashion in the event of a

⁴⁸ *Ibid*, pp. 8–14, paras. 23–44.

⁴⁹ *Ibid*, pp. 14, paras. 50–51.

⁵⁰ *Ibid*, pp. 13.

⁵¹ Joint Forum, High-level Principles for Business Continuity, (August, 2006), pp.1.

disruption. Its purpose is to minimise the operational, financial, legal, reputational and other material consequences arising from a disruption".

The document illustrates that effective business continuity management is comprised of three elements. It starts with a business impact analysis, which identifies and measures the effects of loss of business both quantitatively and qualitatively. The other element is the recovery strategy which spells out the recovery objectives and prioritises actions in light of the business impact analysis. The last element is the provision of a business continuity plan which provides details on the recovery strategy.⁵²

The document provides seven principles comprising a framework for business continuity management for both financial supervisors and financial institutions.⁵³

The first principle calls upon institutions to have business continuity management integrated within their risk management plans and procedures. This entails the board and senior management roles in developing and implementing sound business continuity management, and an adequate reporting framework. It also covers defining roles, responsibilities and succession plans, particularly determining the *locus* of responsibility during a crisis. The second principle emphasises on the importance of addressing major operational disruptions on business continuity including the allocation of a remote alternate site with adequate infrastructure, the availability of current data and essential systems and equipment as well as the provision of sufficient staff.

The third principle advises setting out recovery objectives which represent the scale of the institution's operations and risk profile. Critical service problems e.g. should be recovered within the day of disruption. Supervisory authorities are also advised to participate in the recovery objectives of supervised institutions. The fourth principle emphasises on the inclusion of effective communication procedures with internal and external parties during the event of operational disruptions, including the decision to invoke the business continuity plan. The communication procedures should, at a minimum, identify personnel charged with communication, utilise existing communication protocols, regular updating for contact details, responses to

⁵² Ibid, pp. 7 read together with the glossary on pp. 1-4.

⁵³ Ibid, pp. 11-18.

communication disruption and, as far as financial institutions are concerned, contain contact information with government authorities.

Principle five warrants the attention of both supervisors and institutions to the importance of cross-border communication during disruptive events and the necessity of including related procedures in business continuity plans. The sixth principle draws attention to the significance of testing business continuity plans, and accordingly updating these plans. Finally, the document calls upon financial authorities to incorporate the evaluation of business continuity plans in their assessment of supervised institutions.

4.1.6 Compliance Risk

Compliance risk has emerged as a new type of banking risk,⁵⁴ as a result of compliance related deficiencies which occurred in important international banking institutions, most significantly ABN AMRO Bank.⁵⁵ The BCBS responded by issuing a novice document for this purpose in 2005 entitled 'Compliance and the Compliance Function in Banks'. This document defines compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities".⁵⁶ The definition of compliance risk is therefore a broad one as it entails breach of legislation and codes of conduct related to anti-money laundering and countering the financing of terrorism on one hand, and other legislation such as tax evasion, on the other hand.⁵⁷

The BCBS and other standard-setting fora, most notably, the Financial Action Task Force ("FATF")⁵⁸, an inter-governmental forum which aims at setting out policies for promoting anti-money laundering and the financing of terrorism, had already

⁵⁴ BCBS, Basel Committee Issues Guidance on the Compliance Function in Banks, Press Release 29 April, 2005.

⁵⁵ Arnold Schilder, 'Banks and the Compliance Challenge', BIS Review No. 20, 2006 pp. 4-6.

⁵⁶ BCBS, Compliance and the Compliance Function in Banks, (April, 2005), pp. 7.

⁵⁷ *Ibid*, pp. 7.

⁵⁸ For Further details, please see: www.fatf-gafi.org.

recognised and addressed the potential danger of money laundering and the finance of terrorism. It is beyond the scope of this thesis to discuss in detail related international standards. It is sufficient to mention that early documents focused on the duty of banks to know their customer for financial crimes purposes, while the 2005 BCBS document on compliance seeks to create an umbrella compliance function which generally embedded within the bank's culture. In addition, it charges bank's boards of directors with the duty to approve their respective banks compliance policies including the establishment of a formal policy document as well as monitoring the management of compliance risk.⁵⁹ The major responsibilities for managing the compliance function fall on the senior management; it is their duty to ensure that the compliance plan is observed, and disciplinary or remedial action is imposed and reported to the board of directors whenever there is a breach. They are also responsible for the establishment of an effective and permanent compliance function.⁶⁰

The BCBS does not impose on banks to have a separate unit or department for compliance, as long as they have independent and well resourced compliance functions capable of undertaking their responsibilities. The latter document however, also recommends that the compliance function be subject to the internal audit function⁶¹. It further sets out four safeguards for the independence of the compliance function. First, it should have a formal written document establishing its status within the bank. Secondly, there should be a head for the overall compliance function of the bank. Thirdly, compliance staff should not be charged with other responsibilities that do or may conflict with their compliance duties. Finally, compliance staff should have access to documents and be empowered to induct investigations as well as have a direct reporting line to the board of directors.⁶²

It is noteworthy that Basel II⁶³ does not cover compliance risk. It rather states that banks should cover all material risks in their capital assessments.⁶⁴ Basel II lists

⁵⁹ BCBS, *Ibid* (n 56), (April, 2005), pp. 9-10.

⁶⁰ *Ibid*, pp. 10.

⁶¹ *Ibid*, pp.15.

⁶² *Ibid*, pp.10-13.

⁶³ References to Basel II in this Thesis are made to the Comprehensive Version issued by the BCBS in June 2006. This document is a compilation of the June 2004 Basel II Framework, the elements of the

compliance risks within a broad category of “other risks” (i.e. other than credit market, operational, interest rate risk in the banking book) expecting banks to manage them despite admitting that they are not easily measured.⁶⁵

4.2. Public Private Partnership

The new risk focused approach requires the co-operation between a number of public and private key players: the supervisory authorities, bank management, shareholders, external and internal auditors and the general public. Therefore, the BCBS has increasingly focused on setting standards on corporate governance, external and internal auditors as well as transparency of banks’ financial systems.

4.2.1. Internal Control

Significant banking failures, which took place during the 1990s were attributed to weak internal controls.⁶⁶ The first shortcoming in internal controls was weak board management oversight of the internal control function, particularly, in relation to two elements: lack of emphasis on the importance of strong internal control systems and failure to define organisational structures and lines of managerial responsibilities. The second shortcoming was inadequate risk identification and assessment. An example was banks’ involvement in new sophisticated financial instruments without updating their risk assessment systems. A third shortcoming was the lack of segregation of duties. Another shortcoming was inaccuracy and inadequacy of financial information and problems in communicating important information such as reports on improprieties committed by employees. Finally, banks did not effectively monitor their internal controls or did not adequately address weaknesses referred by evaluation reports.

In light of the lessons learned from above banking failures, the BCBS issued its 1998 document ‘Framework for Internal Control Systems in Banking’. It defines

former 1988 Capital Accord that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to Incorporate Market Risks, and the November 2005 paper on Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework.

⁶⁴ BCBS, Basel II, para. 732, pp. 206.

⁶⁵ Ibid, para. 742 read in conjunction with pars. 733-741, pp. 206-208.

⁶⁶ BCBS, Framework for Internal Control Systems in Banking Organisations, (September, 1998), see generally: Appendix II pp. 27-31.

internal control as a “process” necessary for a bank to meet its objectives and achieve financial viability, rather than the historic approach which saw internal control a merely a mechanism for decreasing banks’ exposure to errors, misappropriations and fraudulent actions.⁶⁷ The document sets out twelve principles on sound internal control which evolve around five elements:

The first element is management oversight and control culture. The document takes the view that the board of directors has the ultimate responsibility for maintaining adequate and effective internal control systems. They should accordingly approve and monitor the business strategy, organisational structure and risk levels of the bank.⁶⁸ The senior management should implement and monitor the application of said and policies, as well as, oversee the banks’ risk levels and organisational structure. Senior management should also delineate responsibilities including the delegation of responsibilities, and set out reporting lines.⁶⁹ Both board of directors and senior management should establish and promote a strong internal control system that can be well understood by all personnel.⁷⁰ In addition, compensation schemes should not provide wrong incentives to personnel so that long term performance targets are not jeopardised for short term profits.⁷¹

The second element is risk recognition and assessment. The document states that the risk control system should cover all material risks faced by the bank and should be constantly reviewed to capture new and any existing uncontrolled risks.⁷²

The third element is controlling activities and segregation of duties. The document illustrates that control activities should be an integral part of every-day business of the bank.⁷³ Examples of control cover are top-level reviews undertaken by

⁶⁷ *Ibid*, pp. 1.

⁶⁸ *Ibid*, Principle 1, pp. 2.

⁶⁹ *Ibid*, Principle 2, pp. 3.

⁷⁰ *Ibid*, Principle 3, pp. 3.

⁷¹ *Ibid*, pp. 13.

⁷² *Ibid*, Principle 4, pp. 3.

⁷³ *Ibid*, Principle 5, pp. 3.

boards of directors and senior management (e.g. comparing financial results as opposed to the budget); reports of activities on a department or division level; physical controls such as limiting access to vaults; setting up and observing risk exposure limits; approval and authentication requirements concerning specific transactions; and verification of transactions and undertaking periodical reconciliations. (e.g. comparing cash flows and account records). Secondly, the stresses on the segregation of duties and avoiding assigning conflicting responsibilities to the same person. For example responsibilities for the trading book and the banking book should be segregated.⁷⁴

The fourth element is information and communication. The document emphasises the need for the establishment of a reliable information management system. The information system should cover internal data external market information needed to support decision-making. In addition, information should be provided on a standard format and meet the requirements of reliability, timeliness and accessibility.⁷⁵ Reliable information systems should cover all of the bank's activities.⁷⁶ Furthermore, there should be an adequate flow of information in all directions throughout the banking institution.⁷⁷

The fifth element is monitoring activities and correcting deficiencies. The document stresses on the importance of monitoring the effectiveness of the internal control systems on a continuous basis.⁷⁸ The document also emphasises the importance of internal audits in building a robust control system. Auditors should be well trained, competent, enjoy operational independence and report directly to senior management or, where applicable, the audit committee.⁷⁹ Finally, the document recommends that deficiencies in the internal auditing should be timely reported to the appropriate managerial level, and that there should be quick response to correct such deficiencies.⁸⁰

⁷⁴ *Ibid*, Principle 6, pp. 4.

⁷⁵ *Ibid*, Principle 7, pp. 4.

⁷⁶ *Ibid*, Principle 8, pp. 4.

⁷⁷ *Ibid*, Principle 9, pp. 4.

⁷⁸ *Ibid*, Principle 10, pp. 4.

⁷⁹ *Ibid*, Principle 11, pp.4.

⁸⁰ *Ibid*, Principle 12, pp. 5.

In addition to the above, the document stresses that banking supervisory authorities should require banks to implement adequate internal control systems, relatively to the size of the bank and the nature of its on and off balance sheet activities. It calls supervisors to monitor whether banks have adequate internal control system and adopt necessary measures to address weaknesses in the internal control system. The document further encourages supervisors to adopt a risk-focused approach that is flexible and institution-specific. Banks should for example address special attention to situations usually associated with increased risks such as introducing changes in personnel and information systems.⁸¹

4.2.2. Internal Audit

The BCBS issued its specialised document 'Internal Audit in Banks and the Supervisor's Relationship with Auditors' in 2001.

The role of internal auditors was further elaborated on in the specialised 1998 BCBS paper on Internal Audit in Banks.⁸² This document illustrates that the objective of the internal audit is providing assistance to the board of directors and senior management in carrying out their responsibilities effectively and efficiently.⁸³

Internal auditing should also adhere to various principles.⁸⁴ It should first of all be a permanent function and, therefore, should be supplied with adequate resources and staff commensurate with the size and complexity of its activities. The internal audit must also be independent from the daily control process as well as the bank's audited activities. The internal audits therefore should be given an appropriate standing within their organisation. Specifically they should be able to undertake their duties on their own initiatives, be placed directly under and have direct communications with the chief executive, board of directors or, where applicable, the auditing committee. The internal audit should undertake its assignments free from any undue interference and bias, which entails avoiding conflict of interest as well as any involvement in a banking operation

⁸¹ Ibid, pp. 22-24.

⁸² BCBS, Internal Audit in Banks and the Supervisor's Relationship with Auditors, (August, 2001).

⁸³ Ibid, pp 3.

⁸⁴ Ibid, pp. 4 – 8.

which would adversely affect its independence of judgement. Furthermore, each bank should draw up and circulate throughout the organisation an audit charter that increases enhances the standing of the internal audit.

Individual internal audits as well as the internal audit department as a whole should be competent by acquiring knowledge, experience and continuous training. The scope of internal auditing should cover all of the bank's activities and entities including subsidiaries, branches and outsourced functions. They should be given access to all data and records including those related to management. In addition, it should regularly review the internal capital assessment procedure of the bank. Furthermore, the document recommends the establishment of a permanent audit committee particularly for large, complex banks as a solution to the practical problems of maintaining internal controls.⁸⁵ The document also accepts the outsourcing of internal auditing, a practical method for smaller banks, provided that the board of directors and senior management continue to be the ultimately responsible parties for maintaining effective internal controls.⁸⁶

In addition to the above, the document stresses on the tripartite relationship between supervisors and external auditors, between supervisors and external auditors as well as between external audits and internal audits.

The relationship between supervisors and internal audits: Supervisors should assess the work of the bank's internal audits. If the supervisors are satisfied with the level of internal auditing, then they can rely on their reports as the main mechanism to identify internal control problems and potential risks.⁸⁷ Bank supervisors are also recommended to undertake regular consultations with the internal audits in order to discuss risk areas and how such risks should be dealt with.⁸⁸ In addition, supervisors are recommended to meet with heads of internal audits if and when they are relieved from their duties. Furthermore, it is considered good practice for the supervisory authorities to discuss matters of general policies with the internal audits.

⁸⁵ Ibid, pp.15.

⁸⁶ Ibid, pp. 17.

⁸⁷ Ibid, pp. 11.

⁸⁸ Ibid, pp. 11-12.

The relationship between internal and external auditors: The document envisages a role for supervisors in encouraging co-operation between external and internal auditors.⁸⁹ It explains the mutual benefit of the co-operation for both of them. External auditors have a positive impact on the quality of internal auditing. The external auditors on their part may find internal audits helpful in determining the scope, timing and nature of their auditing. They both need to co-ordinate efforts as well as exchange information on significant issues which affect their work, reports and common understanding.⁹⁰

The relationship between supervisors and external auditors: The document illustrates that the relationship between supervisors and external auditors should be regulated under law or contractual. It also stresses that supervisors can only assign to the external auditors tasks which are within the latter's competence or complementary to their regular assignments.⁹¹ The co-operation between supervisors and external auditors is important because they can provide each other with insights originating from their perspective works. External auditors, as an important example, can provide supervisors with significant information such as the failure of the audited bank to meet one or more of the banking licensing requirements or where there is a substantial adverse movement in the bank's risk exposures.⁹² The paper therefore has recommended relieving external auditors from legal responsibilities for disclosing confidential information to supervisors in good faith,⁹³ as well as, legalise disclosure of information by supervisory authorities to external auditors when this is found necessary for performing supervision.⁹⁴

Co-operation among the supervisory authority, the external auditors and the internal auditors: Finally, the document recommends co-operation among the three

⁸⁹ Ibid, pp. 12.

⁹⁰ Ibid.

⁹¹ Ibid, pp. 13.

⁹² Ibid.

⁹³ Ibid, pp. 14.

⁹⁴ Ibid, pp. 15.

parties in order to achieve efficiency and effectiveness in performing their tasks. It also recommended holding regular periodic meetings among them.

4.2.3. Supervisory Authorities Relationship with External and Internal Auditors

The BCBS issued in 2002 its document 'Internal Audit in Banks and the Supervisor's Relationship with Auditors'. This document looks into the responsibilities of the directors and management, explains the respective roles of, and the inter-relationship between the auditors and banking supervisory authorities as well as the contribution of auditors to the supervisory process.

First, the document emphasises the primary responsibility of the board of directors and management.⁹⁵ It reiterates that the primary responsibility for the conduct of the business of a bank is vested in the board of directors and the management appointed thereby. The bank's management should undertake the responsibilities of preparing financial statements according to an appropriate reporting framework, allowing external auditors accessibility to information needed to perform their tasks and adopting necessary measures to ensure the continuity and adequacy of the internal audit function. Furthermore, the internal audit function should be independent, well resourced and regularly report to the bank's board of directors and management. The management, therefore, should ensure that there are procedures established for the consideration and, whenever appropriate, the implementation of the recommendations of the internal audit.

Secondly, the document clarifies the main features of the role of the external auditors.⁹⁶ Most importantly, the document explains that the objective of the external auditors' opinion is to ascertain the credibility of the bank's financial statements and not to provide assurances on either the future viability of the bank or the effectiveness or efficiency of its management. Furthermore, the external auditor follows procedures set out to ensure that the bank's financial statements are prepared according to an identified financial reporting framework. The audit, however, does not provide a guarantee that all material misstatements, such as failure to disclose essential information, will be

⁹⁵ BCBS. The Relationship between Banking Supervisors and Banks' External Auditors. (January, 2002), pp. 2-4.

⁹⁶ Ibid, 4-8.

detected. Where a material misstatement is detected, the external auditor asks management to correct the misstatement by adjusting the financial statements. Otherwise, the external auditor issues an adverse or a qualified opinion on the financial statements, which could have serious repercussions on the credibility and even stability of the concerned bank. In addition, the document explains that the practice in certain countries is that the auditor sends reports the banks management on internal control function. In some countries the auditor is required to promptly report to the supervisor of any material breach of law. The document however did not make recommendation on this regard, the.

Thirdly, the document explains the role of the banking supervisors as to maintain the stability of the banking system.⁹⁷ The supervisory tasks depend heavily on the collection and analysis of information and, therefore, supervisors need to received data and information through onsite inspection or external auditors. That is why supervisors are interested that external auditors are independent, licensed, in good standing, have professional experience, competent, objective and impartial and subject to applicable codes of ethics and quality assurance programs.

The document then proceeds to review the relationship between the banking supervisor and the bank's external auditors.⁹⁸ It explains that external auditors and supervisors play complementary roles.⁹⁹ First, the primary concern of the supervisor is to maintain the safety and soundness of the whole banking system and, therefore, he or she monitors the current and future viability of the bank on basis of its financial statements, amongst other tools. By contrast, the auditor is interested in reporting on the financial statements to the bank's board of directors and shareholders and consequently judges the bank's management on the going concern assumption. Likewise, bank supervisors are interested in the role of the internal control function in maintaining the safety of the bank's activities while the external auditor is focused on the reliability of internal control to plan and perform the audit. Bank supervisors and external auditors also share the same interest that banks maintain adequate and reliable financial records, but for various reasons: the supervisors are interested in the sound appraisal of the

⁹⁷ Ibid, pp. 8-11.

⁹⁸ Ibid, pp. 12-15.

⁹⁹ Ibid, pp. 12.

financial condition of the bank and its profitability, while auditors need to avoid material misstatements in order to express their opinion on financial statements.

In cases of supervisory authorities, which assign part of their supervisory duties to external auditors, the document requires the establishment of a suitable legal framework in the form of contract or legislation as well as sets criteria that should be applied to separate engagements.¹⁰⁰ First, the bank's management retains the primary responsibility of supplying the supervisor with complete information. Secondly, the normal relationship between the bank and the external auditor should be retained. For example, information should be furnished to the supervisor by the bank itself. Thirdly, the external auditor needs to resolve any problem of conflict of interest before undertaking an assignment. Fourthly, supervisory tasks assigned to the auditor must be clear and specified. Fifthly, the supervisor should only assign tasks that can be technically and practically undertaken by an auditor. Sixthly, there should be a rationale for assigning a task to the auditor, for example, to reduce cost or avoid duplication of work. Finally, the confidentiality duty of the auditor should not be breached.

The significance of the role of the external auditor for sound banking supervision has been highlighted by the recent BCBS document 'External Audit Quality and Banking Supervision' issued last December. This illustrates four key areas of interest: supervisory authorities and banks have increased their reliance on the external auditors' expert judgment; state of the art auditing improves market confidence, specially in times of market stress; supervisors are increasingly relying on high-standard bank auditing to complement their processes; and the globalisation and complex structure of major external audit firms draws attention to possible weak governance and lack of transparency, which could adversely affect the bank.¹⁰¹

The BCBS has accordingly set out a list of actions to address the above areas in cooperation with international bodies representing external auditors.¹⁰²

¹⁰⁰ Ibid, pp. 15-17.

¹⁰¹ BCBS, External Audit Quality and Banking Supervision, (December, 2008), pp. 4-8.

¹⁰² Ibid, pp. 8-9.

4.2.4. Accountancy and Transparency

The recognised international accountancy standard setter is the International Accounting Standard Board (“IASB”) (previously known as the International Accounting Standard Committee (“IASC”)). IASC was established in 1973 and has been issuing International Accounting Standards (“IAS”). The issue of banking accountancy, however, is relevant to supervisory work for two reasons. Accounting standards are an essential basis of reliable measurement of banks’ equity and income, assets, liabilities and transparency.¹⁰³ Accountancy standards also enjoy an increasing importance in the new supervisory approach where transparency of accounts is considered an essential ingredient to assure market discipline. The BCBS has, therefore, established a Task Force on Accounting issues in 1996.

The BCBS undertook a review of accounting standards both international and domestic, upon the request of the Group of Seven (“G-7”) Central Bank Governors and Finance Ministers in October 1998. The BCBS also issued separate guidelines on the four interrelated issues of loan-loss provisioning, loan valuation, fair value accounting and banking transparency. These documents include its document on ‘Sound Practices for Loan Accounting and Disclosure’ issued in July 1999 and the above-discussed document ‘Sound Credit Risk Assessment and Valuation of Loans’ in 2006.

4.2.4.1. Enhancing Bank Transparency

The BCBS issued the document ‘Enhancing Bank Transparency’ in 1998. It defines transparency as “public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank’s financial condition and performance, business activities, risk profile and risk management practices”.¹⁰⁴

The document adopts the view that bank supervisors can play an active role in improving bank transparency in three ways. First, in order to achieve the “maximum benefit of public disclosure”, supervisors should pursue policies that encourage the

¹⁰³ BCBS, Report to G 7 Finance Ministers and Central Bank Governors on International Accounting Standards, (April, 2000), pp. 6.

¹⁰⁴ BCBS, Enhancing Bank Transparency: Public Disclosure and Supervisory Information that Promote Safety and Soundness in the Banking Systems, (September, 1998), pp. 4.

disclosure of comparable, relevant, reliable and timely information.¹⁰⁵ Supervisory authorities can particularly encourage the application of supervisory definitions as well as reporting classifications for disclosure purposes.¹⁰⁶ Supervisors should also cooperate with the banking industry in order to reduce the costs of disclosure.¹⁰⁷ Secondly, supervisory authorities should utilise their stock of supervisory information in order to enrich market information, providing that this done legally e.g. by publishing aggregate information on banks.¹⁰⁸ Finally, supervisors should use their powers to ensure compliance with disclosure standards. Compliance can be complemented with the application of effective internal control, sound risk management systems and independent external auditing.¹⁰⁹

The document also provides a number of recommendations on transparency.¹¹⁰ Most importantly, it recommends that banks should disclose their financial statements to the public under the six broad categories: financial performance (particularly profitability), financial position (including capital, solvency and liquidity), risk management strategies and practices, risk exposures (market, liquidity, operational and legal risks), accounting policies as well as basic business, management and corporate governance information. The level of details within each category should be relevant to the bank's size and nature of business.

4.2.4.2 Fair Value Accounting

Traditionally banks held their assets and liabilities to maturity and applied historical cost accounting, which is based on the original purchase price. Deterioration in the value of loans under this approach is recognised only when assets are impaired and provisions are held against them. When banks in industrialised countries became more involved in securities markets, they started to apply the fair value approach to

¹⁰⁵ *Ibid*, pp. 10.

¹⁰⁶ *Ibid*, pp. 11.

¹⁰⁷ *Ibid*, pp. 11.

¹⁰⁸ *Ibid*, pp. 12.

¹⁰⁹ *Ibid*, pp. 13.

¹¹⁰ *Ibid*, pp. 17-26.

their trading book. Instruments held for trading purposes would be valued according to market prices.¹¹¹

This mixed approach in accounting methodology in the banking book and the trading book was followed by IASC in its International Accounting Standard 39 'Financial Instruments: Recognition and Measurement' ("IAS 39") first issued in 1998 then amended in 2005. The initial IAS 39 applied fair value accounting to derivatives and securities held for trading purposes, while applied amortised value to deposits, loans and securities held to maturity. In 2005, IAS 39 was amended to permit institutions to decide irrevocably on the designation of any financial instrument as at fair value, where certain conditions are met. This was an important development for banks implementing or planning to implement internal risk-based models, which brought the evaluation of their loan book closer to an economic value than the historical cost value.¹¹²

The BCBS responded to accounting developments by issuing its 2006 document 'Supervisory Guidance on the Use of the Fair Value Option for Financial Instruments by Banks'. This document illustrates the banking supervisory expectations relevant to the adoption of fair value generally, (though it reflects specifically on IAS 39) as well as, supervisory evaluation of banks' application of the fair value option.

Concerning supervisory expectations,¹¹³ banks should meet the criteria set out under IAS 39, which allows banks to use the fair value option for the purpose of substantially reducing or eliminating accounting mismatch, or where a group of assets and/or liabilities is evaluated and managed on a fair value basis. Supervisors should also ensure that banks set out and implement sound risk management systems before they apply fair value and continuously afterwards. Risk management systems need to focus particularly on the volatility of fair values as well. In addition, supervisors expect that banks will apply fair value options only to instruments that they are capable of estimating their fair values. If the value can be obtained from market prices, banks should ensure that the mentioned market is liquid and that prices do represent actual

¹¹¹ Patricia Jackson and David Lodge, 'Fair Value Accounting: Capital Standards, Expected Loss Provisioning and Financial Stability', 2000 Financial Stability Review, (8)(June), pp. 106.

¹¹² *Ibid*, pp. 120.

¹¹³ BCBS, Supervisory Guidance on the Use of the Fair Value Option for Financial Investments by Banks, (June, 2006), pp. 6-11.

trades. Banks should apply more robust methods where the market is illiquid, e.g. by reference to similar financial instruments traded in more liquid markets. Where the value cannot be obtained from the market, banks should apply robust valuation methods. Whatever valuation method is applied, it should be documented and back-tested. Finally, supervisors may require banks to provide additional information to enable them to assess the impact of fair value measurement on the level of banks' capital, earnings, and risk.

The document sets out three guiding principles on supervisory evaluation of controls, risk management and capital adequacy for banks applying the fair value option.¹¹⁴ Supervisors should at least ensure that banks comply with the above guidelines on supervisory expectations as well as IAS 39. Supervisors should also examine the effect of risk management and controls pertaining to the use of fair value in their capital adequacy assessments. Potential supervisory responses to the lack of sound fair value evaluation include increase of capital and the exclusion of related unrealised Tier 1 Capital. Finally, banks should adjust their capital when designating a financial liability as at fair value, which could cause gains and losses from changes in credit risk.

The market turmoil of 2007-8 revealed difficulties in estimating fair values emanating from the wide use of complex structured financial instruments. As market liquidity was reduced rapidly and prices were no longer available, banks had to depend more on unobservable inputs.¹¹⁵ The BCBS evaluated the challenges emanating from the valuation of fair value lately in June 2008 and proposed developing related international supervisory standards in relation to five areas: (1) governance and controls; (2) quality of measurement tools and diversification of valuation measures; (3) production of valuations during stressed periods; (4) banks assessment of uncertainty in valuation; and (5) internal and external transparency.¹¹⁶ A new Consultative document was issued accordingly and it is open for comment until February 2009.¹¹⁷

¹¹⁴ Ibid, pp. 11-13.

¹¹⁵ BCBS, Fair Value Measurement and Modelling: An Assessment of Challenges and Lessons Learned from the Market Stress, (June, 2008), pp. 3.

¹¹⁶ Ibid, pp. 7.

¹¹⁷ BCBS, Supervisory Guidance for Assessing Banks' Fair Value Practices, (November, 2008).

4.2.5. Corporate Governance

The issue of corporate governance gained momentum towards the end of the 1990s. The OECD was the first inter-governmental organization to develop international standards for corporate governance. The OECD document 'Principles of Corporate Governance' were issued in 1999 to serve as a benchmark against which governments evaluate and improve their related legislation. It defined corporate governance as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders”, as well as “the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”.¹¹⁸ Furthermore, the document set out five categories of non-binding principles of corporate governance, which focused on a particular cause of corporate failures; namely, the lack of separation between ownership and control. These categories were the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board.

In 2004, the OECD issued the revised 'OECD Principles of Corporate Governance' in response to prominent corporate failures such as Parmalat in Italy and Enron in the USA. Public concerns were also raised concerning the enforceability of the principles, particularly the independence and accountability of board members and the opacity of corporate structures in many jurisdictions. Furthermore, the initial OECD principles did not cover executive compensation and institutional investors.¹¹⁹

The revised OECD principles retain the five categories of the earlier document and build upon them. Below is a brief review of the principles with particular focus on the amendments introduced by the revised document:

¹¹⁸ OECD, Principles of Corporate Governance, (1999), pp. 8.

¹¹⁹ Bill Witherell, 'Corporate Governance: Stronger Principles for Better Market Integrity' 2004 OECD Observer, (243)(May).

First, the revised principles introduce a sixth set of principles entitled “the governance frameworks, which aims to promote market transparency and efficiency as well as define the lines of responsibilities among various supervisory authorities.”¹²⁰

Secondly, the category of protection of shareholders’ rights covers a wide array of rights. First, basic rights including securing ownership registration, conveyance of shares, obtaining information on the corporation, participation and voting in general shareholders meetings, taking of profits and electing members of the board. Secondly, participation in fundamental corporate decisions such as amendments to the articles of association and extraordinary transactions. Thirdly, *effective* participation in general shareholding meeting safeguarded by furnishing shareholders with timely and adequate information on their meetings, securing their right to ask questions and vote in person or in absentia. Fourthly, disclosure of corporate structures which might lead to disproportionality between control and equity ownership such as pyramid structures and cross shareholdings, shares with multiple or limited voting rights, and shareholders’ agreements granting preferential rights.¹²¹

The revised principles further strengthen shareholder’s rights. They empower shareholders to remove members of the board of directors for the first time.¹²² They also grant shareholders are also granted the novice right to decide on the remuneration policy for key-executives and board members.¹²³ In addition, institutional investors are required for the first time to disclose their corporate governance policies; their plans on using their voting rights as well as how they manage material conflict of interest. Furthermore, restrictions on shareholders to consult each other on the exercise of their rights are recommended to be eased, where there is no breach of applicable Competition Law.¹²⁴

¹²⁰ OECD, *Ibid* (n 118), pp. 11.

¹²¹ *Ibid*, pp. 29-31.

¹²² *Ibid*, pp. 33.

¹²³ *Ibid*, pp. 34.

¹²⁴ *Ibid*, pp. 37-39.

Thirdly, the principles stress on the equitable treatment of shareholders, including minority and foreign shareholders, whereby self-dealing is prohibited and redress of violation of rights is granted.

Fourthly, the principles call for the protection of the rights of stakeholder such as creditors and employees to be protected while recommending performance-enhancing mechanisms. The revised principles tackle the protection of stakeholders whether established by mutual agreement or by law. They also recommend providing procedures and protection for employees and their representative bodies' who pass information on the corporate's unethical or illegal behaviour.¹²⁵

Fifthly, the initial principles called for timely and accurate disclosure of all material information including "[t]he financial operating results of the company; Company objectives; Major share ownership and voting rights; Members of the board and key executives, and their remuneration; Material foreseeable risk factors; Material issues regarding employees and other stakeholders; Governance structures and policies".¹²⁶ It also called for information to be prepared by independent auditors and be subject to auditing and disclosure requirements according to best international accounting standards, and that information is disseminated giving users fair and cost-efficient access, The new principles add new elements to the definition of material information for disclosure purposes, being party transactions of major shareholders, or close family members.¹²⁷ They also focus on the independence of the auditors and call for their accountability before shareholders and their duty to exercise professional care.¹²⁸ Another new principle states that rating agencies, brokers and other entities responsible for providing information analysis and advice should avoid conflict of interest situations.¹²⁹

Finally, the initial principles covered the responsibilities of the board members and their accountability before the company and its shareholders. The principles also stressed on

¹²⁵ Ibid, pp. 47.

¹²⁶ Ibid, pp. 21.

¹²⁷ OECD, Principles of Corporate Governance, (2004) pp.52.

¹²⁸ Ibid, pp. 55-56.

¹²⁹ Ibid, pp. 56.

the board's independence from management, and recommended the appointment of non-executive board members. It also called management to devote adequate time to the company. The revised principles clarify the duty of board members as a "fiduciary duty" which combines a duty of care and a duty of loyalty.¹³⁰ They also add a new function to the board members; namely, the alignment of board and key executive remuneration with the interests of the company and its shareholders.¹³¹ The principles also stress on the independence of the board. They do not recommend the adoption of the tow-tier structure but suggest that the role of the chief executive should be segregated from the role of the chairman. Furthermore, they emphasise the independence of board members from controlling shareholders.

The BCBS has stressed on the importance of corporate governance in various documents including the 1999 document 'Enhancing Corporate Governance for Banking Organisations,' which reinforced the OECD first set of principles, and addressed and updated its principles in this regard.¹³²

In its attempt to define corporate governance, the BCBS document quoted the following definition from the OECD standards:

"[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".¹³³

Furthermore, the document explained that as far as banks are concerned, corporate governance entails how banks' boards of governors and senior management manage their respective banks, and influenced how these banks do the following: set objectives for the banking corporation; run the daily business operations; adjust the

¹³⁰ Ibid, pp. 59.

¹³¹ Ibid, pp. 61.

¹³² BCBS Enhancing Corporate Governance for Banking Organisations, (September, 1999), pp. 1.

¹³³ Ibid, 3.

bank's objectives and behaviour with the need to maintain the safety and soundness of the banking business and compliance with applicable legislation; the protection of the depositors' interests; and serve the interests of various stakeholders who include bank's employees, suppliers and customers should be adequately addressed. The government and supervisory authorities are considered amongst the stakeholders as well, due to the particular nature of the banking business.¹³⁴

The BCBS 1999 document provided for the following standards of sound corporate governance practices:¹³⁵

First, banks should set strategic objectives and corporate values to control the ongoing operations of the bank. These values should be applied to top management and circulated throughout the banking institution. The board of directors should be certain that senior management is adopting policies which counter practices likely to reduce the quality of corporate governance including conflict of interest, imprudent self-dealing (for example lending to banks' employees on terms inconsistent with market conditions), and treatment of related parties on a preferential basis.

Secondly, the key responsibilities and line of authorities of both the boards of directors and senior management should be defined clearly in order to avoid slow and diluted responses to problems. Senior management is ultimately responsible for the running of the banking business though they should also set a hierarchy of accountability for staff.

Thirdly, the board of directors should provide checks and balances to senior management. Board members should also be well qualified, understanding their role as well as be independent. Measures that can be adopted to ensure that board members do not fall under undue influence from both bank management and outside concerns include having a sufficient number of board members, including qualified independent members from outside the management or a separate supervisory board of auditors. Furthermore, the board should regularly evaluate its performance and adopt any necessary corrective measures.

¹³⁴ Ibid.

¹³⁵ Ibid, pp. 5-9.

Fourthly, senior management should monitor line managers of specific business activities. In smaller banks, the rule of “four eyes principle,” decisions being made by at least two people, should be applied. The senior management group should also include the chief auditor, the chief financial manager and divisions’ heads. They should enjoy adequate skills and knowledge as well as control over key individuals.

One of the remaining three principles illustrated the important role of internal and external auditors should be recognised and properly utilised in order to enhance banking corporate governance. Another principle called for banks’ compensation schemes to be aligned with their overall values, objectives, strategies and control environment. This recommendation was particularly relevant to traders and loan officers. The experience of the failure of Barings bank, as a strong example, illustrated that business incentive schemes should not be based only on volume or short term profits. Finally, the document focused on the need to enhance corporate governance with transparency.¹³⁶

After the OECD had released its new revised principles on corporate governance, the BCBS launched consultations on amending its own guidance for banks. It issued its document 'Enhancing Corporate Governance for Banking Organisations' in 2006. Like the earlier document, the BCBS withholds the definition of 'corporate governance' adopted by the OECD. It also explains guiding principles on sound corporate governance that widely accepted and well-established principles that guide supervisory authorities as well as all types of banks' managements.¹³⁷

The document provides eight principles on sound corporate governance.¹³⁸ The first principle illustrates that board members should be well-qualified and understand their role in maintaining sound corporate management in order to exercise their judgment independently (particularly from senior management) and objectively to the best interest of the bank. To be able to do so, the board members should be of adequate

¹³⁶ The report referred here to the earlier BCBS document on enhancing bank transparency, *Ibid* (n 104).

¹³⁷ BCBS, Enhancing Corporate Governance for Banking Organisations, (February, 2006), pp. 2.

¹³⁸ *Ibid*, pp. 6-18.

number and comprise non-executive members. Furthermore, the document recommends the formation of an audit committee, the majority of its members are non-executive members. The functions of the committee include oversight of external and internal auditors, recommending the appointment and dismissal of external auditors and determining their remuneration. Other recommended specialised committees are the risk management, the compensation (or remuneration) committee and the nominations/ corporate governance/ human resources committees.

The second principle calls upon the board of directors to approve and monitor the implementation of the bank's strategic policies and corporate values. These policies should prohibit conflict of interest situations, preferential treatment to related parties and illegal extension of credit to bank managers, officers or controlling shareholders. The third principle illustrates that effective boards of directors define and enforce lines of authority and accountability in their banks separately and on a group-wide level. Banks' managements and control functions must be particularly vigilant where matrix management structures are employed. The fourth principle emphasises the board's role to ensure that senior management on its part oversee the daily management of the bank according to the board policy. This role significantly includes establishing an effective internal control function. Meanwhile, the fifth principle states that banks' boards and senior management should recognise and enhance the effectiveness, independence and competence of the internal audit and internal control functions, external auditors as well as utilise their findings. The sixth principle states that the board should ascertain that the compensation policies are linked to the bank's corporate strategy and controls. Salary scales should also be set to avoid undue risk taking. The seventh principle focuses on the pivotal importance of transparency. It calls banks for timely and accurate disclosure of information related to the bank's corporate governance and commensurate with its size and complexity. In addition to financial information, banks are encouraged to disclose information on their organisational structure, ownership structure, board and senior management structures, code of business conduct and conflict of interest policy. Finally, the document calls upon the board and senior management to thoroughly understand and manage their operational structure, particularly where the bank operates through opaque structures (such as SPEs) or in jurisdictions that obstruct appropriate transparency.

In addition to the above, the document sets out several principles to assist supervisors in their assessment of banks' corporate governance.¹³⁹ First, banks should provide guidelines on sound corporate governance with emphasis on transparency and accountability. Supervisors should also implement processes for evaluating the effectiveness of banks' implementation of corporate governance principles. Supervisory assessment should cover banks internal controls; external and internal auditing; and the bank's group structure. Supervisors should also bring to the bank's board and management's attention information on any poor corporate governance practices within the bank. Finally, supervisors should take into consideration the existence of any deposit protection scheme not merely the interests of shareholders.

This chapter is the last chapter on the substantive rules of international banking supervisory standards issued by the BCBS. The following chapter will discuss the rules on international cooperation on banking supervision which have had to expand from the simple initial standards to tackle the more sophisticated aspects such as the emergence of conglomerates and electronic banking.

¹³⁹ Ibid, pp. 19-20.

CHAPTER 5

STRENGTHENING INTERNATIONAL COOPERATION

5.0 Introduction

Chapter 2 illustrated how the BCBS early international banking supervisory standards were divided into two complementary types: prudential standards as well as standards on defining and enhancing cooperation between banking supervisory authorities. This pattern continued through the second era of the BCBS which started approximately in the mid 1990s, although the standards became more sophisticated. Chapters 3 and 4 explained the BCBS standards related to the prudential supervision of banks during the second era, while this chapter describes the standards issued simultaneously by the BCBS on enhancing international supervisory cooperation.

The BCBS standards on strengthening international cooperation are commensurate with both market developments and the BCBS own prudential standards. They can be grouped under three categories. First, standards set out to improve cross-border exchange of information in relation to, amongst others, information sharing under Basel II, electronic banking as well as shell banks and booking offices (Section 1). The chapter also shows how the BCBS has been engaged with other international financial fora in setting out cross-sectoral international standards on financial conglomerates (Section 2). Thirdly, the chapter examines the importance of the Core Principles for Effective Banking Supervision and their methodology in reaching out for non-BCBS member countries. While the BCBS has supported the risk focused supervisory approach indirectly by providing rules on risk management and public-private cooperation, the Core Principles illustrate that applying this method is discretionary (Section 3). The Chapter is also supplemented with Annex 1 which contains the BCBS Core Principles.

5.1 Emphasis on Supervisory Cooperation

5.1.1. Statement of Cooperation 2001

A number of countries expressed the need for a document which sets a framework for a “Memorandum of Understanding,” to act as a reference for bilateral supervisory relations. The BCBS responded by releasing the document ‘Essential Elements of a Statement of Co-operation between Banking Supervisors’ in 2001. This was a short document establishing a Memorandum of Understanding that can be used as “a reference for establishing bilateral relationships between banking supervisory authorities in different countries”.¹ It clarifies that information should be shared for the purpose of facilitating effective consolidated supervision, which should cover contact during banking authorisation procedures, supervision of on-going institutions as well as banks facing difficulties. Furthermore, the document gave in detail the information that should be contained in the Memorandum of Understanding regarding authorisation and licensing, on-going supervision, on-site inspections, protection of information and on-going co-ordination between supervisory authorities.²

5.1.2 Shell Banks and Booking Offices 2003

The BCBS addressed again in 2003 the issue of banking structures which pose serious obstacles to cross-border banking supervision, namely, “shell branches”, “booking branches”, “booking subsidiaries” and “parallel-owned banking structures”.

Shell branches are defined as “banks that have no physical presence ... in the country where they are incorporated and licensed, and **are not affiliated to any financial services group that is subject to effective consolidated supervision**”.³ Physical presence is also defined to mean “meaningful mind and management” located in the same jurisdiction, a concept which covers the existence of administration rather than maintaining books and records or even low level-staff or a local agent,⁴ a practice

¹ BCBS, Essential Elements of a Statement of Co-operation between Banking Supervisors, (May, 2001), pp.1.

² Ibid, pp. 3-5.

³ BCBS, Shell Banks and Booking Offices, (January, 2003), Section 1, pp. 1.

⁴ Ibid, Section 1, pp. 1, footnote (2).

most practiced in off-shore centres. Accordingly, the country where the shell branch is located becomes the only one responsible for supervising the shell bank, yet it cannot exercise its supervisory role due to the existence of the bank's mind and management in another jurisdiction. The BCBS consequently recommends that supervisors should no longer license shell banks or permit the continuation of their presence.⁵

Booking branches are also branches of foreign banks which have no meaningful mind and management in the jurisdictions where they are licensed, and usually their local operations are not generated therein.⁶ Unlike shell banks, booking branches are a part of an institution with a home supervisory authority.⁷ In cases where the booking branch is directly controlled or managed by the home country, the home supervisory authority should exercise its duty of consolidated banking supervision, as well as have access to information needed within this context.⁸ In situations where the mind and management of said banks are located in a jurisdiction other than the home and host countries, the BCBS states that home and host supervisory authorities "must" satisfy themselves that they are subject to effective banking supervision. To this end, these authorities and the third supervisor may conclude a Memorandum of Understanding providing for the allocation of supervisory responsibilities and rules on the flow of information.⁹ The BCBS also states that booking branches, which mind and management are based in an unregulated entity in a third jurisdiction should be prohibited.¹⁰ Concerning banks, which take the form of "booking subsidiaries," the BCBS recommends that they should be subject to the supervision of the home and host authorities.¹¹ It also recommends that supervisory authorities should not license a

⁵ Ibid, Section 1, pp. 1.

⁶ Ibid, Section 2, pp. 2.

⁷ Ibid, Section 2, pp. 2.

⁸ Ibid, Section 2, pp. 2.

⁹ Ibid, Section 2, pp. 3.

¹⁰ Ibid, Section 2, pp. 3.

¹¹ Ibid, Section 3, pp. 4.

booking subsidiary or allow it to continue its operations if its mind and management are located in a third country.¹²

Parallel banks are defined as “banks licensed in different jurisdictions that, while not being part of the same financial group for regulatory consolidation purposes, have the same beneficial owner(s), and consequently, often share common management and interlinked businesses. The owner(s) may be an individual or a family, a group of private shareholders, or a holding company or other entity that is not subject to banking supervision”.¹³ Parallel banks can be identified by a number of characteristics such as having an individual or coordinated group of individuals who controls a foreign banking institution as well as a class of voting shares in a domestic bank; an officer or a director of a domestic bank controls a foreign bank or serves as a director or officer therein; sharing a similar name or adopting similar unique strategies or policies by a domestic bank and a foreign bank; or having extensive correspondent banking between a domestic and foreign bank.¹⁴

Parallel-owned banks might escape consolidated banking supervision as they have at least two home supervisory authorities, and none of which finds it feasible or practicable to undertake consolidated supervision of the whole group.¹⁵ The BCBS recommends that parallel-owned banks should not be permitted. Where the supervisory authority lacks the legal or practical power to do so, it should at least reduce supervisory gaps during licensing procedures and during on-going supervision.¹⁶ To this end, supervisors should request information from applicants for licensing concerning their respective group structures and the applicants’ relationship therewith. Upon granting authorisation, the supervisory authority may take a number of preventative measures including enforcing a change of the group structure, imposing restrictions on the bank’s ability to conclude transactions, or sharing management process with parallel banks as well as requesting declarations from the bank’s beneficial owners to furnish information

¹² Ibid, Section 3, pp. 4.

¹³ BCBS, Parallel-owned Banking Structures, (January, 2003), Section 1, pp. 1.

¹⁴ Ibid, Section 2, pp. 1.

¹⁵ Ibid, Section 3, pp. 3.

¹⁶ Ibid, Sections 4 and 5, pp.3-6.

related to parallel banks. Regarding on going supervision, the BCBS proposes the close coordination between supervisory authorities and, when practicable, the appointment of a lead supervisory authority. The supervisor may also place a restructure plan of the bank group or ring-fence the operations of the domestic bank. Ultimately, and where the international standards cannot be satisfactorily implemented, the supervisory authority should close the bank.

5.1.3 Supervision of Cross-border Electronic Banking

Developments in electronic banking have also posed new challenges related to the allocation of roles between home and host supervisory authorities. Information becomes available in any jurisdiction once they are posted on the Internet by a bank. It is therefore difficult to determine who the host supervisory authority is and how to define the scope of the home supervisory authority's role to exercise global consolidated supervision. The BCBS has consequently examined the definition of "cross-border e-banking", stating that it is "the provision of transactional on-line banking products or services by a bank in one country to residents of another country".¹⁷ Therefore, the availability of information on the internet *per se* is not considered as cross-border banking.¹⁸ The BCBS provides an annex containing list of "possible indicators of cross-border e-banking-ascertaining an entity's intentions to extend services",¹⁹ such as the extent and types of electronic activities extended to the residents of the host country. BCBS also admits that there is a need for exercising discretion on a case by case basis. Another difficulty related to how the host authority can determine that electronic banking is provided without effective home country supervision.²⁰ Despite these practical difficulties, the BCBS emphasises the application of the home country control.

¹⁷ BCBS, Management and Supervision of Cross-Border Electronic Banking Activities, (July, 2003), para. 12, pp.5

¹⁸ *Ibid.*, para. 36, pp.10

¹⁹ *Ibid.*, Annex 1, pp.12-13.

²⁰ *Ibid.*, Annex 2, pp.14-15.

5.1.4. Information Sharing between Home and Host Supervisors under Basel II

The complexity of Basel II and the widening of the scope of the application of internally-based models mean that respective supervisory authorities need to be fully aware of their role and coordinate their efforts. The BCBS has therefore issued guidelines on the exchange of information specifically under Basel II.

5.1.4.1. High-level Principles for the Cross-Border Implementation of the New Accord, 2003

This document illustrates that the home and host supervisors should approve of the capital adequacy method adopted by banks. It also calls supervisors to adopt the following six principles of coordination and cooperation under Basel II:²¹

"Principle 1: The New Accord will not change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision".

"Principle 2: The home country supervisor is responsible for the oversight of the implementation of the New Accord for a banking group on a consolidated basis".

"Principle 3: Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised".

"Principle 4: There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort".

"Principle 5: Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on the banks, and conserve supervisory resources".

"Principle 6: In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions. The home country supervisor would lead this coordination effort in cooperation with the host country supervisors".

²¹ These principles are extracted directly from BCBS, High-level Principles for the Cross- Border Implementation of the New Accord, (August, 2003).

5.1.4.2. Home-Host Information Sharing for Effective Basel II Implementation, 2006

This document recommends extensive information sharing when a bank selects the advanced Basel II options.²² It differentiates between *judgmental information* such as inspection reports and assessments information which can only be obtained from respective supervisors, on one hand, and *factual information* can be obtained from the supervisors and possibly banks.²³

This document most significantly illustrates that the home authority is best situated for providing information on the whole group and calls host supervisory authority to supply the information needed by the home supervisor. It also explains that the home and host supervisors are entitled to exchange information related to the methods of supervision. It stresses that both supervisory authorities have the right to obtain from the respective supervised institutions information concerning a particular entity within the banking group.

5.1.4.3 Home-Host Supervisory Cooperation and Allocation Mechanisms in the Context of the Advanced Measurement Approach

This document covers a set of principles which apply the home-host information sharing principles to banks that apply the Advanced Measurement Approach (“AMA”) to operational risk. It confirms the long-established principles of information sharing and the high level principles of information sharing under Basel II. It also determines that the home supervisor undertakes a pivotal role for coordinating the following on a group-wide level:²⁴

1. "The supervisory assessment of the bank's rollout plan(s) and implementation, resulting in a decision on the approval of the bank's group-wide AMA; and
2. Practical cooperation across multiple host supervisors responsible for the group's legal entities".

²² BCBS. Home-host Information Sharing for Effective Basel II Implementation, (June, 2006), par 11.

²³ *Ibid*, par 11.

²⁴ BCBS. Principles for Home-Host Supervisory Cooperation and Allocation Mechanisms in the Context of Advanced Measurement Approaches (AMA), (November, 2007), pp.2.

The document further explains that the frequency, scope and mechanics of information sharing should be adapted according to the circumstances of the supervisors as well as the risk profile of the bank on both group and subsidiary levels; the type of risk management; the degree of centralisation within the group; and the significance of the subsidiary and its operational risk profile. Enhanced cooperation is required whereby the bank employs a stand alone AMA relying on information supplied by the parent bank. In the case of hybrid AMA, the host authority should have adequate information on the allocation mechanism and any other relevant risk data²⁵. Home and host supervisors should also have access to the inputs, outputs and assumptions related to the allocation mechanism.²⁶

5.2. Cross-Sectoral Cooperation on Conglomerates

We have seen in Chapter 1 how despecialisation of financial institutions, innovation in financial instruments, internationalisation and deregulation have led to the growth of the phenomenon of financial conglomerates in industrial economies and many emerging economies. Since international conglomerates cut across the jurisdictions of different sectoral supervisors in different countries, it has become essential for the major sectoral supervisory authorities to cooperate with each other. The BCBS took the first initiative to tackle supervisory concerns arising from financial conglomerate's economies and many emerging economies as in the 1990 document 'Exchange of Information between Banking and Securities Supervisors'.²⁷

Further cooperation was needed and a Tripartite Group of international banks, securities, and insurance regulators, was formed in 1993; namely, the BCBS the International Organisation of Securities Commissions ("IOSCO") and the International Association of Insurance Supervisors ("IAIS") to deal with prudential concerns regarding conglomerates from a cross-industry perspective. Conglomerates were referred to as "any group companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different

²⁵ Ibid, pp. 4.

²⁶ Ibid, pp. 8.

²⁷ For further information, see above pages 56 and 57 of Chapter 2.

financial sectors (banking, securities, insurance)".²⁸ The Tripartite Group issued a document which was published in 1995 as a discussion document²⁹ on the problems of conglomerates and how can supervisors deal with them.

In 1996, the Joint Forum was established under the auspices of the same parent organisation to immediately replace the former Tripartite Group. The original mandate of the Joint Forum focused on facilitating the exchange of information between the three types of financial supervisory authorities and the enhancement of effective guidance on the supervision of conglomerates.³⁰ In 1999, the parent organisations announced that the mandate of the Joint Forum was expanded to cover cross-sectoral issues that supervisors need to deal with.³¹ The first principal mandate is to revise issues of general interest to the three financial sectors as well as develop principles and guidance and/or identify best supervisory practices, as appropriate. The Joint Forum also has the specific mandate to work on risk assessments and capital, disclosure of financial risks, as well as, cross-sectoral repercussions of severe exogenous shocks³². The other principle mandate is the supervision of conglomerates.

The Joint Forum has conducted surveys and issued supervisory guidelines on issues important to conglomerates such as capital adequacy as spelt out in the following sections.

5.2.1. Capital Adequacy Principles

The Capital Adequacy document has two major purposes³³. The first one is to promote techniques for the capital adequacy measurement of conglomerates. This is a difficult task to achieve, because conglomerates are heterogeneous groups of financial

²⁸ The Tripartite Group, (n 29), p. 1.

²⁹ The Tripartite Group, The Supervision of Financial Conglomerates: a Report by the Tripartite Group of Bank, Securities and Insurance Regulators, (July, 1995).

³⁰ Joint Forum, Original Mandate of the Joint Forum: Mandate for the Financial Conglomerates Group reproduced in BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001) Annex 1, pp. 8.

³¹ Ibid, pp. 6.

³² Joint Forum, Mandate of the Joint Forum.

³³ Joint Forum, Capital Adequacy Principles, (February, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum , (July, 2001), pp. 11-28.

companies often subject to various capital requirements. Therefore, the document does not seek to set out a unified technique for capital assessment of conglomerates, but rather determine approaches that can lead to generally equivalent results. The second objective is the identification of situations that can yield inaccurate estimation of conglomerate's capital.³⁴

The objectives of the document should be attained by following five guiding principles.³⁵ The first three principles focus on double or multiple gearing whereby the same capital is used against risks in two or more companies within the conglomerate. The first principle is that the capital adequacy measurement must detect situations of the double or multiple gearing, whereby the same capital is used against risks in two or more companies within the conglomerate. Solo assessment of each company's capital will lead to an overestimation of the group-wide capital. Consequently, intra-group holdings should be excluded from group capital. The second related principle is that banks should include mechanisms to assess the effects of double, multiple or excessive gearing via unregulated intermediate holding companies. The third principle is that capital assessment should detect excessive gearing resulting from the parent company issue of debt and downstreaming it to a dependent, as equity for example. The fourth principle considers the possibility of mixing regulated and unregulated entities within a single group. It states that conglomerates should address the risks accepted by unregulated entities undertaking similar financial activities, such as leasing, in their capital measurements. As to non-financial entities, the general rule is that they should be excluded from the conglomerate's capital base.

The last principle illustrates how conglomerates should address participations in regulated entities. Conglomerates are hereby called to distinguish between the three situations. First, if the participation does not lead to control or significant influence on the target company (usually a participation of less than 20%), it should be subject to the solo supervision rules on capital adequacy. Secondly, group participation of significant influence (generally participants of 20% or more, but less than 50% of target company) should be included in the capital assessment of the group to the extent it is in excess of

³⁴ Ibid, paras. 1 and 14.

³⁵ Ibid, paras. 17 and 47.

the target company's own capital requirements. Thirdly, participants who have effective control or meet the applicable company law definition of a subsidiary (usually ranging from above 50% up to and including 100% of the target company) should be fully consolidated, and minority shareholdings should be illustrated separately.

Finally, the document sets out alternative techniques capable of producing consistent and comparable capital adequacy measures on a conglomerate-wide basis.³⁶ It allows three alternative measures for calculating the capital adequacy of conglomerates. The first, and most preferable technique, is the "building block" approach whereby the consolidated capital of the conglomerate is compared with the aggregate of the solo capital of each financial block (or sector). The second method is the "risk-based aggregation", which resembles the previous approach with amendments needed to suit unconsolidated groups. The solo capital of each entity after deducting intra-group investments is compared with the solo capital of each entity comprising the financial conglomerate. Thirdly, the "risk-based deductions", where the parent capital is replaced by investments in other dependants then adjusted by solo capital surplus of the conglomerate's entities.

5.2.2. Fit and Proper Principles

The Joint Forum's document 'Fit and Proper Principles'³⁷ seeks to ensure sound supervisory assessments of the soundness and prudence of the conglomerates' managers, directors and key shareholders (who enjoy material influence on the group or hold shareholdings above a specific threshold) as well as facilitate exchange of information between different supervisory authorities.³⁸

Solo supervisors of banks, insurance, and security firms are interested in the fitness (i.e. the competence) of the directors, managers, and key shareholders of their regulated firms as well as their propriety (i.e. their suitability and integrity). When these regulated entities form part of a wider financial conglomerate, managers and directors of unregulated entities might have material influence on the regulated entities. This

³⁶ Ibid, pp. 19-27.

³⁷ Joint Forum, Fit and Proper Principles, (February, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001) pp. 41-46.

³⁸ Ibid, para. 42.

explains why supervisors are interested in the fitness and propriety on a conglomerate wide-basis. Supervisors are also concerned about the geographical and sectoral limits to their jurisdictions in the exercise of their latter role, as well as, the constraints on the flow of information between supervisors of various sectors particularly on a cross border level.

The Joint Forum accordingly sets out various principles on fitness and propriety. First, directors and managers of all entities within a conglomerate can influence the operations of other regulated entities and must be subject to the rules of fitness and propriety. Similarly, the key shareholders who hold substantial shares that can materially influence a regulated firm within the conglomerate must be subject to supervisory criteria of fitness and propriety. In addition, qualification tests should be applied at the authorisation stage and on-going basis, and regulated entities are expected to apply them continuously. In addition, where a director or a manager of an entity within the conglomerate is or has been assuming an equivalent position in another regulated entity in the same conglomerate, consultations should take place between the respective supervisory authorities. Finally, supervisors should inform each other when a manager, director, or a key shareholder is deemed unfit, improper, or does not meet other qualification requirements.

5.2.3. Supervisory Information Sharing

The Joint Forum issued in 1999 'Principles for Supervisory Information Sharing',³⁹ which builds upon earlier standards set out by IAIS, IOSCO, and the BCBS. This document sets out five guiding principles on enhancing information exchanged amongst and between various supervisory authorities of the conglomerate.⁴⁰

The first principle stresses that information should be available to each supervisory authority, taking consideration of the wide range of structures adopted by conglomerates particularly as the growth of complex financial instruments means that business activities and legal structures are no longer aligned. It illustrates that all supervisors need essential information on the structure, management, strategy, risks and

³⁹ Joint Forum, Principles for Supervising Information Sharing, (February, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001), pp. 91-98.

⁴⁰ Ibid, pars 9-27.

financial condition of the conglomerates. The extent of supervisory needs for information, however, varies according to their regulatory systems and objectives as well as the conglomerate's own structure and risk controls. In addition the primary supervisors should wide range of information made available to it. The primary supervisor is the supervisor of the parent or the dominant entity in a conglomerate. Should the primary supervisor be difficult to identify, supervisors need to define it on a case-by-case basis.⁴¹

The second principle is that supervisors should be proactive in communicating material developments and concerns to their counterparts. Supervisors receiving said information should also respond adequately and in a timely fashion. The third principle stresses that all supervisors should inform the primary supervisor about material developments and emerging issues of adverse nature including supervisory actions. Fourthly, the primary supervisor, on his turn, is responsible for extending information to other supervisory authorities concerning institutions falling within their regulatory responsibilities such as information on control functions, organisational structures, and plans of supervisory activities. Finally, the fifth principle calls for the supervisors to establish an atmosphere of trust and cooperation amongst them, recommending measures such as face-to-face communication and attending international supervisory meetings.

Exchange of information is the *sine qua non* of effective international supervision. The Joint Forum, therefore, issued another document in 1999 that sets out special rules on information sharing on the 'Framework for Supervisory Information'.⁴² This paper focuses on large internationally active groups but can benefit the supervision of smaller conglomerates.

The document classifies conglomerates into quadrants based on two elements. The first element is the organisational structure and whether it is based along business lines or corporate legal structures. The second one is the corporate control function and whether it is organised on a local or global basis. Quadrant A, for example, represents conglomerates based on the structure of former Barings Bank, where business activities

⁴¹ Ibid, para. 9.

⁴² Joint Forum, Framework for Supervisory Information, (February, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001), pp. 49-87.

are designed along services and activities. This means that the business line structure is unrelated or has a limited relationship to the corporate legal structure. It also means that the matrix management approach is adopted, whereby the front and back offices assume their responsibilities according to the business lines which cover various legal entities and geographical regions, while the corporate control function is largely based at the group's headquarters. Under these complex structures, supervisors should be vigilant and exchange information more extensively. At the other end of the spectrum there is Quadrant D, whereby the conglomerate's control function is organised on a local basis, but its structure is organised along business lines which cut across separate legal entities. The supervisors should under this structure monitor autonomous local managements and be aware of weak global managements and separate audit arrangements.⁴³

The framework further sets out guidelines for the exchange of information in various circumstances, which cover the establishment of a new conglomerate, granting permission for the provision of a new activity or establishing a presence in a new jurisdiction, developing the financial conglomerate structure, ongoing supervision and the identification of supervisory concerns.⁴⁴

5.2.4 The Coordinator Paper

The 'Coordinator Paper' (1999), deals with the needs of conglomerates' supervisory authorities to appoint a coordinator to facilitate the supervision of conglomerates on a cross sector and cross border level. The objectives of this document are to provide guidelines on the identification of a coordinator or more and to set out coordination elements.⁴⁵ To attain these objectives, the Coordinator Paper sets out guiding principles, which help supervisors to assess if they need a coordinator, how to select it and determine its roles. First, the solo supervisor should determine information needed both in ordinary and emergency situations. Secondly, the selection of the coordinator (or less favourably) coordinators should be left to the discretion of the

⁴³ Ibid, paras. 6-36.

⁴⁴ Ibid, paras. 37-62.

⁴⁵ Joint Forum, Coordinator Paper, (February, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001), para. 1.

supervisors. Likewise, supervisors should enjoy the discretion to determine the coordinator's duties. The identification of the coordinator can be easier where, e.g., the group is headed by a bank responsible for consolidated supervision.⁴⁶ An early identification of a coordinator and his duties in an emergency is also recommended to avoid confusion when an unexpected adverse event takes place. Furthermore, the paper recommends that the supervisors' regulatory responsibilities should neither be constrained by appointing a coordinator nor transferred to the coordinator. Finally, if the appointment of a coordinator has no value added to the supervision of a conglomerate, there is no need to appoint one.

5.2.5 Intra Group Transactions and Exposure Principles

One of the most important supervisory concerns regarding conglomerates is the treatment of intra-group transactions and exposures, which can take various forms, such as, cross shareholdings, guarantees, and providing management and service arrangements. The Joint Forum covers this subject in the document on 'Intra-group Transactions and Exposures'.⁴⁷

The main purpose of the document is to ensure the prudential management and control of intra-group transactions and exposures without having to prevent them. This is because these transactions have the advantages of cost efficiency; improved risk management as well as effective control of funding and capital. Intra-group transactions might, however, raise supervisory concerns for various reasons: the inappropriate transfer of capital from the regulated entity; the possible inclusion of unfair terms that would not be accepted by entities dealing at arm's length; possible adverse affect on liquidity, solvency or profitability of a regulated entity, or being employed as a means of regulatory arbitrage e.g. to evade capital adequacy requirements.

The Joint Forum sets out five guiding principles aimed at striking the right balance between the advantages and disadvantages of intra-group transactions. First, conglomerates should have sound and adequate risk management processes which cover intra-group exposures that might jeopardizes the integrity of the entities comprising the

⁴⁶ For Further guidance on this issue please refer to Annex 2 of the Coordinator Paper, Ibid, pp. 107

⁴⁷ Joint Forum, Intra -Group Transactions and Exposures, (December, 1999), as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum, (July, 2001) pp.129-138.

conglomerate. Secondly, supervisors should monitor intra-group exposures regularly whether on consolidated or solo basis. Thirdly, supervisors should encourage public disclosure of intra-group exposures to allow market participants an insight into the conglomerate's inter relationships. Finally, different supervisors should coordinate their efforts and exchange information related to intra group exposures.

5.2.6 Risk Concentrations and Credit Risk Transfer

The Joint Forum issued another document entitled 'Risk Concentrations' in 1993,⁴⁸ because risk concentration in one group has a spillover effect on the other sectors within the group. This document defined a risk concentration as "an exposure with the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations".⁴⁹ The document covered risk concentrations across the conglomerates whether they relate to assets, liabilities or off balance sheet commitments.

There has been sharp increase in the concentration risk of conglomerates since the issuance of the latter document, due to the growth of the credit transfer market in which conglomerates are an active participant.⁵⁰ Traditionally, banks have been employing credit risk transfer ("CRT") tools such as syndications, guarantees, and securitisation for a very long time, mainly because of their ability to distribute risk amongst a wide base of market participants. Banks have also benefited from transferring risky assets from their balance sheets to SPEs. CRT markets, however, have exponentially grown as a result of substantial increase in credit derivatives markets, the broadening of securitisation and the increased involvement of non-bank participants particularly hedge funds and asset managers. Failure to manage CRT and address its risks eventually contributed to the credit crunch of 2007.⁵¹

⁴⁸ Joint Forum, Risk Concentrations Principles, (Decemeber, 1999) as reproduced in the BCBS, Compendium of Documents Produced by the Joint Forum , (July, 2001), pp. 141-150.

⁴⁹ Ibid, para. 4.

⁵⁰ Joint Forum, Cross-Sectoral Review of Group-wide Identification and Management of Risk Concentrations, (April, 2008), pp. 11.

⁵¹ Joint Forum, Credit Risk Transfer Developments from 2005-2007, Consultative Document, (April, 2008), pp. 4- 8.

The Joint Forum reviewed the effect of CRT on financial stability in its 2005 document 'Credit Risk Transfer', which concluded with various recommendations addressed to institutions and market participants dealing in CRT instruments as well as the supervisory authorities.

Institutions should use CRT instruments consistently with their overall risk management policies and framework. They also need to understand and properly assess risks underlying CRT instruments and comprehensively measure their risk exposures. The documents stresses that institutions should assess CRT instruments by using internal models and hire well trained staff who understand the underlying assumptions of models and their limitations including correlation assumption. They should also assess the extent models capture risk where trading or hedging takes place. Furthermore, the documents emphasises that institutions should understand the market liquidity risk associated with CRT transactions. Furthermore, calls institutions to manage vigorously counterparty credit risk related to unfunded CRT transactions (swaps and other instruments where payments are not made upfront). In addition, the document highlights the importance of operational, legal and compliance risks. It recommends that institutions comply with the applicable laws on the use of material non-public information. Confirmations and other documents related to the settlement of CRT transactions should be executed quickly and handled by experienced personnel.

The document stresses that parties to CRT transactions should assess the legal risk and the appropriateness of their CRT transactions before entering into them. Within this context, the contracting parties should understand the risks involved and do not over rely on external credit ratings. Investors should also have access to information necessary to evaluate their risks initially and on-going basis. The document stresses that market participants should particularly understand external credit rating of CRT instruments so that they can evaluate their potential risks. Furthermore, market participants are advised to exert their efforts to improve disclosure of CRT transactions as well.

As to the supervisory authorities, the document illustrates that they should improve their understanding of CTR market development. Supervisors should also regularly review the supervisory procedures related to CRT transactions as well as enhance the mutual exchange of information pertinent to CRT transactions. Finally,

supervisory authorities should support efforts to improve the identification of aggregate information on credit risk.

The above recommendations were reviewed by the Joint Forum in the wake of credit crunch, 2007. A new Consultative Document on CRT was accordingly issued in 2008,⁵² which retains the earlier guidelines of 2005, and builds upon them. It also focuses on five supervisory concerns:

First, institutions might fail to assess and manage risks pertaining to CRT transactions due to their increased complexity. Many institutions particularly appear to have failed to appreciate the correlations between liquidity risk on one hand and market, credit, and other risks on the other hand.

Secondly, despite the 2005 recommendation on excessive dependence on external credit ratings, the Joint Forum found out that this trend continues. Institutions also do not seem to understand clearly how ratings are assigned. Therefore, institutions are recommended to deepen their understanding of CRT transactions and credit rating methodologies particularly in circumstances leading to downgrading of ratings. Thirdly, the complexity and innovation of new CRT transactions cast doubts on the valuation and adequacy of internal risk models to capture all risks. There are also concerns about the valuation of fair values in shallow markets. Fourthly, there are questions concerning the originate-to-distribute model for exposing institutions to liquidity funding risk and limiting banks' ability to move credit assets to their off-balance sheets, which can cause concentrations of credit risk. Fifthly, banks are exposed to reputational risk as a result of financial difficulties affecting SPEs and other entities associated with banks' CRT activities. Banks might interfere to protect these entities although they are not obliged to do so. Another important regulatory concern is that banks are prompted to transfer risks to less regulated markets for regulatory arbitrage purposes. It can be even difficult for supervisors to identify the ultimate risk holder.

⁵² Joint Forum, Credit Risk Transfer Developments from 2005-2007, Consultative Document, (April, 2008).

5.3. The Core Principles

5.3.1. The First Generation of Documents

The BCBS with the cooperation of non G-10 countries⁵³ developed in 1997 its important document on the 'Core Principles for Effective Banking Supervision' ("Core Principles 1997"). The document was issued in response to the G-7 meeting in Lyon⁵⁴ in June 1996, which had called for the strengthening of the financial system.⁵⁵ Its purpose was to provide a basic reference for supervisory and other public authorities on a domestic and international level.⁵⁶ It contained 25 core principles which were a compilation of "minimum requirements" mostly extracted from earlier supervisory standards, and which in many situations would need supplementary measures suitable for the financial systems of adopting countries.⁵⁷ These principles were broadly categorised into seven groups: "preconditions for effective banking supervision"; "licensing and structure"; "prudential regulations and requirements"; "methods of ongoing banking supervision"; "information requirements"; "formal powers of supervisors" and "cross-border banking". An important development in the document was that the BCBS dealt with the structure of banking supervisory authority directly in a standalone principle.

The Core Principles 1997 transferred the BCBS from a limited elite forum to an international leader in setting out comprehensive regulator of banking supervision.⁵⁸ According to the BCBS, the Core Principles 1997 became "the most important global

⁵³ There were representatives from the following countries: Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Eight other countries were closely associated with the BCBS namely, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.

Source: BCBS, Core Principles for Effective Banking Supervision, (Sept 1997) para. 3.

⁵⁴ The Group of Seven ("G-7") major industrial countries held its first annual economic summit meeting of heads of state or governments in 1975. Members are, Canada, France, Germany, Italy, Japan, the UK and the USA.

Source: IMF, A Brief Guide to Committees, Groups, and Clubs: A Fact Sheet, (April, 2008).

⁵⁵ BCBS, *Ibid* (n 53), para. 1.

⁵⁶ *Ibid*, para. 8.

⁵⁷ *Ibid*, para. 7.

⁵⁸ George Walker, International Banking Regulation Law, Policy and Practice, 2001, pp. 135.

standard for prudential regulation and supervision" and were endorsed by the overwhelming majority of countries.⁵⁹ During the Asian financial crisis of the late 1990's voices were raised for enhanced global banking supervision and particularly for implementing the Core Principles 1997. As implementation begins with self-assessment, the Basle Committee resorted to distributing a survey for banking supervisory authorities worldwide on compliance with the core principles. Over 120 countries responded, but the level of the responses varied.⁶⁰ This prompted the BCBS to resort to issuing the 'Core Principles Methodology' in 1999 to serve as a harmonised assessment tool. The draft was prepared by the Core Principles Liaison Group, a subgroup of the BCBS, which consisted of supervisory authorities from the G-10 and non-G-10 and after consulting with the IMF and World Bank.

While the IMF and the World Bank envisaged a role of assessing countries implementation of the core principles, the BCBS would not follow suit, explaining the following:⁶¹

"The Basel Committee on Banking Supervision has decided not to make assessments of its own due to a lack of necessary resources; however, the Committee is prepared to assist in other ways, *inter alia* by providing advice and training. Committee members may also individually participate in assessment missions conducted by other parties such as the IMF, the World Bank, regional development banks, regional supervisory organisations and private consultants. "Peer reviews" are also possible, whereby supervisory experts from one country assess another country and vice versa".

5.3.2. The Second Generation of Documents

The BCBS issued in 2006 a new set of core principles ("Core Principles 2006") which emphasised the role of the core principles as "a framework of minimum standards for sound supervisory practices", which would strengthen the financial system both in developed and developing domestic banking systems and globally.⁶² They were also issued in cooperation with a wide base of regional banking supervisory committees

⁵⁹ BCBS, Core Principles Methodology, (October, 1999), para. 6.

⁶⁰ Ibid, para. 19-20.

⁶¹ Ibid, para. 2.

⁶² BCBS, Core Principles for Effective Banking Supervision, (October, 2006), para. 5.

representing non G-10 countries including the Arab Committee on Banking Supervision ("ACBS") and the ; the Islamic Financial Services Board ("IFSB") and after consulting with the IMF, The World Bank and other international supervisory standards setters such as IOSCO and IAIS.⁶³ The Core Principles 2006 are also comprised of 25 principles, which only adjust the Core Principles 1997 to ensure their relevance and consistency with comparative international standards on insurance, securities and anti-money laundering.⁶⁴

The new 'Core Principles Methodology' was issued in 2006 to update the earlier methodology as part of the BCBS effort to aid assessors of a country's compliance with the Core Principles 2006.⁶⁵ Although the BCBS does not undertake the responsibility of monitoring the application of these principles by domestic supervisory authorities, it reaches out to them via the International Liaison Group which focuses on the implementation of the Core Principles 2006 as well as seeks to deepen the BCBS relationship with supervisors from within and outside the G-10 countries.⁶⁶ The Core Principles Methodology reinforces the dual approach of banking supervision by setting out two types of criteria for assessing the implementation of the core principles. The first type is the "essential criteria", which "are the only elements on which to gauge full compliance with a Core Principle" and the "additional criteria", which are "suggested best practices which countries having advanced banks should aim for".⁶⁷ The additional criteria are only voluntarily employed by countries.

⁶³ Ibid, par. 4.

⁶⁴ Ibid, par. 6.

⁶⁵ For further details, see: BCBS, Comparison between the 1999 and 2006 versions of the Core Principles Methodology, (April 2006).

⁶⁶ There are eight countries represented in the BCBS: France, Germany, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States. In addition, there are 16 countries that are not members in the BCBS: Argentina, Australia, Brazil, Chile, China, the Czech Republic, Hong Kong, India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, and the West African Monetary Union), the European Commission, the IMF, the World Bank, the Financial Stability Institute, the Association of Supervisors of Banks of the Americas and the IFSB.

Source: BCBS, About the Basel Committee.

⁶⁷ BCBS, Core Principles Methodology, (October, 2006), pp. 2.

5.3.3. Elements of the Core Principles Methodology 2006

The Core principles 2006 and their Core Methodology 2006 can be grouped under four dimensions. The first dimension supports the institutional capacity of banking supervisory authorities by providing for rules on the objectives, independence, legal powers (including corrective measures and remedial actions), transparency, and cooperation. The second dimension is cross-border supervisory cooperation. The third dimension is the implementation of minimum rules of substance to banks at the authorisation stage and continuously afterwards. The last dimension is supervisory techniques and methods.

5.3.3.1 International Cooperation

Core Principles (25) confirms importance of home-host supervisory cooperation, which should be based on the exchange of information between respective supervisory authorities as well as exercising comprehensive home country consolidated supervision

The criteria of assessing cross-border cooperation are based on the documents issued by the BCBS on this regard. A noticeable exception which appears in both generations of core principles is the role of the home supervisory authority in enforcing remedial or corrective measures on a consolidated basis. The 1996 document 'the Supervision to Cross Border Banking'⁶⁸ referred to the role of the home authority exchanging information on "a track record of taking effective remedial action when problems arise".⁶⁹ The Core Principles Methodology 2006, by contrast, states that it the host supervisor which should provide information on any remedial Action.⁷⁰

5.3.3.2 Minimum Prudential Powers

The Core Principles 2006 and its Methodology are overwhelmingly extracted from the BCBS general documents and principles on prudential requirements. Below is a summary of these prudential requirements. The full text of the Core Principles is annexed to this thesis due to its importance and in order to avoid excessive repetition.

⁶⁸ BCBS and Offshore Group, The Supervision of Cross-Border Banking, (1996). See above pp. 57 for an outline of this document.

⁶⁹ *Ibid*, Annex A paragraphs 6 and 7.

⁷⁰ BCBS, *Ibid* (n 67), pp. 41.

First, Core Principles 2 calls for the definition of the term “banks” in legislation and the prohibition of the employment of this term and its derivations (e.g. banking) without prior permission in situations where the public might be misled. Likewise, the legislation should determine activities by banks.

Secondly, Core Principles 3 calls for the supervisory authority to set out licensing criteria which should at least cover governance structure, ownership assessment (including fitness of management and board members), strategic plan, risk management, operating plan, financial projection as well as the prior approval of the home supervisory authority in relation to cross border banking.

Thirdly, Mergers and acquisition of financial institutions have prudential dimensions.⁷¹ Principle 4, therefore, states that the supervisory authority should have the power of reviewing and rejecting any significant transfer of “controlling interest” or “significant ownership” held either directly or indirectly. This power entails various essential criteria. First, the law provides for a definition of the terms “controlling interest” and “significant ownership”. Secondly, the supervisor should have the powers of prior notification, approval and obtaining information from banks on such holdings. Thirdly, the supervisor should have the legal power to reject the transfer of significant ownership or controlling interest in banks. Fourthly, the supervisor should also be empowered to reverse any undesirable transfer of power without its prior notification or approval. In addition, Core Principle 5 illustrates that the supervisor should have the power to review major acquisitions. An essential criterion is that the legislation should define major acquisitions which require the prior notification of the supervisors. Another essential criterion is that legislation should determine the standards against which an acquisition is reviewed, including the prohibition of acquisitions exposing banks to endure excessive risks or which hamper effective supervision.

Fourthly, Core Principles 4 and 5 accordingly determine indirectly the relationship between the banking supervisory authorities and any other local authority responsible for competition. The conclusion is that the supervisory authority, not the competition authority, should have the final decision in terms of banks’ mergers and

⁷¹ Michael Andrews, ‘Addressing the Prudential and Antitrust Aspects of Financial Sector Mergers and Acquisitions’ in Charles Enoch, David Martson and Michael Taylor (eds), Building Strong Banks through Surveillance and Resolution, 2002 pp. 201.

acquisitions. In other words, there is a primacy of prudential concerns over competition issues although the principle should have called for the legislation to explicitly embody this supremacy principle. The Core Principles should have also called domestic supervisory and competition authorities to set out a framework (most probably a memoranda of understanding) organising the sequence of events in a merger.

Fifthly, Supervisors should also ensure that banks have a comprehensive risk management plan and processes according to the bank or banking group risk and complexity. Supervisors should identify, measure, monitor, and control credit risk (including counterparty risk), country risk, transfer risk, market risk, liquidity risk, operational risk, and interest rate risk in the banking book. Supervisors should be satisfied that banks manage their problem assets and maintain adequate reserves and provision. Supervisors should also impose limits on banks' large exposure to individual and connected counterparties. In addition, they should identify related parties, ensure that they are treated equally to other counterparties as well as monitor and control bank's exposure thereto (Core principles 7-16).

The remaining Core Principles stress that supervisors should ensure that banks have adequate internal controls and internal audit function in place (Core principle 17); be satisfied that banks have adequate policies that prevent the criminal use of its assets such as money laundering (Core Principle 18); be empowered to collect and review statistical data and prudential reports both on a solo and consolidated basis (Core Principle 21) be ensured that banks maintain and publish sufficient records according to widely acceptable accountancy standards (Core Principle 22), as well as exercise their supervision on a consolidated basis (Core Principle 24).

This chapter finalises all the chapters on international banking supervisory rules regarding substantive standards and international cooperation. The following chapter will consider the international standards on structural issues with reference to the UK law.

CHAPTER 6

THE BCBS STANDARDS ON THE STRUCTURE OF THE BANKING SUPERVISORY AUTHORITIES WITH REFERENCE TO UK LAW

6.0. Introduction

This Chapter looks into the BCBS standards on institutional issues. It shows that the BCBS focuses only on the strengthening the institutional capacity of the banking supervisory authority (Section 1). The BCBS standards, by contrast, neither recommend a particular form of supervisory technique nor the adoption of a specific type of supervisory structure (Section 2). These BCBS standards, however, overlook that there are certain prudential aspects to the structure of the banking supervisory authority. Most significantly, the relationship between the banking supervisory authority, on one hand, and the Central Bank and any authority responsible for bailing out troubled banks, on the other hand, should be regulated. The recent UK experience financial turmoil beginning in 2007 illustrates this point. The earlier amendments introduced by the Banking Act 1987, by contrast, provide an example of how to strengthen the institutional structure of the banking supervisory authority without having to segregate the institution from the central bank (Section 3).

6.1 International Standards on the Institutional Capacity

The first principle of the Core Principles (2006) is the central BCBS standard on institutional capacity, though it is entitled “[o]bjectives, independence, powers, transparency and cooperation”.

6.1.1. Clear Responsibilities and Objectives

The Core Principles Methodology 2006 identifies four essential criteria for the assessment of this element. First, the responsibilities and objectives of each authority involved in banking supervision should be determined and disclosed to the public. There is no definition of what is meant by involvement in banking supervision but the text is broad enough to cover any degree of monitoring role. It should, therefore, cover

deposit insurance or deposit guarantee agencies responsible for banking inspection as well as any central bank which assumes a residual role in banking supervision after segregating their banking supervisory departments. It is less obvious whether this criteria encompasses securities exchange authorities, where banks are established as public shareholding companies. It is equally not evident whether controllers of companies are included in this criterion. Secondly, the regulatory framework of the banking supervisory authority should provide for minimum prudential standard to be adopted by banks. Thirdly, the banking supervisory legislation should be updated when necessary. Fourthly, supervisors should confirm that information on the performance and resilience of banks are available.

6.1.2. Independence, Accountability and Transparency

The Core principle Methodology 2006 identifies four essential criteria to attain the independence, accountability and transparency of the supervisory institution.

First, the law should clearly stipulate the operational independence, governance structure and accountability for each institution assuming banking supervisory responsibilities. There should specifically be no interference from the Government officials or banks which might undermine the operational or financial independence of the supervisor. Furthermore, the senior executives of the supervisor should not be removed from their positions except for reasons determined under law and that the removal should be disclosed to the public. By contrast, specifying the tenure of senior staff is considered an additional criterion.

The second essential criterion is that the supervisory objectives should be publicly disclosed and that the supervisor should be accountable for the attainment of these objectives in a transparent fashion. The third essential criterion refers to the professionalism and integrity of the supervisor's staff. Furthermore, the supervisory authority should be financed without compromising its independence. In order to do so, the budget should cover the costs of appointing skilled and adequate staff, paying competitive salary rates, outsourcing expenses (when necessary), continuous training programmes, costs of computers and other equipments as well as travelling expenses for on-site supervision.

6.1.3. Legal Framework

The supervisory institution should have a legal framework, which supports its authorisation and on-going supervisory tasks. The Core Principle Methodology 2006 identifies three essential criteria within this context. First, that the law identifies the authority or authorities charged with the responsibility of licensing banks. Secondly, supervisory authorities should be empowered under law to set out prudential rules. Thirdly, the law should empower supervisors to obtain needed information from banks when deemed necessary.

6.1.4. Legal powers

The law should empower the supervisory authority to address non-compliance issues and the right to apply their qualitative judgement in their attempt to maintain the safety and soundness of the banking system. Supervisors should also be granted complete access to the banks' board of directors, managers, staff, and records. Legal powers should cover corrective or remedial measures as well as the imposition of sanction. An informal communication may solve a minor violation of the rules. However, where there is a serious violation, corrective measures should range from restrictions on permissible activities, withholding approval of new activities, and restricting or suspending the distribution of profits. Supervisory authorities should also be able to oppose the appointment of external auditors and senior management. In an extreme situation, they should be empowered to withdraw licences and to launch liquidation procedures. Therefore, the Core principle (23) was specifically set out to emphasise that supervisors should have at their disposal a range of supervisory tools to address problem banks.

The BCBS document 'Supervisory Guidance on Dealing with Weak Banks', issued in March 2002 also looks into remedial actions. This document calls for the application of prompt and consistent corrective actions in relation to 'weak banks',¹ as opposed to observable weaknesses which are temporary or isolated and can be rectified

¹ A weak bank is defined as "one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management".

Source: BCBS, Supervisory Guidance on Dealing with Weak Banks, (March, 2002), para. 10, pp. 6.

by suitable remedial action.² It states that supervisory authorities should be guided by five related principles being the realisation of supervisory objectives of deposit protection and financial stability, timeliness, commitment of the bank's management, proportionality as well as comprehensiveness, which refers to covering both the causes and symptoms of banking weaknesses.³ The supervisor should also draw up an action plan of corrective measures based on the assessment of the nature and seriousness of the bank's underlying weaknesses as well as the extent of its management cooperation with the supervisor.⁴ The document further recommends that countries issue laws and regulations facilitating the application of prompt corrective actions to avoid procrastination in handling problem banks which could be attributed to good faith or to pressure from the government or the banking industry.⁵

The Core Principles Methodology 2006 does not make a reference to the last document. It rather sets out six essential criteria of the exercise of remedial and sanctioning powers. It calls supervisors to intervene early where they have concerns, by addressing management in writing and requesting remedial actions as well as the submission of progress reports on the implementation of these actions. It also emphasises on the supervisor's participation in the resolution of the problem bank including the decision of closure. Furthermore, it also stresses on the importance of having a wide range of remedial tools at the disposal of the supervisory authorities as well as sanctioning powers that should apply to banking institutions and individuals (managers for example). In addition, it calls supervisors to take measure where the capital adequacy of the bank falls below the minimum capital ratio.

6.1.5. Legal Protection

The Core Principles Methodology 2006 considers it an essential criterion to guard both the supervisory authority and its staff from "lawsuits for actions taken and/or

² Ibid, para. 11, pp. 6.

³ Ibid, para. 68, pp. 19.

⁴ Ibid, para. 69-87, pp. 19-23.

⁵ Ibid, para. 78 and 79. pp. 21.

omissions made while discharging their duties in good faith”.⁶ The authority and its staff should also be protected from the costs of such law suits.

6.1.6. Cooperation with other Authorities

This element is subdivided into four essential criteria. First, there should be effective formal or informal (Memoranda of Understanding etc) cooperation arrangements between cross border supervisory authorities for banks and banking groups. This issue has been a central to the work of the BCBS as illustrated in Chapter 5. The second element relates to the cooperation with domestic authorities but briefly. The BCBS calls for the establishment of formal or informal forms of cooperation between “all domestic authorities with responsibilities for the soundness of the financial system”.⁷ Furthermore, supervisors should ensure that extended information should only be used for supervisory purposes. Finally, supervisors should be entitled to maintain the confidentiality of information received as well.

6.2 International Standards on the Technique and Type of the Supervisory Authority

6.2.1. The Techniques of the Supervisory Authority

Supervisory techniques are covered in Core Principle 20 which calls supervisors to appropriately mix between on site supervision and off-site supervision. The supervisors should also have policies and processes for assessing the quality and effectiveness of their supervision as well as the integration of on-site and off-site supervision. Supervisors should ensure that on-site and off-site supervision are conducted coherently and according to set objectives and responsibilities as well. On site supervision can be conducted either by outsourcing or the supervisor's own personnel provided that it is used as a means to verify the adequacy of corporate governance, reliability of information submitted to the supervisor by banks, obtaining needed additional information as well as monitoring issues that raise supervisory attention. Off-site supervision should on its part be used as a means to analyse the financial condition of banks on basis of prudential returns, follow-up on supervisory

⁶ BCBS, Core Principles Methodology, (October, 2006), pp. 9.

⁷ Ibid, pp. 9.

concerns as well as plan on-site work. Furthermore, the supervisor should evaluate the quality of the bank's management from both on-site and off-site supervision. It should also determine whether it can rely on the internal auditors to identify areas of weaknesses in the bank. In addition, the supervisor should maintain regular contact with bank managements and communicates its findings to it.

Banking supervision in industrialised countries is becoming increasingly risk-focused. According to a study of the World Bank in 2000,⁸ most supervisory authorities in the OECD countries have moved away from monitoring the compliance of banking institutions with prescriptive supervisory rules. The basic role of supervisory authorities has become evaluation, and perhaps supporting the internal models applied by banking institutions for risk management purposes. Their main mission is to create an environment where risk management can be optimised. This approach is also forward looking as it determines supervisory programmes and allocate resources on basis of risk expectation. Where the risk-focused approach of banking supervision is applied, there exists a partnership between the supervisory authorities and the private players. The other approach is rule-based and depends on on-site and off-site supervision.

The BCBS, as seen in the Chapter 4, provides adequate standards on risk management and partnership with the private sector. The BCBS, however, does not formally support a particular form of supervisory approaches. According to Core Principle 19, it is sufficient that supervisors understand the operations of individual banks and banking groups as well as the whole banking system in order to maintain its safety and soundness. The BCBS rather considers the risk based approach as optional due to the absence of consensus on this point. The Core Principles Methodology 2006 provides the following additional criterion:

“The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks”.⁹

Another additional criterion states the following:

⁸ Hennie van Greuning and Sonja Bratanovic, Analyzing Banking Risk: a Framework for Assessing Corporate Governance and Financial Risk Management, World Bank (2000), pp. 31-57.

⁹ BCBS, *Ibid* (n 6), pp. 32.

“In determining supervisory programmes and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks”.¹⁰

The BCBS standards, however, have failed to warn supervisory authorities, particularly those from developing countries, of the dangers that surround the risk-focused approach. While this approach is useful for reducing the regulatory bill, particularly in advanced banking markets,¹¹ wrong estimation of risk might allow weaker banks to escape the supervisory net. One of the countries which apply the latter approach is the UK¹² which failed to diagnose the problems of the Northern Rock Bank *ex ante*.

6.2.2. The Type of the Supervisory Authority

The BCBS standards do not specify any particular structural form for the banking supervisory authority as the optimal structure. They also do not attempt to answer any of the following major structural questions: what should be the basis of the structure of the supervisory authorities? Should the same authority supervise all financial institutions? Should the functional scope of the supervisory authority encompass regulatory goals other than the maintenance of the safety and soundness of the banking system, such as regulating the conduct of business (consumer protection) and competition? Should the supervisory authority be segregated from the central bank?

A study published early in 2008 and which covers 193 jurisdictions¹³ shows that there is a wide variety of institutional forms of banking supervisory authorities. The simplest form is the one adopted by Jordan. As will be discussed in Chapter 10 in further details, the CBJ undertakes the supervision of banks, while insurance and investment companies are supervised separately. This is the case in the majority of countries which supervise banks separately from other financial institutions, as their

¹⁰ BCBS, *Ibid* (n 6), pp. 7.

¹¹ Gray, Joanna. 2008. ‘The Difference a Year Makes in Financial Regulation’ *JIBFL* Vol. 23(5)(May), pp. 245.

¹² The FSA applied the ARROW framework, an acronym for Advanced, Risk-Responsive Operating FrameWork and which covers the three components of individual firms, cross-cutting themes and internal risk management. For further details, see: FSA. The FSA’s Risk Assessment Approach, 2006 (August).

¹³ ___. How Countries Supervise their Banks, Insurers, and Securities Markets, (2008).

respective central banks are responsible for this task. In Panama and Chile, however, banking supervision is undertaken by a specialised separate banking supervisory authority. In France and Germany, both the Central Bank and the banking supervisory authority play a joint role in banking supervision; Germany has a single financial supervisory authority, while France has a separate banking supervision institution.

Another survey conducted in 2007¹⁴ on 128 jurisdictions illustrates that major changes has taken place in banking supervisory structures during the last two decades: the decline in the number of supervisory authorities located in central banks, and a parallel increase in separate banking supervisors, although central banks remain the major location for banking supervision.¹⁵ Countries, which are adopting the unified (or single) financial supervisory model themselves, take various forms. In some small countries, (Bahrain, Bermuda, Cayman Island, Ireland, Macau, Netherlands Antilles and Singapore), the central bank supervises banks, insurance and investment companies. Most countries, however, locate the unified supervisory authority outside the central bank. The single supervisory authority might encompass banks and insurance companies which is the situation in Canada; banking and securities industries such as the situation in Switzerland and Liechtenstein; or cover all three types of financial industries in one institution segregated from the Central Bank as it is the case in Norway and Denmark.

The Jordanian model is also a simple traditional model whereby the main function of the banking supervisor is maintaining the safety of the banking system. Some jurisdictions, by contrast, apply the "twin peaks", model whereby the financial system is subject to the supervision of two supervisory authorities, one responsible for prudential regulation and the other one for consumer protection or market conduct. Prominent examples of the latter form are Australia and the Netherlands. The United Kingdom adopts a unique model which combines the unified model with the twin peaks model. Jordan and the UK stand therefore at opposite ends of the supervisory structures' spectrum. A common factor between two jurisdictions is that the developments of their banking supervisory structures have been influenced by market structure and domestic

¹⁴ FSI, Institutional Arrangements for Financial Sector Supervision: Results of the 2006 FSI Survey, (Occasional Paper No.7, (September 2007).

¹⁵ Ibid, pp. 14.

experience, while international standards apply an insignificant role. The recent financial turmoil of 2007-8 has however, highlighted the importance of setting out standards on certain aspects of the supervisory structure adapted by the UK.

6.3. The United Kingdom Model

Banking supervision in the UK started from the Central Bank and was distinguished for its informal approach. As the UK banking market grew in size and sophistication, the approach became more formalistic and the banking supervision was becoming more semi-independent. A complete change took place in 1995 when the FSA was established.

6.3.1. Evolution of Banking Supervision

6.3.1.1. Early Stages

The UK has a long tradition of central banking and banking supervision. The Bank of England was established in the seventeenth century as a private institution pursuant to the Bank of England Charter of 1694.¹⁶ Although the Bank of England was established as a private institution, a central banking role emerged gradually. The monetary role has led the Bank to assume a supervisory role.

Banking supervision was initially characterised by its informal nature. The Macmillan Committee noticed in 1931 that banks were not subject to formal legal requirements and advocated the continuation of this traditional approach.¹⁷ The first time any statutory authority was given to the Bank was through the Bank of England Act 1946, which nationalised the Bank and entitled it for the first time the right to issue “directions” in a hesitant language. Section 4(3) states that the Bank, “if they think it necessary in the public interest” may make recommendations and request information from bankers and may also, if authorised by the Treasury, issue directions to them. Despite the new Act, the culture of the Bank remained persuasive and flexible.¹⁸

¹⁶ The Charter of the Corporation of the Governor and Company of the Bank of England, (July 27. 1694).

¹⁷ Committee on Finance and Industry, Reports of the Committee on Finance and Industry, (Cmd 3897, 1931), (known as “Macmillan Committee”), pp.15-18.

¹⁸ G. Blunden. ‘The Supervision of the UK Banking System’ 1975 B.E.Q.B. Vol. 15(2), pp. 189-190.

The informal approach was considered suitable for the British banking structure at the time, which had two particular characteristics:¹⁹ first, the dominant position enjoyed by the Bank in the City of London, which again emanated from its functions as a central bank. In an official report issued in 1959, it was stated that the Bank “does not formally supervise the policies or operations of the clearing banks”.²⁰ The Radcliff Committee report stated regarding above Section 4(3) of the Bank of England Act that “[e]ven before this Act was passed the Bank could bring pressure to bear upon a bank by refusing to maintain an account for it, though it has not done so in recent years.”²¹ Furthermore, the Bank assumed at an early stage a Lender of Last Resort role towards institutions involved with its money market operations.²² There were a number of examples of the Bank’s willingness to interfere in the market.²³ The Bank, for example, assisted banks during the crisis.

Before 1974, there was no special banking supervision department in the UK. It was conducted through the Discount Office, which specialised in the Bank’s money market functions. Banks accepted the supervisory role of the Bank, as they wanted to benefit from the Lender of Last Resort facilities as well as discount their acceptances.²⁴ Secondly, there were a small number of dominant homogenous clearing banks, which enjoyed an oligopoly and did not have to enter into fierce competition (e.g., they formed an interest rate cartel). They were also cohesive institutions, which observed business standards. Another contributory factor that made the informal approach possible was the particularity of British banking authorisations, which led to dividing banks into hierarchal types known as the “ladder of recognitions”. A small number of depository-

¹⁹ D. Llewellyn, The Regulation and Supervision of Financial Institutions. (Gilbart Lectures on Banking, Institute of Bankers, London, 1986), pp. 31-32.

²⁰ Committee on the Working of the Monetary System, Report of the Committee on the Working of the Monetary System, (Cmnd 827, 1959), (known as “Radcliffe Committee”), pp. 118.

²¹ Ibid

²² This refers to banks, discount houses and acceptance houses. For more information see for example: J. Fforde, The Bank of England and Public Policy: 1941-1958, (1992), pp. 749-760.

²³ See for example: R. Sayers, The Bank of England: 1891-1944, Vol. 2 (1976), pp. 528-560.

²⁴ Wilson, J., ‘Supervision of the United Kingdom Banking System’ 1977 Banka Nazionale del Lavoro Quarterly Review Vol. 30(120)(March), pp. 38.

taking institutions, classified as authorised or recognised banks, were allowed to provide all banking activities and fell within the supervisory remit of the Bank.

6.3.1.2. The Seventies

The period from 1973 to 1979 was characterised by the increased trend towards formalism because of the three following factors. The first factor is the formation of the BCBS in 1974 after the disruption which had taken place in the Euro market leading to the convergence of international supervisory standards. The second one is the Europeanisation process of the British banking supervisory legislation. The transposition of EU Treaties and secondary legislation into UK law was carried out by the enactment of the European Communities Act 1972.

The third factor refers to the British market development and its interaction with domestic regulatory experience. Changes in the British banking market structure led to changes in monetary policies and consequently supervisory policies.²⁵ The central oligopolist position of clearing banks was challenged by competition from other institutions, particularly finance houses. A major contributory factor was the deregulation of direct credit controls.²⁶ The catalyst was the issuance of the Competition and Credit Control,²⁷ which abolished the interest rate cartel of clearing banks, lending ceilings and Hire Purchase Terms Control. Consequently, there was a trend of disintermediation by other deposit-taking institutions who under-cut the clearing banks. A wholesale secondary or parallel market (outside the traditional discount market) was developing whereby secondary or fringe banks were active. Meanwhile, clearing banks have become active in the "Eurodollar" market based in London.²⁸

The growth of fringe banking in large numbers beyond the scope of the banking supervisory remit, which were involved widely in property securities, eventually faced failures as the property prices went down, deposits were withdrawn

²⁵ For more details, see: J. Fforde, 'Competition, Innovation and Regulation in British Banking' 1983 B.E.Q.B. Vol. 23 (3), pp. 363-367.

²⁶ M. Hall, Banking Regulation and Supervision: a Comparative Study of the UK, USA and Japan, (1993), pp. 29-30.

²⁷ Bank of England, 'Competition and Credit Control' 1971 B.E.Q.B. Vol. 11(2)(June), pp. 189-193.

²⁸ J. Fforde, *Ibid* (n 22) pp. 367.

and a crisis looked imminent,²⁹ known as the "fringe banking or secondary banking crisis". The Bank interfered by launching the "lifeboat", a support scheme at shared risk, as well as subsequent operations in order to assure domestic and international confidence in British banks.³⁰ This crisis called for attention to deal with four matters: first, a large number of deposit taking institutions escaped banking supervision by the Bank and any other authority; secondly, the Bank failed to exercise banking supervision effectively. thirdly, there was a need for formal deposit protection arrangements. finally, the public was confused about which institutions could be described as banks considering the ladder of recognitions.³¹

Although the lifeboat was generally considered successful, it led to calls for tightened banking supervision culminating with the promulgation of the Banking Act 1979. A number of supervisory arrangements were undertaken, nevertheless, before 1979. The Discount Office, responsible for banking supervision at the time was expanded and reorganised; returns were required from statistical banks and prudential examination started to be undertaken by the Bank. London and Scottish clearing banks were, however, exempted from submitting prudential returns.³² In 1975, a new Banking Supervision Department was established headed by a higher rank of official, namely Head of Department and the number of officials working for the Department was increased.³³

6.3.1.3. The Banking Act 1979

The above mentioned international and regional supervisory developments, as well as the fringe-banking crisis, led to the promulgation of the Banking Act 1979. This was the first comprehensive law regulating banking supervision in the UK. The linchpin of the Act was Section 1(1), which prohibited the acceptance of deposits in the course of

²⁹ See generally: M. Reid, The Secondary Banking Crisis, 1973-75: Its Causes and Course, (1982).

³⁰ For further details on the lifeboat scheme, see: 'The Secondary Banking Crisis and the Bank of England's Support Operations' 1978 B.E.Q.B. Vol. 18(2)(June), pp. 230-239.

³¹ Ian Morison, Paul Tillett and Jane Welch, Banking Act 1979, (1979), para. 56.

³² G. Blunden, *Ibid* (n 18), pp. 190-192.

³³ J. Wilson. *Ibid* (n 24), pp. 40.

carrying on a deposit-taking business, unless the concerned institution fell within the exempted categories (or the transaction was exempted).³⁴

The exempted institutions were mainly those institutions, which were granted the status of “authorised” or “recognised” banks by the Bank of England.³⁵ This led to what became known as the “two-tier system” whereby two categories of authorisations emerged of “licensed” and “recognised” deposit-taking institutions which caused confusion amongst the public.³⁶ Applications for authorisation as a recognised bank had to show that the applicant satisfied two requirements over and above those required from licensed deposit-takers. The first one was to enjoy “a high reputation and standing in the financial community”. The second was to supply either a “highly specialised banking service” or a “wide range of banking services”.³⁷ Only recognised banks were permitted to describe themselves as banks and as institutions engaged in the banking business.³⁸ The two-tier system ensured a close relationship between the Bank of England, while the latter retained its control over licensed banks.³⁹

In addition to controlling deposit-taking, the Banking Act 1979 strengthened the supervisory authority of the Bank of England in a number of respects. First, it was entitled with a wide scope of discretionary power to issue directives in the interest of depositors.⁴⁰ Failure of banks to comply with these directives would result in the imposition of summary convictions ranging from imposing a fine to imprisonment.⁴¹ The Bank was also given the right to solicit information, to conduct investigations, and to seek the winding-up of deposit-taking institutions.⁴² The Act, nevertheless, did not

³⁴ For further details see: Ian Morison, Paul Tillet and Jane Welch, *Ibid* (n 31), paras. 71-116.

³⁵ Banking Act 1979, Section 2(1).

³⁶ Treasury, The Licensing and Supervision of Deposit-Taking Institutions, (Cmnd 6584, 1976), pp. 4.

³⁷ Banking Act 1979, Sch 2.

³⁸ *Ibid*, Section 36.

³⁹ G. Penn, A. Shea and A. Arora, The Law Relating to Domestic Banking: Banking Law. Vol. 1, (1987), pp. 13.

⁴⁰ Banking Act 1979, Section 8.

⁴¹ *Ibid*, Section 8(5).

⁴² *Ibid*, Sections 16, 17 and 18.

provide for the duty of institutions to supply the Bank with prudential returns. It only entitled the Bank to compel licensed deposit-taking institutions to provide information and to supply reports by an accountant approved by the Bank.

6.3.1.4. The Banking Act 1987

The collapse of Johnson Matthey Bankers Limited (“JMB”) in 1984 raised questions about the effectiveness of the Bank’s traditional discretionary approach of banking supervision.⁴³ JMB was a recognised bank as well as one of five members of the London Gold Market Association, responsible for fixing the price of gold, which led the Bank of England to step in and bailout JMB. The losses of JMB were attributed to bad loans and high concentration in the loan portfolio, which were reported to the Bank too late. This had brought into question the adequacy of the supervisory system, which relied on voluntary submission of information by recognised banks.⁴⁴ The British Government responded by establishing a committee to review the banking supervisory system.⁴⁵ A White Paper was issued in the same year, which proposed a number of reforms to the Banking Act.⁴⁶

The proposals found their way into the new Banking Act 1987.⁴⁷ The purposes of the Act were stated in its lengthy title as “to make new provision for regulating the acceptance of deposits in the course of a business, for protecting depositors and for regulating the use of banking names and descriptions”. The Act sought to attain its objectives by regulating deposit-taking authorisation (licensing requirements, refusal, restriction and revocation of authorisation),⁴⁸ providing for a deposit guarantee

⁴³ Chris Blackhurst, ‘What Lurks behind UK Bank Supervision?’ 1985 I.F.L.Rev. Vol. 4 (February), pp. 4.

⁴⁴ Maximilian Hall, UK Banking Supervision and the Johnson Matthey Affair, (Research Paper No. 8, Loughborough University Banking Centre, May, 1985), pp. 1.

⁴⁵ The Treasury, Report of the Committee Set-up to Consider the System of Banking Supervision, (Cmnd 9550, 1985).

⁴⁶ Treasury, Banking Supervision. (Cmnd 9695, 1985).

⁴⁷ For description and analysis of the Banking Law 1987 see: Anu Arora, ‘The Banking Act 1987 (1)’ 1988 The Company Lawyer Vol. 9(1), pp. 8-13; Anu Arora, ‘The Banking Act 1987 (2)’ 1988 The Company Lawyer Vol. 9(2), pp. 39-46; Christos Hadjiemmanuil, Banking Regulation and the Bank of England, (1996), pp. 78- 276; and: G. Penn, Banking Supervision: Regulation of the UK Banking Sector under the Banking Act 1987, (1989).

⁴⁸ Banking Act 1987, Pt I, Sections 3-49.

scheme,⁴⁹ and laying down restrictions on the usage of banking names and descriptions,⁵⁰ while introducing an appeal system for the aggrieved party. A vestige of the two-tier system is that only authorised institutions incorporated in the UK and with a paid-up capital amounting to at least five million pounds can use the name “bank” or “banker”.⁵¹

Most importantly, the Banking Act 1987 enhanced the trends towards the formalistic approach of banking supervision.⁵² It imposed a specific duty on the Bank to supervise institutions for the first time (though the duty could be inferred from the earlier Act). It mainly provided for the duties “to supervise the institutions authorised by it in the exercise of those powers”⁵³ and “to keep under review the operation of this Act and developments in the field of banking which appear to it to be relevant to the exercise of its powers and the discharge of its duties”.⁵⁴ The Act also put the Bank under a duty to report annually to the Chancellor of the Exchequer on its functions pursuant to the Act during the year ended. The report should also be published and submitted to the Parliament,⁵⁵ thus enhancing the accountability and transparency of the Bank. Furthermore, the Act conferred upon both the Bank and its staff immunity from liability for damages for the actions and omissions committed during the discharge of their supervisory functions.⁵⁶

The Banking Act 1987, though obsolete now, can provide guidance for countries who seek to enhance their banking supervisory structure without completely segregating it from the banking supervisory authority. The British Government had

⁴⁹ Ibid, Pt II, Sections 50-66.

⁵⁰ Ibid, Pt III, Sections 67-73.

⁵¹ See Pt III of the Banking Act 1987 for rules on banking names and descriptions and for explanation: E. Ellinger and E. Lomnika, Modern Banking Law, (1994), pp. 45-48.

⁵² For the view of the Bank of England on the influence of the Banking Acts on banking supervision, see for example: Brian Quinn, ‘The Influence of the Banking Acts (1979 and 1987) on the Bank of England’s Traditional Style of Banking Supervision’ in Norton, Joseph (ed), Bank Regulation and Supervision in the 1990s, pp. 1-6.

⁵³ Ibid, Section 1(1).

⁵⁴ Ibid. Section 1(2).

⁵⁵ Ibid, Section 1(3).

⁵⁶ Ibid. Section 1(4).

deliberated seriously on the issue of segregating the banking supervisory function from the Bank prior to the Banking 1987.⁵⁷ Instead, the Board of Banking Supervision was established in 1986 to act as a supervisory committee to the Bank. The Banking Act 1987 conferred upon the Board statutory enforcement. It provided that the Board was comprised of nine members: three *ex officio* members: the Governor, (the Chairman of the Board of Directors), the Deputy Governor, and the Executive Director of the Bank, responsible for supervision, as well as six independent members.⁵⁸ The duty of the six independent members was to advise the *ex officio* members on supervisory functions.⁵⁹ The Banking Act did not oblige the Bank to follow the advice of the independent members. Should the Bank reject the latter's advice, the independent members should inform the Chancellor of the Exchequer in writing.⁶⁰ The Bank should also supply the Board with regular reports on its discharge of its supervisory functions as well as any other reasonably required information.⁶¹

The Banking Act 1987 provided for a number of measures to assure the independence of the Board. First, section 2(7) conferred on the members of the Board immunity from liability in the discharge of their functions. Secondly, Schedule 1 to the Act defined rules for independent members' terms of reference for removal from office. The Bank was entitled to remove such a member, after consultation with the Chancellor of the Exchequer, if it was satisfied that he had become bankrupt or had been put under similar proceedings with creditors, become incapacitated, has not attended the Board's meetings for a period exceeding three months without the prior consent of the Board or has become unfit or unable to perform his functions. The Act also determined the quorum for meetings as three independent members and only one *ex officio* member. The Act, nevertheless, left it to the discretion of the Bank of England to determine provisions for the independent members' allowances, remuneration and other benefits.⁶²

⁵⁷ Treasury, *Ibid* (n 47), paras. 5.3-5.4.

⁵⁸ Banking Act 1987, Section 2(2).

⁵⁹ *Ibid*, Section 2(3).

⁶⁰ *Ibid*, Section 2(5).

⁶¹ *Ibid*, Section 2(4).

⁶² *Ibid*, Sch 1, Section 5.

The new banking supervisory framework was questioned because of two major banking failures in the UK, namely the BCCI and Barings Bank. Concerning BCCI bank, a special UK inquiry which was conducted to examine the supervision of the BCCI (known as the “Bingham Report”),⁶³ praised the Bank’s traditional approach based on trust and cooperation with banks.⁶⁴ The issue of creating an independent supervisory body for banking supervision separate from the Bank of England was also considered in the Bingham report. The inquiry stated that the “[a]rrangements of this kind are not immutable, and it is not impossible to conceive the future development of a national or an international supervisory body”.⁶⁵ The head of the Bank’s Banking Supervision Department also supported the integration of banking supervision within the Bank.⁶⁶

As regards the Barings Bank, an inquiry was conducted by the Board of Banking Supervision into the circumstances of the collapse of Barings in 1995.⁶⁷ It neither called for major changes in the supervisory system nor recommended changes in the Banking Act 1987. It rather called for the re-evaluation of the number and skill of surveillance officers, the conduct of quality assurance reviews of banking supervision, and the increase of resources as a consequence of banks conducting complex and material trading activities.

It is important to notice that the latter Inquiry, and subsequent discussions at the House of Commons, did not mount to a recommendation to change the basis of the structure of banking supervision, suggesting the alternative route of nominating a lead

⁶³ Bingham L.J., Inquiry into the Supervision of the Bank of Credit and Commerce International, (known as the “Bingham Report”), (October, 1992).

⁶⁴ *Ibid*, para. 3.7-3.8.

⁶⁵ *Ibid*, para. 3.5.

⁶⁶ Brian Quinn, ‘The Bank of England’s Role in Prudential Supervision’ in Brian Quinn, Robert Morgenthau, and Sir Thomas Bingham. Banking Supervision after BCCI. (LSE Special Paper No. 54, August 1993), pp. 9.

⁶⁷ Board of Banking Supervision. Inquiry into the Circumstances of the Collapse of Barings. HC (1994-5) 673.

regulator.⁶⁸ The House of Commons, nevertheless, was concerned about the problem of "regulatory capture".⁶⁹ It stressed on the following:

"Bank to demonstrate that it is able to separate its supervisory activities from its other functions and avoid any possible weakening of its regulatory effectiveness due to its proximity to the day to day banking market. Otherwise it maybe that in order to bring about the necessary cultural change banking supervision will have to be taken away from the Bank of England".⁷⁰

The Bank of England consequently took steps to strengthen its Supervision and Surveillance function,⁷¹ which would remain part thereof. The Barings Bank failure had a significant impact on the technique of banking supervision UK. The traditional approach was questioned and the Bank of England preferred a system which prioritised supervisory efforts according to potential risks.⁷²

6.3.2. The Financial Services Authority

Soon after the newly elected Labour Party assumed office in the UK in 1997, the Chancellor of the Exchequer (i.e. Minister of Finance) announced the most important institutional and operational changes at the Bank of England for decades. First, the Bank was given operational responsibilities for setting interest rates.⁷³ A new Bank of England Act was enacted in 1998, providing in Section 13 that operational decisions are made by the Monetary Policy Committee comprised of the Governor,

⁶⁸ Treasury Committee, First Report, Barings Bank and International Regulation: Report together with the Proceedings of the Committee, Vol. I HC (1996-97) 65-I (12 December 1996), para. 62-68.

⁶⁹ Ibid, para. 99.

⁷⁰ Ibid, para. 100.

⁷¹ The Bank applied a number of measure consequent to the 17 recommendations of the Inquiry directly or after conducting a study by Arthur Anderson firm. For further details, see: Memorandum submitted by the Bank of England, in Treasury Committee, First Report, Barings Bank and International Regulation: Minutes of Evidence and Appendices, Vol. II, HC (1996-97) 65-II (12 December, 1996), pp. 144-148; Bank of England, Arthur Anderson: Findings and Recommendations of the Review of Supervision and Surveillance, (July, 1996); Bank of England, The Bank's Review of Supervision, (July 24, 1996); Bank of England, Banks' Internal Controls and the Section 39 Process, a Consultative Paper, (February, 1997); and Bank of England, The Objectives, Standards and Processes of Banking Supervision, (February, 1997).

⁷², Dalvinder Singh, Banking Regulation of UK and US Financial Markets, (2007), pp. 48-49.

⁷³ Chancellor, Letter from the Chancellor to the Governor on 6 May 1997. As reproduced in 1997 B.E.Q.B. Vol. 37(3), pp. 244.

Deputy Governor and other six members.⁷⁴ Secondly, and only a fortnight later, the Chancellor announced the formation of a new regulatory authority responsible at a minimum of the supervision of the banking institutions and investment services. Banking supervisory responsibilities were to be transferred to a new and strengthened Securities and Investment Board (“SIB”), which had already been the regulatory authority of the investment sector. The Bank would accordingly be responsible for the overall stability of the financial system, while the new integrated authority would be responsible for the prudential supervision and, later on, the conduct of business rules by firms.⁷⁵ The SIB was officially renamed the Financial Services Authority in October 1997.

The reform was introduced in progressive stages before it became fully operational.⁷⁶ The first stage of reform was completed by the transfer of the banking supervision function from the Bank of England to the FSA in June 1998,⁷⁷ but the Board of Banking Supervision was dissolved later on.⁷⁸ The Financial Services and Markets Act was enacted in 2000 (“FSMA”), which transferred the responsibilities of six other regulatory authorities, namely, the Building Societies Commission, the Friendly Societies Commission, the Investment Management Regulatory Organisation, the Personal Investment Authority, the Register of Friendly Societies and the Securities and Futures Authority. Most of the responsibilities were assumed in 2001, while responsibility for general insurance sales and mortgage advice were assumed in 2005.

⁷⁴ For further explanation of the Act and the role of the MPC, see: Governor, (the Governor of the Bank of England), ‘The New Lady of Threadneedle Street’ 1998 B.E.Q.B. Vol. 38.(2)(May), pp. 173-177; Peter Rodgers, ‘The Bank of England Act’ 1998 B.E.Q.B. Vol. 38.(2)(May), pp. 93-96; Peter Rodgers, ‘Changes at the Bank of England’ 1997 B.E.Q.B. Vol. 37(3)(August), pp. 241-243; and Maximilian Hall, ‘All Change at the Bank of England’ 1997 JIBFL. Vol. 12(July-August), pp. 295-302.

⁷⁵ Chancellor, The Chancellor’s Statement on the Bank of England on 20 May 1997. As reproduced in 1997 B.E.Q.B. Vol. 37(3), pp. 246.

⁷⁶ For further details of early plans for the progressive stages, see: FSA, Financial Services Authority: an Outline, (1997).

⁷⁷ The Banking Act 1987 was initially amended by Bank of England Act 1998 Sch. 5(I)(1) para. 2(a) in order to transfer the function of banking supervision to the FSA. (See also Bank of England Act 1998 (Commencement) Order 1998/1120). The Banking Act 1987 was later on repealed by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001/3649, Pt 1 art. 3(1)(d).

⁷⁸ Section 416(3)(d) of the FSMA which came into existence by virtue of the Financial Services and Markets Act 2000 (Dissolution of the Board of Banking Supervision) (Transitional Provisions) Order 2001/3582, which came into force on 26th November 2001.

6.3.2.1. The Wide Powers of the FSA

The FSMA creates a very powerful authority in terms of its institutional coverage, functions, principles, and statutory powers.

The FSA enjoys a wide institutional scope which encompasses banks, insurance companies, building societies and friendly societies, credit unions, investment and pensions advisers, professional firms offering particular types of investment services, stockbrokers, fund managers, as well as, supervisory cooperation with the Lloyd's insurance underwriting market. Regulated activities initially covered activities inherent from earlier legislation including accepting deposits,⁷⁹ but are defined and altered by statutory instruments.⁸⁰ The authority of the FSA was extended, e.g. to cover issuers of electronic money.⁸¹

The FSA also regulates prudential and market conduct aspects of the financial sector. The FSMA states that the FSA has four objectives.⁸² First, market confidence, which is 'maintaining confidence in the financial system' operating in the UK. Secondly, public awareness, meaning 'promoting public understanding of the financial system.' This objective encompasses the understanding of risks and benefits of various types of investment as well as the provision of adequate information and advice. Thirdly, the protection of consumers, which means 'securing the appropriate degree of protection for consumers'. Finally, the reduction of financial crimes, which cover (a) fraud or dishonesty, (b) misconduct, or misuse of market-related information, and (c) handling crime proceeds.

The FSA should have regard to the seven 'principles of good practice' provided for in Section 2(3) of the FSMA. They cover cost efficiency, the responsibilities of managers of authorised persons, the proportionality of restrictions and burden imposed and their expected outcome, facilitating innovation, and preserving the international

⁷⁹ FSMA, Section 22 read together with Sch. 2 numerate the specific activities including deposit taking.

⁸⁰ Section 22(5) of the FSMA empowers the Treasury to determine the classes of regulated activities and accordingly Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544 and its amendments were issued.

⁸¹ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002/682.

⁸² FSMA, Section 2(2) as further illustrated by Sections 3-6.

competitiveness of the British financial system. Furthermore, the FSA should take account of "the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions" as well as "the desirability of facilitating competition between those who are subject to any form of regulation by the Authority."⁸³

The FSA enjoys a wide range of powers encompassing the authorisation, legislation and enforcement.

As to authorisation, the FSMA provides for a general prohibition⁸⁴ on undertaking regulated activities including deposit-taking⁸⁵ by anyone other than an authorised person or an exempt person (such as a 'recognised clearing house' or 'recognised investment exchange').⁸⁶ There are three types of authorised persons:⁸⁷ first, applicants granted Part IV Permission by the FSA and who should satisfy minimum threshold conditions related to their legal status, location, approval of close links, adequacy of resources, and satisfying the fit and proper criteria.⁸⁸ Secondly, European Economic Area ("EEA") credit institutions⁸⁹ authorised by their respective home state authorities may apply for authorisation under Schedule 3 of the FSMA which basically implements the EU passport concept. Thirdly, Treaty credit institutions which do not meet the requirements of an EEA firm are authorised under Schedule 4 of the same law. The FSA may also vary its Part IV upon the request of the applicant or on its own

⁸³ A banking review was undertaken at the time by a team of Treasury Consultants headed by Don Cruickshank to the Chancellor of the Exchequer on competition and regulation recommended that competition should become a primary objective of the FSA, but was overlooked by the UK Government.

Source: Don Cruickshank, Competition and Regulation in Financial Services in the UK: Striking the Right Balance, an interim report, (1999) reproduced at Annex F, Don Cruickshank, Competition in the UK Banking: a Report to the Chancellor of the Exchequer, (March, 2000) pp. 317-366.

⁸⁴ FSMA, Section 19(1).

⁸⁵ Deposits are defined in Sch 2, para. 22 and Article 6 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544 and amendments. Article 5 of the same order defines deposit-taking activity.

⁸⁶ FSMA, Sections 39 and 285.

⁸⁷ FSMA, Section 31.

⁸⁸ FSMA, Sections 40 and 41 and Sch 6.

⁸⁹ European Parliament and Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177, (30 June 2006), 1-200, Article 4.1.

initiative and may also cancel the authorisation.⁹⁰ Furthermore, the FSMA requires certain persons who carry specific functions in an authorised institution to be registered as 'approved persons'.⁹¹ In addition, financial promotion for soliciting deposits can only be undertaken by an authorised person and according to the requirements set out by the FSA.⁹²

The FSMA confers on the FSA with enforcement powers including obtaining information and documents, conducting investigation and may enter premises in order to search for documents and seize them.⁹³ The FSA also has at its disposal a wide range of disciplinary measures such as public censorship, imposing financial penalties⁹⁴ and restitution.⁹⁵ The aggrieved person has a right of reference to the Financial Services and Markets Tribunal.⁹⁶ Furthermore, the FSA may apply to the court for injunctions and restitution (or 'disgorgement') orders which apply to authorised and non-authorised persons.⁹⁷ In addition, the FSA may take part in any insolvency proceeding or petition for the winding up of an authorized person.⁹⁸

The FSA enjoys wide rule-making powers both generally⁹⁹ and on specific issues such as financial promotion rules.¹⁰⁰ The obligation of legislation is mainly expressed in the FSMA Handbook of Rules and Guidance, which combines high principle standards and prudential standards, many of which are carried forward from the previous banking Laws.¹⁰¹ In addition, the FSA is responsible for establishing the

⁹⁰ FSMA, Section 44 and 45.

⁹¹ FSMA, Section 59.

⁹² FSMA, Sections 21 and 145.

⁹³ FSMA, Section 165-169 and 176.

⁹⁴ FSMA, Sections 205 and 206.

⁹⁵ FSMA, Section 384.

⁹⁶ FSMA, Pt IX.

⁹⁷ FSMA, Section 380, 382.

⁹⁸ See generally, FSMA, Pt XXIV.

⁹⁹ FSMA, Section 138.

¹⁰⁰ FSMA, Section 144-147.

¹⁰¹ Available online: www.fas.gov.uk

Financial Deposit Compensation Scheme,¹⁰² which replaced the earlier Deposit Compensation Scheme, as well as establish the Financial Ombudsman Service,¹⁰³ which provides an alternative dispute resolution scheme.

It is noteworthy that the FSMA as well as its members, officers and staff are also immune from liability in damages for acts and omissions undertaken or purported to be undertaken in the discharge of its business.¹⁰⁴ It is noteworthy that the House of Lords ruled concerning the equivalent Section 1(4) of the Banking Act 1987 that the immunity does not extend to acts or omissions committed either in bad faith or under the tort of misfeasance in public office.¹⁰⁵

6.3.2.2. Relations with the Bank of England

The Bank of England Act 1998 put a statutory responsibility on the Bank to maintain the monetary stability,¹⁰⁶ which entailed maintaining financial stability. Although the Bank of England Act 1988 did not provide directly for the objective of financial stability, it was considered by the Bank as a "core purpose" beside monetary stability, due to their influence and counter-influence relationship.¹⁰⁷ The Financial Stability Board was accordingly established in 2004 and is comprised of senior Bank of England staff under the chairmanship of the Deputy Governor for Financial Stability. Its objectives are to review and prioritise potential risks to the financial system, and to determining follow-up action; review of the implementation of the risk mitigation plan; and proposing policy lines.¹⁰⁸

In order to set a formal relationship between the Bank of England, the FSA and Her Majesty's Treasury, a Memorandum of Understanding between the three parties

¹⁰² FSMA, Pt XV.

¹⁰³ FSMA, Pt XVI.

¹⁰⁴ FSMA, Sch 1, para. 19.

¹⁰⁵ *The Three Rivers District Council v Bank of England* No. 3 [2003] 2 AC1.

¹⁰⁶ Bank of England Act 1998, Section 11.

¹⁰⁷ Bank of England, 2008 Financial Stability Report.(24)(October), cover page.

¹⁰⁸ Bank of England, Bank of England Annual Report. (2004), pp. 19.

was agreed in 1997.¹⁰⁹ Accordingly, a high level Standing Committee representing the three authorities was established. It conducted regular meetings in order to reach a common position regarding important matters. The relationship was further strengthened by the membership of the Deputy Governor in the FSA Board and the Chairman of the FSA as one of the Bank of England's Court. This arrangement was believed to have improved the sight of the Bank into the non-banking financial sector as well as the flow of information in the system.¹¹⁰

The Treasury, the Bank of England and the FSA signed another Memorandum of Understanding in 2006.¹¹¹ The Memorandum seeks to coordinate their efforts and delineate their responsibilities in the field of financial stability. It explains that the Treasury is responsible for "the overall institutional structure of financial regulation and the legislation which governs it".¹¹² It also illustrates the main responsibility of the Bank as contributing to maintaining the financial stability of the financial system, which stems from its monetary role. The main relevant role of the FSA under the FSMA is the authorisation and prudential supervision of banks such as setting out solvency ratios. The Memorandum explains that the division of responsibilities is based on four principles: the accountability of the institution which entails the clear definition of responsibilities; transparency that allows the Parliament, the markets and the public of the specific responsibilities of each institution; the facilitation of the exchange of information amongst these institutions; and the avoidance of the duplication of efforts amongst the institutions.¹¹³

The Memorandum of Understanding of 2006 also establishes a Standing Committee on Financial Stability, which is chaired by the Treasury and comprises representatives of the three authorities. Under normal conditions, the authorities are represented at deputy level and conduct monthly meeting to discuss financial stability

¹⁰⁹ Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority as reproduced in: 1998 B.E.Q.B. Vol. 38(2) (May), pp. 97-99.

¹¹⁰ Clive Briault, Revisiting the Rationale for a Single National Financial Services Regulator, FSA, Occasional Paper. No. (16), (February, 2002), pp. 15.

¹¹¹ The first tripartite Memorandum of Understanding was signed in 1997.

¹¹² Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority, (March 22, 2006), para4.

¹¹³ *Ibid*, para.1.

and significant individual cases.¹¹⁴ In crises situations, the Bank undertakes "official financial operations...to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system",¹¹⁵ while the FSA undertakes operations other than the ones the Bank is charged with including charging of capital.¹¹⁶ If support operations are needed, the Standing Committee convenes at principal level.¹¹⁷ In exceptional circumstances, where there is "genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy", the Chancellor becomes ultimately responsible for the authorisation of support operations.¹¹⁸

6.3.3 The Banking Act 2009

The segregation of the Bank of England and the FSA was subject to criticism in the wake of the Northern Rock failure, where the first run on a British Bank for a very long time took place. A number of UK reports were conducted on the causes of the failure and the lessons to be learnt therefrom.¹¹⁹ The House of Commons Financial Reform Report issued in September 2008 stresses on the role of the Central Bank in a segregated financial regulation system and the inter-relationships between depositor protection and preventative supervision. It explains the following:

"The separation of regulatory responsibilities from the continuing responsibility for liquidity support to secure financial stability has created uncertainty within the Bank of England. As we have noted above, the Governor has interpreted this as meaning the Bank was not to engage with individual institutions. This interpretation placed the Bank in a no-man's-land".¹²⁰

¹¹⁴ Ibid_ para. 10 and 11.

¹¹⁵ Ibid_ para.2.

¹¹⁶ Ibid_ para.3.

¹¹⁷ Ibid_ para.13.

¹¹⁸ Ibid_ para.14-16.

¹¹⁹ Treasury Committee, Fifth Report, The Run on the Rock, HC (2007–08) 56–I (January 26, 2008); Treasury Committee, Eleventh Special Report, The Run on the Rock: Government Response to the Committee's Fifth Report of Session 2007-08. HC(2007-08) 918, (July 10, 2008); Bank of England, HM Treasury and FSA, Financial Stability and Depositor Protection: Strengthening the Framework, (Cm. 7308, January, 2008); FSA Internal Audit Division, The Supervision of Northern Rock: a Lessons Learned Review: Report, (March, 2008); Bank of England, HM Treasury and FSA, Financial Stability and Depositor Protection: Further Consultation, (Cm 7436 July, 2008); Treasury Committee, Seventeenth Report, Banking Reform, HC(2007-08) 1008, (September 16, 2008).

¹²⁰ Treasury Committee, Banking Reform. Ibid. para. 10.

The major shortcoming of the UK supervisory structure was the late intervention by the Bank to handle the crisis. This is attributed to two shortcomings in the institutional arrangements. First, the differences in priorities and cultures between the Bank of England which emphasises more on the moral hazard problems,¹²¹ and the FSA which concentrates more on the effects of banking failures on third parties. Secondly, weak coordination amongst the Tripartite authorities rendered them unprepared for a covert support operation or facing systemic crisis.¹²² The standing committee on Financial Stability was perceived as "a sleepy backwater" in normal circumstances which needs to start from scratch where financial trouble strikes.¹²³ In addition, the general corporate insolvency rules proved to be inadequate in the case of the Northern Rock Bank and the temporary Banking (Special Provisions) Act 2008 was impermanent.¹²⁴

A new Banking Bill was submitted to the UK parliament in October 2008 and was enacted in February 2009. It introduces key amendments. First, it amends the Bank of England Act by adding financial stability as one of its objectives.¹²⁵ It also introduces amendments to the Bank of England governance including the reduction of the number of its board members from sixteen to nine.¹²⁶ In addition, the also confers on the Bank immunity from liability in damages in the exercise of its monetary role in improving the stability of the financial systems.¹²⁷ Furthermore, it creates the Special Resolution Scheme for handling banks which have failed or facing imminent failure. The scheme covers stabilization procedures (transferring the troubled bank to a private purchaser or a bridge bank and placing the bank into public ownership) as well as new banking administration and insolvency procedures. The objectives of these procedures are set out under Section 4 of the Banking Act 2009 as the protection of financial stability in the

¹²¹ Mervyn King, Governor of the Bank of England, Turmoil in Financial Markets: What Can Central Banks Do?, paper submitted to the Treasury Committee on September 12, 2007, pp. 8.

¹²² Treasury Committee, Banking Reform, Ibid (n 119), paras. 25-27.

¹²³ House of Commons, Treasury Committee Seventeenth Report of Session 2007-08, Banking Reform, HC 1008, (September 16, 2008), para. 268.

¹²⁴ Bank of England, Ibid (n107), pp. 49-51.

¹²⁵ Banking Act 2009, Section 238.

¹²⁶ Ibid, Section 239.

¹²⁷ Ibid, Section 244.

UK particularly the continuity of its banking system, the enhancement of confidence in the stability of the financial system, protection of depositors and public funds and avoiding interference with private property rights.

Most relevantly, the Act determines one of the thorniest issues in a segregated financial supervisory authority, which is determining the institution responsible for deciding that a bank has failed or is facing imminent failure and the selection of suitable measures. The Banking Act assigns to the FSA the responsibility to "trigger" the decision after consultation with the Bank of England and the Treasury, the Bank of England is made responsible for its operation.¹²⁸

The Banking Act does not seek to change the tripartite arrangement. It rather creates the Financial Stability Committee, a sub-committee of the court of directors of the Bank of England, comprised of the Governor, two Deputy Governors and four designated directors of the Bank. Its functions include the provision of recommendations to the court of directors on the implementation of the financial stability strategy; advice the banks on individual institutions on issues relevant to the financial stability; and monitor how the Bank exercises its monitoring role of the inter-bank payment systems.¹²⁹

Therefore, the UK experience shows that there are important prudential aspects in the institutional structure and techniques of the financial or banking supervisory authorities that should be addressed. The following chapter will examine the legal nature of the BCBS.

¹²⁸ Banking Act 2009, Sections 7-9.

¹²⁹ Banking Act 2009, Section 238.

CHAPTER 7

THE LEGAL NATURE OF THE BCBS STANDARDS

7.0 Introduction

The previous five Chapters covered the international standards on banking supervision as set out by the BCBS either alone or in coordination with other international fora. This chapter seeks to analyse the legal nature of the BCBS as soft international law (Section 1). It also draws preliminary conclusions on the significance of the soft law as the best legal method for setting out international rules for banking supervision in terms of implementation and compliance. The chapter afterwards examines the influence of the BCBS standards even on non-member countries and the reasons behind it.

7.1. What is soft international law?

The researcher takes the view that the BCBS documents are characterised as soft law.¹ Soft law refers to documents, which do not legally bind countries and, therefore, are not directly enforced by judicial authorities and tribunals. They are described as soft law as opposed to "hard law" or "firm law", such as treaty rules. Authors explain that states would initially have no agreed legal rules to govern their relations, then agree on written formulae and eventually start to have expectations towards each other built upon these formulae, and refer to them in further negotiations or settlements. Authors also explain that the direct effect of soft law on relations of states *inter se* is that it

¹ There is a vast body of literature on sources of international law generally and soft law specifically, see particularly: H. Baade, 'The Legal Effects of Codes of Conduct for Multinational Enterprises' in N. Horn (ed.), Legal Problems of Codes of Conduct for Multinational Enterprises. (1980), pp. 3-38; R.R. Baxter, 'International Law in "Her Infinite Variety"'. 1980 ICLQ. Vol. 29(4)(October), pp. 549-566; C. Chinkin, 'The Challenges of Soft Law: Development and Change in International Law' 1989 ICLQ. Vol. 38(4)(October), pp. 850-866; T. Gruchalla-Wesierski, 'A Framework for Understanding "Soft Law"' 1984 Mcgill L.J. Vol. 30, pp. 37-88; D. J. Harris, Cases and Materials on International Law, (2004), pp. 18-65; Frieder Roessler, 'Law. De Facto Agreements and Declarations of Principle in International Economic Relations' 1978 GYIL. Vol. 21, pp. 27-73; and I. Seidl-Hohenveldern, 'International Economic "Soft Law"', Recueil Des Cours (Collected Courses of the Hague Academy of International Law) Vol. II. (Tome 163 de la collection), pp. 165-246.

legitimises conduct which abides by soft documents, making it very difficult for states that abstain or reject them to challenge such conduct.²

Soft law is not numerated as an authoritative source of international law, unlike treaties and international customary law³ provided for, *inter alia* in Article 38(1) of the Statute of the International Court of Justice ("ICJ").⁴ Some authors argue that there is no such distinction between hard and soft law.⁵ Indeed the existence of vast volume of documents, particularly in the field of international economic law proves that Article 38(1) has failed to contain an exhaustive list of international law.

In 1983, Sir Joseph Gold,⁶ then General Counsel of the IMF, wrote an important Article in which he observed how the IMF resorted to soft law to assure compliance with exchange rate measures. His ideas were later on applied by Norton in

² C. Chinkin, *Ibid* (n 1), pp. 866.

³ Supporters of the soft law as a source of international law usually rely upon the Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America) (Merits), ICJ Rep. 1986, pp. 14. The ICJ in this case deducted that there was an *opinio juris* (i.e. that a certain practice is believed to be obligatory by a rule of law) prohibiting the use of force directly from the attitudes of States concerning General Assembly resolutions which themselves are a traditional example of soft law. *Opinio juris* takes very long time to evolve, and it is doubtful in the case of rapidly changing international banking standards that they can be of norm-creating character.

⁴ Article 38(1) of the Statute of the ICJ states the following:

“The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:

(a) international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;

(b) international custom, as evidence of a general practice accepted as law;

(c) the general principles of law recognized by civilised nations;

(d) judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law”.

⁵ Prosper Weil took a critical view of the theory of ‘relative normativity’, which had evolved in international law in a much celebrated article published in 1983. He argued that it constituted a major deviation from the principles of international Law.

Source: Prosper Weil, ‘Towards Relative Normativity in International Law?’ 1983 AJIL Vol. 77(3)(July), pp. 413-442.

⁶ Joseph Gold, ‘Strengthening the Soft International Law of Exchange Arrangements’ 1983 AJIL Vol. 77(3)(July), pp. 443-489.

his 1995 important thesis on devising international banking standards, whereby he characterised the BCBS standards as international soft law.⁷

When the BCBS documents are examined in light of the description of soft law, it can be deduced that these documents are soft law. First, the BCBS was declared as a forum for the exchange of opinion and has not been constituted as an international organisation entitled with a capacity to enter into international agreements.⁸ Secondly, BCBS members made it clear that they had no intention to be bound by the decisions and none of their representatives was empowered to do so. On the contrary, they retained discretionary powers to apply the documents and some times admitted that contravening enforceable laws might hamper the application of the decisions. Thirdly, the language of the BCBS documents reflects the weakness of enforceability. Most of the documents took the form of lengthy documents explaining supervisory concerns and ways to deal with them. Hortatory terms such as "desirable", "should", "can", "problems of a material nature" and "may wish" have been used throughout the documents, and do not even contain "whereas" clauses.⁹ The BCBS documents are also only been endorsed, not signed.

7.3. The Influence of the BCBS Standards

This thesis argues that soft law is the best from of international banking standard setting as a general rule. The author takes a critical view of the leading articles published by the then General Counsel of the BIS, Mario Giovanoli,¹⁰ who calls for international banking standards to be hardened into treaty form. This will be done by

⁷ Joseph J. Norton, Devising International Bank Supervisory Standards, (1995), pp. 241.

⁸ The Vienna Convention on the Law of Treaties, Article 5 regarding "treaties constituting international organizations and treaties adopted within an international organization", states:

"The present Convention applies to any treaty which is the constituent instrument of an international organization and to any treaty adopted within an international organization without prejudice to any relevant rules of the organization."

⁹ Peter C. Hayward, 'Prospects for International Co-operation by Bank Supervisors' 1990 The International Lawyer, Vol. 24(3)(Fall), pp. 787-788.

¹⁰ Mario Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting' in Mario Giovanoli (ed.) International Monetary Law: Issue for the New Millennium, (2000), pp. 3-59; and 'Reflections on International Financial Standards as "Soft Law"' in Joseph Norton and Mads Andenas (eds.), International Monetary and Financial Law upon Entering the New Millennium, (2002), pp. 71-98.

weighing the advantages of treaties (formalism, precision, binding effect and sanctioning) and soft law in light of the nature and characteristics of international banking supervision.

Treaties might be preferred due to their formalities particularly because they require the ratification of the legislative body (according to the applicable constitutional law).¹¹ This arguably ensures the commitment of the country comparable to non binding agreements. Treaties also reflect the seriousness of the country towards its underlying commitments.¹² These factors are irrelevant to international standards on banking supervision due to the nature of banking and banking supervision.

Let us consider why progress has been achieved by the BCBS mainly in the field of preventative banking supervision. This field is influenced by a major public policy interest of maintaining the safety and soundness of the banking system. It is hard to imagine that there could be differences amongst jurisdictions on this issue because of the universal recognition of the importance of the safety of banking as well as the lack of socio-politically sensitive issues. Therefore, it is easier to reach genuine consensus on banking supervisory standards without having to resort to concluding a treaty. States also do not need the assurance of a treaty endorsed by the legislative body of counterparty states.

One exception is related to the issue of safeguarding the banking system from exposure to risks because of serious financial crimes of money laundering and the financing of terrorism. These crimes transcend prudential requirements and enter into the realm of national security, a highly significant political issue. This is why the recommendations not only of BCBS but also of the Financial Action Task Force ("FATF") were hardened into international agreements and binding UN Resolutions. Here, the researcher would like to depart view with the authors who set the FATF recommendations experience as a model for BCBS standards.¹³

¹¹ Jack L. Goldsmith and Eric A. Posner, The Limits of International Law, (2005), pp. 91.

¹² Ibid. pp. 98.

¹³ K. Alexander, R. Dhumale and J. Eatwell, Global Governance of Financial Systems: The International Regulation of Systemic Risk, (2006), pp. 151.

These features of the BCBS standards on preventative supervision can be further clarified by drawing a comparison with protective banking supervision, where controversial issues arise strongly. States have variable views on how and to what extent they should bail out a troubled bank, because a substantial amount of public money might be spent. This issue then becomes harder to reach an international consensus on. In fact there has never been an international treaty on deposit guarantees or insurance compared to the Deposit Guarantee Directive of the EU.¹⁴

Similarly, there are strong policy issues, which influence the degree of openness of a country to foreign banking. This is why states had to have an international treaty; namely, the General Agreement on Trade in Services ("GATS") for this purpose. The BCBS standards do not provide that countries should allow foreign establishments, but recommend which supervisory requirements should be followed to ensure a sound market entry. Likewise, the BCBS standards do not determine the range of permissible activities for a foreign bank, but set out universal prudential rules to be applied should a certain activity be undertaken.

Another related feature of preventative banking supervision is its highly technical nature. They are full of practical details that need to be reviewed specifically and repeatedly. This is why its details are usually spelt out in secondary legislation and working manuals (within the framework of formulae laws). Secondary regulations often fall within the original or delegated powers of executives in supervisory authorities. In other words, they do not pass through legislative bodies.

The second reason why states might opt for international treaties is the precision of their wording and them being subject to specific rules of interpretation under the Vienna Convention on the Law of Treaties.¹⁵ The rather "loose" language of soft law documents makes them open to various interpretations and hence there could be variable applications, each of which is claiming conformity with soft law. The author

¹⁴ European Parliament and Council Directive 94/19/EC of May 30, 1994 on deposit-guarantee schemes. OJ. L 135, (31 May 1994), pp. 5-14. This directive is amended by the European Parliament and Council Directive 2005/1/EC of 9 March 2005 OJ. L 179, (24 March 2005), pp. 9-17. There is also a current proposal to amend the directive, see: Directive of the European Parliament and of the Council amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, Council Document 3743/08, Ecofin 645, Brussels, (20 February 2009).

¹⁵ Jack L. Goldsmith and Eric A. Posner, *Ibid* (n 11), pp. 95.

discussed this problem with the participants in a conference on soft law.¹⁶ Her question was specifically whether there are rules in international law to guide the legal practitioner in the field of financial regulation on how to interpret a soft law document? They agreed that there were no such guidelines, despite the importance of the issue. The former Director of Banking Supervision Department ("BSD") at the CBJ, then Mr. Abdul Fattah, also confirmed to the researcher that there have been incidents where there were varying interpretations regarding the scope of the consolidated supervision between home and host supervisory authorities. This was one of the reasons behind the issuance of the first BCBS' "Core Principles Methodology" which explained the following:

"The Core Principles were designed to provide general guidance that could apply to various supervisory regimes, allowing some flexibility in the design and implementation of concrete measures. In so doing, the Basel Committee was also aware that national supervisory authorities might misinterpret the Core principles. In the same vein, the assessment of compliance with the Core Principles by numerous interested parties (e.g. the IMF, World Bank, regional development banks, consulting firms) is likely to result in varied interpretations and possibly inconsistent advice. Although the results of the assessments may not be made public, it is still important that assessments be conducted in a consistent manner from country to country."¹⁷

The legalism of treaties, nevertheless, means that there is less flexibility in their interpretation, a quality that contradicts the nature of banking supervision in general. This is because banking supervisors would like to agree with precision on issues that affect banking competition specifically. Therefore, they have agreed on a certain minimum capital ratio. Supervisors yet deal with banks with variable traditions, different market structure and subject to very different legal infrastructures. For all these reasons, international standards should be flexibly worded and implemented. Flexibility has actually been a major contributory factor in the successful wide implementation of the BCBS standards.

Even in the case of the most precise standard, the capital adequacy ratio, it is noticed that consensus was built upon a *minimum* ratio not a fixed one. Furthermore,

¹⁶ SPTL International Law Group and the British Institute of International and Comparative Law, Sixth Conference on Theory and International Law, (March 25, 1996).

¹⁷ BCBS, Core Principles Methodology, (October, 1999), pp. 5, par. 23.

international standards on capital adequacy have been increasingly flexibly worded. Basel II, most notably, provides banks and supervisors with a catalogue of options for capital adequacy measurement, while Basel I provided fixed buckets and ratios.

Another striking example is the rule of home country control. This rule is one of the pillars of international banking standards, but can or should this rule be immune from change? The vast development in technology and the consequential growth of online banking is bringing a gradual end to geography. Putting this contentions point aside, the exact meaning of home country control has various degrees of understanding. This is because home country control is itself dependent on two factors: the degree of consensus on substantive rules, as well as the effectiveness of the host country's cooperation with the home country. The case is most evident in relation to developing countries hosting large international banks permitted by their home countries to apply the more advanced capital adequacy measures. If the host supervisory authority has not yet built up its institutional capacity to understand and monitor the capital adequacy of such a bank, how then can there be effective exchange of information between the two authorities? The home country should in this case become more proactive and intrusive in its exercise of its supervisory role to ensure the safety of the bank. Furthermore, supervisors might exercise their home and host supervisory role variably depending on their evaluation of their counterpart supervisory authority. A country with a reputation of corruption, nepotism or weak institutional capacity might be less trusted than the UK for example. This is an important practical issue which supervisors confide to themselves due to political sensitivities.

The third reason why proponents of treaties prefer them is related to their binding nature. This should result into treaties being implemented and enforced before the judiciary. The Vienna Convention on the Law of Treaties incorporates the related doctrine of *pacta sunt servanda* in Article 26, which provides that treaties in force are binding upon their parties, who should perform the treaties in good faith. Treaties might contain procedures for dispute settlement or enforcement which allow the invocation of state liability or reparation against a state in breach of underlying obligations.

The most important defence against this argument is found in the wide implementation of the BCBS standards. Many of the BCBS rules transformed into

binding legislation in important financial centres.¹⁸ This includes the G-10 countries and the EU Member States. Furthermore, the BCBS standards have been accepted by a plethora of regional organisations and fora. Wide implementation by BCBS member and non-member states has taken place irrespective of the transitory role played by their regional organisations. By contrast, states' implementation of treaties might not lead to compliance in the sense of actual adherence to the obligations of the treaty.¹⁹ One author provides this interesting following explanation:²⁰

"In fact states may sign commitments for a host of reasons of self-interest independent of any expectation of subsequent compliance. States may recognize that they are unable to comply, and commit with the hope that others will help them comply at home (as with many Eastern European governments in the area of the environment) or to strengthen a leader's political potential for implementing at home later, or to associate with the signing ceremony of a diplomatic conference".

"If compliance is a matter of choice, then there is little difference between whether the obligation is nominally binding or nonbinding. The limiting factors associated with compliance are the political and technical factors associated with the decision to comply. In this chapter, I refer interchangeably to treaties, obligations, accords and international instruments. I presume that there is no significant variation in compliance depending upon the nature of the obligation. The question is under what conditions do states comply with international obligations of any sort".

This point is further illustrated by examining the experience of the EU and the League of Arab States in this regard. The existence of nine common members between the EC and the BCBS, and the collaboration between them led to an *in tandem* growth of their legislation.²¹ The EU, most significantly, transposed the BCBS non-binding

¹⁸ For further details see, particularly: C. M. Chinkin, *Ibid* (n 1), pp. 860-861. See also: A. D'Amato, 'Manifest Intent and the Generation by Treaty of Customary Rules of International Law' 1970 *AJIL*. Vol. 64(5)(October), pp. 892-902.

¹⁹ Cynthia Crawford Lichtenstein, further argues that the distinction between soft and hard law is unnecessary since what matters is obtaining effectiveness.

Source: Cynthia Crawford Lichtenstein, "'Hard" Law v "Soft" Law: Unnecessary Dichotomy?' in J. Norton and M. Andenas (eds), International Monetary and Financial Law upon Entering the New Millennium, (2002), pp. 363.

²⁰ Peter M. Haas, 'Why Comply, or Some Hypothesis in Search of an Analyst' in Edith Brown Weiss (ed.), International Compliance with Nonbinding Accords (1997), pp. 23.

²¹ See for example: Nadia Al-Anani, The Future of the Harmonisation of Banking Supervisory Rules in the EC Law: Home Country Control v Centralisation, (Research Paper No. 139/99, Loughborough University Banking Centre, 1999); Joseph Norton, 'The European Community Banking Law Paradigm: A Paradox in Bank Regulation and Supervision - Reflections on the EC Second Banking Directive' in

standards into hard law directives. A non-comprehensive list includes the First Banking Directive,²² which was adopted not long after the endorsement by the BCBS of the “Report to the Governors on the Supervision of Banks’ Foreign Establishments”, which later became known as the “Concordat”. The Consolidated Supervision Directive, 1983²³ was first proposed by the Commission to respond to the BCBS decisions in this field. The Directive was adopted only one month after the issuance of the parallel, “Principles for the Supervision of Bank’s Foreign Establishments”, otherwise known as the 1983 Basle Accord, and was reinforced by the Second Banking Directive.²⁴ Likewise, the Consolidated Supervision Directive issued in 1992²⁵ was mainly inspired by the failure of the BCCI, while the BCBS responded by producing the parallel “Minimum Standards for the Supervision of International Banking Supervision of International Banking Groups and their Cross-Border Establishments”. Another example is the Solvency Ratio Directive²⁶ which incorporated the Basel Capital Accord of 1988 into EU law in the following year. The EU more recently incorporated Basel II into a directive issued in 2006.²⁷

Joseph Norton, Chai-Jui Cheng and I. Fletcher (eds), International Banking Regulation and Supervision: Change and Transformation in the 1990s, pp. 49-80; and W. van Garven, ‘The Second Banking Directive and the Case Law of the Court of Justice’, 1990 YEL Vol. 10, pp. 57-70.

²² First Council Directive 77/780/EEC of 12 December 1977 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, OJ L 332, (17 December 1977), 30. This Directive had been replaced by Directive 2000/12/EC, which subsequently was replaced by Directive 2006/48/EC (recast).

²³ Council Directive 83/350/EEC of 13 June 1983 on the supervision of credit institutions on consolidated basis. OJ L 193, (18 July 1983), 18-20. This Directive had been replaced by Directive 92/30/EC, which was replaced by Directive 2000/12/EC, replaced by directive 2006/48/EC (recast).

²⁴ Second Council Directive 89/646/EEC of 15 December 1989 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, OJ L 386, (30 December 1989), 1-13. This Directive had been replaced by Directive 2000/12/EC, which was subsequently replaced by directive 2006/48/EC (recast).

²⁵ Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis. OJ L 110, (28 April 1992), 52-58. This Directive had been replaced by Directive 2000/12/EC, which was replaced by directive 2006/48/EC (recast).

²⁶ Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions. OJ L 386, (30 December 1989), 14-22. This Directive has had been replaced by Directive 2000/12/EC, which was subsequently replaced by 2006/48/EC (recast).

²⁷ European Parliament and Council Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast). OJ L 177, (30 June 2006), 201-255.

The efforts of the League of Arab States, by contrast, have not resulted into the adoption of hard legislation equivalent to the EU directives. Whatever reasons are behind the absence of banking supervisory legislation at the level of the Arab League, it is interesting to see that alternate fora have emerged to cover this regional loophole. The Council of Central Bank Governors, meeting at the Arab Monetary Fund ("AMF") has issued guidelines calling basically for the adoption of banking supervisory measures modulated on the BCBS standards. The major impetus for creating this forum was to coordinate efforts with the BCBS. Similarly the Islamic Financial Services Board ("IFSB") was created for the purpose of, amongst others, the coordination with the BCBS and other fora. The private sector, represented by the Union of Arab Banks, has also contributed in raising awareness of banks and even banking supervisory authorities on the possible impact of the BCBS standards on their activities.

The above facts lead to an interesting conclusion that the attributed role of the EU directives in the wide implementation of the BCBS standards could be exaggerated. One leading author on this subject, Norton, has already made the following observation:²⁸

"[T]he dismissal of the Basle Committee as simply an informal group of bank supervisors is rather misleading. The Basle Committee represents the leading international bank supervisors in the world, each of whom has significant legal authority and discretion within its own national jurisdiction. And with respect to the EC itself, the EC, through the connecting factor of the contact group and overlapping membership between the Basle Committee and the EC, also clearly has significant legal potency in giving credence to the Basle principles".

The main conclusion of this argument is not to undermine the significance of the EU. It is rather to illustrate that the BCBS standards have an intrinsic value that leads to the implementation of its standards despite the level of regional involvement in their drafting.

The fourth reason why states might prefer treaties is the availability of sanctioning powers. The BCBS has no sanctioning powers, and has not resorted to alternative weaker methods of enforcement such as surveillance.²⁹ The BCBS has

²⁸ Joseph J. Norton, Devising International Bank Supervisory Standards, (1995), pp. 258.

²⁹ For further details, see: Niels Blokker and Sam Muller, Towards More Effective Supervision by International Organizations: Some Concluding Observations. In Niels Blokker and Sam Muller (eds.), Towards More Effective Supervision by International Organizations, (1994), pp. 275-311.

already decided that it would not undertake assessment of countries' compliance with the Core Principles due to lack of resources.³⁰ It has rather encouraged individual supervisory authorities to make their own compliance assessments and the document "Conducting a Supervisory Self-Assessment – Practical Application" was issued in April 2001 for this purpose. The BCBS does not use "peer-pressure" measures, unlike FATF, which issues lists of countries that do not adhere to its Anti-Money-Laundering and Countering the Financing of Terrorism measures. Enforcement has however been encouraged via horizontal linkages with other international organisations; namely, the World Bank and the IMF.

The role of the World Bank in strengthening the international financial architecture has risen from a series of financial crises. It should be understood within the context of its mandate as the international institution of global development and poverty reduction.³¹ The World Bank has utilised structural and investment lending as well as technical assistance loans to handle crises. During the Asian crises specifically, the World Bank concentrated its efforts on the affected countries' financial systems.³² It has particularly focused on problems related to corporate governance, insolvency and bank restructuring.³³

The involvement of the IMF in banking supervision finds its roots in the G-7 Lyon Summit of 1996, which, in response to deep and frequent financial crises, stressed on the essential role played by prudential regulation in maintaining the stability of monetary and financial systems. In a letter addressed to the researcher in November 1995, which discussed the role of the IMF in relation to banking supervision, the IMF stated the following:

"The objective of the International Monetary Fund (IMF) is the promotion of international monetary cooperation which permits the expansion of international trade in a setting of stable and orderly exchange rate arrangements free from exchange restrictions. While international

³⁰ BCBS, *Ibid* (n 17), pp. 1, Executive Summary par. 2.

³¹ World Bank, International Financial Architecture: An Update on the World Bank Group Activities, Information Note by World Bank Staff, April 27, 2001, page 1, par. 3.

³² Andrés Rigo, 'Recent Financial Crises-Comments from International Development Banks' in IMF (ed), Current Developments in Monetary and Financial Law Vol. 1(1999), pp. 154-156.

³³ *Ibid.*, 150-154.

banks may play a key role in international trade and international capital flows, the supervision of such banks remain a responsibility of national supervisory authorities and is beyond the scope of the Fund.

Please note further that the IMF does not require countries to adopt particular policies or follow special economic programs. Rather, the institution works together with the countries to develop mutually agreed-upon economic programs that can be supported by IMF resources. This general principle applies in the area of supervision. The IMF does not demand the application of the Basle Committee guidelines. But in the discharge of its surveillance and other regulations that promote sound and safe banking practices, and these include, off course, those advocated by the Basle Committee".³⁴

The roles of the IMF's are regular multilateral and bilateral surveillance,³⁵ technical assistance and conditionality.³⁶ In multilateral surveillance, the IMF projects and analyses the international and regional economy where important banking developments are featured. More recently, the IMF has been working on the dissemination of international banking standards issued by the BCBS for the G-10 countries to the international scene. The IMF has the advantage of universal membership and close knowledge and relations with governments. As to bilateral surveillance, its most important tool is the consultations undertaken under IMF Article of Agreement IV, whereby IMF staff visit member states once yearly at least. Traditionally consultations focused on macroeconomic considerations specifically, monetary, fiscal and exchange rate policies but increasingly have been focusing on the surveillance of the banking system and infrastructure. Furthermore, the IMF, often in co-operation with the World Bank, provides "technical assistance" to diagnose and rectify banking problems. Finally, there is the conditionality, which refers to the economic policies that member states to the IMF intend to adopt in order to avail themselves of the IMF resources.³⁷ The IMF sees, within this context, a strong line between the soundness of the banking system in a country and macroeconomic

³⁴ This letter was sent by Pamela J. Bradley on behalf of Mr. Michael Camdessus, the then Managing Director of the IMF, on November 8, 1995.

³⁵ For a historical background on the IMF surveillance role, see: William Holder, 'Surveillance, Crisis, and Architecture' in IMF, Current Developments in Monetary and Financial Law Vol. 1, (1999), pp. 17-29.

³⁶ Stanley Fischer, 'Banking Soundness and the Role of the Fund' in Charles Enoch and John H. Green (eds.), Banking Soundness and Monetary Policy, (1997), pp. 22-34.

³⁷ IMF, Glossary of Selected Financial Terms.

stabilisation programmes. Therefore, it puts strong emphasis on the situation of the banking system in macroeconomic conditionality.³⁸

In addition to the above, the Financial Sector Assessment Programme (“FSAP”)³⁹ is an important collaborative effort between the IMF and the World Bank to strengthen the monitoring of financial systems in the context of the IMF’s bilateral surveillance and the World Bank’s financial sector development work. The FSAP was introduced in 1999; it aims to enhance the soundness of the financial systems in member states. Essential by-products of this programme are the “Reports on the Observance of Standards and Codes” (“ROSCs”), whereby a modular assessment of countries’ observance of international standards and codes is undertaken.⁴⁰ FSAP is also the basis of the Financial System Stability Assessments (“FSSAs”), whereby the IMF addresses topics relevant to its surveillance, such as the resiliency of the financial system, which entails deeper coverage of financial sector topics. The results of the FSAP form the basis of priorities for technical assistance, as well as financial support provided by the IMF and the World Bank to member states.⁴¹

What matters most is that the assessed standards, in the context of the FSAP, include the BCBS Core Principles.⁴² Furthermore, the BCBS together with other international standard setting bodies, central banks and supervisor agencies, and other institutions, have cooperated with the IMF and World Bank in conducting the FSAP. To put it simply, compliance with the BCBS Core Principles can influence the ability of countries to avail themselves of financial assistance from the IMF and World Bank.

³⁸ Stanley Fischer, *Ibid* (n 36), pp. 30.

³⁹ For further details, see: IMF and World Bank, Financial Sector Assessment Program (FSAP), A Review: Lessons from the Pilot and Issues Going Forward, (November 27, 2000); and IMF, IMF Reviews Experience with the Financial Sector Assessment Programme (FSAP) and Reaches Conclusions on Issues Going Forward (PIN No 01/11 February 5, 2001).

⁴⁰ IMF and World Bank, Reports on the Observance of Standards and Codes (ROSCs): An Update, (March 30, 2000).

⁴¹ IMF and the World Bank, Financial Sector Assessment Program (FSAP): A Review: Lessons from the Pilot and Issues Going Forward, (November 27, 2000), para. 37.

⁴² For a thorough explanation on this point, see: World Bank and IMF, Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives, (September 23, 2002).

However, the assessment does not aim to be a simple “pass or fail”.⁴³ The IMF and World Bank staff has prepared the “Structure and methodology for assessment reports prepared by the International Monetary Fund and the World Bank”.⁴⁴ These explain that assessment will be on basis of each of the BCBS Core Principles.

Results then will be set under one of the following criteria:⁴⁵ First "compliant", which indicates full observance or utmost immaterial shortcomings in relation to the “essential” criteria; secondly, "largely compliant", where minor shortcomings are noticed, which do not undermine the supervisory authority’s ability to realise the objectives of the underlying core principle; thirdly "materially non-compliant", where the shortcomings cast doubts on the ability of the supervisory authority to achieve observance, but the deficiencies have been substantially rectified; fourthly, "non-compliant", when no substantial progress toward observance has taken place; and finally, there is the self explanatory criteria of "not applicable".

International law theorists have various explanations on why countries abide by international agreements.⁴⁶ The researcher broadly agrees with international lawyers who employ the game theory in their efforts to explain why states comply with international agreements.⁴⁷ By implementing this theory to international banking standards, we find out that states are faced with four strategic options. The first option is the "coincidence of interests". The second option is "coercion", whereby the stronger party threatens with retaliation such as closure of foreign banks or increasing applicable prudential measures. The third option is "cooperation" whereby states defect or refrain from undertaking retaliatory measures predicting that their counterparties would do the same. The final option before states is "co-ordination", whereby states prefer to concur on common rules and by doing so avoid retaliation and gain a good reputation of compliance.

⁴³ IMF and the World Bank, *Ibid* (n 41), Box 2: Comments from the FSAP Outreach Meeting in October 2000.

⁴⁴ This is an annex to the BCBS, The Core Principles Methodology (Draft September 22nd 2005), (October, 2006), pp. 43-48.

⁴⁵ IMF and World Bank, *Ibid* (n 42), pp.11. footnote: 15.

⁴⁶ Peter M. Haas, *Ibid* (n 20). pp. 21-48

⁴⁷ The researcher is heavily influenced by the thesis developed by Professors E. Posner and J. Goldsmith *Ibid* (n 11), particularly pp. 83-106.

In this era of globalisation and interdependence in the international financial market, states have a joint interest in the continuity of international banking institutions and markets while maintaining their safety and soundness. It is not enough for states to refrain from retaliatory actions such as closing a foreign bank. They have to agree on a set of rules to ensure that the foreign bank does not cause systemic risk or any other risk to its banking system. Countries need more than "cooperation". They have to resort to coordination by achieving agreement on common supervisory standards.

The coincidence of interest and coercion does not alone explain why non-BCBS member countries comply with international banking standards. Consider for example why some of the member countries of the League of Arab States choose to comply, while other countries do not, although non-complying countries might need loans or technical assistance more than complying ones. A key element, I think, is the political willingness of the country i.e. does the country would like to be viewed as a modern, open and advanced one. There could be various reasons behind this trend such as the acceptance of the international community and the attraction of foreign investment. Another key element is awareness of the importance of compliance with international standards not only for attaining supervisory goals, but also for the image-building of the perspective country, as an open, modern and investment friendly, and financially sound host country.

The BCBS members have on their own part exerted efforts to ensure compliance with its standards by third countries. The duality approach in banking supervision partially aims at tailoring international banking supervisory standards suitable for varying banking systems across the globe. The issuance of the Core Principles constitutes an attempt to set out basic and relatively easy to apply international standards.

In addition the BCBS exerted effort to raise awareness of the importance of international supervision standards. It has maintained a dialogue with supervisory authorities from non-member countries. The International Conferences of Banking Supervisors⁴⁸ organised by the BCBS have successfully attracted a large number of

⁴⁸ Some recent conference papers can be obtained on-line for the BIS web page. The earlier proceedings of the conferences are distributed and confided to Central Banks. A copy is also held with the Basel Secretary. The Basel Reports on International Developments in Banking Supervision also contain summaries of the proceedings.

World supervisors.⁴⁹ The BCBS has maintained ties with regional supervisory groups and has often been represented by its Secretariat at their meetings. These groups cover many jurisdictions⁵⁰ including Jordan, other Arab states which are members of the Arab Committee on Banking Supervision (“ACBS”) and the Arab Monetary Fund (“AMF”). In addition, the BCBS and the BIS established the Financial Stability Institute (“FSI”), with the aim of assisting supervisory authorities in the enhancement and strengthening of their efforts. The main objectives of the FSI are the promoting sound supervisory standards and practices, providing supervisors with updated information related to the financial sector as well as training and sharing information amongst supervisors.⁵¹ The BCBS also participates in the training and technical assistance programme conducted by the FSI. Education and previous experience with international economic organisations also determine the degree of awareness a country has. Therefore, countries with longer experience of openness and interaction are more likely to adopt international standards.

A final note should be made regarding countries with limited connectivity to the international banking markets or which simply host international banks but hardly export banking institutions and services. These countries need further incentives to comply with international standards. This issue is of a particular relevance to offshore centres which find their interest in competing in laxity i.e. in attracting foreign banking through weak prudential requirements. Ambrosiano Bank, BCCI and Petra Bank International, which failures were discussed throughout the thesis, had connection with off-shore centres. As Jordan does not fall within the category of these countries, it would be beyond the scope of this thesis to discuss this point any further.

⁴⁹ The last conference, the 15th International Conference of Banking Supervisors held in Brussels in September 2008, was attended by over 130 countries.

⁵⁰ Regional banking supervisory groups include the following: Association of Financial Supervisors of Pacific Countries; The Association of Supervisors of Banks of the Americas; The Banking Supervision Committee of the European System for Central Banks (“ESCB”); Caribbean Group of Banking Supervisors; Committee of Banking Supervisors of West and Central Africa; Committee of European Banking Supervisors; Executives’ Meeting of East Asia and Pacific Central Banks Working Group on Banking Supervision; Group of French-Speaking Banking Supervisors; The Islamic Financial Services Board; Offshore Group of Banking Supervisors; Regional Group on Banking Supervision of Transcaucasia, Central Asia and the Russian Federation; Southern African Development Community Subcommittee of Bank Supervisors; and South East Asia, New Zealand, Australia Forum of Banking Supervisors.

For further details see BCBS, Report on International Developments in Banking Supervision. Report No. 15. (September, 2006). pp. 27-72.

⁵¹ FSI, The Financial Stability Institute (FSI).

Jordan provides an evident example of a country influenced by the BCBS standards characterised as international soft law. The following Part II will examine the effect of the BCBS standards on Jordan.

PART II

JORDANIAN LAW

CHAPTER 8

THE EVOLUTION OF BANKING SUPERVISION LAW

8.0. Introduction

Part I of this thesis explained the BCBS standards on international banking supervision and concluded that they represent soft international law. Part II validates this conclusion by examining the strong impact the BCBS standards have had on banking supervision in Jordan, despite Jordan being a non-member country of the BCBS. This Chapter looks into the evolution of banking supervision in Jordan. It begins by examining the banking system from the early twentieth century to 1971 (Section 1). Then it explains the developments which occurred until 1989 (Section 2) and the financial crises which took place afterwards mainly as a result of the multi-tier financial system (Section 3). These sections show that the evolution of the financial system and the supervisory response in Jordan paralleled the economic development of the country.¹ The beginning of the 1990s witnessed a progress towards openness and liberalisation. The economic system of Jordan is mostly free market oriented, and this was true particularly since the adoption of liberalisation policies in the 1990s. These trends lead towards an increasing interest in implementing international banking supervisory standards specially as of the Banking Law No. 37 for the year 2000 ("Banking Law 2000") (Section 4).

¹ The main resources for this section are:

- CBJ, The Financial Structure of Jordan, (October, 1989).
- Marwan Hayek and Sami Zreikat, The Financial System in Jordan, Royal Scientific Society, Amman, (September, 1976).
- البنك المركزي الأردني، البنك المركزي الأردني خلال خمسة وعشرين عاما (عدد خاص صدر بمناسبة مرور خمسة وعشرين عاما على تأسيس البنك المركزي الأردني)، (تشرين الأول، 1989).
- زيان زوانة، دورة التشريعات المصرفية في الأردن، معهد الدراسات المصرفية: عمان، (1993) غير منشور.
- عبدالله المالكي، الموسوعة في تاريخ الجهاز المصرفي الأردني: البنك المركزي الأردني والسياسة النقدية، ج(1)، (1996).
- عدنان الهندي ومحمد جاسر، نشأة وتطور الجهاز المصرفي في الأردن، (1982).
- محمد سعيد النابلسي، التطور التاريخي للجهاز المصرفي والمالي في الأردن، (1994).

8.1. Early Stages – 1971

Jordan became part of the larger Ottoman Empire in 1516, where financial intermediary institutions did not exist due to Jordan's shallow economy at the time. The Jordanian banking system, including central banking, emerged only during the British mandate from 1920-1946. Transjordan (the name given by the British to the area east of the Jordan River) was made in 1920 part of the British League of Nations mandate of Palestine. Jordan was, consequently, linked to the Palestine Currency Board established by the UK government in 1926. Several foreign currencies were circulated as legal tender including the Egyptian pound² and lastly the Palestine pound in 1927.³ Jordan became an independent state in 1946 under the Hashemite Prince Abdullah I. Jordan and the West Bank had been declared one in 1950 after the breakout of hostilities with Israel in 1948 until it was disengaged from legal and administrative ties in 1988.⁴

The Palestine pound continued to be the currency of Jordan until June 1950. The Jordan Currency Law No. (35) for year 1949 provided for the issuance of the first Jordanian currency, the JD, as well as the establishment of the Jordanian Currency Board ("JCB").⁵ The JCB was comprised of five members, three of whom were British including the Chairman⁶ and had its seat in London, although it had a Currency Officer in Amman. Its main functions were, first, the issuance and the redemption of the JD and, secondly, the investment of its assets in the gilt-edged securities in London.⁷ The JCB issued JDs in Jordan on payment of Sterling in advance in London against the surrender of JDs in Jordan at the rate of one Sterling pound for one JD. The JCB had to maintain reserves in Sterling amounting to 100 percent of issued currency.⁸ This meant

² Currency Law (Item A), 1923.

³ Administration Council, Decision on Dealing in the Palestinian Currency, 13 October 1927. This Decision was confirmed by the Law on the Replacement of the Egyptian and Ottoman Currencies with the Palestine Pound (Paragraph B) for year 1927, which was later on replaced by the Palestinian Currency Law for year 1928.

⁴ Prime Minister Disengagement Order No. (1) for year 1988. Adalah Publications.

⁵ Jordan Currency Law No. (35) for year 1949, Section 6.

⁶ عبدالله المالكي، *Ibid* (1n)، ص 21.

⁷ *Ibid* (n 5), Section 7.

⁸ *Ibid*, Section 17.

that each time the JCB sought to expand its currency issue it had to immobilise an equivalent amount of Sterling. It also meant that the JCB could not provide commercial banks with rediscount facilities. In other words, the JCB did not amount to a monetary authority because it could not influence money or credit supply directly or indirectly.⁹ In addition, the JCB had no authority to control currency,¹⁰ although a special Currency Control Department was established later on within the Ministry of Finance. Finally, the JCB did not assume any banking supervisory role.

A report prepared by the staff of the World Bank in 1955 called for undertaking gradual steps towards the establishment of an independent monetary authority for Jordan that is also responsible for currency control.¹¹ The report prompted the Jordanian Government to prepare the way for the establishment of Jordan's first monetary authority, the Central Bank of Jordan ("CBJ"). As a preparatory step, the seat of the JCB was first moved to Amman in 1957 (although an Investment Committee continued to function in London until 1962).¹² The number of Jordanian representatives was increased to four members including the Minister of Finance as the Chair, three representatives of the private sector compared to one British member representing the Bank of England.¹³

A set of laws were promulgated in 1959 for the purposes of establishing the CBJ and determining its functions. First, the Central Bank of Jordan Law No. (4) for year 1959 soon amended by Law No. (33) for year 1960. This Law provided for the establishment of the CBJ as a corporate body. Section 6 stated that the objectives of the CBJ were the "regulation of coins and banknote issue; maintaining reserves for the purposes of maintaining the price stability of the JD in Jordan and abroad; controlling credit for public interest and acting as a banker to the Government". It also stated that

⁹ The World Bank, The Economic Development of Jordan, Report of a Mission organized by the International Bank for Reconstruction and Development at the Request of the Government of Jordan, 1955, published in 1957, pp. 366.

¹⁰ The first legislation on currency control was the Defence Regulation – Financial Affairs No. (2) for year 1944 issued pursuant to the Defense Law of Trans-Jordan for year 1935.

¹¹ The World Bank, *Ibid* (n 9), pp. 31-34.

¹² JCB, Report of the Jordan Currency Board for the Year Ended 31st March, 1963, pp. 2.

¹³ 22 ص *Ibid* (n 1)، عبدالله المالكي،

the CBJ would undertake four activities for the purpose of achieving its objectives: "(a) Regulating the quality and quantity of credit and interest rates to meet the needs of trade, industry and agriculture; (b) Adopting suitable measures to deal with local, financial and economic problems; (c) Banking supervision; (d) Management of Government reserves of gold and foreign exchange".

The simultaneous Banking Control Law No. (5) for year 1959 regulated certain aspects of banking supervision without granting the CBJ operational independence in performing its tasks. The Law prohibited undertaking banking activities, being defined as receiving deposits, payment of checks and extending advances to clients,¹⁴ without prior authorisation.¹⁵ The Law also prohibited unauthorised persons from employing the word 'bank' in their names and addresses unless the prior approval of the Minister of Finance is obtained.¹⁶ The Law imposed limits on credit extension as well.¹⁷ Furthermore, it provided that banks should have a minimum paid-up capital of JD250.000 and JD500.000, for national and foreign banks respectively,¹⁸ as well as maintain reserves equivalent to their paid-up capital.¹⁹ The Law also stated that banks should maintain certain liquid assets to be determined by the CBJ.²⁰ Furthermore, the Law provided that payment of dividends was restricted until all capitalised expenditures would have been written off.²¹ In addition, the Law provided for the duty of banks to appoint independent external auditors with the approval of the Minister of Finance.²² The latter was also authorised to order the auditing of a bank's operations upon the request of its creditors or depositors.²³ The Law imposed on banks the duty to supply

¹⁴ Banking Control Law No. (5) for year 1959, Section 2.

¹⁵ *Ibid*, Section 3(a).

¹⁶ *Ibid*, Section 5(a).

¹⁷ *Ibid*, Section 6.

¹⁸ *Ibid*, Section 4(a)(b).

¹⁹ *Ibid*, Section 7.

²⁰ *Ibid*, Section 10(c).

²¹ *Ibid*, Section 8.

²² *Ibid*, Section 16.

²³ *Ibid*, Section 12.

the CBJ and the Minister of Finance with copies of their audited balance sheets and profit and loss statements within six months of the financial year ended.²⁴ Banks were also to supply the CBJ with monthly statements of their assets and liabilities, as well as, a quarterly statement of loans.²⁵

The Law vested the Minister of Finance with the authority to request information deemed necessary for authorisation²⁶ and issuing authorisation after consulting with the CBJ Board of Directors,²⁷ provided that minimum capital requirements would be met.²⁸ The Minister of Finance was authorised to revoke banking licences after consulting with the CBJ as well.²⁹ In addition, the Law stated that in cases where the CBJ finds out that a bank's assets do not cover its liabilities, it should inform the Minister of Finance.³⁰ The latter was authorised to decide, on basis of a new auditing report, to appoint an expert to either assist the troubled bank or withdraw its licence.³¹

In 1964, the CBJ assumed its functions. Banking supervision was at the beginning assigned to a division within the Research and Statistics Department, which functions were to analyse banks' monthly returns for the purposes of evaluating their operations and financial positions.³² Implementation of the CBJ Law (1959) and the Banking Control Law, however, highlighted significant shortcomings and practical difficulties resulting from the CBJ's inadequate authorities. This led to the promulgation of a new set of laws.³³

²⁴ Ibid, Section 9(a/2).

²⁵ Ibid, Section 10(a).

²⁶ Ibid, Section 4(c).

²⁷ Ibid, Section 3(a).

²⁸ Ibid, Section 4(a).

²⁹ Ibid, Section 4(d).

³⁰ Ibid, Section 11.

³¹ Ibid, Section 14.

³² البنك المركزي الأردني، التقرير السنوي الأول عن أعمال البنك خلال سنة 1965/1964، ص 8

³³ البنك المركزي الأردني، Ibid (n 1)، ص 11.

In 1966, a new CBJ Law was promulgated to strengthen in particular the monetary and economic role of the CBJ. Section 4 redefined the objectives of the CBJ as to "maintain monetary stability in the Kingdom and to ensure the convertibility of the JD, and to promote the sustained economic growth in the Kingdom in accordance with the general economic policy of the Government". The Law explained in more detail the functions of the CBJ, most relevantly, Section 4(f), which stated that one of the means by which the CBJ attained its objectives was "[s]upervising licensed banks with a view to ensuring sound and adequate banking services for the general public".

The Law provided that the CBJ Board of Directors should approve of the licensing, merger and revocation of licences of banks as well as the opening and closure of banks' branches.³⁴ It also authorised the CBJ to request information from banks and specialised credit institutions as well as imposing pecuniary sanctions thereon.³⁵ Furthermore, the Law empowered the CBJ to impose on banks a compulsory reserve requirement not exceeding 25 percent of their current and time liabilities.³⁶ In addition, the Law empowered the CBJ to impose ceilings on interest rates received and charged by banks as well as minimum and maximums limits on their commissions.³⁷

The simultaneous Banking Law No. (94) for year 1966, which replaced the Banking Control Law, completed the transfer of banking supervisory authorities to the CBJ, though the Central Government retained a smaller role. The CBJ was designated with the authority to license banks³⁸ and revoke their licences, although banks were permitted to appeal against the revocation decisions to the Council of Ministers.³⁹ Banks were not permitted to open new branches in Jordan, merge with other banks or introduce changes to their memoranda or articles of association without the prior approval of the CBJ, although the latter's decisions were appealable to the Council of

³⁴ Central Bank of Jordan Law No. (93) for year 1966, Section 12(g).

³⁵ *Ibid*, Sections 45 and 46.

³⁶ *Ibid*, Section 42(a).

³⁷ *Ibid*, Section 43.

³⁸ Banking Law No. (94) for year 1966, Sections 3 and 4.

³⁹ *Ibid*, Section 7.

Ministers.⁴⁰ The Law stated clearly that banks' holdings of foreign exchange had to be according to the limits and conditions specified by the CBJ as well.⁴¹ Most importantly, the CBJ was empowered to inspect banks.⁴² In situations where the CBJ found that the interests of a bank's customers or its financial safety were threatened, it had the authority to request banks to undertake corrective actions. If the concerned bank failed to implement the CBJ's instructions, the latter was authorised to revoke the bank's licence.⁴³ In cases of liquidation, the CBJ was assigned the role of a bank's liquidator.⁴⁴

The Banking Law for year 1966 also contained banking supervisory rules. Banks had to maintain a liquidity ratio ranging from 25-35 percent of deposits.⁴⁵ Banks were required to maintain 10 percent of their annual net profits into a general reserve account as well.⁴⁶ Banks were also not allowed to extend credit to a customer that exceeded 25 percent of their paid up capital and reserves without the prior approval of the CBJ⁴⁷ and were generally restricted from extending loans and advances secured by real estate exceeding 40 percent of the bank's deposits unless the CBJ agreed otherwise.⁴⁸ In addition, foreign banks had to remit a minimum working capital of JD 250.000 and their assets in Jordan had to surmount their liabilities of at least JD 250.000.⁴⁹

Year 1967 witnessed the break out of hostilities between Israel and Arab countries leading to the closure of Jordanian banks in the West Bank. A State of emergency was declared and the Emergency Regulation on Financial and Economic

⁴⁰ Ibid, Section 10.

⁴¹ Ibid, Section 11(h).

⁴² Ibid, Section 20(a).

⁴³ Ibid, Section 20(d) and (e).

⁴⁴ Ibid, Section 24(c).

⁴⁵ Ibid, Section 17(b).

⁴⁶ Ibid, Section 13.

⁴⁷ Ibid, Section 11(a).

⁴⁸ Ibid, Section 11(g).

⁴⁹ Ibid, Section 5.

Affairs No. (2) for year 1967 was issued pursuant to Section 125 (2) of the Jordanian Constitution (1952). The latter Regulation established the Economic Security Council ("ESC"), which was comprised of the Minister of Finance as the Chairman and other four members of the Government including the Governor of the CBJ. The purposes of the ESC were to maintain the economic and financial security of the country as well as to handle any financial or economic difficulties that the effective legislation did not cover sufficiently or effectively. The Regulation stated clearly that the ESC decisions should be taken according to the public interest even if they contravened effective legislation.⁵⁰ The CBJ resorted to the ESC in 1967 to handle the situation of closed banks in the West Bank,⁵¹ and continued to do so during the lifetime of the ESC which extended to April 1992.⁵²

The CBJ launched its first banking rescue operation in 1967. The concerned bank was Intra Bank/ Jordan, whose headquarters in Lebanon declined to pay its depositors as of October 1967.⁵³ The CBJ issued an emergency cease-and-desist order and appointed an administration committee to run Intra Bank and to collect its debts. Intra Bank was able to cover its losses and resume its operations in the following year.

8.2. The Seventies and Eighties

8.2.1. The 1971 Generation of Laws

The Banking Law No. (24) for year 1971 and amendments (hereafter "Banking Law (1971)")⁵⁴ together with the concurrent Central Bank of Jordan Law No. (23) for

⁵⁰ The Higher Court of Justice decided clearly that the established trend of the Court is to approve of the right of the ESC to issue decisions not only where there was no effective law but also when the ESC deemed such laws inadequate including basic laws such as the Law of Commerce and the Civil Law.

Source: Higher Court of Justice decision 202/1990 dated 31/1/1991, Adalah Publications.

⁵¹ البنك المركزي الأردني، Ibid (n 1) ، ص 105-111.

⁵² Council of Ministers, Decision on the Lifting of the Emergency Laws, and the Declaration on the Lifting of the Emergency Laws Official Gazette, No. 3818, 1.4.1992, pp. 624-5.

⁵³ For further details, see: 1967، عبدالكريم الخليل وهشام البساط انترا: أزمة مصرف أم أزمة نظام، 1967.

⁵⁴ The Banking Law (1971) was amended by Law No. (5) for year 1975, (which was later replaced by Law No. (11) for year 1992) and Law No. (5) for year 1997. It was repealed by the Banking Law No. (28) for year 2000.

year 1971 and amendments⁵⁵ (hereafter "CBJ Law (1971)") re-established and strengthened the CBJ's legal authority as the banking supervisory authority. Despite that the BCBS was issuing its standards during this period, it did not influence Jordanian law then.

8.2.1.1. The Central Bank of Jordan Law (1971)

This Law authorised the CBJ to request banks to refrain from publishing their annual financial statements and not to distribute their profits without the prior consent of the CBJ.⁵⁶ The CBJ Board of Directors was also charged with the authority to approve the licensing and the revocation of licences of branches or representative offices of foreign banks including those established in the free zones as well as to approve the licensing and the revocation of the licences of financial companies.⁵⁷

8.2.1.2. The Banking Law (1971)

The Banking Law (1971) and subsequent CBJ regulations⁵⁸ issued pursuant thereto enhanced the supervisory powers of the CBJ in relation to licensing and branching, requesting information, conducting inspection as well as coordination with banks' external auditors. It also provided for prudential requirements and few rules on internal controls and management.

Concerning licensing, the Law prohibited the carrying out of banking business except by a 'licensed bank'.⁵⁹ The Law also prohibited using the name "Bank" and its synonyms other than by licensed banks.⁶⁰ The Law, however, remained silent on the procedures and penalties to be applied in cases where a non-licensed bank solicits deposits from the public.

⁵⁵ The CBJ Law (1971) was amended by Law No. (4) for year 1975 (replaced by Law No. (10) for year 1992); Law No. (19) for year 1979 (replaced by law No. (16) for year 1992); Law No. (21) for year 1989 (replaced by Law No. (14) for year 1991); and Law No. (37) for year 1989.

⁵⁶ CBJ Law (1971), Section 44(c).

⁵⁷ *Ibid*, Section 12(g/2).

⁵⁸ The regulations of the CBJ are entitled as instructions, memos, circulars or simply regulations. There are no legal differences between them. The CBJ also issued during the last few years 'Guidance Notes'.

⁵⁹ Banking Law (1971), Section 3(a).

⁶⁰ *Ibid*, Section 8.

The Law confirmed that the CBJ is the authority designated with the duty to issue banking licences according to specified procedures.⁶¹ The Law set only two minimum requirements for authorisation: that the applicant bank was a public shareholding company (with the exception of branches of foreign banks); and own capital of no less than the minimum specified by Law.⁶² Meanwhile the CBJ enjoyed the discretion to request information it deemed necessary on the capital, expected earnings, management as well as the country's need for the applicant bank's services.⁶³ The CBJ had also the discretion to accept or refuse an application for licensing without providing for the aggrieved applicant's right of appeal against the refusal decision. In addition, the prior approval of the CBJ was a necessary requirement for merger and subscription of a licensed bank in another licensed bank.⁶⁴ If a newly licensed bank failed to operate within one year of notification of the licensing thereof, the CBJ should either withdraw its licence or extend its validity for only six further months, thereafter withdrawal would be imposed if the applicant bank assumed its operations.⁶⁵ Furthermore, the CBJ was empowered to revoke a banking licence in the situations where a bank was declared bankrupt, liquidated, merged with another bank or upon a request of the bank itself.⁶⁶ The CBJ was entitled to take the initiative to revoke the licence where the bank repeatedly breached the Banking Law to the detriment of its depositors.⁶⁷ Again the Law did not set out revocation procedures or provide for the aggrieved right of appeal against such decision.

As to branching, the Law stated that a licensed bank may not open or transfer a branch inside Jordan without the prior approval of the CBJ.⁶⁸ Likewise, a prior approval was required for opening new branches abroad or reallocating a branch from one

⁶¹ Ibid, Section 4(a).

⁶² Ibid, Sections 3(c)(d) and 5.

⁶³ Ibid, Section 4(c).

⁶⁴ Ibid, Section 10(b).

⁶⁵ Ibid, Section 4(d).

⁶⁶ Ibid, Section 24(a)(b)(c).

⁶⁷ Ibid, Section 24(d).

⁶⁸ Ibid, Section 9(a).

country to another.⁶⁹ The Law, however, made no reference to the licensing of subsidiaries abroad.

The Law provided for the CBJ to have the right to request information regularly from supervised banks and whenever the CBJ deemed this necessary.⁷⁰ The Law particularly imposed on banks the duty to furnish the CBJ with their certified annual financial statements within three months period of the year ended.⁷¹ Furthermore, the Law provided for the CBJ authority to inspect banks and request information therefrom.⁷²

The Law also empowered the CBJ to sanction banks that violate the provisions thereof by issuing a warning; and reducing or suspending credit facilities extended to the concerned bank.⁷³ In cases of repeated violation, the CBJ could also prohibit the bank from undertaking certain operations or extending loans to its customers; appoint a controller to supervise the bank or even withdraw its licence.⁷⁴

As to external auditors, the Law stipulated that licensed banks should annually appoint a certified external auditor, provided that the auditor was not indebted to the bank, had no vested interest therein, and was not an agent, manager, official or employee thereof.⁷⁵ The Law also empowered the CBJ to appoint an external auditor for the licensed bank, should the latter fail to appoint one within three months.⁷⁶ Furthermore, the auditor should supply the CBJ with copies of audit reports as well as any further information requested by the CBJ.⁷⁷

⁶⁹ Ibid, Section 10(a).

⁷⁰ Ibid, Section 18.

⁷¹ Ibid, Section 15(b).

⁷² Ibid, Section 20.

⁷³ Ibid, Section 29(a)(b).

⁷⁴ Ibid, Section 29(b).

⁷⁵ Ibid, Section 21(a).

⁷⁶ Ibid, Section 21(b).

⁷⁷ Ibid, Section 21(c).

The Banking Law (1971) and regulations issued pursuant thereto determined certain prudential requirements of banks as follows:

Firstly, the Law stated that banks should maintain a menu of liquid assets such as Jordanian currency and balances held with the CBJ.⁷⁸ The Law also adhered itself to the stock approach by setting a minimum ratio of 25 percent of deposits without specifying a maximum limit.⁷⁹ The Law and the regulations issued pursuant thereto did not introduce maturity mismatching monitoring, which eventually become the international norm.

Secondly, the initial Section 5(a) of the Banking Law (1971) determined a bank's own capital to be 250,000 JDs only. In 1992, the Law was amended to confirm the increase of minimum own capital of banks to JD 5 million, as well as, entitle the CBJ to increase the own capital amount without having to resort to amending the Banking Law.⁸⁰ Furthermore, the Law required that each bank should transfer 10% of its annual net profits accrued in Jordan to its statutory reserves until its statutory reserves account become equivalent to the bank's working capital in Jordan.⁸¹

Thirdly, the Banking Law (1971) stated that the CBJ "shall determine the minimum capital/deposits ratio".⁸² Accordingly, the CBJ determined the ratio of capital to deposits as 7.5%.⁸³ The same Section also referred to less important ratios of capital/credit and capital/assets. None of these narrowly defined capital adequacy ratios, nevertheless, covered the risk-weighted methodology, which eventually have become an international norm in 1988.

Fourthly, the Banking Law (1971) did not make a specific reference to loan classification and provisioning. The CBJ, according to its objective of maintaining the safety and soundness of the financial system, issued memos to regulate certain aspects

⁷⁸ Ibid, Section 17(a).

⁷⁹ Ibid, Section 17(b).

⁸⁰ Ibid, Section 5(d) as amended by the Law Amending Banking Law No. (11) for year 1992, Section 5.

⁸¹ Ibid, Section 13.

⁸² Ibid, Section 5(d).

⁸³ CBJ, Memo on Capital/ Deposits Ratio No. (141/79) dated 14.7.1979.

of provisioning. The CBJ, nevertheless, did not introduce a comprehensive loan classification system. In addition, Jordan's accounting procedures allowed the delay of provisioning for non-performing loan until a court decides on the disputed underlying loan. This often did not allow for timely provisioning.⁸⁴

Fifthly, the Banking Law (1971) stated that a licensed bank may not extend facilities and guarantees to a single customer amounting to more than 25 percent of its paid-up capital and statutory reserves.⁸⁵ This provision was accordingly in line with the best international standards.

Sixthly, Although the Banking Law (1971) did not employ the term 'connected lending' it provided that the written approval of the CBJ was a mandatory requirement for extending credit facilities of more than 1000 JDs. to a member of the bank's board of directors or to any company which ten percent or more of its equity capital is acquired by the board member. Banks were also required to obtain the consent of the CBJ before extending a loan to one of its employees if such credit would exceed the employee's annual salary.⁸⁶ Seventhly, the principle of consolidated supervision was not applied by the CBJ although it had been established as one of the pillars of international supervisory standards. It is also noteworthy that neither the Banking Law (1971) Law nor the CBJ regulations provided for supervisory rules on monitoring country risk or foreign exchange risk.

Finally, the Banking Law (1971) made scattered references to the management of banks. It stated that the CBJ, upon considering an application for a banking licence, *may* require information on management.⁸⁷ The Law also stated that any member of a bank's board of directors, management or staff would forfeit his position if (i) he was convicted by court of a financial crime, (ii) become unable to settle debts owned to the bank or (iii) an attachment of his indemnity was ordered by court in settlement of his

⁸⁴ Eduard Maciejewski and Ahsan Mansur (eds), Jordan: Strategy for Adjustment and Growth, IMF, Occasional Paper No. (136), (1996), pp. 39.

⁸⁵ Banking Law (1971), Section 11(a).

⁸⁶ *Ibid*, Section 11(c).

⁸⁷ *Ibid* Section 4(c).

debts.⁸⁸ In cases where a bank is put under liquidation or its licence was withdrawn, the manager of such bank and members of its board of directors, were not allowed to work in another licensed bank unless the CBJ approved otherwise.⁸⁹ The Law also stated that banks' managers and officials were responsible for the implementation of the Banking Law and other effective legislation as well as ensuring the reliability and accuracy of information supplied to the CBJ.⁹⁰ The Law and the regulations issued pursuant thereto did not, however, provide for detailed "fit and proper" criteria for banks' management.

The Banking Law (1971) also contained no rules on how to properly set and administer internal controls within a banking institution. The CBJ inspectors, however, took note of absent key internal controls. The CBJ, consequently issued regulations providing that banks' headquarters should establish internal control departments to closely monitor the operations of their branches and adequately staff such department.⁹¹ The CBJ did not issue at the time a comprehensive regulation on internal controls. There was also no reference to the concept of corporate governance neither in the Law nor regulations issued pursuant thereto.

8.2.2 The Multi-Tier System

The Banking Law 1971 and subsequent CBJ Regulations effectively lead to the creation of what the researcher describes as a *multi-tier* supervisory system comprised of the higher tier Commercial banks then investment banks, followed by the lower tier comprised of financial companies (including *savings and loans companies*). There was also a sizeable amount of confusion in the Jordanian Law over the meaning of the term *licensed bank* and hence over the distinction between banks and other financial companies. Furthermore, the scope of the CBJ authority did not cover *specialised credit institutions*, which created another tier in the supervisory scope between banks on one hand and those specialised credit institutions bearing similarities to banks. These points will be explained thoroughly by looking first at the legal definition of licensed banks

⁸⁸ Ibid, Section 25(a).

⁸⁹ Ibid, Section 25(b).

⁹⁰ Ibid, Section 26.

⁹¹ CBJ, Memo on Internal Controls No. (88/80) dated 21.6.1980 and CBJ Circular on Internal Controls No. (7030/7424) dated 26.3.1988.

and financial companies, then examining various types of banks and specialised credit institutions.

8.2.2.1. Definition of Licensed Banks and Financial Companies

Section 2 of the Banking Law (1971) utilised the term 'licensed bank' and defined it as 'any company licensed to carry on banking business in the Kingdom under the provisions of this law'. The same Section defined 'banking business' as accepting deposits and the extension of loans and other funds. The definition of financial companies was introduced into the Law in 1975:

"Financial Company means any company established and registered to carry on as one of its objectives banking business or part of it, particularly the acceptance of funds on deposit or granting of loans and advances, but does not include the insurance companies....."⁹²

The first CBJ regulations⁹³ allowed financial companies to undertake a wide range of activities grouped under six headings: money market operations including deposit-taking, financial market operations, dealings in foreign exchange, finance and investment, extending credit facilities as well as 'other operations' such as mutual fund management. A major difference between a financial company and a bank was that the former could accept deposits provided that their term was no less than six months. Another difference between banks and financial companies was that financial companies were prohibited from providing overdraft facilities. CBJ Regulations also did not prohibit financial companies from providing Islamic banking services and accordingly the CBJ licensed the Islamic Investment House. In addition, financial companies were subject to a less own capital requirement (JD4m. compared to JD5m. for banks).

In 1982, the CBJ regulated a specific type of financial companies, known as "savings and loans institutions". The rest of financial companies became known by default as "financial intermediaries". The preamble to the latter Regulation⁹⁴ defined

⁹² The Law Amending Banking Law No. (5) for year 1975, Section 2.

⁹³ CBJ, Regulation on the Licensing of Financial Intermediaries, issued pursuant to the CBJ Board Decision No. (65) dated 18.5.1982. This Decision employed the term 'financial intermediary' instead of 'financial company'.

⁹⁴ CBJ, Licensing Conditions and Permissible Activities of Savings and Loans Institutions issued pursuant to the CBJ Board Decision No. (16) dated 20. 2. 1982, as amended by CBJ Circular No.

savings and loans as "those financial companies, which *are not permitted to accept deposits from the public but may receive funds earmarked for professional or contractual saving purposes* such as real estate companies which undertake construction activities, mutual investment companies and co-operatives [emphasis added]". The same Regulation permitted savings and loans institutions to undertake specified activities including accepting only savings deposits not exceeding JD25,000; owning or selling real estate and bonds without undertaking the role of an intermediary; extending credit to finance purchase and construction of real estate; issuing banking guarantees provided that the aggregate value thereof does not exceed 200 percent of the institution's declared capital; and the establishment of real estate companies and land development. Meanwhile, savings and loans were subject to a less stringent own capital requirement of only one million JDs.

8.2.2.2. Types of Banks

The Banking Law (1971) referred only to licensed banks without reference to a particular type of banks. Successive Banking Laws, nevertheless, contributed to the segregation of the market through direct prohibition from providing certain activities or by imposing ceilings on banks' shareholdings in companies providing such activities. Section 11(d) of the Banking Law (1971) prohibited banks from engagement in wholesale or retail trade, whether on a commission basis or on their own account, unless for the purpose of realizing debts due thereto. The Banking Law (1971) did not define the term 'trade'. It was understood, however, that banks should not undertake activities associated with trading risks which traditional banks did not customarily undertake such as the purchase and sale of products.⁹⁵ Islamic banking activities were accordingly prohibited. Banks were also restricted from undertaking insurance activities being

(7021/292) dated 31.12.1985 and CBJ Circular No. (7021/9779) issued on 19.4.1988. The 1985 Circular employed the term 'savings and contractual lending institutions'.

⁹⁵ One opinion was to define the term 'trade' according to the provisions of Sections 6 and 7 of the Law of Commerce No. (12) for year 1966, which provide an inclusive list of activities deemed as a trade activities. These Sections, nevertheless, only seek to distinguish trade activities, as opposed to civil activities, for certain legal purposes such as the application of insolvency procedures. This explanation is further emphasised by Section 6 (1/d) of the Law of Commerce, which cites banking itself as a trading activity. For further details on Section 6 of the Law of Commerce, see:

عبدالقادر الفار، التمييز بين الأعمال المدنية والتجارية، (1990). و عبدالقادر حسين العطير، الوسيط في شرح القانون التجاري الأردني: الأعمال التجارية- التجار- المحل التجاري- العقود التجارية، (1993)، ص 64-90.

considered as a commercial activity for same reasons. Furthermore, Section 11(e) of the same Law restricted banks' contribution, purchase of shares or bonds of any agricultural, industrial, commercial or any other enterprise to 75 percent of each bank's working capital and reserves in Jordan. In addition, Section 11(g) prohibited banks from extending loans and advances for the construction or purchase of real estate with the exception of specialised banks. This in practice meant the exception of the Housing Bank as well as the Arab Land Bank (also was known as the Egyptian Arab Land Bank).

Market developments, subsequent CBJ regulation and other legislation have lead to the existence of various types of banks, namely, commercial banks, investment banks and Islamic banks.

1. Commercial Banks

As seen in the previous section, the evolution of the banking system in Jordan took place during the British Mandate era, and therefore it was influenced by the British banking system. Commercial banks, modelled after the British clearing banks, were the first type of banks established in the country. In 1925, the Ottoman Bank (later on Grindlays Bank) had opened a branch in Amman. There had been no other forms of financial intermediaries in the country other than the branches of *Al-Masref Al-Zira'i*, a small bank specialised in extending agricultural loans. The Arab Bank was the first national bank established in Jordan in 1948, followed by the Jordan National Bank established in 1956 then by the Bank of Jordan and the Cairo Amman Bank, both established in 1960.⁹⁶ Further commercial banks were established in following years mounting to nine banks in 2001.

Commercial banks were initially sufficient to meet the market needs of a small economy. Their basic activities were to accept deposits, usually short and medium term deposits, and extend short and medium credit facilities. They particularly focused on providing import finance mainly via overdraft accounts, in addition to other facilities such as discount of bills and documentary credits. Providing short and medium credit facilities was often justified on the grounds that banks' liabilities were short term as well as the absence of a Lender of Last Resort's facilities. In the post independence era

⁹⁶ CBJ, *Ibid* (n1), pp. 10.

demand grew substantially for long-term credit for the growing productive sectors of mining, agriculture, industry, construction and tourism as well as export credit.⁹⁷ Meanwhile, banking deposits increased in terms of size and witnessed a structural change in favour of time and savings deposits.⁹⁸ In the 1970s, commercial banks started to respond to market demand by increasing their finance for export credit, for example, but the need remained for long-term lending such as syndicated loans and underwriting corporate bonds as well as making secondary markets necessary for the exchange of such instruments.⁹⁹ The governmental response for the market need for long lending was the establishment of specialised credit institutions under acts of parliament as well as the encouragement of the establishment of investment banks.

2. Investment banks¹⁰⁰

The Jordan Investment Bank was the first licensed investment bank in Jordan in 1978. There had been no CBJ Regulations on the licensing investment banks, but the license itself imposed more stringent restrictions on the bank's deposit taking and lending activities than those applicable to commercial banks.¹⁰¹ Investment banking was regulated for the first time under a CBJ Regulation issued in 1988,¹⁰² which was substituted by another Regulation in 1991.¹⁰³ The Regulations had two purposes: first, to stimulate the establishment of banks modelled on the US investment bank that would extend long-term credit facilities for investors, particularly institutional investors as well as widen and deepen the capital market; secondly, to encourage the transformation of

⁹⁷ جمال صلاح (إعداد)، ضرورة اتجاه البنوك التجارية في الأردن نحو الائتمان طويل الأجل، (1981)، ص 10

⁹⁸ CBJ, Ibid (n 1), (1989), pp. 11-12.

⁹⁹ جواد حديد، "الواقع المصرفي العربي ومدى إنسجامه مع فكرة ومفهوم المصارف الشاملة، مع إشارة خاصة إلى التجربة الأردنية" في اتحاد المصارف العربية (إعداد)، الصيرفة الشاملة: مفهومها ووظائفها مع الإشارة إلى بعض التجارب العالمية، (1994)، ص 102-103

¹⁰⁰ For a detailed examination of the experience of investment banks in Jordan, see:

جواد حديد، التجربة المصرفية الاستثمارية في الأردن، (1984).

¹⁰¹ عبدالله المالكي، Ibid (1 n)، ص 146

¹⁰² CBJ, Regulation on the General Conditions for the Licensing of Investment Banks, issued pursuant to the CBJ Board Decision No. (93) dated 12.10.1988.

¹⁰³ CBJ, Circular on the General Conditions for the Licensing of Investment Banks No. (7020/14482) dated 16.7.1991 amended by the CBJ, Circular No. (7020/10229) dated 19.5.1992.

financial companies, which were facing serious financial difficulties during the 1980s, into investment banking. The latter Regulation, therefore, specifically authorised the CBJ to grant an investment banking license to a financial company restructured and transformed to an investment bank as well as to a company resulting from the merger of financial companies. In contrast with financial companies, investment banks were allowed an additional activity of issuing chequebooks on current accounts and consequently, investment banks were allowed membership in the check clearinghouse. Most financial companies were eventually transformed into investment banks.

Investment banks were put at a competitive disadvantage to commercial banks. The CBJ restricted investment banks from undertaking the lucrative business of overdraft facilities and short-term finance.¹⁰⁴ In addition, CBJ regulations clarified that investment banks were not allowed to undertake Islamic banking activities. It also forced investment banks to direct their finance to non-trade investments (tourism, agricultural, mining, industrial and housing sectors). Meanwhile, commercial banks were allowed to extend all types of credit facilities to all sectors and were particularly allowed to manage syndicated loans, which was a traditional activity of investment banks. Furthermore, commercial banks were only prohibited from the underwriting and management of securities, which was not anyway a lucrative activity of investment banks (due to various factors such as tax treatment, restrictions on interest rates and competition from other non-banking financial intermediaries). Consequently, investment banks made an estimated 90 percent of their profits from commercial banking activities. In other words, investment banks were not performing their envisaged role.

3. Islamic Banks

Conventional banks, as it has been discussed above, were not licensed to undertake Islamic banking activities under Section 11(d) of the Banking Law (1971). Islamic banking therefore, could be provided only under special legislation. The first Islamic bank in the country, the Jordan Islamic Bank for Finance and Investment was, accordingly, established as a public shareholding company pursuant to the Jordan

¹⁰⁴ Ibid, Article Third (1).

Islamic Bank for Finance and Investment Law No. (13) for year 1978.¹⁰⁵ This Law was replaced by the Jordan Islamic Bank for Finance and Investment Law No. (62) for year 1985 (hereafter "Islamic Bank Law"). Section 6 stated that the main object of the bank was meeting the economic and social needs for banking and investment services on a non – usurious basis. Usury was strictly defined to cover two types of dealings related to debts and sales. Usury in sales "included the exchange of various currencies on forward basis", while the usury in debts covered "the receipt or payment of interest in the various types of lending and borrowing, including the payment of any fee by the borrower where no effort which results in a substantive benefit in accordance with accepted doctrinal opinion, is expended in consideration for such fees".¹⁰⁶ Any internal regulations or instructions issued by the Bank in violation of its obligation to avoid usury in all activities would have no legal effect.¹⁰⁷

The Islamic Bank law stated that the Bank carried out three types of functions to attain its objects.¹⁰⁸ First, undertaking non-usurious banking operations, which covered accepting deposits of various types as well as providing banking services such as payment and clearance of checks, opening letters of credit, issuing guarantees and transfer of funds. Other permissible services included management of property, acting as a trustee, undertaking consultancy services and providing feasibility studies. It was also allowed to extend fixed term loans as a mere service without charging interest either by instalment lending or discounting promissory notes, with over-draft facilities being excluded. The Bank was also prohibited from borrowing foreign exchange, as this involved the payment of interest charges. It could, nevertheless, deal in foreign exchange either on spot basis or interest free mutual lending. Secondly, providing social services, mainly, *Ghardh Hassan* i.e. beneficial loans, for productive purposes. Thirdly, the Islamic Bank was allowed to provide non-usurious financing and investment activities to attain its objects.

¹⁰⁵ For details on the early experience of the Jordan Islamic Bank for Finance and Investment, see: Ramadan Shallah, Jordan: 'The Experience of the Jordan Islamic Bank' in Rodney Wilson (ed.), Islamic Financial Markets. (1990), pp.100-128.

¹⁰⁶ Islamic Bank Law, Section 2.

¹⁰⁷ Ibid, Section 5.

¹⁰⁸ Ibid, Section 7.

The Islamic Bank Law defined the types of deposits the Bank was allowed to accept,¹⁰⁹ as well as, certain modes of Islamic financing activities, namely, *joint mudarabah*, *murabaha* and *musharakah*.¹¹⁰ The Law also entitled the Bank to issue *muqaradah* bonds, an equivalent of interest bearing debenture bonds¹¹¹ issued by companies. Furthermore, the Bank enjoyed the powers necessary for the attainment of its activities including the acquirement, sale, exploitation as well as lease of movable and immovable properties.¹¹² Conventional banks were prohibited from undertaking these activities under Section 11 of the Banking Law (1971).

There are two important notes that should be made on the Islamic Bank Law. First, it did not provide coverage for the establishment of new Islamic banks. In 1989, the CBJ had to resort to the ESC in order to authorise the *National Islamic Bank*.¹¹³ With the abolishment of the ESC in 1992, the CBJ lacked the authority to authorise further Islamic banking activities and institutions. Secondly, Section 15(b) explained that the Islamic Bank of Jordan was subject to the supervision of the CBJ.

8.2.2.3. Specialised Credit Institutions

Section 2 of the CBJ Law (1971) provides a simple definition of specialised credit institutions as being "any institution or body established in the Kingdom with the primary objective of extending credit for special purposes, and designated by the Council of Ministers as a specialised credit institution for the purposes of this law after the consultation with the Governor." These institutions are established under laws, which provide them with adequate protection by granting them the status of, or at least the benefits of, public institutions such as tax concessions and priority in the collection of debts. The main objective of specialised credit institutions is extending medium and long credit to certain developmental sectors.

¹⁰⁹ Ibid, Sections 2, and 11-13.

¹¹⁰ Section 2 of the Islamic Bank Law provided definitions of the mentioned modes of financing.

¹¹¹ Ibid, Section 14.

¹¹² Ibid, Section 8.

¹¹³ ESC Decision No. 23/89 dated 22.11.1989, concerning the National Islamic Bank.

The CBJ Law (1971) outlines the relationship between the CBJ and the specialised credit institution. It states that the CBJ acts as a banker to specialised credit institutions,¹¹⁴ including accepting deposits, opening of accounts and collection of monetary claims.¹¹⁵ It also provides that the CBJ may discount or rediscount for, sell to, or buy from specialised credit institutions certain credit instruments,¹¹⁶ as well as grant advances for them.¹¹⁷ The CBJ may request statistical information from credit institutions, and the latter shall comply with such requests in a timely fashion.¹¹⁸ Furthermore, the CBJ sets out interest and commissions rates for these institutions.¹¹⁹

All specialised credit institutions were established under Law with the initiative of the Jordanian Government in order to provide medium and long-term credit facilities for various economic sectors, particularly agriculture, industry and housing, at preferential terms, for the purpose of promoting and developing these sectors.¹²⁰ Three institutions were government-owned public institutions: the Agricultural Credit Corporation, the first one to be established in the country in 1959;¹²¹ the Housing Corporation (1965)¹²² (later replaced by the Housing and Urban Development Corporation in 1992);¹²³ and the Municipal and Village Loan Fund (1966)¹²⁴ (replaced by the Cities and Villages Development Bank in 1979).¹²⁵ The remaining institutions were jointly owned by the Government and the private sector. The latter category

¹¹⁴ CBJ Law (1971), Section 4(e).

¹¹⁵ Ibid, Section 38.

¹¹⁶ Ibid, Section 39.

¹¹⁷ Ibid, Section 40.

¹¹⁸ CBJ Law (1971), Section 45(a).

¹¹⁹ Ibid, Section 43.

¹²⁰ أحمد حسن مصطفى، مؤسسات الإقراض المتخصصة في الأردن، (1984)، ص 1

¹²¹ Agricultural Credit Corporation Law No. (28) for year 1959.

¹²² Housing Corporation Law No. (47) for year 1965.

¹²³ Housing and Urban Development Corporation Law No. (28) for year 1992.

¹²⁴ Municipal and Village Loan Fund Law No. (41) for year 1966.

¹²⁵ Cities and Villages Development Bank Law No. (38) for year 1979.

covered the Industrial Development Bank (1965),¹²⁶ the Housing Bank,¹²⁷ as well as, the Jordan Cooperative Organisation (1968) which combined the Cooperative Bank.¹²⁸

Neither the CBJ Law (1971), nor the Banking Law (1971), provided for the supervisory role of the CBJ over specialised credit institutions, although it supervised the Housing Bank and to a lesser extent the Cooperative Bank. This is understandable as far as Governmental credit institutions are concerned because they rely on the funds and loans allocated by the Government as well as local and international organisations,¹²⁹ and do not provide their services on a commercial basis. The remaining institutions, by contrast, solicited deposits from the public and acted more on a commercial basis.

1. The Cooperative Bank

The Cooperative Bank was established pursuant to the Cooperation Law No. (55) for year 1968 to be one of the departments of the Jordan Cooperative Organisation, a *quasi* governmental institution, which capital sources were from the Government, member societies and others. The main objective of this bank was to “undertake banking activities and extend credit facilities to cooperative societies”.¹³⁰ The bank’s functions included the acceptance of deposits from societids, cooperative societies’ members and the whde public, npening burrent accounts, as well as, acting generally as a bank for cooperative societies.¹³¹ The Cooperation Law stated that the Cooperative Organisation should co-ordinate its credit policy with the CBJ as well as supply the CBJ with all information it requested.¹³² Furthermore, the CBJ was represented in a

¹²⁶ Industrial Development Bank Law No. (27) for year 1965.

¹²⁷ The Housing Bank was established by Housing Bank Law No. (41) for year 1973.

¹²⁸ The Organisation was first established pursuant to Section (6) of the Cooperation Law No. (55) for year 1968.

¹²⁹ For a broader discussion on the structure, activities of specialised credit institutions, see:

وليد الحديد، مؤسسات الإقراض المتخصصة الأردنية: دراسة تحليلية وتقييم، (رسالة ماجستير مقدمة إلى كلية الدراسات العليا/ الجامعة الأردنية، عمان، 1992)

¹³⁰ Cooperation Law No. (20) for year 1971, Section 21.

¹³¹ Council of Ministers, Cooperative Bank Bylaw No. (5) for year 1971, Section 5.

¹³² *Ibid*, (n 130), Section 23(a).

Consultative Committee, which met at least once quarterly to provide the Cooperative Bank's board of directors with its recommendations on the latter's credit policy.¹³³

2. The Housing Bank

The Jordanian Three Year Development Plan for 1973-1975¹³⁴ was first in promoting the establishment of a governmental or mixed Housing Bank to assist in avoiding a would be housing problem. The Housing Corporation, which had been established since 1965 was unable to fully meet the country's needs due to the legislative restrictions imposed on it as a public specialised credit institution. The Government, therefore, put forward the Housing Bank Law,¹³⁵ which established the Housing Bank a hybrid institution between public specialised credit institutions to support the housing and construction sector in line with public needs and development plans, on one hand, and private banks on the other.¹³⁶

The Housing Bank accordingly enjoyed advantageous treatment under its Law as opposed to private banks. Its sources of funds included compulsory deposits of various institutions, funds and housing corporations.¹³⁷ The Government also guaranteed the Housing Bank's obligations towards third parties and provided it with an umbrella exemption from taxation.¹³⁸ In addition, the Bank enjoyed preferential rights in debt collection.¹³⁹

¹³³ Ibid, Section 24.

¹³⁴ National Planning Council, Three Year Development Plan 1973-1975, pp. 279-283.

¹³⁵ Housing Bank Law No. (41) for year 1973 replaced by the Housing Bank Law No. (4) for year 1974, ("Housing Bank Law").

¹³⁶ For details on the development of the Housing Bank, see:

- جمال أبو عبيد، التطوير الإداري: تجربة بنك الإسكان، (1996).

- بسام عطاري، "مصارف الإقراض السكني في الوطن العربي: تجربة بنك الإسكان/الأردن"، في إتحاد المصارف العربية (محرر)، التمويل الإسكاني في الوطن العربي مع تركيز على التجربة الأردنية. (1986)، ص 63-89.

¹³⁷ The Housing Bank Law, Section 14.

¹³⁸ Ibid, Sections 16, 17, and 65.

¹³⁹ Ibid, Sections 54-68.

The Housing Bank, nevertheless, had many characteristics of a private banking institution. The Law Explanation Bureau¹⁴⁰ in its decision No. (7/1976)¹⁴¹ resolved that the Housing Bank was a public shareholding company rather than a public institution. The Decision was based on various sections of the Housing Bank Law. Section 3 stated that the Housing Bank should be established as a public shareholding company, and Section 69 further stated that the Housing Bank should undertake its activities on a commercial basis. According to Section 8, half of the Housing Bank paid up capital was constituted of ordinary shares offered for public subscription under Section 11. Section 47 also provided that profits were to be distributed according to the decisions issued by the General Assembly of Shareholders. Section 7, most importantly, provided that the Housing Bank undertook various activities including providing loans and advances for any period less than twenty years, discount of bills and bonds, attracting foreign investments for construction purposes, as well as, the acceptance of deposits. The Housing Bank, therefore, was authorised to accept deposits whether earmarked to housing/ constructing purposes or not. In addition, Section 7(e) provided broadly that the Housing Bank carried out 'any banking activity closely related to achieving its objectives and any other activity authorised by the board of directors of the Central Bank of Jordan'.

The Law Explanation Bureau examined in another decision¹⁴² whether the Housing Bank was deemed 'a similar or competitive company to other commercial banks' for the purpose of determining the legality of cross-membership in the board of directors of the Housing Bank and another private bank, the Arab Jordan Investment Bank. The Law Explanation Bureau answered to the positive on basis of the similarities of the two banks' objectives stating that, 'the objectives of the Housing Bank are not limited only to supporting the Housing sector but extend to providing other banking services, whether related to the attainment of the housing related objective or not'. Furthermore, the practice of the Housing Bank, based on its law, proved the validity of

¹⁴⁰ The Law Explanation Bureau is established pursuant to Section 123 of the Jordanian Constitution (1952) and the Constitutional amendment of 1958 for the purpose of providing explanation on Jordanian Law upon the request of the Prime Minister.

¹⁴¹ Law Explanation Bureau, Decision No. (7) for year 1976, Official Gazette No. (2650), 16.08.1976, pp. 2049.

¹⁴² Law Explanation Bureau Decision No. (7) for year 1978, Official Gazette, No. (2793), 1.7.1978, pp. 1868.

the Law Explanation Bureau's decision. The Housing Bank Law allowed the Housing Bank to compete with ordinary banks. In fact it succeeded in adopting a vigour policy of soliciting deposits, including deposits from remote areas and small savers, through a wide net of branches, movable banks and promotional schemes such as offering prices on savings. The total deposits at the Housing Bank mounted to JD 987,9m. in 1997.¹⁴³ The Housing Bank also undertook a wide range of activities upon the approval of the CBJ, including foreign exchange, mutual fund and margin trading. Furthermore, the Housing Bank extended increasingly what it termed 'developmental loans' and 'credit facilities', being facilities usually extended by commercial banks such as overdraft accounts, advances and discounted bills.¹⁴⁴ In addition, the Housing Bank distributed high profits which amounted to 13 percent in 1993 and 7 percent in 1994.¹⁴⁵

3. The Industrial Development Bank

Section 6 of the Industrial Development Bank Law stated that its principal objective was the promotion and funding of 'industrial projects', being defined as any industrial, mining, manufacturing, tourism and related services projects, as well as small scale industries and handicrafts. The Bank attained its objectives mainly by financing, and providing various types of technical assistance toward the establishment and upgrading of industrial projects with loans and other facilities such the issuance of guarantees and counter guarantees. It may also participate in the equity of such projects, as well as holding shareholdings therein.

The Law Explanation Bureau considered in 1974¹⁴⁶ whether the Industrial Development Bank was a company for the particular purpose of determining whether the Bank should be registered as a company according to the effective Law of Companies. The Law Explanation Bureau concluded that the Industrial Development Bank was a public institution established by law not merely a company established upon

¹⁴³ بنك الإسكان، التقرير السنوي الرابع والعشرون، (1997)، ص 10

(1995) عبدالله المالكي، الموسوعة في تاريخ الجهاز المصرفي الأردني: بنك الإسكان / بنك الإنماء الصناعي، ج(3)، ص 124-125

¹⁴⁵ Ibid, 58 ص

¹⁴⁶ Law Explanation Bureau, Decision No. (4) for year 1974, Official Gazette, No. (2476), 1.3.1974, pp. 252.

the request of a number of persons. Furthermore, the Law Explanation Bureau emphasised that Section (5) of the same Law, which subjected the Industrial Development Bank to the Law of Companies did not mean that the legislator considered it as a private bank. This decision was affirmed by following decisions.¹⁴⁷

The Law Explanation Bureau failed to explain why the Industrial Development Bank was considered a public institution while the Housing Bank was considered a bank. A thorough review of the effective Industrial Development Bank Law shows similarities between this law and the Housing Bank Law. The Industrial Development Bank had characteristics of a public institution. It was incorporated by law with its main objective was the development of a public sector. It may delegate the Attorney General in judicial proceedings as well. Furthermore, the Industrial Development Bank enjoyed public sectors' advantages including governmental guarantee of external debts and tax exemptions.¹⁴⁸ The Industrial Development Bank Law, even bestowed on the latter Bank many of the characteristics that the Law Explanation Bureau relied on to decide that the Housing Bank is a company rather than a public institution. First, it was subject to the Law of Companies as a general rule. Secondly, its paid up capital was JD6m., JD4.89m., the majority of which were preferential shares owned by the private sector, while the remaining shares were ordinary shares owned by the Government.¹⁴⁹ Preferential shares were offered for the public as well.¹⁵⁰ Thirdly, the Industrial Development Bank Law, most importantly, provided that the latter Bank's activities include the acceptance of deposits (with the prior approval of the board of directors), the extension of loans of all terms to maturity, investment in industrial loans, providing technical assistance as well as providing a variety of other facilities such as guarantees.¹⁵¹

Finally, there are two important elements, which were overlooked by the Law Explanation Bureau Decision while considering the legal status of the Housing Bank.

¹⁴⁷ Ibid (n 141), pp. 508.

¹⁴⁸ The Industrial Development Bank Law No. (5) for year 1972, Sections 9, 11(2), 14(j/4), 20(b)(d) and 56.

¹⁴⁹ Ibid, Section 17.

¹⁵⁰ Ibid, Section 19.

¹⁵¹ Ibid, Sections 7, 14 and 15.

First, the board of directors of the Industrial Development Bank appointed its general manager, which was similar to the practice of privately owned banks.¹⁵² The general manager of the Housing Bank, on the other hand, was appointed by the Council of Ministers subject to Royal Assent.¹⁵³ This was a significant difference, considering that the Housing Bank Law provided that the general manager was the head of the board of directors¹⁵⁴ and that the board could delegate its authorities thereto.¹⁵⁵ Secondly, a number of institutions were obliged to make compulsory deposits into the Housing Bank under Section 14 of its Law, while there was no equivalent requirement in the Industrial Development Bank Law.

8.3. 1989-2000: Financial Crisis, Treatment, Restructuring and Reform

8.3.1. Causes of the Crisis

The Jordanian financial system went through a crisis phase towards the end of the 1980s, marked by the failure of the third largest bank in the country and the holder of more than 10 percent of the assets of the banking system, Petra Bank. Different types of banks, financial companies and even the Cooperative Bank also faced financial difficulties. The crisis is attributed to the multi-tier system, regulatory shortcomings which effects were exacerbated by the economic conditions in Jordan at the time.

The Jordanian economy started to slowdown during the mid-eighties. Lower oil prices lead to a reduction of grants from oil exporting countries in the region, drop in export and decline of remittances from Jordanians working in neighbouring countries. The Jordanian economy suffered from its worst recession in modern history during the period from 1988-89. The general budget deficit (external grants excluded) surmounted 20 percent of GDP. External and domestic debt rates escalated rapidly to reach 212

¹⁵² Ibid, Section 36(d).

¹⁵³ The Housing Bank Law, Section 38(a).

¹⁵⁴ Ibid, Section 26(a).

¹⁵⁵ Ibid, Section 36.

percent of GDP. The inflation rate increased by 25 percent annually, while the JD exchange rate decreased sharply.¹⁵⁶

The multi-tier system weakened competition between financial institutions. It also allowed less regulated institutions to escape supervision despite that they shared many commonalities with other institutions. This was particularly evident in the case of financial companies. The Jordan Securities Corporation,¹⁵⁷ for example, faced financial difficulties as of 1983 as a result of excessive credit exposure to a single client which amounted to five times of the Company's own capital. In addition, the deal revealed weak internal controls as the general manager of the company signed the deal *ultra vires* and was not detected. These events lead to changes in the management of the company, restructuring of its capital after making provisions for its doubtful debts. The Company, however, never fully recovered because it could not restore customers' confidence. Its solvency and liquidity ratios had been increasingly diminishing until the company reached a critical financial situation during the financial crisis in 1989. Another example is REFCO, a financial company which was active in the real estate market.¹⁵⁸ It sustained losses because of the real estate market slump down in the late 1980s, and its position further worsened further in 1990 due to consumers' withdrawal of deposits during the Gulf War. The CBJ eventually launched rescue plan to save the companies.

As to regulatory shortcomings, the CBJ failed to implement two of the fundamental international supervisory standards, being consolidated supervision and on-going coordination with cross border supervisory authorities. In addition, the CBJ failed to detect weak internal controls. These regulatory shortcomings were most evident in the cases of Petra Bank and Jordan and the Gulf Bank. Furthermore, a study conducted by a team from the IMF attributes the crisis to three major factors.¹⁵⁹ First, the existence of deficiencies in the legal framework relating to provisioning identification. Secondly, a parallel market for foreign exchange emerged in 1987 causing many banks to be exposed to foreign obligations. Improvident speculations between the formal and

¹⁵⁶ محمد سعيد النابلسي، (n 191) below ص 6-4

¹⁵⁷ عبدالله المالكي، الموسوعة في تاريخ الجهاز المصرفي الأردني: البنوك الأخرى، ج(9)، (1997)، ص 141-147

¹⁵⁸ Ibid، ص 207-231

¹⁵⁹ Eduard Maciejewski and Ahsan Mansur (eds), Ibid (n 84).), pp. 39

parallel markets lead to losing substantial banking assets. Thirdly, banks and financial companies sustained excessive exposures to the real estate market. The early-mid eighties had witnessed a large inflow of capital leading to increase in demand and a consequent expansion in the construction business. This period was followed by a slump in the real estate market towards the end of the 1980s leading to similar decrease in the value of collateralised real estate loans and consequential losses to the financial sector.

8.3.1.1. Petra Bank

The main source of information on the circumstances leading to the failure of Petra Bank is the decision of the Jordanian National Security Court of 1992¹⁶⁰ (hereafter "Petra Bank case").¹⁶¹ The National Security Court¹⁶² is a specialised criminal panel and, consequently, was interested in the facts leading to the failure of Petra Bank only to the extent needed to verify accusations and determine penalties. The decision of the Court, however, provides the analyst with adequate and well-established facts to conclude that the reasons for the failure of Petra Bank were fraud committed by management, weak internal controls, violation of supervisory rules, as well as, the lack of consolidated supervision and on-going coordination with cross border supervisory authorities.

The Petra Bank case focused on the family relationships, which connected Petra Bank to other cross-border financial companies.¹⁶³ It found that at the centre of this relationship was the general manager of Petra Bank, who had planned since the establishment of Petra Bank a financial policy that would serve his interests and the interests of his family through a network of connected companies. Most importantly, the

¹⁶⁰ The National Security Court Decision No. 17/1992 dated 9/4/1992 concerning Petra Bank.

- عبدالله المالكي، حوار يجريه رئيس التحرير مع الدكتور محمد سعيد النابلسي محافظ البنك المركزي، البنوك ¹⁶¹ في الأردن، المجلد 8، العدد (10)، (1989)، ص 1250 - 1265 و 1302

- جواد العناني، "حالة بنك البتراء/ الأردن" في اتحاد المصارف العربية (محرر)، المخالفات المصرفية. 1991. ص 179-203.

¹⁶² The National Security Court is established pursuant to the National Security Law No. (17) for year 1959.

¹⁶³ Petra Bank Case, pp. 26-30.

general manager and his family owned shares in connected banks, mainly Mebco and Socofi. These banks shared common management and interrelated investments and faced simultaneous financial difficulties. They also facilitated for each other fraudulent transaction, for example, by opening fictitious accounts, issuing cross guarantees, tampering with bank accounts and destroying original documents and records.

The Court further explained that it was possible for one man to cause the failure of Petra Bank because of the weak internal controls within Petra Bank and the influential character of Petra Bank's general manager. Petra Bank's board of directors did not exercise its legal role of monitoring the general manager. The top administration, which enjoyed high commissions, was totally loyal and obedient to the general manager. Very often, employees followed oral orders, which should have been approved by two signatories according to best banking practices. Another common practice of Petra Bank was described as "completing signatures," whereby a document would be signed by one employer in a certain department and, another cosmetic signature would be obtained within "one last minute notice".¹⁶⁴

8.3.1.2. Jordan and the Gulf Bank

Jordan and the Gulf Bank was established in Jordan in 1977. The CBJ explained broadly that investigations conducted by the CBJ revealed strong connections and common interests between the managers of Petra Bank and Jordan and the Gulf Bank.¹⁶⁵ The CBJ particularly referred to the fact that the general manager of Jordan and the Gulf Bank, who was also the Head of its board of directors, had assumed before a managerial position at Petra Bank. While he was still at Petra Bank, he had been purchasing shares in Jordan and the Gulf Bank, which eventually allowed him to assume his managerial role in the late eighties. One author¹⁶⁶ explained that Petra bank funded the purchase of shares from Petra Bank's deposits. The bank was prone to failure in 1990 which prompted the intervention of the CBJ.

¹⁶⁴ Ibid, pp. 27.

¹⁶⁵ البنك المركزي الأردني، التقرير السنوي السادس والعشرون، (1989)، ص 85.

¹⁶⁶ عبدالله المالكي، Ibid (n 157) ص 2.

8.3.2. The Restructuring of Financial Institutions

The immediate response of the Jordanian Government was the initiation of a restructuring plan of banking and financial companies leading to their restructuring, merger, liquidation or, in the case of financial companies only, the transformation from a financial company to banks.¹⁶⁷ The plan was not confined to troubled institutions but covered inefficient institutions, which maintained high liquidity and made little investment, could not attract substantial deposits or their income was mainly gained from interest generated by re-depositing their customers' deposits in other banks. The consequences of the consolidation of the financial system led to the end of financial companies and jointly owned credit institutions and the adoption of the universal banking model which combined commercial and investment services. Some of these achievements were attained after a long time.

8.3.2.1. Financial Companies

The Government sought to encourage merger of companies as a solution as early as the mid-eighties. The Council of Ministers issued in 1986 an important decision, which set out the following merger policies for financial institutions generally:¹⁶⁸

- "If two money changers or more merge and the net shareholders' equity rights thereof amount to JD4m., it can obtain an investment bank license two years as of the merger date, provided that its capital is no less than JD6m.
- If an investment bank merges with a bank or more and the net shareholders' equity rights thereof amount to JD10m., it can obtain a commercial bank license two years as of the merger date provided that its capital is no less than JD10m.
- If a commercial bank merges with an investment bank or more and the net shareholders' equity rights thereof amount to JD15m., the resulting commercial bank may assume the activities of an investment bank via a wholly owned subsidiary which capital amounts to no less than JD6m.

أحمد عبدالفتاح، "التعثر المصرفي ووسائل علاجه" في اتحاد المصارف العربية (محرر)، المصارف المتعثرة ووسائل المعالجة: أبحاث ومناقشات الندوة التي نظمها اتحاد المصارف العربية، 1992، ص 177-228.

¹⁶⁸ عبدالله المالكي، Ibid (n 1)، ص 156.

- If a commercial bank merges with a commercial bank or more and the net shareholders' equity rights thereof amount to JD 20m., the resulting commercial bank may assume the activities of an investment bank via a wholly owned subsidiary which capital amounts to no less than JD6m."

Various financial companies were consequently merged and upgraded to the status of banks. One example is the merger of the Arab Finance Corporation (Jordan)¹⁶⁹ and the National Development and Finance Company and their following transformation in 1991 to become an investment bank, the Union Bank for Savings and Investment. Another example is the merger of the Finance and Credit Corporation¹⁷⁰ with a financial leasing company to create a new investment bank in 1989, Amman Bank for Investments. Furthermore, a rescue plan of the Jordan Securities Corporation¹⁷¹ was launched by the ESC with the assistance of the Housing Bank and the Arab Banking Corporation/ (Bahrain). It was successfully restructured and transformed in 1990 into a new commercial bank, the Arab Banking Corporation/ (Jordan). The Jordan Finance House and DARCO were also merged to create the Philadelphia Investment Bank.¹⁷²

Other financial companies were transformed directly to banks including the National General Investment Company¹⁷³ (renamed the National Financial Investment Company) which became the Business Bank and REFCO (renamed the Middle East Investment Bank).¹⁷⁴ Another example is the Islamic Investment House,¹⁷⁵ which was transferred to the National Islamic Bank, pursuant to a decision of the ESC. Finally,

¹⁶⁹ عبدالله المالكي، الموسوعة في تاريخ الجهاز المصرفي الأردني: بنك الأردن/ بنك الإستثمار العربي الأردني/ بنك الإتحاد، ص 312-303 ج(4)، (1995)، ص

¹⁷⁰ عبدالله المالكي، Ibid (n 157) ص 292-283

¹⁷¹ Ibid, ص 141-149

¹⁷² Ibid, ص 241-235

¹⁷³ عبدالله المالكي، الموسوعة في تاريخ الجهاز المصرفي الأردني: بنك الأعمال/ البنك الأهلي الأردني، ج(6)، (1996)، ص 39 - 21

¹⁷⁴ عبدالله المالكي، Ibid (n 157) ص 217 -207

¹⁷⁵ البنك المركزي الأردني، التقرير السنوي الثامن والعشرون، (1991)، ص 108-106

there was the Jordan Investment and Finance Corporation¹⁷⁶ which was licensed as the Jordan Investment and Finance Bank in 1989.

8.3.2.2. Banks

The financial rescue operation covered six Jordanian and foreign banks. Three banks were liquidated due to their serious financial situation; namely, Petra Bank in 1990,¹⁷⁷ the Syrian Jordanian Bank,¹⁷⁸ the National Islamic Bank.¹⁷⁹ Meanwhile, the Jordan and the Gulf Bank was merged with Bank Al-Mashrek branches in Jordan. The Bank's headquarter in Lebanon was engaged in unsound banking operations which adversely affected the financial position of its branches.¹⁸⁰ The new bank was successfully reconstructed and sold to a group of investors in 1993.

Another foreign bank covered by the rescue operation was the Bank of Credit and Finance International (BCCI).¹⁸¹ BCCI was a large international bank, which established its first branch in Jordan in 1974. As news spread in the market and the media that BCCI was going through financial difficulties, the CBJ took a precautionary measure by demanding BCCI Jordanian branches to repatriate funds denominated in foreign exchange held at correspondent banks abroad or at BCCI headquarters to be credited to the BCCI Jordanian branches' account held at the CBJ.¹⁸² On July the 5th 1991, the banking supervisory authorities in Luxembourg decided that BCCI should seize payment. On the following day, the CBJ issued a decision to close temporarily BCCI branches in Jordan for three days and appointed a management committee. Later on, the Controller of Companies applied to the Amman Court of First Instance to put the

¹⁷⁶ عبدالله المالكي، Ibid (n 157) ، ص 175-179

¹⁷⁷ ESC Decision No. 4/90 dated 15.7.1990 concerning the Liquidation of Petra Bank.

¹⁷⁸ ESC Decision No 4/91 dated 11.5.1991 concerning the Liquidation of the Syrian Jordanian Bank.

¹⁷⁹ ESC decision 2/91 dated 28.2.1991 concerning the National Islamic Bank.

¹⁸⁰ البنك المركزي الأردني، Ibid، (n 165) ، ص 86 - 87

¹⁸¹ عبدالله المالكي، Ibid (n 157) ، ص 330-332

¹⁸² البنك المركزي الأردني، Ibid، (n 175) ، ص 106

BBCI Jordanian branches under liquidation. The Court approved of the application¹⁸³ on basis of Section 23 (b) of the Banking Law (1971)

In addition to the above, two investment banks were upgraded to commercial banks: the Jordan Investment and Finance Bank in 1993 and the Business Bank in 1991. The latter bank was merged with the Jordan National Bank under the name 'Jordan National Bank'. This was the first case of voluntary bank merger in Jordan.

8.3.2.3. Specialised Credit Institutions

The Cooperative Bank faced financial difficulties during the 1988-92 period, which eventually led the Council of Ministers to decide in May, 1993 that the latter bank shall cease immediately from both accepting deposits and extending credit facilities and be put under the management of the CBJ.¹⁸⁴ The committee, which was established accordingly, found that the Cooperative Bank had had a serious liquidity problem and that only one percent of its debts had been collected.¹⁸⁵ This effectively meant that the Cooperative Bank ceased to exist although it took until 1997 to legally confirm the *status quo*.¹⁸⁶

The Housing Bank raised concerns related to the possibility of distortion of competition in the banking sector. In 1997 a new law was issued¹⁸⁷ to abolish previous Housing Bank Law and to subject the Housing Bank to the provisions of the effective Banking Law and the Law of Companies.¹⁸⁸

Finally, the Industrial Development Bank continued to exist as a specialised credit institution until mid-2008. It was transformed to a public shareholding company

¹⁸³ The Court of First Instance, Decision on Application 344/91 dated 10.9.1991 (unpublished).

¹⁸⁴ 341 ص Ibid (n 157)، عبدالله المالكي،

¹⁸⁵ البنك المركزي الأردني، التقرير السنوي الحادي والثلاثون، (1994)، ص 144

¹⁸⁶ Cooperation Law No. (18) for year 1997, Section 21.

¹⁸⁷ The Law on the Abolishment of the Housing Bank Law No. (16) for year 1997, Sections 2 and 3.

¹⁸⁸ For details on the transformation and its effects on the Housing Bank, please refer to:

بنك الإسكان، التقرير السنوي الرابع والعشرون. 1997.

provided that it applies for the CBJ for licensing.¹⁸⁹ It was acquired by an international Islamic bank and was licensed in January 2009 under the name Jordan Dubai Islamic Bank.¹⁹⁰

8.4. The 1990s onwards

8.4.1. General policies

Jordan adopted in the early 1990s an adjustment programme aimed at the stabilisation of the economy to promote growth, restoration of the value of the JD and rebuilding the country's foreign reserves as well as improving the general budget and the balance of payment position. This entailed profound restructuring of the economy towards supporting export-led growth through the privatisations of public owned enterprises, trade liberalisation, deregulation of commodity prices as well as the improvement of business environment.¹⁹¹

A trend of liberalisation also gathered pace in the 1990s. In 1996, Jordan submitted to the WTO its Memorandum on Foreign Trade Regime. After several rounds of questions from WTO Members on Jordan's foreign trade and economic policies had taken place, the WTO General Council approved Jordan's Protocol of Accession relatively speedily towards the end of 1999.¹⁹² The Jordanian Parliament ratified the Law on Jordan's Accession to the WTO early in 2000¹⁹³ and Jordan became officially

¹⁸⁹ Law Repealing the Law of the Industrial Development Bank No. (26) for year 2008, Section 5(a).

¹⁹⁰ المحرر، "الانماء الصناعي" بنك تجاري اسلامي نهاية الشهر. جريدة الرأي. 2009/1/15. ص 21

¹⁹¹ For further details, see:

- محمد سعيد النابلسي، السلسلة المصرفية: التصحيح المالي والنقدي في المملكة الأردنية الهاشمية بين الحاضر والمستقبل، ج(2)، 1997.

- أحمد عبدالفتاح، "إدارة السياستين النقدية والمالية في إطار برنامج التصحيح الإقتصادي: ملامح التجربة الأردنية" في اتحاد المصارف العربية (محرر)، برامج الإصلاح الإقتصادي ودور المصارف العربية. (1996)، ص 43-66.

¹⁹² WTO, Accession of the Hashemite Kingdom of Jordan, WT/ACC/JOR/35, 23 December 1999 (99-5554).

¹⁹³ Ratification Law of Jordan's Accession to the WTO No. (4) for year 2000.

the 136 WTO Member in 2000.¹⁹⁴ The negotiations period had a strong influence on Jordanian Law, as many laws and regulations were issued at the time to meet international requirements.

Jordan concluded other important international agreements. In 2000, Jordan and the United States of America signed an agreement to establish a free trade area between the two countries,¹⁹⁵ which entered into force 2001 after completion of domestic legal procedures.¹⁹⁶ Jordan also entered into an Association Agreement with the European Union¹⁹⁷ and a free trade agreement with the European Free Trade Area states (Iceland, Liechtenstein, Norway and Switzerland) which seeks to promote commercial and economic cooperation.¹⁹⁸

On the regional level, the Economic and Social Arabic Council of the League of Arab States¹⁹⁹ issued a decision in February 1997 to establish the Great Arab Free Trade Area within ten years. The Agreement on the Protection and Promotion of Investment and Movement of Capital amongst Arab States for year 2000 seeks to promote economic cooperation and facilitating the movement of goods, services, capital and natural persons. Jordan also entered in the mid 1990s into peace and economic agreements with Israel²⁰⁰ as well as economic co-operation with the Palestinian

¹⁹⁴ WTO. Protocol of Accession of the Hashemite Kingdom of Jordan to the Marrakesh Agreement Establishing the World Trade Organization, Done at Geneva on 17 December 1999: Notification of Acceptance. Entry into Force, Ref WLI/100, 14 March, 2000.

¹⁹⁵ Agreement between the United States of America and the Hashemite Kingdom of Jordan on the Establishment of a Free Trade Area (2000).

¹⁹⁶ Ratification Law of the Agreement between the United States of America and Jordan on the Establishment of a Free Trade Area No. (24) for year 2001.

¹⁹⁷ Ratification Law of the Euro-Med Agreement between Jordan and the European Union No. (31) for year 1999.

¹⁹⁸ Ratification Law of Jordan's Free Trade Agreement with EFTA No. (68) for year 2001.

¹⁹⁹ The Pact of the League of Arab States was signed in Alexandria in 1945 and was reproduced in the Arab Law Quarterly, Vol.7. Part (2), (1997). pp. 148-142.

²⁰⁰ Ratification Law of the Peace Treaty between Jordan and Israel No. (14) for year 1994. Further agreements between the two parties followed including the Treaty on Commercial and Economic Cooperation between Jordan and Israel in 1995 and the Treaty on the Qualified Industrial Zones in year 1997.

Authorities.²⁰¹ The result of these agreements was the reopening and the new establishment of a considerable number of Jordanian banks in the Self Ruled Territories as well as coordinating banking supervision efforts therewith.

Also in 1995, Jordan assumed the obligations of Article VIII of the IMF Articles of Agreement.²⁰² By doing so, Jordan undertook, amongst others, to refrain from imposing restrictions on "payments for current transactions" without the IMF approval. In 1997, the CBJ issued the Foreign Exchange Regulation No. 111/1997,²⁰³ which is a cornerstone in the liberalisation of foreign exchange in Jordan. This Regulation eliminates restrictions on current account transactions, both visible and invisible, as well as capital transactions. It does not require currency permits.

8.4.2. Banking-Specific Developments

The banking-specific reforms were comprised of the following two elements:

First, policies on consolidating the financial sector, promoting innovation and competition were adopted. The previous section explained how the Government and the CBJ lifted market distortions caused by the multi-tier system. By the end of 1995, the CBJ adopted the 'universal banking model',²⁰⁴ whereby existing commercial and investment banks would be allowed to diversify in each others' activities if the applicant bank met a number of prudential requirements. The CBJ, however, had not issued a universal banking license before the Banking Law (2000).

Further important measures were adopted by the CBJ. The CBJ moved from a system of direct credit control to more market based and indirect instruments of monetary control.²⁰⁵ In 1993, the CBJ started to issue Certificates of Deposits, and

²⁰¹ The two sides concluded several agreements including the Cooperation Agreement on Commercial Affairs between Jordan and the Palestinian Authority in 1995 and Cooperation Agreement on Monetary and Banking Affairs between Jordan and the Palestinian Authority in 1995.

²⁰² IMF, Jordan Accepts Article VIII Obligations, Press Release No. 95/13, March 2, 1995.

²⁰³ Council of Ministers, Foreign Exchange Bylaw for year 1997 issued pursuant to the Foreign Exchange Law No. (95) for year 1966; and the CBJ Regulation on Foreign Exchange No. (111/97) dated 30.6.1997.

²⁰⁴ CBJ. Regulation on Universal Banking No. (330/95) dated 30.12.1995.

²⁰⁵ محمد فضل ملحم، "السوق المصرفية الأردنية، سوق منافسة أم احتكار؟: الجزء الثاني"، البنوك في الأردن، المجلد (24). العدد (1)، (2005)، ص33.

introduced the overnight discount window for deposits.²⁰⁶ Another important step was the liberalisation of interest rates, which started gradually as of 1988. In 1990, the CBJ issued its regulation No. 11/90,²⁰⁷ which liberalised all banking interest rates on both deposits and credit facilities. In 2000, commission rates were also fully liberalised.²⁰⁸

Secondly, the CBJ adopted concurrent supervisory measures to strengthen the banking system. Most significantly, it adopted the below regulations which were obviously influenced by the international standards on banking supervision. An essential development in prudential supervision in Jordan took place in 1992²⁰⁹ when the CBJ modeled its capital adequacy requirements on the BCBS "International Convergence of Capital Measures and Capital Standards" of 1988 ("Accord"), by large. The set capital adequacy ratio was similarly 8 percent. Banks were commanded to supply the CBJ with detailed information on a regular basis. An essential shortcoming of the CBJ capital adequacy measurement was the lack of the calculation of capital adequacy on a consolidated basis. The CBJ employed the capital adequacy ratio as a means to strengthen and consolidate banks. It first raised the ratio from the BCBS standard of 8 percent of risk weighted asset to 10 percent in 1995²¹⁰ then 12 percent in 1997.²¹¹

Another important development was that the CBJ issued in 1990 a new regulation on banks' equity investments including the prevention of cross-ownership amongst banks.²¹² The CBJ issued in 1993 a regulation on the licensing and the supervision of Jordanian banks establishing presence abroad.²¹³ It required the prior approval of the CBJ before a Jordanian Bank may establish a presence abroad. It also

²⁰⁶ البنك المركزي الأردني- دائرة الأبحاث، ملحق بأهم إجراءات السياسة النقدية خلال الفترة (1989-2003)، (2004).

²⁰⁷ CBJ, Regulation on Interest Rates No. (11/90) dated 16.1.1990.

²⁰⁸ CBJ, Regulation on Commission Rates No. (28/2000) dated 31.1.2000.

²⁰⁹ CBJ, Memo on Capital Adequacy No. (7136/8409) dated 26.4.1992.

²¹⁰ CBJ, Circular on Capital Adequacy No. (7136/29292) dated 11.11.1995.

²¹¹ CBJ, Circular on Capital Adequacy No. (10/4/7/1610) dated 21.1.1997.

²¹² CBJ, Banks' Equity Investments Regulation No. (217/90) dated 31.10.1990 amended by CBJ, Banks' Equity Investments Regulation No. (183/93) dated 8.8.1993.

²¹³ CBJ, Regulation on Branching Abroad No. (249/93) dated 9.11.1993.

explained that the CBJ should issue its decision on basis of determined criteria including the comfort letters from the host countries as well as the supervisory systems therein. Banks' management should inform the CBJ with their losses, and supply it with the auditors' reports, its financial statements and the notes of the host supervisor. Furthermore, the CBJ emphasised on its right to undertake on-site supervision of foreign branches. Finally, the CBJ issued in 1995 its first comprehensive regulation on large exposures.²¹⁴

The Banking Law (2000) and the regulations issued pursuant thereto represent a significant step towards the transposition of the BCBS standards into Jordanian law. The following chapter will evaluate the compliance of Jordanian substantive banking supervisory legislation with mentioned standards.

²¹⁴ CBJ. Regulation on Credit Exposures No. (103/95) dated 11.4.1995.

CHAPTER 9

JORDANIAN SUBSTANTIVE SUPERVISORY RULES

9.0. Introduction

This chapter evaluates Jordan's application of the BCBS substantive core principles. It shows the strong influence of the BCBS standards on effective Jordanian banking supervisory legislation. First, it examines the legal powers of the CBJ related to licensing, branching, permissible activities, ownership and investments. While these issues were examined briefly under the Core Principles (2006), the implementation thereof involves many processes and procedures (Section 1). The chapter considers afterwards the application of the BCBS standards related to banks' risk management, as illustrated in the first section of chapter 4. It shows how the Jordanian legislation is progressing towards the application of the BCBS standards. Yet, it illustrates that the Jordanian law is less sophisticated than the former standards, mainly due to the differences between the Jordanian banking system and more advanced banking systems (Section 2). The following section looks into the growing importance of the public/ private partnership in Jordanian law in light of the BCBS standards, which were examined in the second section of chapter 4. It illustrates that the Jordanian banking legislation is largely influenced by international standards despite certain reservations. Many of the aspects of the public/ private partnership depend on infrastructure legislation i.e. they go beyond the BCBS jurisdiction. Therefore, specific references to Jordanian non-banking legislation, such as the Law of Companies, are made (Section 3). Finally, the chapter examines the influence of the BCBS capital adequacy standards, particularly Basel II, on related Jordanian regulations. Since the CBJ regulations are well detailed and depend heavily on the Basel II standards already examined in chapter 3, and in order to avoid excessive repetition of technical details, the chapter sets out comparative tables (Section 4).

9.1. Licensing, Branching, Permissible Activities, Ownership and Investments

The Jordanian Law meets the BCBS requirements related to the requirements of licensing, branching, determining permissible activities, ownership and investments. The BCBS, and as illustrated in above Section 5.3.3.2 of this thesis, provided general guidelines that require detailed legislation and processes to translate the guidelines into enforceable legislation.

9.1.1. The General Prohibition on Using the Term Bank

The Jordanian Law meets the requirement of Core Principle 2, which requires, *inter alia*, that a general prohibition on using the name bank be applied. Section 4(a) of the effective Banking Law (2000)¹ imposes a general prohibition on providing banking services without issuing first a final licence from the CBJ, and Section 4(b) confirms that "[n]o person that is not licensed to engage in banking activities shall accept deposits without a prior written approval of the Central Bank".

Banking activities are defined as "[a]ccepting deposits from the public and using them in full or in part to grant credit, or for any other activities designated by the Central Bank as banking activities".² Therefore, a person has to be involved in both taking deposits and the extension of credit and other services conjunctively in order to be considered a banking services provider. This understanding is reinforced by the following definition of deposits:

"Funds turned over by any medium of payment by one person to another person who agrees to return said funds upon demand or in accordance with agreed-upon terms. The depositary thus acquires

¹ The Banking Law (2000) was amended by the Law Amending Banking Law No. (38) for year 2004; Law Amending Banking Law No. (24) for year 2006; and Law Amending Banking Law No. (61) for year 2006 (which replaced the Law Amending Banking Law No. (46) for year 2003).

² Ibid. Section 2.

ownership of the funds and the right to dispose of them, with the obligation to return to the depositor the equivalent amount in the same currency as that of the deposit".³

According to this text, deposits earmarked for certain investments, such as deposits extended to brokers and other investors or under a life assurance contract have not been considered as deposits for the purposes of licensing a bank under Jordanian Law. There has never been a case filed against a broker or life assurance company for taking deposits neither under effective Banking Law nor previous equivalent texts.

The Jordanian Law also prohibits the employment of the term bank and its equivalent in any language by a person other than a licensed bank or when one of three exceptions takes place: when the term is employed by an international agreement, where it is obvious from the context that the term is irrelevant to banking activities, and where the usage of the name is permitted by a Council of Ministers' resolution upon a recommendation of the Governor, for example where a regional banking institution is allowed to establish a presence in Jordan.⁴ Likewise, the Law prohibits releasing misleading or false information concerning the acceptance of deposits.⁵

Furthermore, the Law penalises any unlicensed person who uses the name 'bank', provides banking services or issues misleading information in this regard by a fine of JD500 to JD3000 per day as of the first day of violating the law. Should the violation persist, the CBJ is entitled to close the place of business of the concerned person.⁶

9.1.2. Licensing of Banks

9.1.2.1. General Licensing Requirements

The Jordanian Law meets the licensing criteria required under the BCBS Core Principle 3. The Banking Law (2000) designates the CBJ as the sole authority responsible

³ Ibid, Section 2.

⁴ Ibid, Section 4(d).

⁵ Ibid, Section 4(e).

⁶ Ibid, Section 5.

for bank licensing, and determines minimum requirements thereof. First, banks should take the form of public shareholding companies with the exception of branches of foreign banks, subsidiaries of banks and off-shore companies.⁷ The bank should also have a minimum start-up capital determined by the CBJ⁸ (currently JD 40m).⁹ Furthermore, the Banking Law (2000) requires the applicant to provide the CBJ with information on the incorporators as well as supply essential documents.¹⁰ In addition, Section 25 provides that the bank's general manager and senior management should have experience in banking, be of good reputation and conduct, devote their time to the bank and shall not assume the position of a board member in any other bank (with the exception of subsidiary banks). As to the board of directors' members, Section 22 similarly requires the board member to be of good conduct, and not assume a position in another bank, but does not require him to have a minimal level of education or expertise. In addition, The Banking Law (2000) permits the CBJ to license new Islamic banks for the first time, providing that the objects of the Islamic bank are providing banking and investment services on non-usurious basis, soliciting savings and promoting social solidarity.

In 2006, the CBJ issued its Bank Licensing Guidelines, where it spells out for the first time its licensing criteria and determines that they are issued "according to the international standards and best practices". The CBJ also explains that it reserves the right to accept or reject an application for licensing but on the basis of clear standards to "reduce the potential for political interference in the licensing process".¹¹ The guidelines refer to multiple criteria,¹² one of which is of an economic nature, being the potential contribution to Jordan's economic development, such as providing banking services to under-banked remote areas and introducing novice financial services.

⁷ Ibid, Section 6.

⁸ Ibid, Section 8.

⁹ CBJ, Regulation on Own Capital for Banks in Jordan No. (17/2003) dated 20.8.2003.

¹⁰ Banking Law (2000), Section 7.

¹¹ CBJ, Bank Licensing Guidelines for year 2006, pp. 2.

¹² Ibid, pp. 3-5.

There five remaining criteria are of prudential nature and cover the following. First, The scrutiny of the financial standing and integrity of major shareholders i.e. ones holding at least 5 percent of the bank's equity, as well as, the ownership structure of the bank's group or affiliate to ensure that they are transparent and do not obstruct effective supervision. Secondly, the assessment of the applicant's operating and human resource plans, which cover the bank's planned strategy, organisation, internal control processes and procedures, corporate governance as well as managerial and other human resources development issues. Thirdly, the CBJ also assesses whether the proposed board of directors and senior managers meet individually and collectively a "fit and proper" criterion, which encompasses a broader range of qualities beyond the provisions of the Banking Law. It covers competence demonstrated by education, training and at least five years of experience as well as having knowledge of the industry including knowledge of international markets when relevant. It also covers the quality of "financial literacy", which refers to understanding of financial ratios and statements as well as the mere "commitment" to learn the business of the bank, fulfil ownership responsibilities and exert effort and time. Other qualities are the ability to provide independent and well informed judgements; probity and good reputation. Finally, they should have strategy and vision, leadership and knowledge of managerial best practices. Fourthly, the CBJ evaluates the financial projections and statements of the applicant bank including the adequacy of its capital and the legitimacy of its sources of capital. Finally, the CBJ assesses the effect of the bank on the safety and soundness of the banking system.

9.1.2.2. Licensing of Foreign Banks

There are four possible forms that a foreign bank might establish a presence in Jordan. First, it might establish a subsidiary,¹³ which enjoys a separate corporate identity and has to meet regulatory requirements such as capital adequacy on a solo basis. The subsidiary is considered a Jordanian company as Section 240(a) of the Law of Companies

¹³ Section 2 of the Banking Law (2000) defines a subsidiary as "[a] company in which one or more persons with a joint interest own at least 50 percent of its capital or hold an effective interest that allows said person or persons to control its management or general policies".

No. (22) for year 1997 (hereafter "Law of Companies")¹⁴ determines that only a company that is registered and has its headquarters outside Jordan is considered a foreign company. A subsidiary of a foreign bank is therefore subject to the same legal requirements of licensing and supervision unless the law indicates otherwise.¹⁵ The second form is the off-shore bank; i.e. a company registered in Jordan which carries out its operations abroad.¹⁶ Although the Banking Law (2000) envisages the possibility of establishing off-shore banks, and empowers the CBJ to license and regulate them,¹⁷ the CBJ in practice has never authorised or issued a regulation to this end. The third type is the representative office of a foreign bank which purpose is to protect the bank's interest e.g. by strengthening its relationship with local Jordanian banks and providing information and advice on the local market thereto.¹⁸ According to the Licensing and Supervising the Activities of the Representative Offices of Foreign Banks and Financial Companies Bylaw No. (11) for year 1977 and amendments, representative offices should be authorised and supervised by the CBJ. There used to be few bank representative offices in Jordan, but there are currently none.

The fourth and most significant form of foreign banking is the branch. The licensing of a foreign branch is subject to the same requirements of licensing a domestic bank with additional prudential requirements related to both the foreign bank and its Jordanian branch. The requirements related to the foreign bank are modelled on the BCBS standards as illustrated in the following Section 11(a) of the Banking Law (2000):

"A foreign bank shall submit an application for licensing for one or more of its branches to operate in the Kingdom pursuant to the orders of the Central Bank and provided that the foreign bank meets the following conditions:

¹⁴ The Law of Companies was amended by Law No. (4) for year 2002; Law No. (40) for year 2002; Law No. (74) for year 2002; Law No. (17) for year 2003; Law No (57) for year 2006; and Law No. (35) for year 2008.

¹⁵ Banking Law (2000), Section 6(c).

¹⁶ Law of Companies, Section 211(a).

¹⁷ Banking Law (2000), Section 6(a)(d).

¹⁸ Council of Ministers Bylaw on Licensing and Supervising the Activities of the Representative Offices of Foreign Banks and Financial Companies No. (11) for year 1977 and amendments No. (85) for year 1981 and No. (110) for year 2001, Section 12.

1. It must be licensed to accept deposits in its home country.
2. It must enjoy a good reputation and a strong financial position.
3. It must have the approval of the competent authority in the country of its head office to operate in the Kingdom.
4. Supervision by the competent authorities in its home country must be based on sound banking supervision, *the minimum of which must be the application of internationally recognized banking supervisory standards*.
5. It must pledge that the branch thereof licensed to operate in the Kingdom shall comply with all legislation in force [emphasis added]."

Section 12 provides for two additional requirements of the foreign branch. The first one is that it should transfer to Jordan in one lump sum the equivalent of half of the capital of Jordanian banks (currently JD20m). This is an important rule since branches do not have separate legal entities and therefore their deposits and assets are available to the creditors of the foreign bank they belong to. The second one is that foreign banks should have their own regional managers; a requirement that should enhance the management of the foreign branch because it provides a clear line of responsibility for the bank and gives the CBJ a clear point of reference.

9.1.2.3. Licensing Procedures

The application procedure is divided into the two stages of preliminary and final approval. The incorporators first submit the documents that should illustrate that they meet the licensing criteria,¹⁹ and the CBJ shall issue its decision of either rejection or preliminary approval in three months and notifies the applicant thereof.²⁰ The CBJ should also determine in its preliminary approval the remaining requirements for authorisation such as the full payment of capital, which the applicant must satisfy within one year, otherwise the preliminary approval would be *ipso facto* cancelled.²¹ If the requirements are otherwise met

¹⁹ The documents required by the CBJ are enumerated by the CBJ, *Ibid* (n 11), pp. 6-11.

²⁰ Banking Law (2000), Section 9(a).

²¹ *Ibid*, Section 9(b)(c).

and notified to the CBJ within one year, the CBJ shall issue its final decision to license the bank.²²

9.1.2.4. Withdrawal of Licensing

The Banking Law (2000) defines the situations where the CBJ *may* revoke the license of a bank and provides that the CBJ shall notify the bank with its decision in seven days as well publish the decision in the Official Gazette and two daily newspapers.²³

Section 18 of the Banking Law (2000) states that the CBJ may revoke the final license of an existing bank under six circumstances: where the license is issued on the basis of false information supplied by the applicant; where the licensed bank fails to undertake its activities within one year of issuing the license or refuses to take deposits; where the bank refuses to implement the penalties or the corrective measures provided for under the Banking Law;²⁴ when a bank submits an application to revoke its license; where the license of a bank which enjoys an effective interest is revoked; and where the bank is merged with or acquired by another corporate.

Section 19 of the Banking Law (2000) deals specifically with the situations where the CBJ may revoke the license of a foreign bank. This includes the situations where the head office declines to accept deposits, the financial position of the foreign bank has become weak or where "any change has occurred that the Central Bank views as having a negative impact on the activities of the foreign bank branch in Jordan and its operational progress".²⁵ The latter text covers the situation where the bank's headquarter or an affiliate bank is facing imminent closure or is subject to investigation for massive fraud or financial crime. The license may also be revoked where "any changes has occurred in the nationality, ownership, memorandum of agreement and articles of association of the foreign bank".²⁶

²² Ibid, Section 10(a).

²³ Ibid, Section 20.

²⁴ Ibid, Section 88.

²⁵ Ibid, Section 19(d).

²⁶ Ibid, Section 19(b).

This broadly drafted text should be construed to mean any changes in the bank's ownership or founding documents that may have detrimental effects on the bank. It must be recalled here that in the case of Jordanian banks, the CBJ's prior consent is required for the validation of the transfer of ten percent of its capital²⁷ or introducing changes into its memorandum and articles of association.²⁸ The CBJ by contrast may only request the foreign bank to supply it with information when such changes occur²⁹ then it can make its decisions concerning the local branches. It is less obvious why the change in the nationality as opposed to the *locus* of the head office, which is essential for cross border international banking cooperation under the BCBS standards, is a ground for revocation. Finally, and most significantly, Section 19(e) states the following as one of the reasons for license revocation:

"Where it has been established that the relevant authorities in the country of its head office have not applied sound standards of banking supervision".

The latter section provides evidence that the Jordanian legislator considers the BCBS standards as a reference point for best supervisory standards and illustrates its willingness to incorporate them into binding laws.

9.1.3. Branching

Section 17(b) of the Banking Law states that banks may not open, close or transfer branches, whether inside or outside Jordan without the prior approval of the CBJ. The CBJ spells out the details of licensing branches in special regulations.

9.1.3.1. Branching Inside Jordan

The CBJ's regulation on branching inside Jordan³⁰ allows the three forms of branches or offices (including money exchange offices), ATMs and locations for marketing banking services and products. Banks should apply for the CBJ in writing to open a branch

²⁷ Ibid, Section 34(a) read together with Section 2.

²⁸ Ibid, Section 16.

²⁹ Ibid, Section 12(c).

³⁰ CBJ, Regulation on Licensed Banks' Branching Inside Jordan No. (36/2007) dated 30.9.2007.

or office on a determined date and in a specific geographical area supplemented with the approval of their board of directors, an economic feasibility study and any other information requested by the CBJ. The CBJ reserves to itself the right to approve or reject the application, but its decision is based on the criteria of the financial, administrative and organisational soundness of the bank as well as its compliance with banking legislation. If the opening of the branch is approved, it should be opened within one year extendable to a maximum period of two years.

Banks by contrast do not have to apply to the CBJ to open the other forms of presence. In the case of banks seeking to establish ATMs, they should notify the CBJ of the proposed locations. They should also ensure the validity of ATMs and provide surveillance cameras. Likewise, banks should only notify the CBJ of proposed locations of marketing banking services and products and their launching dates. They should announce in a conspicuous place that the location is not a branch or office.

9.1.3.2. Branching Outside Jordan

The CBJ regulation on cross border establishments³¹ allows Jordanian banks which have been providing banking services locally for at least five year to establish a presence abroad in the form of an ordinary or offshore branch, subsidiary, representative office or any other form approved by the CBJ. The bank must first submit an application supported with an economic feasibility study for the CBJ for approval. It must have a written policy on coordinating the relationship between the head office and its establishments abroad, as well as, demonstrate that is it solvent, well managed and well rated bank.³² The CBJ approval is based on the BCBS requirements as explained below:³³

"When reviewing the applications for cross-border establishment, the Central Bank of Jordan will take into consideration the following:

³¹ CBJ, Instructions for Cross- Border Establishment by Jordanian Banks No. (18/2004) dated 24.6.2004, which replaced CBJ, Regulation on Branching Abroad No. (249/93) dated 9.11.1993.

³² The bank must meet the category of "Well Capitalized" as defined in the CBJ, Framework for Corrective Actions Regulation No. (4/2004) dated 11.1.2004; be classified as 2 "Well Rated" and its management rating is 2 on basis of the CBJ CAMEL system.

³³ Ibid (n 31), Article 3.

- a. The nature and level of supervision by regulatory authorities in the host country on cross-border establishments of the Jordanian bank.
- b. The nature of the conditions or pledges or comfort letters required by regulatory authorities in the host country either from the head office of the bank or the Central Bank of Jordan.
- c. The cooperation of the host country with respect to the exchange of regulatory information and, generally, its commitment to the Basel Committee accords for the supervision on cross-border establishments.
- d. The signed agreements with the regulatory authority in the host country".

The regulation also commits Jordanian banks to provide the CBJ with information and documents concerning their branches outside Jordan. First, the bank should inform the CBJ in advance of the date of launching the operations of the branch supplemented with the name of the manager and full contact details. Likewise, it should inform the CBJ in advance of its decision to move or transfer one of its branches. The bank should also supply the CBJ with summaries of audit and inspection processes, the external auditor's report, directives issued by the host authority thereto, certified annual financial statements and the head office's assessment of the branch's risks and the adequacy of reserves and provisions set against them, as well as, any substantial losses or important events that may adversely affect it. It is noteworthy that the CBJ may impose on the branch a higher reserve ratio or assign a higher risk weight thereto.

9.1.4. Permissible Activities

The Banking Law (2000) and regulations issued pursuant thereto clearly define activities permissible to banks as required under the BCBS Core Principle 2. It first of all carries forward the prohibition on banks to provide trading, industrial or any services other than financial ones.³⁴ The Law allows Islamic banks to undertake their activities which involve exposure to trading risks,³⁵ but did not permit the combination of Islamic and conventional banking within the same bank. In addition to accepting deposits, Islamic

³⁴ Banking Law (2000), Section 40(a/2).

³⁵ Ibid, Section 54.

banks are entitled to carry out the activities which were earlier only allowed to be supplied by the Jordan Islamic Bank for Finance and Investment under its specific law. These activities cover issuing *Muquaradha* bonds and other investment funds or portfolios, *Mudharaba*, *Musharaka*, and *Murabah*³⁶ and any other investments undertaken on a non-usurious basis.³⁷ Furthermore, banks may not acquire real estate except in settlement of debts and for a period that shall not exceed two years as of the acquisition date or for the purpose of conducting its own banking services therefrom,³⁸ and should have to adhere to the related instructions of the CBJ.³⁹

Section 37(a) of the Banking Law (2000) provides an inconclusive list of permissible financial activities and allows the combination of commercial and investment banking within the same bank. It states that banks, subject to their licenses, may undertake one of twelve activities including the acceptance of deposits, extension of credit including financing commercial transactions, provision of payment and collection services as well as the issuance and administration of instruments of payment. The list covers providing financial agency services and banks are accordingly allowed to provide insurance agency services,⁴⁰ as well as, insurance consultative services.⁴¹ Banks are also allowed for the first time to deal in money and capital markets either to its own account or for its customers' accounts; purchase and sale of debts; financial leasing; dealing in foreign exchange; foreign exchange management; underwriting, management and dealing in securities; investment trustee services; providing management and consultations on investment portfolios; advisory services, safekeeping, and managing of precious objects and securities. The list,

³⁶ Ibid, Sections 52.

³⁷ Ibid, Sections 51 and 53.

³⁸ Ibid, Section 48.

³⁹ CBJ, Regulation of the Acquisitions of Real Estates Circular No. (2/2000) dated 15.10.2000.

⁴⁰ It is noteworthy that the Insurance Regulatory Law No. (33) for year 1999 as amended by Law No. (57) for year 2002, Section 2 defines the insurance agent as any person appointed and authorised by the insurance company to transact insurance business on its behalf.

⁴¹ CBJ, Circular on Insurance Consultation Services No. (10/2/1304) dated 5.2.2007.

however, does not cover the registration of securities, which is exclusively confined to the Securities Depository Centre ("SDC").⁴²

In addition, Section 37(a) states that banks may undertake any other banking related activities approved by the CBJ in orders issued specifically for this purpose. The CBJ, for example, allowed banks to provide private bonded services provided that the stored goods represent a guarantee from the beneficiary of a credit guarantee extended by the same bank.⁴³ Section 37(b) also allows a bank to have a subsidiary or more extending non-banking services subject to the CBJ approval. The Arab Bank is for example allowed to provide Islamic banking services through its wholly owned subsidiary, the Arab Islamic Banking International. The CBJ also permits banks to provide insurance services through a wholly owned subsidiary.⁴⁴

9.1.5. Transfer of Ownership and Review of Investments

The Jordanian Law meets the requirements of Core Principles 4 and 5 on the transfer of significant of ownership and major acquisitions.

9.1.5.1. Transfer of Significant Ownership

Section 34(a) of the Banking Law (2000) requires the prior written approval of the CBJ to any transfer of a bank's shares which confers ownership of an *effective interest* (significant control in the BCBS terminology) of a person or increases the percentage of such person's effective interest in the capital, being defined as controlling a minimum of 10 percent of the capital of a legal entity.⁴⁵ Otherwise, the underlying transfer contract becomes invalid. Section 34(b) states that the same rule applies to transferring shares to related parties being defined as follows:⁴⁶

⁴² Higher Court of Justice Case No. (483/2005) dated 23.1.2006, Adalah Publications.

⁴³ CBJ, Bonded Services Regulation No. (7/2001) dated 16.4 2001, Article 1.

⁴⁴ CBJ, Regulation of Banks' Acquisition of Insurance Companies No. (5/2000), dated 5.12.2000.

⁴⁵ Banking Law (2000), Section 2.

⁴⁶ Ibid.

“Two or more persons that constitute a single banking risk because one controls the other or owns at least 40 percent of the other person’s capital, they have exchanged mutual guarantees, the settlement of their loans is from a single source, their loans are from the same project, or where other similar circumstances take place. For the purposes of this law, related parties shall be considered as a single person.”

Furthermore, Section 39 provides that a bank which acquires the lesser ratio of 5 percent in a bank or any other company must notify the CBJ within fifteen days. The researcher has raised the question of how does the CBJ ensure that banks performing the notification requirements during an awareness meeting conducted by Amman Stock Exchange (“ASE”)⁴⁷ and was informed that there is an unpublished understanding between the CBJ and the SDC that the latter would inform the CBJ of bank’s holdings exceeding the 5 percent ceiling.

9.1.5.2. Equity Investments

Section 38 of the Banking Act (2000) as outlined in the Banks’ Equity Investments Regulation⁴⁸ provide criteria for banks’ individual and aggregate investments or acquisitions, whether owned directly or indirectly (such as a sub-subsidiary). Accordingly, a bank may not acquire a non-financial company.⁴⁹ No bank, as well, shall have holdings in a company, which activities do not contain accepting deposits, exceeding 10 percent of the subscribed capital of the targeted company. If the bank’s holding in the latter type of company exceeds 10 percent of the bank’s subscribed capital or 10 percent of the subscribed capital of the bank or company in which the holding subsists, whichever is less, the prior approval of the CBJ shall be obtained. Furthermore, a bank may not exceed a 50 percent limit of the acquiring bank’s regulatory capital on its aggregate holdings of shares.

⁴⁷ مؤيد تهتموني، "الأوراق المالية المدرجة في بورصة عمان"، (محاضرة بورصة عمان، حزيران 2007).

⁴⁸ CBJ, Banks’ Equity Investments Regulation No. (12/2002) dated 27.3.2002. This regulation repealed and replaced CBJ, Banks’ Equity Investments Regulation No. (217/ 90) dated 31.10.1999 and CBJ, Banks’ Equity Investments Regulation No. (183/93) dated 8.8.1993.

⁴⁹ Section 38(a) of the Banking Law (2000) specifically prohibited banks from “[h]olding in a company whose objectives do not include acceptance of deposits, an ownership stake exceeding the ratio prescribed by the Central Bank”. The blanket prohibition on ownership by banks in financial companies was pursuantly provided for in Article 1 of the CBJ, Banks’ Equity Investments Regulation, Ibid.

The mentioned limits do not include three types of equity: shares acquired by the bank as a debt settlement provided that the bank disposes thereof within two years as a general rule, shares registered in the name of the bank yet owned by its clients and holdings in subsidiary financial companies and banks.

In addition, the CBJ regulates the banks' purchase of treasury stocks (i.e. shares of their own stocks)⁵⁰ with the prior approval of the CBJ. The regulation permits the purchase within the maximum percentage of five percent of the bank's paid up capital provided that certain precautionary requirements are met. The bank must apply to the CBJ illustrating its reasons for buying treasury stock and its projected effects on its financial position. It should also demonstrate, amongst others, that it has earned net profits over the preceding two years, has a capital adequacy ratio one percent higher than the minimum regulatory ratio (i.e. 13 percent of risk weighted assets) and adhere to liquidity and the credit concentration ratios as well as enjoy a strong financial position. Furthermore, members of the bank's board of directors and their related and connected parties may not deal in the treasury stocks. In addition, the bank may not purchase treasury stocks within six months of increasing its capital as a general rule. Likewise, the bank may not increase its capital before it disposes completely of its treasury stocks, which can be done by distributing them to its partners or employees, or selling them to a strategic partner or the public.

9.2. Risk Assessment and Management

The term 'risk management' is not used by the Banking Law (2000), although Section 21(c) states broadly that banks' boards of directors are responsible for setting out the objectives and policies of the bank and monitoring their implementation. The CBJ regulations, however, focus on the management of credit and foreign exchange risks, being the most common types of risks Jordanian banks are exposed to. The first comprehensive approach to risk management, and which largely meets the requirements of the BCBS Core Principle (2006), is found in the CBJ Regulation on Internal Control Systems issued in 2006. This regulation provides that the board of directors should review the risk exposure

⁵⁰ CBJ, Treasury Stocks Regulation No. (28/2006) dated 23.4.2006.

of the bank and ensure that the bank has adequate procedures to assess, manage and control these risks.⁵¹ It also states that each bank should formulate a risk management system commensurate with its size and complexity. The system should cover the following five elements at least:⁵² the board of directors should approve and periodically review a risk policy which sets out measures and limits for each type of risk and ensures that the bank's employees are informed of it; banks should have specialist and independent employees responsible for risk analysis and developing risk management methods; banks should monitor the application of risk controls and the observance of risk limits; the bank's management should be informed of any breach of risk controls and needed measures to rectify the situation; and the risk management policies, processes and procedures should be regularly reviewed.

Each bank should also establish an independent risk management committee comprised of members of their boards of directors and top executives.⁵³ The committee is responsible for reviewing the risk management policy before its submission to the board of directors; the regular review of the risk management policy, procedures and processes; submitting reports to the board of directors on existing risks compared to the bank's risk policy; deliberating on risk management reports; checking the progress of database needed for risk analysis and finally the review of the business continuity plan.

9.2.1. Credit Risk

The Jordanian law provides adequately for credit risk management. It states that banks' boards of directors are responsible for adopting and monitoring the implementation of a credit risk policy spelling out its criteria and terms of credit extension and supply the CBJ with a copy thereof.⁵⁴ It also sets limits for large credit exposures or concentrations, connected lending and related lending. Banks do not need as a general rule to obtain the

⁵¹ CBJ, Regulation on Internal Control Systems No. (35/2007) dated 10.6.2007, Article Second(1).

⁵² Ibid, Article Sixth.

⁵³ Ibid, Article Sixth(4).

⁵⁴ The Banking Law (2000), Section 21(c).

approval of the CBJ before granting credit (with the exception of large exposures), but they should supply it with monthly returns on their credit exposures.⁵⁵ They should also supply information on the credit ratings of their customers.⁵⁶

9.2.2.1. Credit limits

The law states that banks are prohibited from “[g]ranteeing credit to any person in excess of the limit set by the CBJ, or arranging financing for such person by a third party with the intent of enabling him to discharge his obligations to an affiliate of the bank.”⁵⁷ This is a broad definition which covers all types of credit extension and beneficiaries, yet the Law emphasises the CBJ's authority to set exposure limits for loans granted to a borrower and his affiliates or related parties.⁵⁸ A related party was defined above, while an affiliate is defined in the Banking Law (2000) as a person who "controls or is controlled by another person, or each of two persons controlled by a third person".⁵⁹ The control element is broadly defined to cover the ability to influence the decisions or actions of another person, e.g.⁶⁰ by controlling the board of directors.

The Exposures Limits Regulation issued by the CBJ in 2001⁶¹ spells out regulatory details that shall be applied both in Jordan and by Jordanian banks' branches abroad without prejudice to the limits set by the host authority.⁶² An exposure is defined as “the total of direct and indirect credit facilities and bonds issued by a person and purchased by a

⁵⁵ CBJ, Exposures Limits Regulation No. (9/2001) dated 1.8.2001, as amended by Circulars No. (10/2/3/3/16009) dated 6.10.2006; No. (10/2/3/3/14214) dated 5.10.2003; No. (10/2/3/3/11020) dated 16.10.2005; and No. (10/2/3/3/11647) dated 27.11.2007, ("Exposures Limits Regulation"), Articles Fourteenth(3) and Fifteenth(1).

⁵⁶ Ibid, Article Fifteenth(9).

⁵⁷ Banking Law (2000), Section 40(a)(4).

⁵⁸ Ibid, Section 41(b).

⁵⁹ Ibid, Section 2.

⁶⁰ Ibid.

⁶¹ CBJ, Ibid (n 55).

⁶² Ibid, Article Fourteenth.

bank”.⁶³ The exposure is limited to 10 percent or more of a bank’s regulatory capital, while the aggregate exposure limit is 8 times its regulatory capital. The maximum limit of exposure to a person and its related parties in Jordan may not exceed 25 percent of the bank’s capital held in Jordan, while the limit for a loan extended abroad is charged against capital held by the bank in Jordan and its branches abroad.⁶⁴ Exposure limits also exclude credit extended to or guaranteed by the Jordanian Government, generally non-performing loans that meet provisioning requirement set out below, credit fully covered by cash collateral, and loans fully guaranteed by the Jordan Mortgage Refinancing Company.⁶⁵

The law defines connected persons as affiliates, a bank administrator, his spouse or a relative of his up to the third-degree, or any person who has a personal interest therewith.⁶⁶ A relationship between a bank and a financial company is assumed to exist if either the bank or the financial company enjoys a direct or indirect effective interest in the other.⁶⁷ The law authorises the CBJ to regulate exposures to connected parties,⁶⁸ and accordingly, the CBJ imposes a 50 percent ceiling on loans to all connected parties apart from loans to board members at the bank and its subsidiaries, related parties thereto and housing loans to banks’ employees.⁶⁹ Banks may not extend a loan to a related party on more favourable terms to loans extended to others.⁷⁰ Furthermore, the Law provides that if one of the bank’s directors, general manager or manager does not settle his debts to the bank shall forfeit his position.⁷¹

⁶³ Ibid, Article First.

⁶⁴ Ibid, Articles First and Third.

⁶⁵ Ibid, Article Twelfth.

⁶⁶ Banking Law (2000), Section 46(a).

⁶⁷ Ibid, Section 45.

⁶⁸ Ibid, Section 46(b).

⁶⁹ CBJ, Ibid (n 55), Article Fifth.

⁷⁰ Ibid, Article Fifteenth(4).

⁷¹ Banking Law (2000), Section 30(b).

The CBJ also sets specific terms and limits on credit granted to an administrator being defined as a “member of the board of directors of a bank, whether serving on his own behalf or representing a legal entity, or the general manager of a bank or any other bank officer”.⁷² Loans extended to board of directors' members should adhere to the limits set by the CBJ,⁷³ and on similar terms to loans extended to other borrowers. The board member should not be present when his board deliberates on his loan as well. In addition, the prior approval of the CBJ must be attained.⁷⁴ The CBJ imposes the following limits on exposure to an administrator where the denominator is the regulatory capital: 5 percent limit for credit extended to a board member of the bank or its subsidiary where the aggregate limit is 25 percent; 10 percent for credit extended either to a board member in the bank and all of his related parties including loans guaranteed thereby or a board member in the bank's subsidiary and its related parties; and 50 percent aggregate limit to all credit given to the directors of the bank and its subsidiaries and parties related thereto. It also imposes a fixed 300,000 JDs limit on loans to managers and senior executives and 100,000 JDs on loans to employees' funds.⁷⁵

The CBJ is also empowered to impose limits to credit granted to any financial company that has a relationship with the bank.⁷⁶ The credit limit to exposure to subsidiaries is 20 percent of the latter's paid up capital.⁷⁷ In case of subsidiaries abroad, they shall apply the limits set by the host country if higher than those set by the CBJ, otherwise, they must obtain the prior approval of the CBJ to apply the less stringent requirements of the host authority.⁷⁸

⁷² Ibid, Section 2.

⁷³ Ibid, ection 47.

⁷⁴ CBJ, Ibid (n 55), Article Fifteen(3).

⁷⁵ Ibid, Articles Sixth and Eighth.

⁷⁶ The Banking Law (2000), Section 45.

⁷⁷ CBJ, Ibid (n 55), Article Seventh.

⁷⁸ Ibid. Article Eleventh.

A major source of credit risk in Jordan is excessive loans granted for real estate, and therefore it is limited to 20 percent of the total deposits of the bank in JD.⁷⁹ It covers credit extended for the purchase, construction, expansion or maintenance of immovable property, as well as, loans extended to investors in the real estate sector and housing associations.⁸⁰ Loans extended to finance the working capital of construction companies and credit to development construction such as schools and which term to maturity is seven years at maximum shall be excluded.⁸¹

Finally, banks are not allowed to extend credit to their attorneys or auditors;⁸² finance the purchase of securities which the bank has undertaken to offer, cover or distribute;⁸³ or extend credit guaranteed by the borrower's shares in the bank.⁸⁴ Jordanian and foreign banks also may not extend credit to their prime ten clients exceeding 35 and 70 percent of their direct credit facilities in Jordan, successively.⁸⁵

9.2.2.2. Problem Assets, Provisions and Reserves

The law emphasises on banks' compliance with the orders of the CBJ concerning the classification and valuation of assets including the duration period for considering income from loans as unrealised and provisions held against non-performing loans.⁸⁶ The effective CBJ regulation on this regard, 'Instructions for Classification of Credit Facilities and Calculating Impairment Provisions and Reserve for General Banking Risks' was issued in 2006 "in light of changes in international guidelines", in a clear reference to the BCBS

⁷⁹ Banking Law (2000), Section 40(a/9).

⁸⁰ CBJ, Circular on Exposures Limits on Real Estate No. (10/2/3/3/11647) dated 27.11.2007, Article 1.

⁸¹ Ibid, Article 2.

⁸² The Banking Law (2000), Section 96(a).

⁸³ Ibid, Section 40(a/8).

⁸⁴ Ibid, Section 40(a/10).

⁸⁵ Ibid, Section 41(c) and CBJ, Ibid (n 55), Article Fourth.

⁸⁶ Ibid, Sections 42(a/2,3) and 43.

standards.⁸⁷ The regulation covers the classification of loans, provisioning, rules of rescheduling debts and other terms.

The instructions classify credit facilities into the following types:

First, 'low risk credit facilities' category, which represent credit granted to or guaranteed by the Government of Jordan or a country hosting a branch of a Jordanian bank provided that the underlying credit is denominated in the host country's currency, as well as, credit fully collateralised by cash margin or an 'eligible bank guarantee' i.e. one issued by a bank rated an investment grade by a recognised credit rating agency.

Secondly, 'acceptable risk credit facilities' which refers to credit granted to an obligor with strong cash flows and financial position, available alternative cash resources, timely repayment of due principal amount and interest thereon, competent management and has his credit covered by eligible collateral.

Thirdly, the category of 'watch-list credit facilities' which covers ten types of less worthy credits. It includes obligors with past due repayment of principal and/ or interest for a period ranging from 60 to 90 days; overdraft facilities exceeding their limit by ten percent for a period ranging from 60 to 90 days; performing credit facilities restructured from a previous non-performing category and in the case where there is no adequate financial analysis of the obligor.

The last category is 'non-performing credit facilities' which covers overdue repayments, overdrafts which are dormant or exceed their limit with over ten percent, unrenewed mature credit facilities, current accounts that are overdrawn and claimed guarantees which value is unpaid or inadequately covered. These credit facilities are subdivided according to their duration into the three types of 'substandard' (90 to 179 days), 'doubtful' (180-359 days) and 'loss' (more than 359 days). Credit facilities extended to an

⁸⁷ BCBS, Sound Credit Risk Assessment and Valuation for Loans, Consultative Document (November, 2005), which was amended by the final version: Sound Credit Risk Assessment and Valuation for Loans (June, 2006).

obligor declared subsequently bankrupt is classified as 'loss', while those rescheduled twice within one year are classified as 'substandard'.

The instructions also set out the following rules various rules on sound on provisioning. First, banks should set aside 'general banking risk reserves' from their profits and disclose them under the owner's equity section of their balance sheet. This provision should be no less than one percent of direct acceptable risk credit facilities and 0.5 percent of indirect credit facilities with the exception of low risk credit facilities. The part of credit facilities covered by a Government guarantee, acceptable bank guarantees, the Jordan Loan Guarantee Corporation, cash collateral, the Jordan Mortgage Refinancing Company, recognised export credit agencies, as well as auto loans covered by insurance companies and certain export promotion loans shall be excluded. Secondly, banks should maintain the equivalent of 3 percent of their total direct credit facilities as 'impairment loss provision' against watch-list credit.

Thirdly, banks should also maintain an impairment loss provision for non-performing facilities against principal outstanding amounts. Banks need to distinguish between credit facilities on basis of whether they are covered by eligible collateral or not. Eligible collateral is defined as cash margin; 75 percent of real estate value or the value of the mortgage deed whichever is less (common ownership excluded); 75 percent of the listed financial securities evaluated according to market value; and 50 percent of the value of machineries and vehicles or the value of the mortgage whichever is less. Real estate collateral should be appraised by an expert during the approval phase, when the credit is categorised as non-performing, when devaluation in real estate takes place and every four years at minimum. As to fully collateralised credit facilities, the provision should be 25 percent of sub-standard credit, 50 percent of doubtful credit and 100 percent of loss credit. The provision should be set aside during a five years period until it amounts to the 100 percent coverage. As to partially colleteralised credit, the provision held against each portion is calculated separately then summed up. The provision against the uncolleteralised portion is 20 percent of the amount of principal or 100 percent of the uncovered portion whichever is more. Certain credits are also excluded from this provision such as credit guaranteed by The Jordan Loan Guarantee Corporation.

Fourthly, banks should create a full impairment loss of guarantees paid thereby on behalf of the client and have not been debited for more than 90 days. An impairment loss should also be created for overdrawn current accounts after 29 days starting from 3 percent and mounting to 100 percent after 90 days. Finally, in case of personal credit such as credit card withdrawals and auto loans, an impairment loss provision should be created according to the period of delinquency ranging from 15 percent when the delinquency period is 60-89 days and mounting to 100 percent when the period is more than 270 days.

In addition to the above, the instructions set out rules on the rescheduling of credit facilities to remove them from the non performing category. First, the obligor should make a cash down payment from his own resources that covers at least 10 percent of outstanding amount for the first reschedule, and may be doubled in the second reschedule. The other settlement instalments must be periodical and their maturity is a maximum of ten years as a general rule. The grace period should not exceed six months as well. The credit facility can also be rescheduled for only three times provided that no more than two reschedules take place within twelve months. If the obligor defaults, the credit facilities will be reclassified according to their original category. Credit facilities can also be removed from the watch-list to the acceptable risks category, if the obligor makes six monthly or three periodical repayments and meets other regulatory requirements.

The CBJ instructions provide for further prudential rules to protect banks from credit risk. Most significantly, they provide that interest and commissions of non-performing credit should be suspended. They also state that banks may not extend new credit facility to an obligor who has one of his debts classified as non-performing. Furthermore, they states that repayments of non-performing loans should not be taken from the proceeds of new credit facilities extended to the obligor or a third degree relative of his, his related parties or affiliates. They also set out the general rule that an obligor who had one of his credit exposures written off may not benefit from further credit facilities, unless he makes full repayment. Finally, if one of the credit facilities extended to a particular obligor is classified as non-performing, the same category will be assigned to any other facility extended to him as a general rule.

9.2.2. Market Risk

The CBJ adopts a number of precautionary measures to minimise banks' exposure to market risk, which can result mainly in the case of Jordanian banks from adverse movements in securities and interest rates in the trading book and foreign exchange risk. As to securities, Section 38 of the Banking Law (2000) and regulations issued pursuant to limit banks' holdings of shares and hence their exposure to market risk. The CBJ protects banks from interest rates fluctuations in the Interbank market by applying a system of interest rate corridor to overnight deposits and repurchase agreements, whereby the upper and lower interest rates limits are indirectly controlled.⁸⁸ There has never been, however, any regulations which adopt the BCBS detailed rules of risk management to equity and interest rate risk prior to the Basel II Regulation on Market Risk: the Standardised Approach released recently. By contrast, the CBJ adopts more extensive rules on the management of foreign exchange currency whether the bank is managing its own portfolio or dealing on behalf of its customers.

As to foreign exchange, the CBJ sets out prudential rules on banks' management of their assets and liabilities in foreign exchange. Banks should have an investment policy approved and monitored by their boards of directors and supply the CBJ with a copy thereof. The investment policy should cover the types of permitted investments, limits on foreign currencies' investments (currency, geographic distribution, economic sectors), concentration limits, daily and overnight positions, matching assets and liabilities in foreign currency, instruments susceptibility to interest rate risk as well as a "risk management policy related to investment, such as credit risk, market risk, operational risk, liquidity risk, and legal risk".⁸⁹

⁸⁸ CBJ, Deposit Window Regulation No. (36/98) dated 28.2.1998; and CBJ, Repurchase Agreements Regulation No. (136/98) dated 5.7.1998 and subsequent orders.

⁸⁹ CBJ, Instructions for Managing Banks' Assets/Liabilities in Foreign Currencies, No. (32/2006) dated 6.12.2006, Article Second. The Instructions replaced earlier Circular on the Management of Assets and Liabilities in Foreign Exchange No. (179/2000) dated 5.7.2000.

The CBJ allows the extension of direct credit facilities only to export economic entities⁹⁰ and inserts limits on banks' open positions to major foreign currencies within a limit of 5 percent of their shareholders' equity per currency, while the total overnight position for all currencies is confined to 15 percent of shareholders' equity.⁹¹ Violations of these limits lead to the imposition of financial penalties.⁹² Banks should have clear procedures, trained technicians as well as a back office to settle the transactions and a middle office to monitor client account that are independent from the treasury division and the trading room.⁹³ Furthermore, the tasks of the middle office are listed in the instructions, which explain that this is done according to "international best practices". Finally, banks should supply the CBJ with monthly returns on their investments in foreign currency calculated on mark-to-market basis, and when not possible on mark-to-model basis.⁹⁴ The shortcoming in these instructions is that they apply only to banks in Jordan, which indicates that external branches of Jordanian banks will be subject only to the host country.⁹⁵

The CBJ allows banks to manage client portfolios and investment funds in foreign currencies only as mediators and according to set prudential rules.⁹⁶ The board of directors should agree to a written policy on this regard that determines investment instruments, operational principles and controls and furnish the CBJ with a copy thereof. Instruments may include derivatives provided that appropriate hedging takes place.⁹⁷ Banks should separate client and proprietary accounts and are not allowed to extend credit facilities to

⁹⁰ Ibid, Article Fourth (1).

⁹¹ Ibid, Article Fourth (2/a).

⁹² CBJ, Financial Penalties on the Breach of Credit Exposures in Foreign Exchange No. (23/2006) dated 6.11.2005.

⁹³ Ibid, (n 89) Article Fifth.

⁹⁴ Ibid, Article Sixth (5).

⁹⁵ Ibid, Article Seventh.

⁹⁶ CBJ, Instructions for Managing and Marketing Portfolios and Investment Funds in Foreign Currencies on behalf of Clients, No. (34/2007) dated 5.3.2007, Article 13.

⁹⁷ Ibid, Articles 1 and 2.

fund investment portfolios, use their shares therein as collateral, or become counterparty in operations performed on behalf of their customers.⁹⁸

Banks may provide margin trading services in transferable foreign currencies and precious metals for their clients. These banks should adopt work policies and guidelines approved by their boards of directors.⁹⁹ They should also obtain from their customers a preliminary margin amounting at least to 15 percent of open positions' value. If the margin decreases to below than 10 percent during trading, the customer should feed the account, and the position should be liquidated if the margin drops to below 5 percent.¹⁰⁰ Banks under all circumstances may not grant credit facilities to finance the margin.¹⁰¹ In addition to the above, banks should supply the CBJ with daily foreign currency position statements.

9.2.3. Liquidity Risk

Section 36(b) of the Banking Law (2000) states that banks should maintain adequate liquidity to meet their business requirements, while Section 42(a/1) of the same law states that the CBJ is endowed with the authority to issue orders to set minimum limit for certain liquid assets to the total assets or specific types of liabilities or assets. The CBJ approach has been to combine the traditional method of imposing regulatory requirements on liquidity ratio in addition of the method of constructing a maturity ladder.

The CBJ instructs banks to maintain the liquid assets ratio of 100 percent of their total weighted liabilities calculated on a daily basis.¹⁰² The assets are constituted of cash; net balances with the CBJ, local banks and other financial institutions; net balances with banks abroad; securities issued or guaranteed by the Jordanian Government; securities issued by the Jordanian Mortgage Refinancing Corporation; and triple A securities issued

⁹⁸ Ibid, Articles 3 and 14.

⁹⁹ CBJ, Instructions for Margin Trading in Foreign Currencies and Major Precious Metals for the Benefit of their Clients, No. (31/2006) dated 18.10.2006, Article 1.

¹⁰⁰ Ibid, Articles 2 and 4.

¹⁰¹ Ibid, Articles 5.

¹⁰² CBJ, Liquidity Regulation No. (37/2007), dated 11.11.2007, Article First.

and guaranteed by foreign governments in their own local currencies which term to maturity is less than one year. The liabilities include, amongst others, 30% of total client deposits. It also covers 30 percent of Interbank deposits which term to maturity is more than one year. The weighted liability of Interbank deposits for less than one year are increased to 100 percent (as opposed to previous 50-75 percent ratio) in order to avoid liquidity risk emanating from banks' over reliance on short term funding from the Interbank market.¹⁰³

The Instructions for Liquidity Based on the Maturity Ladder¹⁰⁴ seeks to ensure that the inflows cover the outflows over particular time periods (1-7 days, eight days-one month, one month-three months, three months-six months, six months-one year and over one year). The net excess or deficit should be calculated for each specific period". The prudential returns should be submitted to the CBJ on a regular basis.

9.2.4. Country Risk

The CBJ has not adopted clear guidelines on country risk management with the exception of the Jordanian banks' branches in the Palestinian Territories, which are obliged to supply the CBJ with regular returns on their activities, sources of funds and exposures.¹⁰⁵ There are further two occasional references to country risk in the CBJ regulations. First, the Exposures Limit Regulation states that Jordanian bank's cross border branches abroad "should take into consideration the risks of the country where it is established before extending credit and reflect that in its credit policy."¹⁰⁶ Secondly, the CBJ requests from banks to supply investment policies on their management of assets and liabilities on foreign

¹⁰³ البنك المركزي الأردني، تقرير استقرار القطاع المالي في الأردن، (2007)، ص 24.

¹⁰⁴ CBJ, Instructions for Liquidity Based on the Maturity Ladder No. (41/2008), dated 23.6.2008, which replaced earlier CBJ, Circular No. (10/2/2/6641), dated 25.4.2000.

¹⁰⁵ CBJ, Circular on Financial Statements in the Palestinian Territories, No. (7020/9760), dated 18.4.1995 and CBJ, Circular on Financial Statements in the Palestinian Territories No. (10/7/7/9760), dated 22.4.1996.

¹⁰⁶ CBJ, Ibid (n 55), Article Fourteenth(4).

exchange which includes "studies and proposals for developing the management of the bank's foreign currencies assets".¹⁰⁷

9.2.5. Operational Risk

The CBJ issued two regulations which cover operational risk. The first one is the Basel II: Operational Risk Regulation for year 2008 which quotes the definition of operational risk from the BCBS standards,¹⁰⁸ as the risk resulting from failures in internal processes or external circumstances excluding strategic and reputational risks. Instead of regulating operational risk management, the latter CBJ regulation states that banks should adopt the BCBS 2003 document on 'Sound Practices for the Management and Supervision of Operational Risk' without providing any further rules or guidelines. This shortcoming in the CBJ legislation is alarming. In 2003, six Jordanian banks were susceptible to substantial financial losses in what became known as the 'Facilities Case'. These banks extended credit to similar fraudsters who claimed they were funding projects for the benefit of the Jordan Intelligence Department.¹⁰⁹

The other CBJ regulation covers one particular type of operational risk; namely, the Business Continuity Plan Regulation¹¹⁰ which is influenced by international standards.¹¹¹ This regulation obliges banks to adopt a business continuity plan defined as one "that ensures the resumption of the institution's operation, especially critical work, after a reasonable period of interruption of business".¹¹² It also contains principles that should be followed by banks. First, boards of directors and senior management must ensure that the business continuity plan is set up and properly implemented by the bank. They should also

¹⁰⁷ CBJ, Ibid (n 89), Article(7) of the attachment.

¹⁰⁸ BCBS, Basel II, par. 644.

¹⁰⁹ National Security Court Decision on the Facilities Case for year 2003 as reproduced in Al Dustor, (July 11, 2003), pp. 6-7.

¹¹⁰ CBJ, Business Continuity Plan Regulation No. (27/2006) dated 30.3.2006.

¹¹¹ The Joint Forum, High-level Principles for Business Continuity, (August, 2006).

¹¹² CBJ, Ibid (n 110), Article 1(a).

allocate adequate resources and train personnel for this purpose. The second principle explains the four stages of the life cycle of the plan. The first stage is the business impact analysis which estimates potential losses emanating from expected and unexpected incidents. The second stage is risk assessment, which considers potential threats and their impact, prioritises actions to deal therewith, and provides gap analysis i.e. the comparison between the business objectives of the bank and the time required to resume its activities. The following stage is plan development, whereby banks distribute the plan internally and specify methods and procedures for quick recovery. The final stage is the development of the plan as well as the continuous testing, independent reviewing and updating thereof. Thirdly, the plan should contain principles on change control, training, data management, insurance policies and coordination with local authorities such as the police and civil defence.

9.2.6. Compliance Risk

The Banking Law (2000) states that boards of directors should adopt measures to ensure the compliance of their banks with any other legislation related to their activities.¹¹³ Banking supervisory instructions focused initially on compliance issues related to countering money laundering and the financing of terrorism.¹¹⁴ They were issued pursuant to Section 93(a) of the Banking Law (2000) which obliges banks to notify the CBJ if they suspect that certain transactions or payments are crime-related. In 2007, Jordan issued its first Anti-Money Laundering Law. It sets out the National Committee on Anti-Money Laundering under the chairmanship of the CBJ Governor, which main tasks are the formulation of general policies and monitoring their implementation.¹¹⁵ It also establishes an independent Anti-Money Laundering Unit within the CBJ, which receives, analyses and processes reports on suspicious transactions.¹¹⁶ Furthermore, it imposes on Jordanian banks

¹¹³ Banking Law (2000), Section 21(g).

¹¹⁴ CBJ, Regulation on Anti-Money Laundering No. (10/2001) dated 5.8.2001 which was replaced by CBJ, Regulations on Anti-Money Laundering and Terrorism Financing No. (29/2006) dated 28.5.2008.

¹¹⁵ Anti-Money Laundering Law No. (46) for year 2007, Sections 5 and 6(a).

¹¹⁶ Ibid, Sections 7 and 8.

and their branches abroad the duty to exercise due diligence to identify their customers, avoid dealings with anonymous persons, and report suspicious transactions.¹¹⁷ The CBJ illustrates the duties of banks in its new regulation on money laundering issued in 2008,¹¹⁸ according to which banks should adopt policies, processes and procedures on anti-money laundering and countering the finance of terrorism. It also establishes the role of the Money Laundering Reporting Officer, an upper management officer, whose main tasks are to receive information on suspicious transactions, report thereon, maintain their files and issue regular reports to the bank's board of directors.¹¹⁹

The first specialised Compliance Regulation for banks was issued in 2006,¹²⁰ and is heavily based on the BCBS standards. The regulation adopts a comprehensive definition of compliance risk, which encompasses “[r]isks of legal or regulatory sanctions, financial loss or loss to reputation a bank may suffer as result of failure to comply with laws, regulation, rules, codes of conduct, and sound banking practices applicable to its banking activities”.¹²¹ Like the BCBS standards, the CBJ regulation charges the board of directors with the duties of approving the compliance policy at the bank and evaluating its implementation.¹²² The executive management sets out the compliance policy and communicates it throughout the bank, ensures that compliance measures are implemented as well as establishes a permanent compliance function independent from the internal audit procedures. It also draws a plan, on a yearly basis at least, whereby weaknesses in compliance and needed measures are identified.¹²³

¹¹⁷ Ibid, Sections 13 and 14.

¹¹⁸ CBJ, Regulations on Anti-Money Laundering No. (42/2008) dated 3.7.2008.

¹¹⁹ Ibid, Section 7.

¹²⁰ CBJ, Compliance Regulation No. (33/2006) dated 26.12.2006.

¹²¹ Ibid, Article First (2).

¹²² Ibid, Article Second (A).

¹²³ Ibid, Article Second (B/1-5).

The Compliance Regulation allows banks to establish a separate unit for compliance or, alternatively, allocate the compliance function to employees from various departments.¹²⁴ Yet, it provides for adequate safeguards to ensure its independence. The compliance function should appear on the organisational structure of the bank and have its own work guidelines. There should be an adequate number of educated and trained employees in the compliance unit or function as well. The compliance staff should also be empowered to contact other employees, have access to documents, as well as, request assistance from the banks' specialists such as lawyers and external parties provided that confidentiality is maintained. In addition, the compliance head/ function should be able to report directly to the board of directors or to the compliance committee. Furthermore, compliance employees should not be assigned any tasks that may conflict with their roles.¹²⁵ In practice, Jordanian banks had to separate the compliance function from the wider risk function. Some Jordanian banks resorted to establishing a compliance unit comprised of a money laundering reporting officer who is specialised in suspicious financial transactions, as well as, the new compliance staff.¹²⁶ Finally, banks should supply the CBJ with their compliance plan as well as details on compliance structure and staff.¹²⁷

9.3. The Public-Private Partnership

9.3.1. Internal Controls

The previous section illustrated how the Jordanian law provided for internal controls on risk management and the segregation of duties between front, middle and bank offices in investment activities; between customers and proprietary foreign exchange accounts as well as internal audit and compliance functions. The Banking Law (2000) and the CBJ Regulation on Internal Control Systems issued in 2006 covers the other aspects of internal controls in line with the BCBS 1998 document 'Framework for Internal Control

¹²⁴ Ibid, Article Fourth (4).

¹²⁵ Ibid, Article Second (B/6).

¹²⁶ The researcher is indebted to Mr. Jamal Mizher of the Compliance Unit at the Housing Bank for his useful remarks.

¹²⁷ Ibid (n 120), Article Fourth (1)(3).

Systems in Banking', which provide, amongst other, for rules on management oversight, internal audit function, and sound information systems and management.

As to management oversight, the board of directors is charged with the responsibility of choosing competent management, assessing their performance and monitoring the effectiveness of their implementation of internal controls.¹²⁸ It also approves of the budget, the bank's strategies and policies, the organisational structures and codes of conduct; determines the functions of units, delegates authorities; forms committees as well as issues internal regulations to achieve financial and administrative control.¹²⁹ Furthermore, the board reviews the reports of the supervisory authorities, external and internal auditors and internal committees and follows up the implementation of requested corrective measures.¹³⁰ Finally, it adopts measures to ensure that the CBJ is supplemented with accurate information.¹³¹

The executive management is charged with the following responsibilities:¹³² developing and reviewing strategies and policies; setting up work procedures that define, measure, and control risk; preparing financial statements and the budget and reporting to the board of directors on its implementation; proposing internal control policies to the board of directors and following up their implementation; and generally ensuring the effective implementation of the internal control system. The executive management should also ensure that the supervisors and auditors are supplied with needed information. The bank's annual report should contain a statement on internal controls as well. In addition, the executive management should enhance the integrity and professionalism of their employees as well as develop and distribute a code of conduct throughout the bank. Finally, they need to draw up a comprehensive organisational structure of the bank and detailed job descriptions. The organisational structure should ensure the dual supervision of all

¹²⁸ Banking Law (2000), Section 21(b) and CBJ, Ibid (n 51), Article Second (4)(7).

¹²⁹ Banking Law (2000), Section 21(h) and CBJ Ibid (n 51), Article Second (2)(3).

¹³⁰ Ibid (n 51), Article Second (5).

¹³¹ Banking Law (2000), Section 21(f).

¹³² CBJ, Ibid (n 51), Article Third.

activities, the segregation between conflicting responsibilities and conformity with the CBJ instructions.¹³³

The internal audit function should be assumed by the auditing committee and the internal audit unit. An auditing committee should be established in every bank by the board of directors and be comprised of a chairman and two non-executive board members.¹³⁴ It assumes seven major responsibilities: it monitors the external audit operations and coordinates the relationship between any multiple external auditors; examines the observations of the CBJ and the external auditor and adopted measures in this regard; reviews the internal audit annual plan and the observations of the external auditor thereon as well as the measures adopted consequently by the bank; reviews the financial statements of the bank with particular focus the classification of debts and the adequacy of collateral; ensures the adequacy of accounting and risk control procedures; ascertains the bank's compliance with the law and the CBJ instructions; and performs the tasks assigned thereto by the board of directors.¹³⁵

The auditing committee submits regular reports to the board of directors and works under its supervision during its tenure.¹³⁶ It meets at least once quarterly and when the need arises, upon the request of its chairman or two of its members.¹³⁷ The head of the internal audit department attends the meetings, and the committee may invite other persons to consult with them.¹³⁸ The board of directors also determines the committee members' remuneration.¹³⁹

¹³³ Ibid, Article Fourth.

¹³⁴ Banking Law (2000), Section 32(a).

¹³⁵ Ibid, Section 32(a/1-7).

¹³⁶ Ibid, Section 32(b).

¹³⁷ Ibid, Section 33(a).

¹³⁸ Ibid, Section 33(c).

¹³⁹ Ibid, Section 33(e).

Banks should establish well resourced internal audit unit/administration which covers the activities and operations of the bank.¹⁴⁰ It is responsible for setting out the Internal Audit Charter which spells out administrative powers, tasks and methodologies, as well as, the internal audit work procedures according to best international standards. It also prepares the annual audit plan which needs to cover the risk management unit and other major units of the bank and the annual report. In addition, it adopts procedures to follow up the observations in auditing and supervisory reports and customers complaints.

Banks should have financial and accounting systems.¹⁴¹ The systems should ensure the swift recording of financial transactions, organised book keeping, and necessary backup to ensure the continuity of operations. Banks should have procedures on the selection of financial and accounting systems and qualified personnel as well. Banks should also have regular auditing procedures and supervisory systems to ascertain that the transactions are duly executed and recorded.

The CBJ requires that banks' internal control systems ascertain the integrity of information management and the related technology infrastructure.¹⁴² This includes the formulation of an information management strategy, processes and procedures. They should also establish an organisational structure including a Steering Committee responsible for the proper management of their information system and proper control of information technology-related risks. They should formulate as well a Code of Conduct of Information Security and Protection and spread awareness thereof amongst their employees. Furthermore, they should enhance their information and technology related systems in light of supervisory notes, and external and internal audit reports. Banks need to establish controls to ensure the effectiveness and competency of their information technology infrastructure and application programmes prior to their operation, when developments or alterations take place and on a regular basis. Controls should also provide

¹⁴⁰ CBJ, *Ibid* (n 51), Article Fifth.

¹⁴¹ *Ibid*, Article Eighth.

¹⁴² *Ibid*, Article Ninth.

data protection, ensure the integrity of services provided to customers, as well as, continuously validate and backup information entered, extracted or treated electronically.¹⁴³

9.3.2. External Auditors

The Jordanian Law generally meets the requirements of the BCBS on the external auditor. The general assembly of the bank, like other listed companies,¹⁴⁴ elects the auditor and determines his/her remuneration or authorises the board of directors to undertake the latter task.¹⁴⁵ Banks, however, should select the external auditor from a list of approved auditors provided annually by the CBJ.¹⁴⁶ Should a bank fail to appoint an auditor for a period of four months as of the commencement of its fiscal year, the CBJ may appoint an auditor on the bank's expense.¹⁴⁷ The CBJ might also appoint an additional auditor on the expense of the bank if unsatisfied with the results of the bank's auditing.¹⁴⁸ The bank's audit committee should approve of the external auditor before signing an agreement herewith.¹⁴⁹ The bank should also sign an 'engagement letter' which states that the external auditor will provide the board of directors with reports illustrating observed weaknesses in internal controls or the accounting system; verify the information submitted thereto by the bank; and supply the CBJ with copies of all the reports submitted to the bank.¹⁵⁰

The Jordanian Law provides for a number of safeguards to ensure the integrity and professionalism of external auditors. Most significantly, auditors must be certified by the Jordanian Association of Certified Public Accountants, which can be obtained if the auditor obtains academic degrees and professional training.¹⁵¹ Auditors are also under a duty of professional confidentiality¹⁵² although they are exempt from this duty in their relationship with the CBJ.¹⁵³ Furthermore, the auditor should not work as a trader, or become a partner or a shareholder in the company he audits. He also may not participate in the foundation committee of the company, become a member of its board of directors, be a partner with one of its board of directors or undertake a permanent or consultative work therein.¹⁵⁴ In addition, he is not allowed to take loans or guarantee loans extended by the bank or one of its subsidiaries,¹⁵⁵ or speculate in the company's shares.¹⁵⁶ In order to ensure the

¹⁴³ Further details are provided in the CBJ, E-banking Practices Regulation No. (8/2001) dated 26.7.2001; CBJ, Electronic Money Transfer Regulation No. (20/2004) dated 13.9.2004; and CBJ, E-banking Risk Management Principles Circular No. (10/1/3344) dated 21.3.2005.

independence of the auditor, the law requires that banks may not change the external auditor during the financial year and should rotate the external auditor at least once every four years.¹⁵⁷ Finally, the auditors' fees must be disclosed.¹⁵⁸

The external auditors must audit the annual and biannual financial statements of the bank¹⁵⁹ according to best international standards. The external auditors¹⁶⁰ should also supply the CBJ with a copy of the annual report and a certificate on their opinion specifically on doubtful debts and the adequacy of the bank's provisions as well as any information on the financial position of the bank. Another important obligation of the auditors is to inform the CBJ immediately of any adverse developments in the financial position of the bank or any violations committed the directors or administrators of the bank

¹⁴⁴ Accountancy Profession Law No. (73) for year 2003, Section 30, Law of Companies Section 106.

¹⁴⁵ Law of Companies, Sections 171(a) and 192.

¹⁴⁶ Banking Law (2000), Section 61(a).

¹⁴⁷ Ibid, Section 61(b).

¹⁴⁸ Ibid, Section 61(c).

¹⁴⁹ Ibid (n 51), Article Seventh(2).

¹⁵⁰ Ibid (n 51), Article Seventh(1).

¹⁵¹ Accountancy Profession Law No. (73) for year 2003, Section 21.

¹⁵² Ibid, Section 27(b) and Law of Companies, Section 202.

¹⁵³ Banking Law (2000), Section 74(a).

¹⁵⁴ Council of Ministers, Practicing Professional Accountancy Bylaw No. (7) for year 2006, Article 4(b)(1)(J).

¹⁵⁵ Banking Law (2000), Section 96.

¹⁵⁶ Law of Companies, Section 203.

¹⁵⁷ Accountancy Profession Law No. (73) for year 2003, Sections 32 and 33.

¹⁵⁸ JSC, Instructions of Issuing Companies Disclosure, Accounting and Auditing Standards for year 2004 Article 4(16).

¹⁵⁹ Law of Companies, Sections 141 and 142.

¹⁶⁰ Banking Law (2000), Section 61(a).

or any of its subsidiaries. Finally, they should examine the internal auditing and internal controls of the bank in general and provide their recommendations accordingly.

9.3.3. Accountancy

The Banking Law (2000) requires banks to maintain records of their operations and organise their accounts according to "recognised accounting principles"¹⁶¹ being defined as these of the Board of International Accounting Standards.¹⁶² The CBJ requests banks to supply various financial returns, most significantly, the bank should supply the CBJ with its certified consolidated annual and semi annual financial statements supplied with the income statement, cash flow and clarifications.¹⁶³ The statements should be signed by the chair of the board of directors or the regional manager in the case of foreign banks.¹⁶⁴ The financial statements should be prepared on a solo basis for the Jordanian branches and on a consolidated basis for the banks branches and subsidiaries inside and outside Jordan. Investments in companies which are not consolidated should be deducted from capital and be counted for when measuring capital against market risk.¹⁶⁵ Finally, banks should publish their financial statements as well as disclose significant information that might influence the company's profits, securities' prices or financial position.¹⁶⁶

The CBJ instructs banks¹⁶⁷ to set out written procedures that guarantee that records are maintained safely, confirm the high quality of information presented to supervisors and provide rules on the selection of the suitable financial and accounting systems. The records should also be subject to regular auditing and be supervised internally to ascertain that the

¹⁶¹ Ibid, Section 61(a/2).

¹⁶² JSC, Instructions of Issuing Companies Disclosure, Accounting and Auditing for year 2004, Article 14.

¹⁶³ CBJ, Circular on Financial Statements No. (10/1/11141) dated 12.11.2007, Articles 1, 2 and 3.

¹⁶⁴ Ibid, Article 4.

¹⁶⁵ Ibid, Article 9.

¹⁶⁶ JSC, Ibid (n 162), Article 8.

¹⁶⁷ CBJ, Ibid (n 51), Article Eighth.

bank's transactions are compliant with legislation and internal work guidelines, executed by authorised employees and well-documented.

9.3.4. Corporate Governance

Chapter 4 examined how corporate governance rules were initially set out by the OECD then were adopted and reframed by the BCBS standards for banking supervisory purposes. This is understandable since corporate governance is mainly concerned with the availability of adequate infrastructure corporate law, which falls beyond the scope of the banking supervisory authority. Similarly, the CBJ regulations focus on banking-specific issues related to banking as will be examined below. It is sufficient here to mention that the Law of Companies and the Jordan Securities Law No. (76) for year 2002 provide for substantial rules on the protection of shareholders' rights, the equitable treatment of shareholders, the protection of stakeholders' rights including creditors, disclosure and board responsibilities. This is not to negate that there are specific shortcomings,¹⁶⁸ most significantly, shareholders do not have the right on voting on the selling of substantial assets unless it mounts to the selling of the whole company. The Law also does not provide for pre-emptive rights for shareholders in public shareholding companies. Furthermore, the law does not give minority shareholders withdrawal right i.e. the right of a shareholder to force his company to buy his/her shares when certain significant changes occur in the company. Finally, the law does not give stakeholders the right to participate in the general shareholders' meeting.

The first attempt of the CBJ to promote a culture of sound corporate governance amongst bank took place 2000, when it circulated the BCBS document 'Enhancing Corporate Governance for Banking Organisations' issued earlier in 1999. The CBJ issued in 2004 the 'Bank Director's Handbook of Corporate Governance' which elaborated on the significance of corporate governance. It also provided guidance on directors' standards,

¹⁶⁸ See generally: IMF and World Bank, Report on the Observance of Standards and Codes (ROSC)- Corporate Governance Country Assessment: Jordan. (June, 2004).

management selection and oversight, planning and policy as well as internal audit and control.¹⁶⁹

In 2007, the CBJ issued the 'Corporate Governance Code for Banks in Jordan'. The Code illustrates clearly that it "draws upon international best practice, in particular the OECD Principles of Corporate Governance and the guidance issued by the Basle Committee on Banking Supervision".¹⁷⁰ It requires banks to have their own codes of conduct provided that they contain the minimum requirements provided therein,¹⁷¹ and which are divided into the following pillars:

The first pillar is commitment to corporate governance, which is achieved by compiling a code on corporate governance and publishing an updated version thereof in the Internet. Banks should also make public annual reports on their compliance with the Code. Furthermore, banks should establish a corporate governance committee comprised of the chairman of its board of directors and two non-executive directors.

The second pillar is the functions of the board of directors, which has many aspects thereto. First, this pillar confirms the duties of the board of directors to monitor the financial soundness and operations of the bank and ensure that the interests of shareholders and stakeholders (including the CBJ) are maintained, while stressing that directors shall take into account the whole interest of the bank not that of a particular shareholder. Secondly, it stresses that the board of directors should be comprised of both executive and at least three non-executive members. It is noteworthy that the Law of Companies does not have an equivalent rule, but the Banking Law (2000) assumes that the board should have two non-executive members to serve in the audit committee.¹⁷² Thirdly, the pillar emphasises on the duty of the chairman to ascertain that corporate governance rules are followed. It calls for the segregation between the positions of the chairman and the general

¹⁶⁹ CBJ, Bank Director's Handbook of Corporate Governance for year 2004, pp. 9 and footnote 1.

¹⁷⁰ CBJ, Corporate Governance Code for Banks in Jordan for year 2007, pp. 5.

¹⁷¹ Ibid, pp. 5.

¹⁷² Section 32(a).

manager, or at least, appointing a non-executive deputy chairman. The last requirement, however, contradicts the following Section 152(c) of the Law of Companies:

"The chairman of the board of directors of a public shareholding company or any member thereof may be appointed as the company general manager or as his assistant or deputy by a decision issued by a two-thirds majority vote of the board members...".

It follows that if a bank selects executives to the positions of the chairman and deputy chairman, the CBJ should not impose sanctions on the bank. Therefore, the CBJ can only rely on its moral persuasion.

The third pillar is that the Code should provide rules on the board of directors' conduct of activities. Most importantly, they should allow directors and their committees to have direct access to executive management as well as to external resources. It should also approve the appointment of senior executives especially the ones responsible for finance and internal auditing as well as set out senior executives' succession plans. In addition, it should conduct an annual self-assessment and evaluate the general manager. Finally, the bank should maintain the integrity of its operations and issues a code of conduct for this purpose that defines and controls insider dealing and conflict of interest.

The fourth pillar relates to the board committees. The bank's code should provide for transparent rules on the nomination, objectives, functions and tenure of the bank's committees, which include the audit committee, the nomination and remuneration committee and the risk management committee. The fifth pillar covers the control environment. The handbook hereby stresses the importance of setting out and reviewing the bank's internal controls, internal audit, external audit, risk management and compliance functions. The fifth pillar covers the treatment of shareholders. Banks are called to encourage shareholders, including minority shareholders, to exercise their rights to participate in the meetings of the general assembly and vote on its decisions, including the election of the external auditor and the board of directors. It also calls the chairmen of board committees to attend general assemblies in addition to the external auditor. The proceeding of the general assemblies and related documents should also be made available to shareholders. The sixth pillar is transparency and disclosure, which covers the disclosure

of financial statements, providing shareholders with meaningful information on the activities of the bank, as well as, disclosing information to the market including 'management discussion and analysis' reports on the current and future operations of the bank.

9.4. Capital Adequacy

Rules on own capital and capital adequacy have always been central to the CBJ's efforts to maintain the stability of the banking system. The current own capital requirement is 40m. JDs for Jordanian banks and 20m. JDs. for branches of foreign banks. In addition, banks should deduct 10 percent of their net profits to the compulsory reserves account until it amounts to the subscribed capital.¹⁷³ They also may not distribute profits before they cover their incorporation expenses and write off their losses.¹⁷⁴ The CBJ also sets out rules on the capital adequacy of banks. It initially focused on the implementation of the leverage ratio (debt to equity) then started to apply the risk weighting of assets approach of the BCBS in the 1990s. The CBJ still applies the leverage ratio, currently set at 6 percent, in parallel with the BCBS standards.¹⁷⁵

9.4.1. The Implementation of the Capital Accord

The Banking Law (2000) obliges banks to comply with the regulatory capital requirements set out by the CBJ to maintain their capital adequacy.¹⁷⁶ The law also provides that banks should comply with the limits set out by the CBJ on "ratios applicable to its assets, risk weighted assets, components of capital, reserves and off-balance sheet accounts".¹⁷⁷ It therefore confirms the status *quo* authority of the CBJ to apply the BCBS

¹⁷³ Banking Law (2000), Section 62(a).

¹⁷⁴ Ibid, Section 62(b).

¹⁷⁵ CBJ, Minimum Own Capital for Banks in Jordan No. (17/2003) dated 20.8.2003, Article First (a) and Second.

¹⁷⁶ Banking Law (2000), Section 36(a) read together with the definition of regulatory capital in Section 2 of same law.

¹⁷⁷ Ibid, Section 41(a).

method of calculating capital adequacy without ruling out additional methods. The CBJ had already introduced major elements of the BCBS Capital Accord into domestic law as discussed in the previous chapter. It was later amended by virtue of the Capital Adequacy Circular of 1997¹⁷⁸ and subsequent regulations,¹⁷⁹ which applied the capital adequacy ratio of 12 percent of risk weighted assets against credit risk only. In 2002, the CBJ incorporated market risk in its capital adequacy ratio¹⁸⁰ in line with the amendment of the Basel Capital Accord. These regulations were again combined and replaced by the Regulatory Capital and Capital Adequacy Regulation No. 16/2003 dated 9.6.2003.

Under the latter regulation, the capital adequacy ratio continued to be set at 12 percent of risk weighted assets (on and off-balance sheet) against both credit and market risks. The components of capital were divided into three categories according to the Capital Accord. First, the Core Capital (Tier 1) which was constituted of paid up capital and disclosed reserves including retained earnings and share premiums. Secondly, Supplementary Capital (Tier 2), which should not exceed the Core Capital, covered undisclosed reserves, revaluation reserves, general provisions/ general loan loss reserves, hybrid debt capital instruments, and subordinated debt instruments. It is worth noting that the Regulation did not provide rules on the eligibility of hybrid debt capital instruments, while it required that subordinated debt should have a minimum original fixed term to maturity of over five and not be guaranteed by the bank's assets. Finally, subordinated debt may not exceed 50 percent of the Core Capital, while general provisions were subject to the limit of 1.25% of risk weighted assets. Thirdly, banks were allowed to issue short-term subordinated debt to meet their capital adequacy requirements against market risk (Tier 3) within the same 250% limit of the Core Capital that was not required to support credit risk. Eligible short-term subordinated debt should have an original maturity of no less than two years, be unsecured and fully paid-up, and not repayable before maturity date except with

¹⁷⁸ CBJ, Circular on Capital Adequacy No. (10/4/7/1610) dated 21.1.1997.

¹⁷⁹ CBJ, Regulatory Capital and Capital Adequacy Regulation No. (3/2000) dated 5.12.2000, and Capital Adequacy Regulation No. (11/2001) dated 11.12.2001.

¹⁸⁰ CBJ, Capital Adequacy Ratio Incorporating Market Risk Circular No. (10/14642) dated 11.9.2002.

¹⁸¹ BCBS, Amendment to the Capital Accord to Incorporate Market Risks, (January, 1996), par. 2, pp. 7.

the approval of the CBJ. The Regulation, however, did not meet the BCBS requirement that the debt should "be subject to a lock-in clause which stipulates that neither interest nor principal may be paid (even at maturity) if such payment means that the bank falls below or remains below its minimum capital requirement".¹⁸¹

The regulation resembled the Capital Accord in its other aspects. First, it deducted goodwill and holdings in unconsolidated subsidiaries engaged in banking and financial activities from the capital. It also applied the same measurement method of the Capital Accord to credit risk as it allocated all claims to five risk categories. The major difference was that a higher 70 percent ratio was assigned to loans completely secured by residential mortgage (as opposed to the minimal 50 percent ratio under the Capital Accord). Likewise, the nominal principal amounts of off-balance-sheet items were multiplied by specified conversion factors ranging from 100 percent risk conversion factors for items serving as substitutes for loans to zero percent conversion factor to commitments which could be cancelled unconditionally. In addition, the calculation of market risk adopted the standardised method of the 1996 amendment to the Capital Accord. It was based on measuring the items of market risk separately then summing them. It also distinguished between risks resulting from movements in broad risk factors and specific risks associated with individual positions. Risk categories covered interest rate position risk for debt instruments, equity position risk for equity instrument and foreign exchange risk on the bank's level. Special rules on the treatment of derivatives including options were also set out. Unlike the Capital Accord, there were no special rules on the treatment for risks arising from commodities. Finally, a minimum of about 28½ of market risks needed to be supported by Tier 1 capital.

9.4.2. The Implementation of Basel II

The CBJ exercised extensive effort for the preparation of the regulations needed for the transposition of Basel II into Jordan. The Basel II Task Force comprised of members from both the CBJ and private banks was established for the purpose of setting out an

implementation road map. The CBJ issued in 2006 its proposed two-phases plan,¹⁸² which stated that the beginning of 2008 was the starting date for the adoption of the Standardised Approach for both credit risk and market risk, and the Main Indicator Approach for operational risk. The CBJ also imposed on banks to start an experimental implementation in 2007 as well as appoint an expert member of staff to become its contact person with the CBJ. The second phase is planned to start in 2012, whereby banks should apply the foundation IRB approach to credit risk and the Standardised Approach to operational risk. The CBJ has adhered to its drawn plan and accordingly issued the following seven regulations in 2008 after prolonged consultations with banks.

9.4.2.1. Basel II: Scope of Application

This document looks first into the institutional scope of Basel II.¹⁸³ It states that it applies to all Jordanian banks on a consolidated basis. Banks are requested accordingly to prepare their capital adequacy statements on the whole group including any holding or subsidiary financial companies with the exception of insurance companies as well as on a sub-consolidated basis for branches in Jordan, branches in Jordan and abroad and subsidiary banks. Temporary holdings in financial companies (for trading purposes or as a repayment of debt) are not consolidated for capital adequacy purposes. Likewise, minority equity shares do not count unless the articles of association and the board of directors of such company both confirm that the minority shares are available for the bank or banking group.¹⁸⁴ While Basel II requires the deduction only of significant investments in financial companies and banks, the Regulation deducts all investments in all banks and investments exceeding 10 percent in non-deposit taking financial companies and provided that the eligible 10 percent have a 100 percent risk weighting. In addition, investments in non-financial companies that exceed 10 percent of the subscribed capital of the acquiring bank for individual investments or 50 percent of the acquiring bank in case of aggregate

¹⁸² CBJ, The Central Bank of Jordan Plan for the Implementation of Basel II, Circular No. (10/2/3/12315) dated 27.12.2006.

¹⁸³ CBJ, Basel II Regulation: Scope of Application for year 2008, Article First.

¹⁸⁴ Ibid, Annex on Bank/Company Board of Directors Approval.

investments shall all be deducted provided that consolidated holdings bear 100 percent risk weighting at least.

The Regulation also retains most of the above-mentioned Regulatory Capital and Capital Adequacy Regulation No. (16/2003) on the components and limits of capital adequacy rules.¹⁸⁵ The broad similarities are due to the fact that Basel II itself carries forward the rules of the Capital Accord on this regard. The major difference in the new Jordanian regulation is that it prescribes the elements of eligible hybrid capital instruments, which should be subordinated, unsecured and fully paid-up, and not redeemed at the initiative of the holder. The regulation, however, mistakenly added the lock in clause as a further requirement for hybrid instruments¹⁸⁶ although it is a requirement for Tier 3 instruments.¹⁸⁷ The lock in clause was actually repeated again as an eligibility requirement for Tier 3 instruments.

9.4.2.2. Credit Risk

1. Individual Claims

The Basel II: Credit Risk-the Standardised Approach Regulation assigns risk weights to credit risk exposures in the banking book, determined according to the type of borrower. Below is a comparison between the CBJ regulation and Basel II.

¹⁸⁵ Ibid, Article Second.

¹⁸⁶ The text of the Regulation could be a mistranslation of the requirement that "although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), *it should allow service obligations to be deferred* (as with cumulative preference shares) where the profitability of the bank would not support payment". Source: BCBS, Basel II, annex 1(a), para. d

¹⁸⁷ BCBS, Basel II, main text par. 49(xiv).

**Table 3: Comparison between Credit Risk Weights in
Basel II and the CBJ Regulations**

Borrower	Risk Weight
Claims on sovereigns	<ul style="list-style-type: none"> - The CBJ applies the same credit ratings of Basel II. - The risk weighting for exposures to the Jordanian Government and the CBJ denominated in the domestic currency is 0%. - Country risk scores might be identified by accredited export credit agencies which should correspond to the scores set out by Basel II. - Claims on the BIS, the European Central Bank and the European Community, the International Monetary Fund and the Arab Monetary Fund receive a 0% credit risk weigh, which is permissible under Basel II for the first four institutions.
PSEs	<ul style="list-style-type: none"> - The CBJ applies the proposed simplified standardised approach of Basel II.
Multilateral development banks	<ul style="list-style-type: none"> - The CBJ assigns a zero risk weighting to a list of multilateral development banks similar to the list provided by Basel II and reserves the right to add further banks to the list.
Claims on banks and securities firms	<ul style="list-style-type: none"> - The difference is that the CBJ differentiates between short claims in foreign exchange and those in the Jordan Dinar: the latter type, by exception, is subject the minimum flat rate of 20% of risk weighted assets.
Claims on corporates	<ul style="list-style-type: none"> - The CBJ applies the same weights under Basel II for lending to corporates in general. - An innovative sub-category for lending to SPEs is created under the standardised approach..
Retail portfolio	<ul style="list-style-type: none"> - The CBJ requires that exposures meet the criteria of Basel II and be subject to its maximum exposure limit of 75 percent.
Claims secured by property	<ul style="list-style-type: none"> - Claims secured by commercial property are subject to 100 percent risk weight similarly to the ratio set by Basel II. - A preferential treatment of 35 percent is granted for residential property according to Basel II. The CBJ, however, imposes additional requirements for the concession, mainly, that the property is owned by individual(s) and that the loan does not exceed 80 percent of the estimated or purchase value of the property whichever is less.
Past due loans	<ul style="list-style-type: none"> - The CBJ applies identical risk weightings to the ones provided for under Basel II.
Higher-risk categories	<ul style="list-style-type: none"> - The CBJ applies the 150% risk weighting for the four higher risk categories under Basel II. - The CBJ adds credit extended to venture capital, subordinated debt and most overdrafts.
Other assets	<ul style="list-style-type: none"> - The CBJ assigns a zero risk weighting to cash and gold bullion similar to the BCBS rules. It treats banks' deposits at foreign branches and compulsory reserves at the CBJ as cash. - Cash in collection and standards risk weights are treated similarly to Basel II. - Loans refinanced by the Jordan Mortgage Refinancing Company are assigned 20 percent risk weight.

As to off-balance sheet items, they are converted into credit exposures by multiplying them by credit conversion factors closely modeled on Basel II as illustrated below:

Table 4: Comparison between Off-balance Sheet Conversion Factors in Basel II and the CBJ Regulations

Basel II	CBJ Regulations
Commitments with a maximum original maturity of one year: (20%)	Similar treatment
Commitments with an original maturity exceeding one year: (50%)	Similar treatment
Commitments which are unconditionally cancellable by the bank without prior notification, or which effectively provide for automatic cancellation because the borrower's credit worthiness has deteriorated: (0%)	Similar treatment
Direct credit substitutes such as acceptances and general guarantees of indebtedness (including standby letters of credit which provide financial guarantees for securities and loans): (100%)	Similar treatment
Asset sales with recourse and sale and repurchase agreements, whereby the bank bears the credit risk: (100%).	Similar treatment
The lending of banks' securities or banks' posting of securities as collateral: (100%)	Similar treatment
Forward deposits, forward asset purchases, as well as, partly-paid shares and securities: (100%)	Similar treatment
Specific transaction-related contingent items (such as performance bonds, warranties and bid bonds): (50%)	Similar treatment
Revolving underwriting facilities and note issuance facilities (50%)	Not provided for.
Self-liquidating short-term trade letters of credit arising from the movement of goods such documentary credits collateralised by the underlying shipment: (20%)	Similar treatment. Short term letters of credits are ones less than 180 days.

2. Specialised Lending

Chapter 3 showed that Basel II introduced a sub-category within corporate lending to cover the higher risks of lending to SPEs. Although Basel II created this category only for countries applying the IRB approach, the CBJ opted for applying the same rules under the standardised approach. The CBJ issued in 2008 its Basel II: Specialised Lending

Regulation for this purpose. This regulation applies the same four categories and definitions for SPEs; namely, project finance, object finance, commodities finance, income-producing real estate and high-volatility commercial real estate. It assigns a 100 percent risk weighting for all categories except for the last one as it carries a 150 percent risk category.

3. Credit Rating

Sound credit rating is essential for the application of Basel II. The CBJ, therefore, issued its Basel II: External Credit Rating Assessment in 2008.¹⁸⁸ This regulation states that banks should rely on ratings issued by credit rating agencies approved by the CBJ. This covers Standard and Poor's, Moody's, Fitch and any other agency approved by the CBJ according to set criteria.¹⁸⁹ The criteria are also based on the Basel II guidelines: the credit agency should meet the standards of objectivity, independence, disclosure, resources and credibility.¹⁹⁰ It is noteworthy that Jordan issued its first Law on the licensing and regulation of credit information bureaus in 2003, yet there has been no company registered yet.¹⁹¹

4. Credit Risk Mitigation

The Basel II: Credit Risk Mitigations Regulation sets out comprehensive guidelines on the treatment of CRM according to Basel II. It states that if a bank does not meet the requirements of eligibility, the CRM shall not be counted as a mitigant or the minimum capital adequacy requirement will be otherwise increased.¹⁹²

¹⁸⁸ CBJ, Basel II: External Credit Rating Assessment for year 2008, Article First (3).

¹⁸⁹ Ibid, Article Second (1)(2).

¹⁹⁰ Ibid, Annex 1.

¹⁹¹ Credit Information Law No. (82) for year 2003.

¹⁹² CBJ, Basel II: Credit Risk Mitigation Regulation for year 2008, Article 1(6).

Table 5: Comparison between Risk Mitigation in CBJ Regulations and Basel II

Item	The Comparison
1. Collateral	
Approaches	The CBJ Regulation and Basel II adopt similar approaches: banks may use either the simple or the comprehensive approach in the banking book, while the comprehensive approach is used in the trading book. Partial collateralisation is allowed, while maturity mismatch is permitted under the comprehensive approach only.
Requirements of eligibility	All collateral under the CBJ regulations must meet the minimum list of requirements under Basel II.
Instruments eligible as collateral	The CBJ provides a list of instruments for recognition as collateral under the simple and comprehensive approaches similar to the ones provided under Basel II.
The simple approach	The definition, minimum conditions and risk weights provided by the CBJ Regulation are modeled on Basel II.
The comprehensive approach	The CBJ adopts the same definition of this approach as that of Basel II. A major difference is that Basel II allows banks to either implement the haircuts set out under Basel II or apply their own estimates, while the CBJ regulation imposes the BCBS haircuts only.
2. On-balance sheet netting	
General rule	Banks under both the CBJ Regulation and Basel II may calculate capital requirements on the basis of net credit exposures according to similar conditions.
3. Guarantees and Credit derivatives	
Method	Basel II allows the standardised approach and the internal rating based approach, while the CBJ Regulation covers the standardised approach only.
Requirements	Guarantees and credit derivatives under the CBJ Regulation must meet the requirements provided for under Basel II.

9.4.2.3. Operational Risk

The Basel II: Operational Risk Regulation is a short regulation which adopts the same definition of operational risk as that of Basel II. It also applies the basic indicator approach for measuring operational risk whereby the income of a bank for the previous three years is multiplied by 15 percent. Banks may alternatively move to applying the more advanced standardised approach with the prior approval of the CBJ. The regulation, however, does not provide any guidelines on the application of the latter standard. In addition, the regulation states that banks should adhere to the BCBS standards on Operational Risk of 2003, without further illustration.

9.4.2.4. Market Risk

The Basel II: Market Risk Regulation issued by the CBJ in 2008 introduces the Basel II standards into Jordanian law. This regulation adopts the Basel II definition of market risk as the risk of losses in positions arising from adverse movements in market prices and encompasses interest rate risk and equity position risk in the trading book as well as foreign exchange risk and commodities risk throughout the bank. The definition of the trading book also covers instruments held for trading and hedging purposes. The Jordanian regulation similarly adopts the Basel II definitions of instruments and positions but clarifies that short term positions are 90 days or less.¹⁹³ In addition, the regulation incorporates the prudent valuation guidelines of Basel II.¹⁹⁴ Finally, OTC derivatives and repo style instruments are charged against counterparty credit risk.¹⁹⁵

As to the method of measuring market risk, the CBJ applies only the standardised approach of Basel II. Accordingly, the CBJ regulation provides for separate capital charges against the following risks:

¹⁹³ CBJ, Basel II: Market Risk Regulation for year 2008, Article 1(1)(4).

¹⁹⁴ Ibid, Articles 7 and 8.

¹⁹⁵ Ibid, Article 16.

- 1- Interest rate risk, whereby eligible instruments are identified according to Basel II. Then the general risks are calculated according to the 'maturity method' (one of two methods recommended by the BCBS) then added to the specific interest rate risk. The capital charge is calculated according to Basel II as well.¹⁹⁶
- 2- Banks should hold capital against general and specific equity position risk. The capital charge is 8 percent only as the CBJ does not provide for the 4 percent concession for liquid and well-diversified portfolios.¹⁹⁷
- 3- The CBJ applies the 'shorthand approach' (as opposed to the 'internal model approach') of Basel II on all banks holding positions in foreign exchange and gold. The capital charge is the sum of net positions for foreign exchange (for single currencies and gross currencies) and the net position in gold multiplied by 8 percent.¹⁹⁸
- 4- The CBJ applies the simplified approach to commodities which calculates net positions in all commodities (except gold). Commodities are then multiplied by a 15 percent capital charge, then summed and has its gross position subject to a further 3 percent capital charge.¹⁹⁹
- 5- Finally, the CBJ regulation covers options (although it refers to them broadly under the title 'measurement of derivatives' risks).²⁰⁰ The regulation applies the simple approach of the Basel II and the same risk measurement of 16 percent divided equally between general and specific risks.

¹⁹⁶ Ibid, Articles 9-10.

¹⁹⁷ Ibid, Article 11.

¹⁹⁸ Ibid, Article 12.

¹⁹⁹ Ibid, Article 13.

²⁰⁰ Ibid, Article 14.

This chapter examined the influence of the BCBS substantive standards, while the following chapter will look into the BCBS standards on structural issues including the regulatory framework on international cooperation.

CHAPTER 10

THE STRUCTURAL FRAMEWORK OF BANKING SUPERVISION

10.0. Introduction

This is the third and last chapter of Part II of the thesis on Jordanian law. Chapter 8 looked into the evolution of banking supervision, while chapter 9 examined the effective substantive banking supervision in light of the BCBS standards. They also showed that banking supervision has been undertaken by the Banking Supervision Department of the CBJ ("BSD") despite the dismantling of many of the regulatory distinctions between financial institutions. This chapter examines the safety and soundness of the structural framework of the Jordanian banking supervisory structure; it considers whether the structure meets the institutional requirements essential for effective banking supervision *including* those set out by the BCBS Core Principles. First, the CBJ should have a robust legal framework determining its objectives, responsibilities and powers including the enforceability of its legislation and decisions as well as the assurance of immunity from liability (Section 1). Secondly, the relationship of the CBJ with other related authorities should be well defined and coordinated. This covers the Companies General Controller/Minister of Trade and Industry, the Insurance Commission, the Securities Exchange Commission, the Deposit Insurance Corporation and the Competition Directorate (Section 2). Thirdly, the supervisory authority should have the inter-related qualities of operational independence, transparency, sound governance, adequacy of resources, and accountability (Section 3). Finally, the law should support the cross-border exchange of supervisory information (Section 4). The Chapter shows how the Jordanian Law was influenced by the BCBS in terms of coordinating its cross-border supervisory efforts, but still has to develop its domestic coordination in line with the Core Principles. It also has to coordinate the relationship between the CBJ and other regulatory authorities.

10.1. The CBJ Legal Framework

As illustrated in Chapter 8, banking supervision has been undertaken by the CBJ since it assumed its functions in 1964 pursuant to Section 6(c) of the Central Bank of Jordan Law No. (4) for year 1959. The CBJ has a clear mandate for maintaining financial stability in Jordan including its functions acting as a banker to bankers, banking supervision and dealing with financial problems. Section 4(f) of the effective CBJ Law No. (23) for year 1971 ("CBJ Law 1971") states that the objectives of supervising banks are clearly stated as "to ensure the soundness of their financial positions and the protection of the rights of depositors and shareholders". The CBJ is not the only authority which influences banking supervision. Financial regulation in Jordan is designated to separate authorities whose responsibilities are divided along institutional lines. A review of the objectives and responsibilities of these authorities shows that there are gaps and overlapping that can adversely affect banking supervision.

Some of the difficulties in determining issues of gaps and discrepancies could be resolved by the Law Explanation Bureau, a *quasi* judicial body established pursuant to Section 123 of the Jordanian Constitution (1952) and comprised of two judges from the Court of Cassation and a representative member from the authority seeking an opinion on the application of certain legislation. The Law Bureau considers matters referred by the Prime Minister's office provided that they are not referred to courts. This effectively means issuing a compulsory decision to a governmental body explaining how to construe the law for the purposes of conducting its functions. The Jordanian Securities Commission ("JSC") and the CBJ, for example, sought an opinion on whether companies located in Jordan and providing financial intermediary services related to trading in securities and gold in foreign markets are subject to the supervision respectively.¹ The Law Bureau jurisdiction is nevertheless limited and retroactive.

10.1.1. Powers and Enforceability

The previous Chapter illustrated the wide supervisory powers enjoyed by the CBJ in licensing banks, approving mergers and withdrawal of licensing. It also looked into the wide range of prudential banking regulations issued by the CBJ and their

¹ Law Explanation Bureau, Decision No. (8) for year 2006. Official Gazette No. (4798), 17.12.2006, pp. 4813.

application on consolidated basis, as well as, the CBJ's powers to approve of and/or appoint banks' external auditors and obtain information, certificates and statements therefrom. The CBJ may also request information, documents, conduct investigations and inspection of both Jordanian banks and branches of foreign banks in Jordan and their subsidiaries.² The CBJ may appoint auditors to undertake its inspection responsibility but the CBJ does not outsource.

The BSD accordingly undertakes extensive on-site and off-site inspection.³ On-site inspection is conducted regularly by inspection teams each designated with the responsibility for certain banks. The back office team reviews prudential returns which are either regular returns such as financial statements, or *ad hoc* returns e.g. reports sent when a bank obtains shares exceeding 5 percent of the target company. There is also a high level of coordination between the on-site and off-site offices. The back-office receives inspectors' reports and follow up their implementation. It also reports to inspection teams on the results of its review of banks' returns.

The CBJ applies rating systems to assess quantitative and qualitative components in the banks' financial conditions. The rating system applied to Jordanian banks is the CAMEL which covers Capital, Assets, Management, Earning and Liabilities. The rating system applied to foreign banks is the less comprehensive rating system of ROCA (Risk Management, Operational controls, Compliance, Asset quality) due to the fact that the home country is the major authority responsible for assessing the financial condition of the bank. If the CBJ finds that a banking institution or its directors, managers or any bank officers are contravening the law or conducting unsound operations, it may impose on them any of the under sanctions and corrective measures: issue a written warning; instruct the violating bank to submit a satisfactory program of measures to abolish the violation; instruct the violating bank to refrain from undertaking certain activities; restrain the bank from distributing dividend; impose a fine on the bank, the maximum amount of which is JD 100,000; instruct the Bank to suspend or dismiss an administrator, other than a member of its board of directors; remove the chairman of board the directors of the bank or any member of the board; dissolve the board of directors of the bank and assume the role of management for a

² The CBJ Law (1971), Section 45(a) and the Baking Law (2000), Section 70.

³ البنك المركزي الأردني، تقرير استقرار القطاع المالي في الأردن، 2007، ص. 18-19.

maximum period of one year extendable for another year; revoke the licence of the bank;⁴ and impose compulsory merger on a bank which "sustains financial problems substantially affecting its financial position" provided that the approval of the other bank is attained.⁵

The CBJ, consequently, enjoys what is termed under Jordanian public administrative law as "discretionary power" in the enforcement of sanctions or corrective measures in terms of timing and selecting which measure to apply. This power should be applied for the purpose of achieving the afore-said objectives of banking supervision, adhere to the doctrine of proportionality and avoid illegality *ultra vires*, abuse of authority or undue process.⁶ In 2004, the CBJ decided to limit its discretionary powers by issuing the Framework for Corrective Actions Regulation No. (4) for year 2004. This regulation, which was influenced by the US Law, defines four standard cases where the CBJ should respond with a certain prompt corrective action: the bank contravenes applicable laws; the bank undertakes unsound banking activities; the classification of the bank according to the CBJ ratings manual declines; the bank's solvency ratio falls below specified thresholds.⁷ The regulation then determines which of the sanctions provided for under the Banking Law (2000) applies in each situation, with financial fines being the primary measure.⁸ The CBJ issued other regulations applying the rule-based approach to specific violations related to the acquisition of securities and shares in companies⁹ as well as concentration instructions on credit facilities denominated in foreign exchange.¹⁰

Finally, the Banking Law (2000) clearly states that the CBJ is the only authority

⁴ Banking Law (2000), Section 88.

⁵ Ibid, Section 80.

⁶ See for example: Higher Court of Justice decision No. (409/2001) dated 13.06.2002. Adalah Publications.

⁷ CBJ, Framework for Corrective Actions Regulation No. (4/2004) dated 11.1.2004, Item First.

⁸ Ibid, Third (1).

⁹ CBJ, Instructions of Money Penalties over the Banks' Investments in Securities No. (21/2005) dated 7.8.2005.

¹⁰ CBJ, Instructions of Money Penalties on the Violations of Credit Concentrations (Exposure Limits) and Credit Facilities in Foreign Currencies No. (23/2005) dated 6.11.2005.

in Jordan endowed with the responsibility of issuing a decision of liquidating. The CBJ may issue the decision in any of the four under situations:

- "1. Where the bank has committed a violation or more which may entail squandering of its assets or damage to its depositors' rights.
2. Where the bank has become unable to meet the demand on its deposits or to fulfill any of its obligations.
3. Where the total losses of the bank has exceeded 75 percent of its subscribed capital.
4. Where a decision is issued revoking its licence".¹¹

10.1.2. Immunity from Liability

The successive CBJ Laws and Banking Laws have neither granted the CBJ nor its staff immunity from tortious liability resulting from conducting any of their functions. The CBJ employees may however benefit of Section 263 of the Civil Code No. (43) for year 1976, which grants employees immunity from tort liability, first, if their actions were undertaken according to the instructions of their employers and, secondly, if the instruction are obligatory or the employee believes that they are obligatory. The Jordanian Court of Cassation has repeatedly decided that the onus of proof falls on the employee to prove that he has committed no negligence and, when applicable, that he has reasonable grounds to believe that the instructions he or she carried through were obligatory and legitimate.¹² Therefore, Section 263 provides a broad cover for employees in both the public and private sectors and does not meet the need of banking supervisors.

The CBJ is a public institution and maybe liable in tort according to the provisions of the Higher Court of Justice Law No. 12 for year 1992. This Law was the first law in Jordan to allow the State to be liable under tort. It states that the Court has jurisdiction to review final decisions issued by a public authority in its administrative or *quasi* judicial capacities as well as compensate injured parties suffering damages

¹¹ Banking Law (2000), Section 84(b).

¹² Court of Cassation (Civil Capacity) decision No. (1464/1995) dated 11.10.1995 Adalah Publications; Court of Cassation (Civil Capacity) decision No. (72/1996) dated 12.6.1996. Adalah Publications; Court of Cassation (Civil Capacity) decision No. (1183/1997) dated 28.8.1997. Adalah Publications; and Court of Cassation (Civil Capacity) decision No. (1391/1997) dated 30.8.1997. Adalah Publications.

therefrom.¹³ The claimant therefore has to establish that the CBJ has issued or refrained from issuing a public decision which renders it null on basis of one of four specific grounds: the abuse of authority, *ultra vires*, contravening the constitution or applicable legislation and lack of due process.¹⁴ The CBJ enjoys wide discretionary powers e.g. in licensing which means that establishing that the CBJ has issued a null decision becomes more difficult. In addition, the claimant has to prove that damage occurred and the causal link between the decision of the CBJ and the damages incurred.¹⁵

In practice, there have been no precedents of cases brought before the Higher Court of Justice against the CBJ to claim damages. There has been however a number of cases on the nullification of decisions issued by the CBJ as an employer or in performing its functions as the regulatory authority of money exchangers and monitoring the movement of currency before the liberalisation of foreign exchange. The Court upheld for example decisions issued by the CBJ to withdraw the licence of a money exchanger on the ground that one of them exceeded its permissible activities by accepting deposits,¹⁶ while the other failed to meet the requirement of minimum regulatory capital.¹⁷ In another case the Court annulled a decision issued by the CBJ to confiscate foreign currency on the ground that the law did not authorise the CBJ to impose this particular sanction.¹⁸

To sum up, it is possible to hold the CBJ and its staff liable for damages in performing their banking supervisory function, but this is a remote possibility.

¹³ Higher Court of Justice Law No. 12 for year 1992, Section 9.

¹⁴ *Ibid*, Section 10.

¹⁵ Civil Code No. (43) for year 1976, Section 266.

¹⁶ Higher Court of Justice decision No. (163/1986) dated 11.4.1987, Adalah Publications.

¹⁷ Higher Court of Justice decision No. (150/1987) dated 5.11.1987, Adalah Publications.

¹⁸ Higher Court of Justice decision No. (13/1989) dated 18.7.1990. Adalah Publications.

10.2. Coordination with Local Authorities

10.2.1. The Controller of Companies and the Ministry of Industry and Trade

There is an old legal tradition of regulating companies in Jordan under the successive Laws of Companies.¹⁹ According to the effective Law of Companies No. (22) for year 1997 ("Law of Companies"), the Companies General Controller based at the Ministry of Industry and Trade registers all companies and maintains their records.²⁰ As far as public shareholding companies are concerned (which is the only form a Jordanian bank may take), the Controller examines the companies' accounts and records, attends their general shareholders' meetings as well as ensures that companies adhere to their objectives.²¹ The Controller is accordingly authorised to examine companies' documents, books and register as well as obtain copies thereof.²²

The Law of Companies also confers on the Minister of Trade and Industry the more intrusive supervisory powers over public shareholding companies. First, according to Section 167 of the Law of Companies, the Minister may establish a committee to manage a company when its board of directors resigns or ceases to have a legal quorum, and the general assembly fails to elect an alternative board. In the case of banks, the same section makes it obligatory to consult with the CBJ before appointing the mentioned committee. Secondly, Section 191 of the Law of Companies states that the Minister issues forms needed for the preparation and presentation of financial statements and accounting policies in coordination with the CBJ. Thirdly, Section 275 of the Law of Companies empowers the Minister to audit public shareholding companies, but banks and insurance companies are excluded. Fourthly, in cases where the company's auditor recommends the rejection of the financial statements, the Controller may appoint a committee to settle the dispute upon the recommendation of the general assembly. This section was amended in 2002 to require the prior

¹⁹ إبراهيم أبو غربية، الشركات الأجنبية في قانون الشركات الأردني رقم (1) لسنة 1989، بحث مقدم لنقابة المحامين الأردنيين لغايات التسجيل في سجل المحامين الأساتذة، 1994، ص. 7-10.

²⁰ Law of Companies, Sections 5, 11, 80 and 92.

²¹ Ibid, Sections 273.

²² Ibid, Sections 283.

coordination with the CBJ.²³ Finally, Section 275 of the Law of Companies also entitles the Minister to assign delegates to audit a company upon the request of at least fourth of its board of directors or 15 percent of its shareholders. Should the audit reveal any violation, the Minister of Industry and Trade is empowered to establish an investigation committee. Unlike the other sections, the Law neither excludes banks nor requests the prior approval of the CBJ.

10.2.2. The Securities Exchange Commission

The first Jordanian capital market regulatory authority, the Amman Financial Market, was established in 1978.²⁴ It combined the regulatory function and bourse activities²⁵ under one organisation. This situation was rectified under the provisions of the Securities Law No. (23) for year 1997 and the effective Securities Law No. (76) for year 2002 (hereafter the "Securities Law"), which have replaced the Amman Financial Market with three institutions: the JSC, an independent public authority²⁶ which aims at developing, protecting and regulating the capital market as well as protecting investors therein;²⁷ the Amman Stock Exchange ("ASE") where the trading activities take place; and the Securities Depository Centre ("SDC") which provides registration, safe keeping and transfer of ownership of security as well as clearance and settlement of securities. The SDC and the ASE are regulated by the JSC.

The JSC is charged with the functions²⁸ of regulating the issuance and dealings in securities and ensuring accurate disclosure of information at issuance stage and on regular basis. It also undertakes the responsibility of registering and supervising "licensed persons"²⁹ being financial brokers, financial advisors, dealers, investment managers, investment trustees, underwriters, financial services companies or

²³ The Law Amending the Law of Companies No. (40) for year 2002, Section 76.

²⁴ CBJ, The Financial Structure of Jordan, (1989), pp. 26.

²⁵ Amman Financial Market Law No (31) for year 1976, Articles 3 and 4.

²⁶ Securities Law, Section 7(a).

²⁷ Ibid, Section 8(a).

²⁸ Ibid, Section 8(b).

²⁹ Ibid, Sections 15 and 47(a).

custodians,³⁰ as well as "registered persons" i.e. natural persons working as directors, managers and employees involved in securities and who work for a licensed person.³¹ Furthermore, the JSC is responsible for the regulation of mutual funds and investment companies.³² Licensed persons therefore include banks undertaking investments in securities as well as investment subsidiaries of banks. The JSC enjoys investigative powers under Law³³ and may cease or suspend the activities of the company, suspend public offerings of its securities, publicly censor violations, impose fines and revoke licences.³⁴

Consequently, the JSC might influence banking supervision for various reasons. First, Jordanian banks must take the form of public shareholding companies.³⁵ They must accordingly register with the JSC and have their shares listed³⁶ and traded in the ASE.³⁷ Banks might also issue other types of securities such as bonds, or deal either directly or through their investment arms in the ASE. Under all circumstances, the CBJ is interested in the efficiency and transparency of the ASE, and consequently in the adequacy of their regulations and the effectiveness of the JSC supervision of the ASE. Disclosure requirements are particularly important, since the successful transposition of Basel II depends on market transparency.³⁸

There are no legal provisions to coordinate the relationship between the CBJ as a banking supervisory authority and the JSC. The two authorities have not also entered into a Memorandum of Understanding to coordinate their supervisory authorities in

³⁰ Section 2 of the Securities Law provides definition of licensed persons.

³¹ *Ibid*, Sections 2 and 47(b).

³² Section 2 of the Securities Law defines the mutual fund for its purposes and exempts banks from its ambit.

³³ Securities Law, Section 15(b).

³⁴ *Ibid*, Sections 17-22.

³⁵ Law of Companies, Section 93(a).

³⁶ Securities Law, Section 5.

³⁷ Law of Companies, Section 98(c).

³⁸ ASC, Amman Stock Exchange Disclosure Directive for the year 2004, and JSC, Instructions for Disclosure, Accounting and Auditing Standards of Issuing Companies for the year 2004.

regard to banks' investment services. This issue was highlighted in the Higher Court of Justice decision No. (483/2005).³⁹ This case concerned a Jordanian bank, then Export and Finance Bank, which was authorised by both the CBJ and the JSC to own, possess and undertake dealings in financial securities. The JSC conducted independent on-site inspection of the Bank's financial securities functions and found irregularities. It accordingly imposed sanctions on the bank. The claimant brought an argument before the Court that the JSC decision was taken before granting the bank adequate time to sort out the situation with its other regulator, the CBJ. The court upheld the JSC decision on the basis that it was the authority designated with the supervision of financial investment services. It gave no guidance or recommendations on how the regulatory authorities should have coordinated their efforts, whether banks are issuing or dealing in securities or fall under the supervision of the JSC as licensed persons.

10.2.3. The Insurance Commission

The main responsibilities of regulating insurance companies and services are designated to the Insurance Commission, an independent corporate body established in 1999⁴⁰ by virtue of the Insurance Regulatory Act No. (33) for year 1999 and amendments.⁴¹ The main functions of the Insurance Commission are protecting the rights of the insured and beneficiaries, supervising the solvency of insurance companies, enhancing the performance and efficiency of insurance companies, achieving positive competition, qualifying human resources to transact insurance business as well as improving public insurance awareness.⁴² The Insurance Commission licenses and regulates insurance companies, brokers, reinsurance brokers, insurance agents, actuaries and other insurance service providers divided into general insurance and life assurance.⁴³ The Insurance Commission also has access to authorised companies and

³⁹ Higher Court of Justice decision No. (483/2005) dated 23.1.2006. Adaleh Publications.

⁴⁰ The Insurance Supervision Law No. (5) for year 1965, the first law regulating the activities of insurance companies, assigned the responsibility of regulating the insurance sector to the then Ministry of Economy which was renamed as the Ministry of Industry and Trade.

⁴¹ The Insurance Commission was first named the Insurance Regulatory Commission then its name was changed by the Law Amending the Insurance Regulatory Act No. (67) for year 2002, Section 2.

⁴² Insurance Regulatory Act No. (33) of 1999, Section 6.

⁴³ *Ibid.* Sections 3, 4, 24, 25, 45, 54 and 55.

persons' information and documents⁴⁴ as well as empowered to impose sanctions against ones contravening its instructions including the withdrawal of licences.⁴⁵

Chapter 8 illustrated how banks in Jordan were not initially allowed to provide financial services or own insurance companies. It also explained that after the issuance of the Banking Law (2000) banks have been allowed to own insurance companies for the first time provided that they are wholly owned subsidiaries as well as provide insurance agency and consultation services. As banking and insurance institutions have become interrelated, their supervisors need to exchange information. Therefore, the CBJ issued in 2000 its Regulation of Banks' Acquisition of Insurance Companies which requests banks to submit thereto copies of the on-site inspection reports of the Insurance Commission as well as the reports of their external auditors.⁴⁶

The CBJ and the Insurance Commission took an important step by concluding their first Memorandum of Understanding in 2006.⁴⁷ The Memorandum is comprised of four major elements. First, it stresses on the timely exchange of information on draft and issued decisions, instructions, regulations and law amendments, as well as, developments in licensing and supervisory requirements, licensing of jointly regulated institutions. It calls for conducting joint meetings to discuss mentioned developments if the need arise and organising joint training programmes. The second element is concerned with the inspection of banks' insurance subsidiaries by the CBJ as well as the inspection of banks providing insurance services by the Insurance Commission. The parties agree that they should send each other a prior notification of the inspection date, and that the respondent authority should supply the inspectors with information related to the purpose of the inspection. The insurance authority should also be allowed to send a representative to join the CBJ inspection team and *vice versa*. The third element concerns the consolidated supervision of the banking group which contains an insurance subsidiary. It states that the approval of the Insurance Commission of publishing the

⁴⁴ Ibid, Sections 37 and 103.

⁴⁵ Ibid, Sections 47-51 and 87-95.

⁴⁶ CBJ, Regulation of Banks' Acquisition of Insurance Companies No. (5/2000) dated 5.12.2000, Article Second(5).

⁴⁷ CBJ, Memorandum of Understanding between the Central Bank of Jordan and the Insurance Commission dated 2.3.2006.

subsidiary's financial statement, then the approval of the CBJ should be attained before publication. Finally, the fourth element focuses on maintaining the confidentiality of exchanged information, which should not be disclosed to third parties except for supervisory purposes or with the prior approval of the authority which sent the information.

One of the outcomes of the Memorandum of Understanding is the issuance of the Instructions of Licensing, Regulating and Supervising the Business of Bankassurance No. (1) for year 2008 by the Insurance Commission. Initially, all insurance agents were subject to the same regulations including banks.⁴⁸ The new regulation addresses the special need of bankassurances. It confirms that banks should obtain the prior approval of the CBJ before their authorisation by the Insurance Commission.⁴⁹ It also states that banks must establish specialised insurance units and sets out the requirements that the management and personnel of the unit should meet, as well as, numerates their functions.⁵⁰ Most importantly, Article 28 sets out the rules of conduct the bank has to follow in order to protect the rights of the consumer. It must be recalled here that consumer protection is an essential objective of insurance regulation as opposed to banking regulation which is more concerned about financial stability. Indeed consumer protection is not one of the objectives of the CBJ. Therefore the regulation fills what would otherwise be a loophole in the regulatory structure.

10.2.4. What Supervisory Role, if Any, for the DIC?

The Deposit Insurance Corporation ("DIC") was established pursuant to the Deposit Insurance Corporation Law No. (33) for year 2000 ("DIC Law"). Jordan had never had a deposit insurance or deposit guarantee institution before.⁵¹ The DIC is an independent corporate entity, which aims to "protect depositors with banks by insuring their deposits with the banks in accordance with the provisions of this law in order to

⁴⁸ Insurance Commission, Instructions of Licensing and Regulating the Business and Responsibilities of an Insurance Agent No. (1) for year 2005.

⁴⁹ *Ibid*, Article 7(b/4).

⁵⁰ *Ibid*, Articles 3-17.

⁵¹ Section 37(e) of the CBJ Law (1971) states the following: "The Central Bank, in participation with the Licensed Banks and Specialized Credit Institutions, may establish an institution for the insurance of deposits up to a maximum limit in accordance with special regulations to be enacted for this purpose".

encourage savings and strengthen confidence in the Kingdom's banking system."⁵² The DIC has strong ties with the CBJ. It was first situated in the premises of the CBJ and its founding staff were seconded from the CBJ or were former CBJ staff. It has had two Directors General both of whom were also *ex* senior CBJ executives. Furthermore, the DIC board of directors is chaired by the CBJ Governor and that one of its members is one of the CBJ Deputy Governors, in addition to the Secretary General of the Ministry of Finance, Controller of Companies, the Director General and two experienced members appointed by the Council of Ministers who may not assume any executive role in a bank during their membership of the board and two years thereafter.⁵³

The DIC assumes the two major roles of deposit insurance and bank liquidation. First, it insures deposits in member banks denominated in the JD with the exception of Interbank deposits, Government deposits and cash collaterals.⁵⁴ The coverage is 100 percent of the first JD10,000 in each bank. The CBJ is empowered to increase the maximum protected cover and cover deposits denominated in currencies other than the JD.⁵⁵ Membership of banks in the DIC is mandatory for all commercial Jordanian banks and branches of foreign banks operating inside Jordan, while Islamic banks are excluded by default unless they decide to become members,⁵⁶ but none has opted for this choice.⁵⁷ Member banks contribute a flat rate of 2.5 per thousand of insured deposits.⁵⁸ The CBJ continues to assume its role as a lender of last resort. In October 2008, and in order to avoid the pseudo effect of the global credit crisis, the CBJ announced that it would guarantee all deposits denominated in the JD in Jordanian banks until 2009 ended.⁵⁹

⁵² DIC Law, Section 5.

⁵³ *Ibid*, Section 6.

⁵⁴ *Ibid*, Section 12(b).

⁵⁵ *Ibid*, Section 32.

⁵⁶ *Ibid*, Section 3.

⁵⁷ DIC, Annual Report 2007, pp. 15.

⁵⁸ DIC Law, Section 12(a).

⁵⁹ Editor, 'Gov't to Guarantee Bank Deposits till 2009 End' *The Jordan Times*, (24.10.2008).

Secondly, while the CBJ decides if and when a bank should be liquidated, the DIC has become the sole liquidator of Jordanian banks both commercial and Islamic ones.⁶⁰ Within this pretext, the DIC is endowed with certain banking supervisory powers under its law. Section 29 states that the DIC may check banks' financial statements available at the CBJ, and the Governor may pass on to DIC board any financial statements and information. In addition, Section 30 provides that the CBJ and the DIC may form joint inspection teams upon the request of the DIC and with the approval of the CBJ. The purpose of the inspection is to review the activities, operations and recommendations to be submitted to both institutions. Furthermore, Section 31 states that the DIC must inform the CBJ of any illegal activities committed by insured banks or their executives, while Section 60 provides for its duty to send the CBJ monthly reports on the progress of banks under liquidation.

The DIC and the CBJ signed a Memorandum of Understanding, which facilitates the cooperation between both institutions, prepares the DIC to perform its role as a liquidator as well as establishes a joint Standing Committee to oversee the implementation of the Memorandum of Understanding.⁶¹ In normal circumstances, the CBJ supplies the DIC with regular financial returns and decisions to authorise a new bank, while the DIC supplies the CBJ with its risk analysis of banks.⁶² A joint inspection may also be conducted according to the CBJ's inspection work procedures and under the leadership of the CBJ team.⁶³ The two institutions should also prepare a banks' watch list (i.e. banks that are susceptible to sharp decrease in solvency or liquidity), maintain regular contact on the development of the financial situation of such banks, as well as, set out a precautionary plan to deal with any probable financial turmoil.⁶⁴ Should the CBJ decide to put a bank under its administration, it may appoint a representative from the DIC to the new administration.⁶⁵ Furthermore, if the CBJ

⁶⁰ Banking Law (2000), Sections 84 and 85 and DIC Law, Section 39(b).

⁶¹ CBJ, Memorandum of Understanding between the Central Bank of Jordan and Deposit Insurance Corporation dated 8.2.2005, Item 9.

⁶² Ibid, Item 2(b\1-4).

⁶³ Ibid, Item 2(b\5).

⁶⁴ Ibid, Item 4.

⁶⁵ Ibid, Item 5(a)

decides to revoke the licence of a bank, it should inform the DIC of its decision *ex ante*.⁶⁶ If the CBJ decides to liquidate a bank, it should involve the DIC in the preparatory work, and agree therewith on the liquidation process.⁶⁷

10.2.5. The Competition Department

The Competition Law No. (33) for year 2004 ("Competition Law"), which replaced the Competition Law No. (49) for year 2002 is the first law setting up a legal framework for regulating competition in all types of production, commerce and services in Jordan or that have effect in Jordan.⁶⁸ Its aim is that the prices of both products and services are determined according to the principles of free competition and market rules.⁶⁹ It establishes the Competition Directorate, an integral part of the Ministry of Industry and Trade as the official authority entrusted with implementing the Competition Law, including the investigation into violations of it.⁷⁰

There are three major elements in the Competition Law. First, it prohibits practices and agreements restricting free competition between business entities. This includes cartels involved in price-fixing, limiting the supply or production of goods or services, market sharing, restricting market entry, eliminating an enterprise from the market and bid rigging.⁷¹ Secondly, the prohibition of abusive behaviour by a firm dominating a market including fixing prices and other trading conditions, tie in agreements, imposing exclusivity trading terms, agreements which restrict market entry or access to sources of supply, discrimination between customers in similar transactions and refusal to deal.⁷² Thirdly, and most relevantly, it regulates mergers and acquisitions by imposing limits on economic concentration.⁷³ Section 9(b) prohibits the full or

⁶⁶ Ibid, Item 5(b)

⁶⁷ Ibid, Item 5(c)

⁶⁸ Competition Law, Section 3.

⁶⁹ Ibid, Section 4.

⁷⁰ Ibid, Section 12(a)

⁷¹ Ibid, Section 5(a).

⁷² Ibid, Section 6.

⁷³ Section 9(a) of the Competition Law defines economic concentration as "any activity resulting in the full or partial transfer of ownership of or interest in property or rights or shares or obligations of an

partial transfer of ownership, interest, rights or shares of one enterprise to another leading to a dominant position of 40 percent or more of the total market transactions, without the prior approval of the Minister of Industry and Trade.

The authorities conferred by the Competition Law on the Competition Directorate and the Minister restrict the supervisory authorities of the CBJ in two situations. Section 9(c) makes it compulsory on licensing authorities, including the CBJ to consult with the Minister before authorising a transfer of shares leading to economic concentration without providing for exceptions in emergency situations such as handling a financial crisis situation. Meanwhile, there is no clear legal text stating that the Minister shall not authorise economic concentration in the banking sector without the prior approval of the CBJ.

10.3. Independence, Autonomy, Accountability, Governance, Transparency and Resources

10.3.1. Main Safeguards of the Independence and Autonomy of the CBJ

The CBJ is an autonomous corporate body that performs its functions according to its law, and may conclude contracts, own property and bring legal action in its name.⁷⁴ It may not be liquidated except by law as well.⁷⁵ It enjoys financial independence, as it has its own budget separate from the annual Public Budget Laws. Sections 7-9 of the CBJ Law (1971) determine the CBJ's capital and reserves and state that the net profits are paid to the Government after deducting expenses. The CBJ certifies a copy of its annual balance sheet and profit and loss statement by a certified external auditor and supplies the Ministry of Finance with a copy thereof.⁷⁶ It also has its own administration directly connected with the Prime Minister which means that it does not fall under the authority of the Ministry of Finance.⁷⁷ Nowhere in the Jordanian

enterprise to another, and which may enable an enterprise or a group of enterprises to control, directly or indirectly, another enterprise or group of enterprises is considered an economic concentration operation".

⁷⁴ CBJ Law (1971), Section 3.

⁷⁵ Ibid, Section 64.

⁷⁶ Ibid, Section 61.

⁷⁷ Council of Ministers, The Organisation of Ministries and Official Institutions and Departments Bylaw No. (16) for year 1988.

Law, that the Council of Ministers or the Minister of Finance are authorised to direct the CBJ on banking supervision. Furthermore, the Law spells out rules on the appointment, dismissal, remuneration and tenure of the board members including top executives in order to ensure the independence of the CBJ. The CBJ also issues its instructions to the Banking sector independently as well. Regulations on public procurement and the CBJ employees' regulations⁷⁸ are by contrast issued by the Council of Ministers with the Royal Ascent.⁷⁹

Although the BSD is an integral part of the CBJ, the legislation provides it with a minimal degree of autonomy. The CBJ Internal Regulations, approved by the Board, outlines the BSD's mandate. The BSD also has its own Work Procedures and Guidelines, which inform staff of their functions, roles and responsibilities and lines of authorities. The BSD is also headed by an Executive Director who can only be dismissed by the CBJ Board of Directors.⁸⁰ The latter also reports directly to the Deputy Governor. However, there is not a particular Deputy Governor who is only in charge with banking supervision.

10.3.2. Accountability

The CBJ is accountable before the Parliament and the Governor appears on behalf of the CBJ in Parliamentary committees set up to examine its affairs.⁸¹ The CBJ is also subject to the review of the Audit Bureau, a public institution established pursuant to Section 119 of the Jordanian Constitution to monitor the expenditure, revenues and expenses of the State and submit reports thereon to the House of Representatives.⁸² Initially, the position was not clear whether the term "State" covers central government budget only or both central and independent budgets. The

⁷⁸ Council of Ministers, Central Bank of Jordan Employees Bylaw No. (62) for year 2001 and Council of Ministers, Central Bank of Jordan Public Procurement Bylaw No. (19) for year 1999.

⁷⁹ The Jordanian Constitution (1952), Section 120 and confirmed in the CBJ Law (1971), Section 65.

⁸⁰ Council of Ministers, Central Bank of Jordan Employees Bylaw No. (62) for year 2001, Section 9(b).

⁸¹ CBJ Law (1971), Section 14(e).

⁸² The Audit Bureau was established under the Audit Bureau Law No. (28) for year 1952.

controversy was resolved by the decision of the High Tribunal⁸³ that the CBJ is subject to the authority of the Audit Bureau.⁸⁴

10.3.3. Sound Governance

The management of the CBJ is assigned to a Board of Directors comprised of independent and *ex officio* members as a safeguard to ensure its independence and its sound governance. The CBJ Governor is the chief executive charged with the responsibilities of the implementation of the CBJ policies and the management of its affairs. He assumes all the authorities and functions of the CBJ (including banking supervision) with the exception of responsibilities reserved for the CBJ board, though he should also inform the board of the important decisions and measures he adopts.⁸⁵ The Governor is assisted with two Deputy Governors. Initially the Governor had one Deputy, but as of 1991, and in an attempt to enhance sound governance, the four-eyed principle has been adopted.⁸⁶

The law determines rules and conditions for the board's appointment, dismissal, functions, tenure, responsibilities and restricted activities. It is comprised of eight members including the Governor (who is also the Chairman, the two Deputy Governors (one of home should be nominated as the vice Chairman).⁸⁷ The Governor and Deputy Governors are appointed and reappointed by the Council of Minister and with Royal Ascent for five years, while other members are appointed by the Council of Ministers for three years.⁸⁸ The other five members are selected from banks and specialised credit institutions on basis of their financial and economic experience.⁸⁹ There can only be one

⁸³ High Tribunal decision on the Interpretation of the Constitution No. (1) for year 1995, Official Gazette, No. (4039), dated 2.5.1995, pp. 1147.

⁸⁴ The High Tribunal is established by the Jordanian Constitution and is comprised of five members from the Court of Cassations and four members of the House of Representatives including the Head of the House. See: the Jordanian Constitution for year (1952), Section 122.

⁸⁵ CBJ Law (1971), Section 13.

⁸⁶ Law Amending the CBJ Law No. (14) for year 1991 replaced by Law Amending the CBJ Law No. (16) for year 1992, Section 2.

⁸⁷ CBJ Law (1971), Section 10(a).

⁸⁸ *Ibid.* Section 10(b)(c).

⁸⁹ *Ibid.* Section 10(d).

representative from the banking sector, and should another serving board member become affiliated with a bank, either member shall forfeit his/ her position in the board.⁹⁰ This composition is therefore very different from the composition of the DIC board where members should not represent banks. The tenure of the CBJ board members is determined under law to ensure the board's independence from Governmental influence. The appointments are also published in the Official Gazette⁹¹ to ensure transparency.

Section 11 of the CBJ Law (1971) sets out the procedural framework for the CBJ board. It provides that the board shall meet once monthly, when the need arises or if two board members request a meeting. The quorum of meetings is four members provided that one of them is the Governor or a Deputy Governor. Decisions are taken by absolute majority and the Chairman of the board has the casting vote in cases where a tie-vote is reached. Most importantly, Section 11 provides that the board member who has an interest in an agreement or transaction considered by the board, that member should withdraw from the meeting. This includes the member representing banks who should not attend the meetings that consider aspects of the bank he is affiliated with.

Section 12 of the CBJ Law (1971) numerates the functions of the CBJ beginning with formulating the CBJ's general policy. Although Section 12 does not provide specifically for the board's role in monitoring the implementation of its policies, this can be inferred from the Law particularly Section 13(d) which states that the Governor is responsible before the board for the implementation of their decisions. Section 12 also authorises the board to formulate the regulations and internal bylaws needed for the administration of the CBJ as well as determine its organisational framework. Likewise, the board must approve contracts concluded with the CBJ advisors including their remuneration and the housing credit facilities extended by the CBJ to the Governor and his Deputies. Furthermore, the board approves the financial statements of the CBJ. In addition, the board determines the compensation paid to the Governor and his Deputies

⁹⁰ Law Explanation Bureau decision No. (24/1972), Official Gazette, No. (2397) dated 31.12.1972, pp. 2446.

⁹¹ CBJ Law (1971), Section 10(c).

when their services terminates, their travelling and medical allowances, gratuities and leaves while the Council of Ministers determines their salaries.⁹²

The CBJ board decides on critical banking supervisory decisions. The powers cover the approval of the licensing of Jordanian banks, their merger, the revocation of their licences, and the opening of their branches inside and outside Jordan and in the free zones. The board also approves the licensing and the revocation of licences of branches or representative offices of foreign banks in Jordan and in the free zones.⁹³ The board penalises persons who take deposits without authorisation, or release misleading information in this regard.⁹⁴ The Governor should also attain the prior approval of the board before penalising a licensed bank by dismissing a board member, dissolving the board, instructing the bank to suspend one of its administrators or imposing a financial fine.⁹⁵ If any member of a licensed bank's board of directors forfeits his position because he no longer meets the requirements of membership or because of a decision of the CBJ, he will not be able to assume a similar position in any other bank without the prior approval of the CBJ board.⁹⁶ Similarly, if a bank is liquidated or its licence is revoked, its manager and board members may not work in any other bank without the prior approval of the CBJ board.⁹⁷

The Governor and his Deputies should devote their time to the management of the CBJ⁹⁸ and are not allowed to become members of Parliament, ministers, civil servants or members of other boards of directors as a general rule.⁹⁹ If any of the Governor or his Deputies nominates himself for membership in the Parliament, holds any of the mentioned positions or if he is convicted of crime, his post at the CBJ is terminated. The Council of Ministers is also authorised to terminate these posts, if any of their holders

⁹² Ibid, Section 18.

⁹³ Ibid, Section 12(e) and Banking Law (2000), Section 88(c) read with Section 88(b/8).

⁹⁴ Banking Law (1971), Section 5.

⁹⁵ Banking Law (2000), Section 88(c) read with Section 88(b/4,5,6 and 7).

⁹⁶ Ibid, Section 24 read with Section 23.

⁹⁷ Ibid, Section 27.

⁹⁸ Ibid, Section 17.

⁹⁹ CBJ Law (2000), Section 20(a)(b).

resigns, becomes unfit for medical reasons, is declared bankrupt, engages in business, accepts permanent paid employment, commits a legal violation causing the CBJ to sustain serious damage or he is absent from board meetings for two consecutive months.¹⁰⁰

10.3.4. Transparency

The CBJ published "values" contain the '[d]issemination of information and knowledge, and the simplification of procedures and regulations in a comprehensible and professional manner'.¹⁰¹ The transparency of the CBJ as the banking supervisory authority covers in practice the under four elements.

First, the supervisor should spread awareness amongst the public on its objectives and mission. One of the issues of concern to the supervisors has been avoiding the moral hazard problem by announcing that no bank is too big to fail less banks and the public make imprudent decisions on where to deposit their money. The recent financial crisis, by contrast, was a reminder that the public also needs assurance that their Governments are ready to support the financial system to avoid a depositors' run on banks. Therefore, the general "mission statement" on the objectives in ordinary times is sufficient and this is the course followed by the CBJ.

Secondly, information on the budget of the CBJ including expenses and remuneration paid. The law provides that The CBJ must publish its monthly statements in the Official Gazette and its annual general report in various types of media.¹⁰² The amount of funding allocated particularly to the BSD for the salaries, remuneration, training and outsourcing of banking staff is not however published.

Thirdly, it is useful to publish information on the position of the financial system and regulatory arrangements to deal with any potential or existing financial risks. The CBJ provides general information in its annual reports, and in 2007 it published a Financial Stability Report which devotes a special section on supervisory measures and regulations. The latter report, however, does not contain details on regulatory plans. In

¹⁰⁰ Banking Law (2000). Sections 20(c)(d) and 21.

¹⁰¹ CBJ. About Central Bank of Jordan.

¹⁰² The CBJ Law (1971). Sections 60 and 62(a).

addition, the CBJ publishes its regulations and annual reports on the Internet. Draft regulations are sometimes made available to the general public such as the draft of the regulation implementing Basel II. Draft regulations are more often sent to banks for prior consultation as well. The CBJ by doing so benefits from the legal permission to publish non-confidential information it deems necessary for the public interest such as aggregate banking statistics.¹⁰³

Fourthly, important decisions concerning banks: The revocation of a banking licence or liquidating a bank should be published in two domestic daily newspapers and the Official Gazette.¹⁰⁴ The Law of Companies makes it also obligatory to publish the registration of a public shareholding company including banks, while the JSC regulations impose on banks many disclosure requirements whether as holders of securities or as registered companies. The CBJ is however not empowered to censure information on penalties imposed on banks, while the JSC is entitled to.

10.3.5. Resources

The previous subsection on transparency illustrated that there is no information available on the expenses of the CBJ on performing its banking supervisory function specifically. Therefore, this section considers, as far as possible, the adequacy of human resources.

The CBJ may appoint by itself the employees it requires for the conduct of its affairs including the banking supervision staff.¹⁰⁵ The appointment, remuneration and benefits are not subject to the Council of Ministers Public Servants Bylaw No. (30) for year 2007, which covers employees of ministries and other central government departments. The CBJ can therefore afford higher salaries and better benefits than the public sector in general. There is no publicly available information on the comparability of salaries and benefits paid by the CBJ, on one hand, and the private banking sector, on the other hand. Likewise, there is no information on the effect of the CBJ's salaries on retaining highly qualified staff.

¹⁰³ The Banking Law (2000), Section 60(b) and the CBJ Law (1971), Section 62(b).

¹⁰⁴ Ibid, Sections 20 and 84(d).

¹⁰⁵ CBJ Law (1971), Section 23(a).

The CBJ also provides extensive training at the Jordanian Association of Banks as well as university scholarships both inside Jordan and abroad particularly to Canada, the UK and the USA. In addition, the CBJ often benefits from the technical assistance programmes provided by international and regional organisations such as the IMF.

The Central Bank of Jordan Employees Bylaw No. (62) for year 2001 and instructions issued pursuant thereto state that the CBJ employees are under the obligations to maintain the reputation and credibility of the CBJ; comply with the law; act diligently, conduct their work with probity and propriety; maintain confidentiality of information; and preserve the CBJ's interests and assets. They should also refrain from borrowing from banks unless within specific limits and with the prior approval of the CBJ. Employees must as well inform their superiors of any misconduct or negligence that they may become aware of, as well as, any financial trouble they may fall into.¹⁰⁶ The Regulation also provides for sanctions imposed against employees contravening the law.¹⁰⁷

10.4. The Exchange of Information

There has been a long tradition in Jordan of exchanging comfort letters with cross border supervisory authorities either when a foreign bank is seeking to establish a presence in Jordan or when a Jordanian bank seeks to establish a presence abroad. In the early 1990s, the CBJ sent inspection teams abroad with the cooperation of the host supervisory authorities.¹⁰⁸ The Banking Law (2000) turned this custom to binding legal texts. Section 11(a) clearly provides that foreign banks must apply for licensing by the CBJ and prove, amongst others the following:

- "4. Supervision by the competent authorities in its home country must be based on sound banking supervision, the minimum of which must be the application of internationally recognized banking supervisory standards".

¹⁰⁶ Council of Ministers, *Ibid* (n 80), Articles 15-18.

¹⁰⁷ *Ibid*. Articles 69-74.

¹⁰⁸ Interview with HE Mr. Ahmad Abdul-Fattah, the former Deputy Governor of the CBJ, February 22nd. 1999.

As explained in Chapter 8, foreign banks are regulated, supervised and sanctioned similarly to Jordanian ones. Section 70(b) of the Banking Law (2000) also establishes the right of the home country supervisory authority to conduct on-site supervision on subsidiaries and branches established in Jordan, in addition to the CBJ inspection. The exchange of information has been facilitated by signing Memorandum of Understandings between the CBJ and each of the following banking supervisory authorities: the Central Bank of Lebanon, the Qatar Financial Centre Regulatory Authority, the Central Bank of Cyprus, the National Bank of Romania, Dubai Financial Services Authority, the Central Bank of Egypt, the Central Bank of Syria, the Central Bank of Bahrain Monetary Agency, and the Palestinian Monetary Authority. If the home country supervisor does not apply "sound standards of banking supervision", the banking Law provides that the CBJ may withdraw the bank's licence.¹⁰⁹

Information received by the CBJ, whether from banks directly, other supervisory authorities both domestic and foreign, is considered confidential and may only be disclosed for supervisory purposes or for certain specific exempt situations. The duty of confidentiality applies to both the CBJ and DIC's management and employees.¹¹⁰ The CBJ may, however, publish aggregate statistical data.¹¹¹

This Chapter concludes Part II of the thesis which examines the influence of the BCBS standards on Jordanian Law by considering prudential institutional standards as opposed to substantive standards which were overviewed in Chapters 7 and 8. This Part has also illustrated the important influence of the BCBS standards on the formation of the Jordanian law as of the 1990s. The following chapter will provide recommendations for the Jordanian banking supervisory law in light of the international standards and any relevant lessons learnt from the recent financial crisis.

¹⁰⁹ Banking Law (2000), Section 19(e).

¹¹⁰ CBJ Law (1971), Sections 19 and 23 and DIC Law, Section 38.

¹¹¹ *Ibid*, Sections 45(c).

CHAPTER 11

SUMMARY AND RECOMMENDATIONS

11.1. Summary of the Thesis

This thesis attempts to evaluate the impact of international standards of banking supervision aimed at the creation of a safe banking system on Jordanian legislation at two levels: to what extent international standards have influenced Jordanian law; and how international standards can direct new reforms.

Chapter 1 sets out the theoretical basis for the thesis. It stems from the premises that banks should be supervised. The Chapter is centred on two basic points concerning the definition of banks as well as why and how banks are supervised. Chapter one concludes that banks are still special in relation to other financial institutions. Despite the continuous narrowing down of barriers between banks and other financial institutions banks are distinguished by their structure of assets and liabilities and maturity transformation problems which make them more prone to failure. The second conclusion is the vital importance of the soundness of the banking supervisory authority structure for the safety of the banking system. Another main conclusion drawn from Chapter 1 is that international standards for banking supervision should deal with the dilemmas and complexities of domestic banking supervision in numerous jurisdictions. In other words they should take into consideration the following:

- The existence of banks of variable degrees of sophistication across the globe.
- The segregation between the authority providing preventative supervision (usually the home country) and the authority that provides protective supervision (usually the host country).
- How to ensure the soundness of the banking supervisory authority's structure for the banking supervisory authority on a domestic level.
- And consequently, how to determine the optimal preventative international banking supervisory architecture that would represent the interests of all

jurisdictions, takes into consideration all the levels of complexities, changes and interactions of banking supervisory measures, while assuring states compliance with set standards.

Part I of the thesis covers international standards throughout six chapters. It shows how the BCBS, being the major international banking standard setting forum, sets out standards that can be divided into three types: Allocation of banking supervisory responsibilities amongst cross-border authorities mainly based on the rule of home country control, and complementary rules on substantive standards such as capital adequacy and prudential issues related to the supervisory authority.

Chapter 2 looks into the evolution of international banking supervision. Chapters 3 and 4 illustrate that as international banking has developed a phenomenon of large complex banking institutions, a dichotomy of banking supervisory standards emerges under what is known as Basel II, as well as, a complementary trend in strengthening the rules of risk management, internal control, auditing and external auditing. Chapter 5 shows how the BCBS has equally exerted extensive efforts to strengthen cross-border and cross-functional cooperation. Chapter 6, by contrast, shows that the BCBS has failed to elaborate on some important aspects of the structure of banking supervisory authorities, mainly the situation where preventative and protective supervisory authorities are segregated. The latter issue is further elaborated on by looking into the recent UK experience. Finally, Chapter 7 provides an analysis of the impact of international standards set out by the BCBS on Jordan. It explains why the BCBS standards constitute soft law and why soft law, as opposed to treaties, is the best form to be adopted.

Part II of the thesis considers the impact of the BCBS standards on Jordan in three chapters. Chapter 8 describes the evolution of banking supervision in Jordan in a chronological order. It shows that the development of Jordanian banking supervision was influenced initially by the local banking market structure. The 1990s represented an era of economic openness and a concurrent increase of interest in the adoption of the BCBS standards which led, amongst other reasons, to the promulgation of a new Banking Law in 2000.

Chapter 9 focuses on the current Jordanian Banking Law (2000) and regulations issued pursuant thereto. It explains how they transposed international standards into Jordanian law to a large extent. Sections 11 and 19 of the Banking Law (2000) make explicit references to the application of such standards on foreign banks. The Chapter further examines current substantive banking supervision legislation on basis of the BCBS Core Principles and complementary documents. Compliance with the Core Principle on the structure of the banking supervisory authority is considered separately under following Chapter 10. This Chapter reveals many gaps in the supervisory structure some of which are not covered in any way by the BCBS standards.

11.2. Recommendations

The main conclusions drawn from this thesis are that soft law is the optimal form for setting international banking supervisory standards, and that Jordanian law is largely compliant with these standards. As illustrated in Chapter 7, there is no need to create an international agreement on preventive banking supervision. It follows also that there is no need to create an international organisation responsible for banking supervision. Yet there are various recommendations suggested to improve Jordanian Law, as well as, international standards on banking supervision particularly from the perspective of developing and small emerging economies.

11.2.1. Recommendations on International Standards

- The Composition of the BCBS

The influence of the BCBS is attributed to the significance of many of the jurisdictions represented in its membership combined with the willingness of many states to comply with its standards. Therefore, the researcher finds herself in agreement with Davies and Green in that China and Australia should become members.¹ A representative from the IFSB is also recommended to become a member, to the mutual benefit of Islamic and traditional banks. The membership should allow the IFSB to consistently convey its supervisory concerns as well as interpret when and how the

¹ Davies, Howard and Green, David. *Global Financial Regulation: the Essential Guide*, (2008), pp. 218.

BCBS standards should apply to Islamic banking.² In addition, there should be representatives from developing countries attending the meetings on a rotating basis.

- **Basel II**

Basel II represents a milestone in the development of international solvency standards. It adopts a more risk-sensitive approach to measuring capital adequacy, allows banks to use their own risk based models (with the approval of their supervisors), incorporates capital adequacy rules against operational risk for the first time as well as emphasises the roles of market discipline and banking supervision. Basel II, however, proved inadequate during the late financial crisis and accordingly there are calls for its amendments.³ In addition, the credit crunch crisis has raised questions about the adequacy and reliability of assessments undertaken by credit agencies in very sophisticated markets. This is a major issue since the proper application of Basel II depends on external credit rating. This is a particular concern for the remaining economies whereby the availability credit ratings are not adequately available.

The application of more advanced credit and operational risk management approaches is very expensive and almost certainly will be adopted only by large complex banking institutions. This will grant large banks a comparative advantage to medium and small-sized banks for two major reasons: Advanced approaches allow banks to reduce their minimum capital requirements and hence provide services at lower rate than other banks; IRB banks will avoid high risk transactions and concentrate on prime customers, leading high business risk to migrate to medium and small-sized banks. The fact that Arab banks, including Jordanian banks have opted for the standardised approach needs to be reconsidered on the long run. Molyneux and Iqbal send the below warning:⁴

² The IFSB has already undertaken on its own initiative to interpret the BCBS standards to Islamic banks on various issues including risk management. See for example: IFSB, Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services. (December, 2005).

³ FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, (7 April, 2008), pp. 12-15; and BCBS, Comprehensive Strategy to Address the Lessons of the Banking Crisis Announced by the Basel Committee, (20 November, 2008).

⁴ Banking and Financial Systems in the Arab World. (2005), pp. 273

"[O]ne must caution that banks in the Arab world are very much likely to rely on the standardized approach to capital calculations and this will place them at a competitive disadvantage to large Western banks. They are therefore unlikely to benefit from the IRB approach. This could be an important policy issue if large international banks compete with domestic Arab banks for large corporate and other business, as the former will have a substantial financing advantage".

Therefore, the current approach of the BCBS to allow jurisdictions to select amongst a wide set of approaches is recommended to subsist.

- **Cross Border Information Sharing**

Information sharing between home and host supervisory authorities can be a difficult task for developing countries, and therefore, the home supervisory authority's role should be intensified. The researcher has written an article on this issue which concludes and recommends the following:

"The Basel Committee exchange of information guidelines under Basel II should be of particular relevance to developing and emerging economies attracting or attempting to attract large and sophisticated banking institutions, which apply the more advanced methods for calculating their risks and approved to do so by their home supervisory authorities. The former Capital Accord methodology will no longer be a valid choice for such banks. The local banks and their respective supervisory authorities might not be yet accustomed to the mind-numbing complexities of Basel II, or at least be familiar only with the less complex foundation methods of grading risks. In addition, the host market might not be developed enough to be used as an instrument to induce banks to maintain adequate capital: information might be disclosed but the investors are not able to read them well or impose a cost on negative information. This adds to the pressure on host authorities interested in the continued presence of foreign banking institutions without exposing their local markets to risks from undercapitalized foreign banks.

An advice that could be extended to host authorities is to sign a detailed bilateral arrangement (MOU) with the home supervisory authority that emphasizes the duty of the home authority, and quite frankly shifts as many supervisory duties and responsibilities to the home authority. The host authority should request information before licensing, on an ongoing basis and when the need arises. It should explain why it needs the information to make sure that the host authority will supply the relevant information. It should particularly request supervisory judgmental information (inspection reports and assessments), whenever this is possible under confidentiality laws.

This simple precautionary advice, I believe, remains valid until the developing and emerging countries build adequate expertise in handling the complexities of evaluating the integrity and accuracy of banks' internal credit rating systems."⁵

- **The Structure of the Supervisory Authority and Supervisory Techniques**

Chapter 1 illustrates the paramount importance of the structure of the banking supervisory authority. It is the vehicle through which supervisory goals are delivered and supervisory policies and rules are enforced. Despite that, the BCBS provides for broad rules on the structure of the banking supervisory authority embodied mainly in Core Principle 1. This Principle should be expanded to cover at least the following two issues:

First, the credit crunch crisis which began in 2007 highlights the significance of the interaction between the banking and money markets. It particularly illustrates the important role of central banks' intervention to provide liquidity for the money market and ensure its liquidity, both on global and local levels. Doubts are therefore cast on the unification model of banking regulation, whereby the central bank's role to ensure financial stability is segregated from the banking supervisory function. The financial problems faced by the Northern Rock Bank in the UK, as the Bank of England is partially blamed for late intervention of the Bank of England and the weak coordination with the Treasury and the FSA. Had the Northern Rock situation occurred in a small developing country, it could have had more serious repercussions.

Therefore, the BCBS should recommend against the segregation of the banking supervision function away from central banks, unless strict precautionary measures are first adopted. It is particularly recommended to retain expert staff on banking supervision, establish cross-board membership between the original and the new supervisory authority, and gradualism in introducing changes. Furthermore, Core Principle 1 should embody the Financial Services Forum ("FSF") recommendation that coordination between the supervisory authority and the central bank should be

⁵ Nadia Al-Anani, 'Information Sharing between Home and Host Supervisors under Basel II', 2007 Arab Banking Review. (2nd Quarter). pp. 127-128.

enhanced, particularly in relation to liquidity contingency plans.⁶ In addition, the assessment reports prepared by the IMF and the World Bank or any self-assessment undertaken by banking supervisory authorities should be redrafted to prioritise the structure of the supervisory authority.

Secondly, the relationship between the banking supervisory authority and the competition authority should be clarified under law or at least under a Memorandum of Understanding. It must elucidate that the banking supervisory authority is the ultimate authority responsible for the approval of licensing, merger and acquisition of banks, as well as emphasise on the exchange of information on this regard.

As to the supervisory techniques, the BCBS should warn banking supervisory authorities, particularly ones from developing countries, of the dangers of transforming towards the risk based approach. Developing countries tend to have less complex and less competitive markets. Therefore, reliance on the rule based approach, as well as on site and off-site supervision is more likely to be reasonable and acceptable whether the supervisory authority or the banking sector will ultimately incur the cost of supervision.

11.2.2. Recommendations on Jordanian Law

- Prudential Requirements

The evaluation of Jordanian Law shows that it is largely compliant with international standards on banking supervision. Below is a list of recommendations on improving compliance therewith or to support certain CBJ methods.

- **Licensing:** The CBJ guidelines on licensing should clarify Section 19 of the Banking Law (2000) on the revocation of licensing. It should explain that the CBJ may revoke the banking licence where material changes in the founding documents of the head bank that can adversely affect the bank, including changing the locus of the head bank, take place.

⁶ FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. (7 April, 2008), pp. 42. Available online: http://www.fsforum.org/publications/r_0804.pdf. Accessed on 25.1.2009.

- **Capital Adequacy:** The gradual implementation of Basel II by the CBJ should be commended. By doing so, Jordanian banks can gradually strengthen their risk management capabilities and expertise to become more competitive. The CBJ should monitor the implementation of Basel II very carefully considering the challenges that face banks because of the lack of local credit rating agencies and the unavailability of historical data on many customers. The CBJ should also enhance its capacity before moving towards stage 2 where banks will be allowed to apply more advanced methods to the measurement of their risks. The CBJ employees already benefit from training programmes provided in Jordan and abroad including the Financial Stability Institute based at the BIS. The CBJ should also consider outsourcing from leading auditing firms.
- The CBJ added prudential requirements to ensure the safety of banks. First, the Basel II: Scope of Application Regulation deducts all investments in banks from the capital base not only significant one. Secondly, the Basel II: Credit Risk- the Standardised Approach Regulation combines rules on specialised lending to SPVs equivalent to the specialised lending rules under the more advanced Foundation Internal Rating methodology under Basel II. The regulation adds eligibility requirements for benefiting from the concessionary treatment for loans for residential property.
- Chapter 9 highlights the weaknesses in the drafting of the Basel II regulations. It is recommended that the CBJ attains the approval of its Legal Consultations Office or an expert external lawyer before issuing a regulation, even if it very technical and unlikely to expose the CBJ to legal risk.
- The CBJ combination of the leverage ratio and the Basel II risk-weighted method also commended for increasing the safety of banks.⁷
- **Market risk:** The CBJ Regulation on Managing Bank's Assets / Liabilities in Foreign Currencies applies does not apply to branches outside Jordan. The regulation should cover banks inside Jordan and abroad.

⁷ Philipp M. Hildebrand, Is Basel II Enough? The Benefits of a Leverage Ratio. Financial Markets Group Lecture. LSE, (15 December, 2008), pp.10.

- **Liquidity Risk:** The 2007 amendment of liquidity regulation should also be praised for increasing the risk weighting for short term Interbank loans. This should protect banks from over reliance on Interbank loans, which represent fluctuating short term sources of income.
- **Operational Risk:** There are no detailed guidelines on operational risk. The CBJ Basel II: Operational Risk Regulation state broadly that banks should adhere to the BCBS standards on operational risk management. This is less than adequate. International banking supervision standards have to find their way into local legislation through scrupulously drafted regulations and manuals, which should be detailed and comprehensible to both supervisors and banks. One exception is the Business Continuity Plan Regulation which provides details on one specific aspect of operational risk.
- **Country Risk:** There are no specific rules on country risk. The CBJ must be satisfied that banks have a comprehensive risk management process to identify, measure, monitor, and control country risk, as well as board and senior management oversight.
- **Corporate Governance:** The Corporate Governance Code for Banks on Jordan contains a minimal list of principles. An analysis of these principles shows that they are divided into three types: (1) Principles that confirm the general rules set out in enforced legislation such as the formation of an audit committee. (2) Principles that are not provided for under law but falls within the CBJ's broad supervisory powers, such as the requirement of implementing a code of corporate governance and the set up of an "appointment and remuneration committee." (3) The principle on the segregation between the chairman of the board and the general manager post which contravenes Section 152(c) of the Law of Companies. The moral authority of the CBJ, however, might lead banks' to comply with the third set of principles. It is, however, preferable to amend the Law of Companies or the Banking Law (2000) to assure enforcement. It is noteworthy that there is a proposal for amending the Law of Companies and that the SEC is working on a universal code of corporate governance for all listed companies. Therefore, it is recommended that the CBJ, the SEC and the

Controllers of Companies should coordinate their efforts to universally amend the law and avoid inconsistencies.

- **External and internal auditors:** The CBJ regulations should provide for conducting joint meetings between the CBJ, external auditors and internal auditors. They should also empower the chairman of the internal audit committee or the head of the audit unit to have direct access to the CBJ.
- **Cross Border Information Sharing**

The Banking Law (2000) and the CBJ regulation on external branching as well as the Memoranda of Understanding signed with foreign banking supervisory authorities provide adequate coverage for the exchange of information and coordination concerning banking activities. There is however no coordination between the CBJ and other financial supervisory authorities. This is perhaps due to the restrictions imposed on investments in securities and foreign exchange and the relatively limited presence of Jordanian banks abroad. If this is the case, then the CBJ should at least explain in its following financial stability report why it has not entered into coordination arrangements with supervisory authorities in which jurisdictions Jordanian banks have established subsidiaries or branches.

- **Structure of the Jordanian Supervisory Authority**

It is recommended that the CBJ continues to assume its role as the authority responsible for the supervision of the banking sector for two major reasons: First, the CBJ is an independent, well-funded and highly regarded institution. This status is attributed to the CBJ role as the country's monetary authority responsible for maintaining the value and convertibility of the local currency as well as ensuring financial stability. A new banking or financial supervisory authority without any monetary role might not be as well funded, independent and autonomous. Secondly, weak coordination between these two authorities, if separated, can lead to serious consequences on handling financial crises. Thirdly, supervising non-banking institutions involves issues that fall outside the customary sphere of the CBJ jurisdiction, and Central banks in general, as it covers issues of customer protection⁸ and competition regulation. Fourthly, banks are the

⁸ C. Goodhart, The Organisational Structure of Banking Supervision, FSI, Occasional Paper No. (1), (November, 2000), pp. 10-11.

key financial institutions in Jordan and, despite the recent increase in deregulation and innovation in the Jordanian banking sector, the local financial market is still largely divided on an institutional basis. Therefore, the major benefits attributed to a single supervisory authority; mainly, attaining economies of scope and scale, as well as, avoiding duplication, gaps and contradiction in supervision are less relevant to Jordan. In short, maintaining financial stability, which interrelates to monetary stability, outweighs the benefits of a single supervisory authority.

The CBJ has clear responsibilities and objectives towards banking supervision which were further enhanced by the gradual abolishment of the multi-tier system. The banking supervisory structure in Jordan should be improved by following the under recommendations which are influenced by the UK Banking Act 1987.

- The administrative structure of the BSD should be upgraded to a semi-independent status. This can be done by conferring a high position on the Director of the BSD and giving him or her direct access to the CBJ Board of Directors as well as a direct and regular reporting line to the Parliament.⁹ Another measure is the imposition of a “Chinese Wall” between the BSD and the rest of the CBJ.¹⁰ There should be a Deputy Governor for monetary functions, and another for banking supervisory functions. This structure ensures co-ordination between supervisory and monetary policies, as well as, a reasonably high degree of transparency and accountability.
- The CBJ board of directors combines *ex officio* members including one representative from banks. By contrast, Section 6(e) of the DIC Law provides that board members should not be executives of any bank. It is recommended to follow the example of the DIC to ensure maximum independence. It is recommended in the same time that the CBJ establishes a supervisory board of senior CBJ members and prominent banking officials so that it would benefit from their expertise while safeguarding its independence.

⁹ J. Tuya and L. Zamalloa, Issues on Placing Banking Supervision in the Central Bank. In Balino & Cottarelli (eds), Frameworks for Monetary Stability: Policy Issues and Country Experiences. IMF, (1994), pp. 683.

¹⁰ Tuya and L. Zamalloa, loc.cit.

- The CBJ has become a more transparent institution. The issuance of the new CBJ Financial Stability Report and the increase in consultations with banks on draft regulations are welcome developments. The CBJ can still improve its transparency by issuing a separate budget and plan for the supervisory function on its own, similarly to the practice of the FSA.¹¹ The scope of consultation on draft regulations should also be expanded to benefit from the experience of the wider public including practitioners in non-banking institutions, consumers and most importantly academic researchers. Banking regulation is a neglected subject in law and finance departments at Jordanian academic institutions. Increasing research and debate on controversial banking supervisory issues is to their mutual benefit.
- Coordination between the CBJ and other local supervisory institutions or institutions with tasks related to banking supervision is needed. Below is a review of the relationship of the CBJ with each institution.
 - There is a degree of overlap between the role of the CBJ and the JSC, but there is no formal coordination between the two authorities. It is therefore recommended that the CBJ and the SDC conclude a memorandum of understanding to determine the extent and regularity of exchange of information between them in common and crisis situations, set out rules for joint inspection teams as well as mutual consultation on draft legislation. This will reduce compliance costs on the industry as well as ensure more effective regulation. The CBJ should also require banks' investment subsidiaries to submit copies of the on-site inspection reports and the external auditor's reports.
 - The Memorandum of Understanding between the CBJ and the DIC indicates a leading role for the CBJ though it does not refer to the CBJ explicitly as such. Most notably, the CBJ is entitled to revoke the licence of a bank without informing the DIC. This is understandable for the time being. In practice, the DIC is still a new institution and it is beyond its financial capacity to bail out a major bank. In the longer run, the

¹¹ FSA. Business Plan 2009/10, 2009.

Memorandum should be reviewed to enhance the supervisory role of the DIC in coordination with the CBJ.

- The CBJ needs to enter into a Memorandum of Understanding with the Competition Department. This Memorandum should clarify that the CBJ is the final authority responsible for the licensing, merger and acquisition of banks.

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ANNEX

CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION, 2006

Principle 1 – Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2 – Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.

Principle 3 – Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 – Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5 – Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6 – Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7 – Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8 – Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9 – Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10 – Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations

within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11 – Exposures to related parties: In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12 – Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13 – Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14 – Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15 – Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the

Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17 – Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18 – Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19 – Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20 – Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 21 – Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22 – Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23 – Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

Principle 24 – Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25 – Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.