



Addis Ababa University
College of Business and Economics
Department of management

**Assessment of
Corporate Governance Practice in Private Banks of Ethiopia**

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September, 2015
Addis Ababa

Assessment of Corporate Governance Practice in Private Banks of Ethiopia

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A thesis submitted to the school of Graduate Studies of Addis Ababa University in Partial
Fulfillment of the requirement for the degree of Executive Masters of Business Administration

September 2015

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Statement of Declaration

I, Paulos Engdawork, have carried out independently a research work on the topic entitled “Assessment of Corporate Governance Practice in Private Banks in Ethiopia” in partial fulfillment of the requirement for the Executive Masters of Business Administration with the guidance and support of the research advisor. This study is my own work that has not been submitted for any degree or diploma program in this or any other institutions.

Paulos Engdawork
September 2015

Statement of Certification

This is to certify that Paulos Engdawork has carried out his research work on the topic entitled “Assessment of Corporate Governance Practice in Private Banks in Ethiopia” under my supervision. This work is original in nature and it is sufficient for submission for the partial fulfillment for the award of Executive Masters of Business Administration.

Advisor: Dr. Wubshet Bekalu

Signature _____

Date _____

Acknowledgements

First of all I am truly indebted to thank the almighty God for helping me in the successful accomplishment of this paper.

I would like to express my deepest gratitude to my advisor, Dr. Wubshet Bekalu., for all his assistance and willingness to share his knowledge and experiences and provide unreserved help and useful information in the course of this research paper

Secondly I would like to thank all who have been involved in this research work directly or indirectly for their kindness and support.

Paulos Engdawork
September 2015

Abbreviation and Acronyms

BOD - Board of Directors

CEO - Chief Executive officer

CFO - Chief Financial officer

FRC - Financial Reporting Council

FRS - Financial Service Authority

IFRS - International Financial Reporting standards

NBE - National Bank of Ethiopia

NED - Non Executive Directors

OECD - Organization for Economic Cooperation and Development

Table of Contents

Acknowledgements.....	i
Abbreviation and Acronyms	ii
<i>Abstract</i>	1
CHAPTER ONE	1
1 INTRODUCTION	1
1.1 Statement of the problem	3
1.2 Conceptual framework	5
1.3 Research question	6
1.4 Research objectives	6
1.5 Scope and limitation of the study	7
1.5.1 Scope (Delimitation)	7
1.5.2 Limitations	7
1.6 Significance of the study	8
LITERATURE REVIEW	9
2. Corporate Governance	9
2.1 Historical Development	9
2.2 Definition	10
2.2 Corporate Board and Governance Practices	11
2.2.1 Board Composition and its Function	11
2.2.2 Board Composition and Performance	11
2.2.3 CEO Duality	12
2.2.4 The Practice of Sitting on Multiple Boards (Interlocking)	13
2.2.5 Board Meeting Frequency	13
2.2.6 Board Effectiveness	14
2.2.7 Board qualifications, capabilities and skill	14
2.3 Board Committees and Compensation.....	15
2.3.1 The Role and Duties of Board Committees	15
2.3.1.1 Nomination/Appointment Committee	15
2.3.1.2 Audit Committees	16
2.3.1.3. The Risk Management Committee	17
2.3.1.4 Remuneration committee	18

2.3.2 Director and Executive Compensation	18
2.3.2.1 Directors' compensation	18
2.3.2.2 Executive Compensation	19
2.4. Shareholders' Roles, Right and Key Ownership Structure	20
2.4.1 Shareholders' Role	20
2.4.2 Shareholders' Right	20
2.4.3 Ownership Concentration	21
2.4.4 The Growing Influence of Institutional Owners	22
2.5. Management Accountability and Agency Relationship	22
2.5.1 Separation of Ownership and Control	22
2.5.2 Management Accountability	24
2.6. The Role of Supervisory and Other Stakeholders	24
2.6.1 The role of supervisor/Regulators	24
2.6.2 The Role of Stakeholders in Corporate Governance	25
2.7 Disclosure and Transparency	25
2.7.1 Disclosure of Financial and Operating Results	26
2.7.2 Non-Financial Disclosures	26
2.8 Risk Management and Internal Control	27
2.9 International Governance Codes and Principles	27
2.9.1. Development of International Codes of Governance	27
2.9.1.1 The Cadbury Report 1992	27
2.9.1.2 Greenbury Report 1995	28
2.9.1.3 Hampel Report 1998	28
2.9.1.4 Turnbull Report 1999	28
2.9.1.5 Higgs Report 2003	29
2.9.1.6 Smith Report 2003	29
2.9.1.7 The Combined Code 2003	29
2.9.1.8. Sarbanes-Oxley Act	29
2.10. Corporate Governance Principles	30
2.10.1 Basel Committee on Banking Supervision- Principles	30
2.10.2 OECD Principles of Corporate Governance	32
2.11. Applicable Laws and Directives on Corporate Governance in Ethiopia	35

2.11.1 Commercial Code of Ethiopia 1960	35
2.11.2. Overview of Banking Business Proclamations	37
2.11.2.1 Overview of the Banking Business Proclamation No.592/2008	38
2.11.2.2 Overview of Banks Corporate Governance Directive No SBB/62/2015	39
RESEARCH METHODOLOGY	41
3.1 Choice of subject	41
3.2 Research design	41
3.3 Research approach	42
3.4 Type and source of data	42
3.5 Data collection	42
3.6 Sampling Techniques	43
3.7 Sample Description	43
3.8 Sampling	45
3.9 Data Analysis Method	45
CHAPTER FOUR	47
DATA PRESENTATION, ANALYSIS AND DISCUSSION	47
4.1 Introduction	47
4.2 BOARD OF DIRECTORS	48
4.2.1 Board Size	48
4.2.2 Board Composition	49
4.2.3 Board Qualification	49
4.2.4 Orientation and Training to Board members	52
4.2.5. Board Meeting	53
4.2.6. Setting and Enforcing Lines of Responsibility	54
4.2.7. Board Vs Senior Management Interaction	55
4.2.8. Setting strategies and overseeing the implementation	55
4.2.9 Board Independence	55
4.2.10 Sitting in Multiple Boards	56
4.2.11 Board Committees	56
4.2.12 Board's Performance Evaluation Mechanisms	57
4.2.13 Board Remuneration	58
4.2.14 Compensation Strategy	58

4.2.15 Related party Transaction and Response to Findings	59
4.3 SHAREHOLDERS	59
4.3.1 Equitable Treatment of all shareholders	59
4.3.2 Influential Shareholders	60
4.3.3 The Impact of Influential Shareholders	61
4.3.4 Auditors’ Independence vs. Promoting Shareholders Interest	61
4.3.5 Rights and Obligations of Shareholders	62
4.4 RISK MANAGEMENT AND INTERNAL CONTROL	63
4.4.1 Internal Control and Compliance	63
4.4.2 Risk Management Practice	64
4.4.3 Established Risk Mitigating Mechanisms	65
4.4.4 Audit Committee Experience and Exposure	65
4.5 EXECUTIVE MANAGEMENT	66
4.5.1 CEO (Insider) Ownership in the Bank	66
4.5.2 CEO Compensation	66
4.6 DISCLOSURE AND TRANSPARENCY	66
4.6.1 Disclosure by Bank	66
4.7 SUPERVISORY/REGULATORY ORGAN	67
4.7.1 Legal Framework in Protecting Internal Abusive Practices	67
4.7.2 Control Environment Vs Bank’s Strategic Plan	68
4.7.3 Clause in the Proclamation and Directives that needs Improvements	68
4.7.4 Suggestions to Improve Governance Practices	68
4.8 GENERAL COMMENTS AND COMPLEMENTS	69
CHAPTER FIVE	71
CONCLUSION AND RECOMMENDATIONS	71
5.1 Conclusion	71
5.2 Recommendations	76
Bibliography	78
Appendices A-Questioner	82

Abstract

It is the separation of ownership and control that resulted the concept of corporate governance. Since governance is the center point for corporate success it needs the attention of all stakeholders. Unless given a focus it deserves in managing a business, it may result undesirable long term consequences. In the current business set up, banks are among the industry that are implementing the concept of corporate governance in the context of Ethiopia. Due to the sensitivity nature of the business and an irreplaceable role banks play in the macro economy of a given country, poor corporate governance practice in banks may have a macroeconomic impact that could potentially affect the whole economy. As a result, this research paper was prepared with the objective of measuring and understanding the level of corporate governance practice in private banks in Ethiopia in light of OECD principles and Basel committee on banking supervision, so as to improve the understating of various stakeholders and also to shed light on the adoption of best practices and principles into the country corporate governance system. Major components like board of directors, shareholders, Executive directors, supervisory organ, disclosure, risk management and internal control were taken as major determinant variables. A questionnaire prepared addressing those variables were distributed and related documents were also reviewed. The data collected were analyzed using descriptive statistics and the results were discussed based on the outcome and conclusion and recommendations were forwarded. From the output of the research, it was learnt that, private banks in Ethiopia are in good corporate governance foundation because of the regulatory organ strict supervision on each and every action of the banks in the market. However, some important and critical manifestation of good corporate governance are lacking both from regulatory side and from the banks side that would promote the practice some steps higher. It is the rule of the land that dictates the level of good corporate governance than the willingness and awareness of the banks to inculcate this business need into their management system.

CHAPTER ONE

1 INTRODUCTION

Business organizations can legally operate in any form which depends on the size and ownership right. For small and sole ownership businesses, owners manages and decide on day to day activity of their business. Thus, owners don't transfer decision making responsibility to managers. However, share companies are managed by professional managers who don't necessarily have shareholding right. This leads shareholder to pass decision making right to third party which might create conflict of interest. The separation of ownership from management reduces a loss of effective control by shareholders over managerial decisions and actions. This separation of ownership and control leads to an agency problem whereby management operates the firm aligning with their own interests, not those of shareholders (Meckling, 1976). Thus, this creates an opportunities for professional managers to decide on the resource of the firm to the benefit of their own interest.

Thus appropriate form of structure and management that deter the influence of agents on owners while taking decisions on their behalf is instituting a corporate governance practice within the organization that is prone to agency cost and leads to uncompromised decision making process to increase the interest of owners. This will improve mutual benefit of both parties and ensure sustainability of the business, specifically for the owners and generally for the whole economy.

Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of social, regulatory and market environment. Governance mechanisms include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices are affected by attempts to align the interests of stakeholders. Thus, corporate governance is about putting in place the structure, processes and mechanisms which ensure that the firm is being directed and managed in a way that enhances long term shareholders' value and firm performance through accountability of managers. In other words, through such structure, processes and mechanisms, the well-known agency problem may be addressed such that the interest of managers can be aligned with those of the shareholders.

There are different business organization having a corporate form of structure and susceptible to risk of agency costs. In the context of Ethiopia, banks have a corporate formation that requires strong good corporate governance culture given the responsibility and the role they are playing in the national economy of the country. If banks fail, it has the magnitude to affect the overall macro economy of the country and can destabilize the financial sector. Hence, sound governance mechanism in the management of banks has tremendous contribution in mobilization and allocation of funds and keeping the industry and the country from instable financial sector.

In all countries banks are the most important financial intermediaries through which financial transactions can be undertaken. The role of banks in any country is irreplaceable, in the developed world it becomes impossible for one to live without having a formal interaction with banks, and the importance of banks to developing countries is also increasing over time. Given this level of importance, it puts more responsibility on regulatory body to support the sector in both regulation and supervision to have an effective corporate governance practices which are essential for proper functioning of the sector and the whole economy. In the current global context, Ethiopian banking industry must also promote a culture of good corporate governance practice for the benefit of all stakeholders.

The global culture of corporate governance is changing over time in a more reactive way as a response to significant corporate scandals and failures. But that doesn't mean that, the failures had a local impact and nature, rather it has brought lessons to the world to have a robust corporate governance system. Besides, the practice of good corporate governance is also considered as a source of competitive advantage. As a vibrant banking sector induces healthy and faster economic growth and stability, there needs to implement sound corporate governance that enables them expand their outreach, improve transparency and disclosure, suitability, accountability, efficiency and effectiveness, become responsive to customer needs and changing environments. Owing to this fact, Ethiopian banking should embrace the concept and best practice of good corporate governance as it is crucial to enhance shareholders value and promote economic growth to the country at large.

Banking in Ethiopia started since 1905, and private ownership was also possible (Belay, 1987), however, during derg regime private banks were nationalized (1974-1991). The private ownership of commercial banks in Ethiopia had resurfaced following the issuance of Monetary and Banking

proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 which laid down the legal basis for the participation of private sector in banking business that had been completely prohibited during the Derge regime. Shortly, the first privately owned commercial bank was established in 1994. Afterwards, additional privately owned banks have been established which currently totaled to 16.

This paper addressed the current corporate governance practice of private banks in Ethiopia in comparison with international best practices of OECD principles, Basel committee guidelines on banking supervision and local commercial laws and National bank of Ethiopia directives.

1.1 Statement of the problem

A business concept which still becomes a challenge to the business world is instituting sound and proper corporate governance system in the organizations. This might scale up to significant and irreversible loss which may lead businesses to closure if not managed and addressed in a timely manner and have a system in place to mitigate the risk. The failure of giant international organization like Enron had provided concrete and costly lesson to the business world and the need to have a well-studied and robust governance system in publicly traded organizations. In connection with this, tight corporate governance requirements were imposed on publicly traded firms by regulators and other organizations in different periods. This is a reactive way of addressing the issue of corporate governance across the world, this can be evidenced by most of the guiding principles which have been enacted based on the incidents observed in the business world.

Studies conducted in the area of corporate governance in the context of Ethiopia have a wide professional range basically focused on the adequacy of legal framework rather than evaluating the practice of corporate governance principles and best practices. Most of the papers in which the investigator came across while reviewing literatures deals with adequacy of legislative provisions on governance issues related to the separation of ownership and management responsibilities, on the composition, independence and remuneration of board of directors in share companies (Tura, 2012), and also on the overall corporate governance standard adequacy by identifying different factors such as limited legislative framework, inadequate shareholders protection law and ineffective judicial system, absence of an organized share market and discrimination on implementations of regulatory framework on banks, (Ayele, 2013), etc.

Due to its legal formation, banks are prone to agency cost in the context of Ethiopia in which shareholders have no control of their investment on a daily basis. There are evident challenges in the sector in terms of adhering to corporate governance rules and international best practices. In different magazines circulated in the country, concerns of malpractices in the industry have been circulating and becoming public concern in previous as well as in recent period. Primary shareholders in one of the Banks were implicated in unduly accessing credit from the bank they have a huge influence. According to some commentators, signs of unduly accessing credit, manipulating influential position in financial institutions to get unfair advantage are on the rise again. And there are instances where some of these institutions have been linked with major breaches of the rules and regulations when it comes to conflict of interest and unethical business conduct. In this regard, the foreign exchange trade is one to mention. Processing letter of credit remained to be a challenging factor for business in Ethiopia. Obviously, this led to activities ranging from nepotism in assigning foreign currency to plain old corruption and bribery.

As a result, it is critical to assess the current level of practice and lessons can be drawn from the study on the level of effectiveness of the banking industry in terms of applying good corporate governance practices, and the discrepancies from the principles set by international organizations can be drawn out to address the gap observed in the practice.

Thus, the focus of this paper was on major dimensions of corporate governance system which are Shareholders, Board of Directors, Executives, Supervisory Organs and other stakeholders, Risk management and internal control and Disclosure and Transparency. Based on those factors, the study comprehensively assessed corporate governance practice of privately owned commercial banks in the country in light of OECD principles and Basel committee banking supervision guidelines.

The current level of practice based on the country law and international standards and best practices will have a paramount importance in terms of identifying the gaps in practice. As a result this paper tried to assess the broad range of corporate governance practice based on OECD Principles, Basel banking supervision committee guidelines and the country laws and provisions. This will help stakeholders to take lesson from the assessment to strengthen their best practice and improve on the gaps identified and also point out areas which need further study.

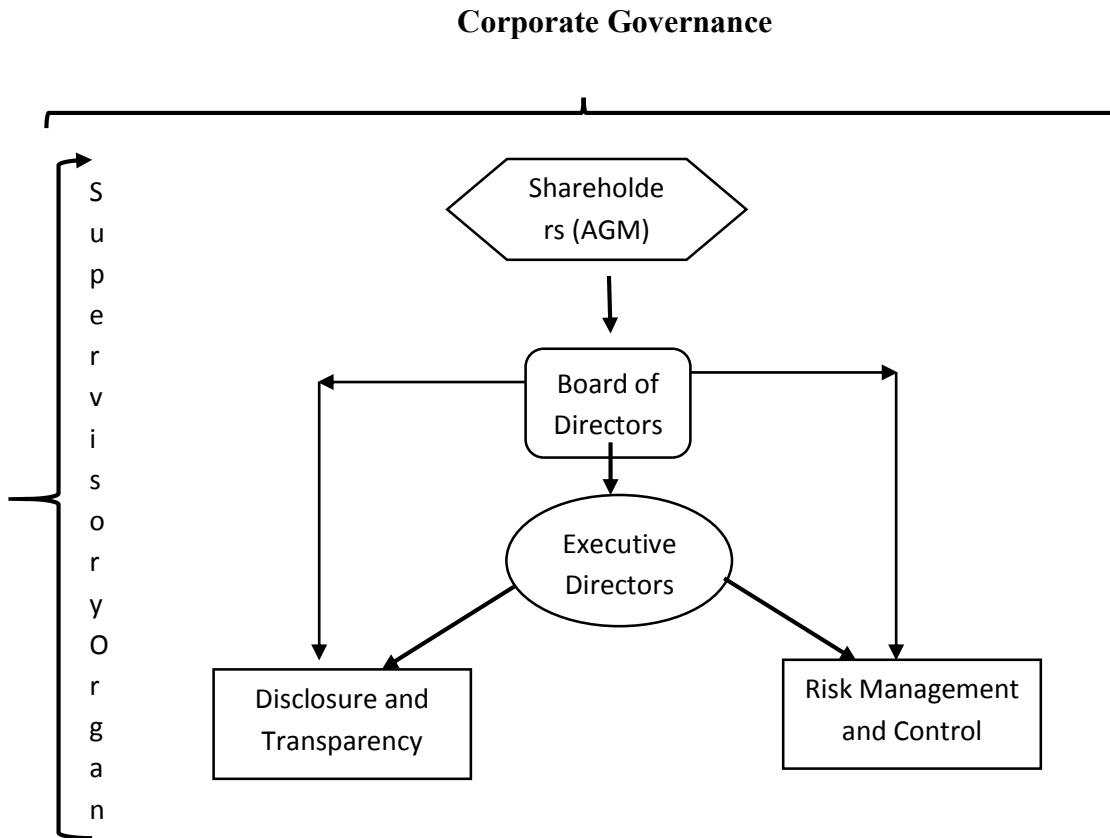
1.2 Conceptual framework

The literature being produced on the practice of corporate governance is becoming very vast both in quantity and variety. Scholars of different backgrounds, particularly accounting and finance, economics, management and law have published series of research outputs on the issue of corporate governance within particular countries and institutional regimes. Since governance involves such a wide variety of interpretation and approaches, it seems appropriate to set the framework generally followed in this study. The difficulty is selecting the framework of assessing the effectiveness of corporate governance mechanisms that is all-embracing and suit to Ethiopian banking business context.

However, attempts were made to frame the research project in the following manner. The governance of a firm includes all stakeholders with different roles and interests. The governance structure specifies the distribution of rights and responsibilities among different participants such as the Board, Management, shareholders, regulators and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. It influences how the objectives of the companies are set and achieved, how risk is monitored and assessed, and how performance is optimized. Governance dimension that embraces these main players contributes for enhancing effective corporate governance practices. The roles of shareholders, the Board, the Management and the regulators are distinctly different but complimentary to the core objectives and functioning of the firm. Supervisors also have a keen interest in sound corporate governance as it is an essential element for the safe and sound functioning of a bank.

Taking the above facts into account, this research project is designed to focus on comprehensive assessment of corporate governance practices in private banks in Ethiopia and identifying the extent of their compliance with international standards, codes, principles and practices as well as country's laws and supervisor's directives. Thus, the study planned to analyze the quality of governance in these banks mainly focusing on Shareholders, Management, boards and Supervisors including role of other stakeholders.

Figure 1.1 Framework of the study adapted from literatures reviewed.



1.3 Research question

This research project was planned to be conducted to assess major aspects of corporate governance practices of private banks and answer the following specific question:

- i. To what extent corporate governance principles from International Best practices like OECD Principles and Basic Committee guidelines on Banking Supervision are practiced in private commercial banks in Ethiopia?

1.4 Research objectives

General Objectives of the Study

The general objective of this paper was to assess the level of corporate governance practices in private banks in Ethiopia in light of OECD principles, Basel committee on banking supervision, and code of best practices so as to enhance the understating of different stakeholders and promote good corporate governance practice in the banking industry.

Specific objectives of the study were:

1. To assess the Board of Directors role on Corporate Governance practice of private banks.
2. To assess the level of exercise of shareholders right
3. To assess the role of executive management on the corporate governances practice in banking sector.
4. To assess the contribution and lack thereof supervisory organ in the governance process.
5. To assess risk management and internal control systems and practice in private banks.
6. To assess disclosure and transparency practices within the banking sector.

1.5 Scope and limitation of the study

1.5.1 Scope (Delimitation)

This study is limited to private commercial banks operating in Ethiopia. Government banks are out of the scope of this study due to the ownership and control issue they have which significantly differs from that of private banks. Since government plays the role of regulator and supervisor and the real nature of agency theory hardly observed in government banks. Major stakeholders of corporate governance are not observed in government banks as well. There is no public shareholders, all the shares are owned by government this signifies lack of agency problem in the governance system as a result government banks were excluded from the study.

1.5.2 Limitations

Though the objective of the study is to assess the extent of Corporate Governance practices in private banks in Ethiopia in light of OECD Principles, Basel committee on banking supervision guideline, country's law and supervisor's directives, it is not free from limitation. Unavailability and limited accessibility of board members who thought to have expertise and exposure about the issue under investigation was a challenge and time taking. Moreover, even if access to these targeted respondent groups is possible, some of them were unwilling to provide information that they thought is confidential. As a result, the study is confined to eight private banks in Ethiopia who provided information they think is not confidential. Based on the information obtained from those actors in the market that conclusion has been reached.

Since banks failure can cause instability in financial system and the economy of the country; they are among highly regulated industries. Their governance system is influenced by laws,

proclamations and central bank's directives. This indicates that they have limited or restricted playground. Furthermore, since corporate governance within particular countries and institutional regimes is almost same, they have practiced almost similar kind of governance system. This shows the homogeneity of banking populations in one country. Considering these facts, the information obtained from these eight banks would likely be indicative of the general governance practices of private banks in Ethiopia.

1.6 Significance of the study

The issue of Corporate Governance practice towards the achievement of the firm objectives shall be the issue of all stakeholders. This paper tried to assess corporate governance practice of private banks in Ethiopia, as a result the outcome of this study will have utmost importance for all interested stakeholders. In assessing the corporate governance practice of private banks, the paper tried to reveal what are the major problems in the area, what areas needs improvement, who can contribute for the improvement of the practice, the identified issues will then be taken as input for further application in the governance system of the country. All stakeholders involved in the practice such as regulators, supervisory organs, board of directors, Executive managers, and shareholders can take their share of contribution from the result of the study in order to boost the overall corporate governance practice and culture of the banking sector in Ethiopia.

CHAPTER TWO

LITERATURE REVIEW

The literature review will provide the readers an insight into different area of previous and existing literatures related to corporate governance. It composed of research works, books, articles and other sources in order to measure and understand the level of corporate governance practice in private banks in Ethiopia. Extensive research works were done and dozens of books were also written in the subject matter, but it was attempted to review some of the relevant document that will address the research question to be examined. All important milestones in corporate governance however, were included in the literature to see the broader aspect of corporate governance.

2. Corporate Governance

2.1 Historical Development

The story of corporate governance starts as far back as 1612, when the world's first listed company was founded. The Dutch East Indies Company experienced many of the same problems as we still have today and whilst Adam Smith understood the issues of corporate governance in 1776, he did not use the phrase corporate governance (Steier, 2005). The first recognized academic work on the issue of corporate governance was (Means, 1932), followed by (Coase, 1937) as they recognized ownership/performance issues arising from the growing separation of power between executive management of major public companies and their increasingly remote and diverse shareholders. In more recent times the term “Corporate Governance” first surfaced in the 1970s in the USA to describe the role, functions and responsibilities of the board and management but did not appear in print until 1983 (Earl, 1983)A lack of transparency meant that shareholders had no idea what managers were doing. In fact, it turned out that many of them were using company funds to run their own private businesses buying spices and selling them privately. The result was the first ideas on how to exercise more control through additional disclosure and the appointment of supervisory directors, who had better access to the detail of what the company was actually doing and who could stop transactions going forward.

The link between corporate governance and principal-agent problems is further highlighted by (Farrar, A Brief Thematic History of Corporate Governance Bond Law Review, 1999) who traces the development of corporate governance with the appearance of managerial capitalism and the need to raise capital from the public. Farrar's view is that in the absence of a countervailing power, management has a tendency to pursue own self-interest at the expense of the corporation. There is a need then to monitor management to prevent shirking and other opportunistic behavior. The corporate governance issues were controlled by both fiduciary restraints developed in the law and supplemented by legislation so that modern directors' duties are an amalgam of law, equity and statute (Lawrence D Brown, 2004). The market for corporate control rewards good performance but judges' under-performance with either falling share price as investors.

2.2 Definition

Various definitions were given by different authors about corporate governance. And yet there is no universally accepted definition of corporate governance. But most of definitions have something in common. For (Wheelen, 2006) corporate governance is defined as the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation. Similarly, (Shleifer, 1997) stated that corporate governance as the way in which suppliers of the fund to corporations assure themselves of getting a return on their investment.

(Melvin, 2005) Described the concept of corporate governance as referring to corporate decision-making and control, particularly the structure of the board and its working procedures. It is also sometimes used very widely, embracing a company's relations with a wide range of stakeholders or very narrowly referring to a company's compliance with the provisions of best practice codes. In addition, (Thomas, 2002) described corporate governance in the ways and means by which the government of a company (the directors) is responsible to its electorate (the shareholders).

Likewise, the OECD principles (2005) defined corporate governance as involving a set of relationships between a company's management, its board, its shareholders, and the stakeholders. It adds that corporate governance provides the structure through which the objectives of the company are set, and the means of attaining the objectives and monitoring of performance are determined.

2.2 Corporate Board and Governance Practices

2.2.1 Board Composition and its Function

The principles of corporate governance place a heavy responsibility on company boards, even if in practice many boards do not take this responsibility seriously. The quality of a company can often be judged by its vigilant and quality of board. The board of directors (BODs) plays the pivotal role in any system of corporate governance. It is accountable to the stakeholders and directs and controls the management. It stewards the company, sets its strategic aim and financial goals, and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in a transparent manner to the stakeholders.

The Basel Committee on Banking Supervision (2006) relies on the responsibility of board directors and bank management on implementing good corporate governance. (Nam, 2004) suggests some aspects that should be concerned in the internal mechanism of corporate governance, including its independency and structure, function and activity, compensation and other relevant responsibilities of BODs. There is a relationship between proportion of independent board composition and firm performance. This issue is largely build around the agency theory and addresses the role of the board in shielding shareholders from manager self-interest (Fama, 1983). Independent directors with no personal or professional relationship to the firm or firm management are more effective in protecting shareholders' interest, resulting in higher performance (Dalton, 1998). Moreover, determining the structure and level of compensation of top executives of the firm is among the task of the board of director.

2.2.2 Board Composition and Performance

As it is known the board of directors is in charge of representing shareholders' interest in ensuring that shareholders have reliable information regarding corporate performance, risks and prospects and that management undertake activities that enhance shareholders interest (Keasey, 2005). Thus it is the official first line of defense against managers, who would act contrary to shareholders' interest.

The board composition is characterized by the relative proportion of independent outside directors. These independent directors are individuals with no connection to the company other than a seat

on the board and possibly ownership of share. The composition of board members is proposed to help reduce the agency problem (Hermalin, 2003). A positive relationship is expected between firm performance and the proportion of outside directors sitting on the board. Unlike inside directors, outside directors are better able to challenge the CEOs. Empirical evidence has grown but the results a (Adams and Mehran, 2003) quoted by (Grove Hugh, 2009) report that banking firms have a larger board of directors in comparison to manufacturing firms and that a larger board of directors at banks is positively associated with return on assets. This suggests that the performance of banks with a smaller board do not surpass their counterparts with larger boards. They speculate that banks have larger boards due to their complex organizational structure and the requirement to have more committees and thus require more members.

Most of “best code of practices” suggests that the typical corporate board is composed of 8 to 16 directors. Larger, more mature companies tend toward the higher end of the range, while smaller, growing companies leaned toward the lower end with appropriate board compositions. The purpose is to have a breadth of expertise in order to deal effectively with the issues confronting the business.

2.2.3 CEO Duality

CEO Duality is when the chief executive officer of an organization concurrently serves as the chairman of the board. Agency theory would suggest that such centralized leadership authority will lead to management dominance of the board and result in poor performance (Shleifer, 1997). CEO and chairman duties if it is one individual, it makes harder for a board to replace a poorly performing CEO, which can reduce the flexibility of a board to address large declines in performance (Goyal, 2002). The dual board leadership structure seriously compromises the independence of the board.

The existence of duality gives the chief executive officer of an organization a chance to manipulate the agenda on the table. According to (Kaen. R., 2003), a very real threat to the exercise of independent judgment by the BODs is the duality role of CEO as board chairperson. This gives the top management official of the corporation simultaneously serves as chairperson of the board who in charge of monitoring and evaluating the same top management. This dual role would seem to suggest a certain conflict of interest. Recent studies state that the roles of chairman and CEO

should be split, with the division of responsibility between them clearly agreed and set out in writing.

2.2.4 The Practice of Sitting on Multiple Boards (Interlocking)

Despite there are many personal benefits for individual board members by sitting on different boards, serving multiple boards lowers the ability of independent directors to perform their duties effectively and reduce time commitment of members of board of directors. Companies at which a large percentage of directors had multiple appointments were less likely to have been targets of unsolicited, hostile or disciplinary takeover bids (Shivdasani, 1993). This is the symptom for the existence of weak internal governance.

Contrary to this, (Pritchard, 2002) opines that firms announcing appointments of outside directors with at least three other board seats experienced a positive stock price effect at the announcement of the director's appointment. However, there are limits to this. (Core et al., 1999) indicated the conditions and impact of serving multiple boards. They define directors to be "busy" if they serve on more than three boards if they hold full-time employment or if they sit on more than six boards if they are retired. They find that the presence of such directors on the board correlates with excessive CEO compensation and imply that busy directors do not contribute as much for effective corporate governance.

2.2.5 Board Meeting Frequency

Board meetings serve as key forums where executives and directors share information on company performance, plans, and policies. Frequent meetings allow for better communication between management and directors. Boards increase meeting frequency after poor performance. On average, meeting frequency does not lead to poor performance but is a reaction to deteriorating performance (Vafeas, 1999). The researcher further indicated that the recovery from poor performance is faster if board meeting frequency is increased. This research suggests that boards should balance the costs and benefits of board meeting frequency and should be willing to increase meeting frequency whenever the situation requires significant board input and supervision.

Contrary to this perspective, (Adams and Mehran, 2003) cited by (Grove Hugh, 2009) suggested that since banks have more committees than non-banking organizations it is necessary that the boards of banks meet more frequently for effective operating purposes. Based on these arguments, they expect that a high frequency of meetings to be a factor of strong corporate governance.

2.2.6 Board Effectiveness

The performance of a company generally reflects the quality of its directors and the effectiveness of its board. According to (Nicholson and Kiel, 2004) an effective board and an effective management team should produce positive performance. Similarly both board and management ineffective may lead to poor operating performance. Nicholson and Kiel further explains what it means when one says board effectiveness i.e. concerned with task outcomes and occurs by fulfilling the set role. The roles of board of directors are classified as control, service and strategic guidance.

If the directors lack business experience, the firm should give those details and support programs based on their roles and responsibilities. Such board practice ensures that directors continue to have the necessary competence to lead complex firms.

The effectiveness of the board is a central issue that should be underlined. This is because the quests for world-class performance in the business start in the boardroom. The effectiveness of boards of directors (or lack thereof) has become a global concern. Corporate collapses, fraud cases, shareholder suits or questionable strategic decisions are attracting attention to the top decision-making body of the corporate governance process, codes of best practice” have been drawn up by several countries, global institutions, and institutional investor organizations and adverse publicity is created for companies with what are seen as ineffective governance systems.

2.2.7 Board qualifications, capabilities and skill

The board of directors has key role to play in the development of good corporate governance practices beyond its conventional role of maximizing shareholders value. Effective corporate governance system thus requires conversant board of directors. Embracing best practice of the governance systems will worth very little if a firm do not have the right people on the board with the right skills, education and experience along with enabling structure. To review, devise and add concept of difference corporate strategy and pick the viable option from among the alternatives, board members collective skills, experience and approach is crucial.

Boards which are endowed with varied skills can assess the internal business conditions and scan the external environment properly in running the business fruitfully. The possessions of these qualities make them the best suited to driving it forward and achieving the company’s goals. In

light with this, (Carey, 2008) suggests that the board needs to prepare a description of the role, experience and skills required for a particular new appointment.

Boards are often criticized for failing to meet their governance responsibilities in firms since they lack detailed knowledge and also existence of information asymmetry among the executives and non-executives (Levrau, 2009). These considerations are especially true for bank boards' considering the complexity of the business, the high dynamism and volatility of the markets in recent years and the responsibility of banking boards in supervising and monitoring as a prerequisite for the sound and prudent management of financial intermediaries (OECD, OECD Principles of Banking Organization: Principles of Corporate Governance, 2005).

2.3 Board Committees and Compensation

2.3.1 The Role and Duties of Board Committees

(John, 1998) stress the role of committee structure as a means of increasing the independence of the board. They refer to the work of (Klein, 1998) and argue for the need to set up specialized committees on audit, remuneration and appointment. For banking business, the Board of Directors is ultimately responsible for the operations and financial soundness of the company, but the board can extend its oversight capacity by forming specialized committees to oversee specific areas of the bank's operations. Primarily the bank has four major committees composition of the audit, nominating, risk and compensation committees. That is why the board size in banking organization is larger than other form of companies.

However, Board committees need not be considered as substitute for oversight by the full board. Committees should not have executive powers – their decisions need to be ratified by the full board.

2.3.1.1 Nomination/Appointment Committee

The nominations committee oversees the appointment of board members and ensures that the process is formalized and transparent. The committee also oversees succession planning for the board and ensures that plans for senior executive succession planning are in place for orderly succession to the board and other senior management positions. Among the role of the board's nomination committee is evaluating the balance of skills, knowledge, time commitment and

experience of the board and, accordingly, prepare a description of the role, experience and skills required for a particular new appointment. For the executive, this is likely to involve key individuals being given opportunities to gain a breadth of experience within the business and to be visible to the board if they are not yet a member of it.

CEO involvement in the director nomination process has been shown to have a significant impact on the types of directors that appointed to boards. When CEOs either participate directly in the selection of new board appointees or serve on the nominating committee, or when no nominating committee exists, companies tend to appoint fewer independent outside directors and more affiliated outside directors with potential conflicts of interests (Fich, 2004). Moreover, when the CEO sits on the nominating committee; the audit committee is less likely to have a majority of independent directors (Klein, 2002).

Major shareholders like institutional investors and other stakeholders are increasingly focusing their attention on the quality of the board and need to be composed of the independent directors- rather than just the management team and the chairman. Their views therefore become valuable for nomination committees as they seek to determine the board's strengths and areas for improvement.

2.3.1.2 Audit Committees

The three main objectives of audit-committees are increasing public confidence in financial information, assisting directors (particularly non-executive directors-NEDs) in meeting their responsibilities in respect of financial reporting, and strengthen the independence position of a company's external auditor by providing an additional channel of communication.

An audit committee should consist largely of non-executive directors which is able to view a company's affairs in a separate and independent way and liaise effectively between the main board of directors and the external auditors. However, although studies do not find any direct link between company performance and audit committee independence, earnings releases tend to be more informative to equity investors when the audit committee is independent (Klein, 2002). This result suggests that, on average, equity investors place greater reliance on earnings releases when the audit committee comprises a majority of independent directors.

There has been little research regarding the role of an audit committee as a corporate governance mechanism at commercial banks. For (Zhou and Chen, 2009) cited by (Grove Hugh, 2009) a more independent audit committee is an important factor in constraining earning management with respect to banks' loan loss reserves. Given the discretionary nature of several bank financial statement items, an independent audit is particularly crucial in the banking sector.

To achieve sufficient objectivities and independence, the audit committee should be comprised, at minimum, of majority board members who are independent and who have firm understanding of the role of audit committee in the bank's risk management and governance. (Carey, 2008) suggests that companies must have an audit committee of at least three (two for smaller companies) non-executive directors, to review the scope, results cost-effectiveness, independence and objectivity of external audit. At least one member of the committee should have up to date exposure and experience of financial reporting, banking, auditing and accounting standards. Overall, we expect that less independent audit committees result in reduced oversight of the external auditor and, therefore, low independence of audit committees to be a factor of weak corporate governance.

2.3.1.3. The Risk Management Committee

The role of the risk committee has been given due emphases during the recent distress in international financial markets – there seems little doubt that some board members did not understand the risks which their firm was taking and were unable to exercise oversight of management actions. The main responsibilities and duties of the risk committee are to advise the full board on risk management, emphasize and demonstrate the benefits of a risk-based approach to internal control and reinforce control consciousness by setting appropriate internal control policies, seeking regular assurance that the system is functioning, reviewing the effectiveness of internal control, providing disclosures on internal controls in annual reports and accounts.

In banking organizations, the risk committee monitors the principal risks which the bank has facing, including those which management may not be aware of or may be underestimating. Many companies including banks either set up a separate risk committee or establish the audit committee as an audit and risk committee. Studies suggest functions for the risk committee are; allowing for cross-over between it and the work of the audit committee, developing risk awareness among staff, define and ensure compliance with risk policies control risks within their own departments, review

audit findings and implement controls, make risk-related recommendations to the board and seek support of the risk unit/department in meeting the challenges presented by business risk.

2.3.1.4 Remuneration committee

The role of the compensation committee is to provide independent oversight in determining the compensation of executives and directors. Research has shown that for listing companies, there was a requirement to implement the composition of compensation committee composed of independent directors. (Klein, 2002) found a positive relation between earnings management and presence of the CEO on the compensation committee. Similarly, Newman and (Mozes, 1999) cited by (Grove Hugh, 2009) found that CEOs receive preferential treatment, at the expense of shareholders, when insiders are members of the compensation committee. There is a clear conflict of interests that can compromise committee independence. According to (Oliver Williamson, 1985) cited by (Keasey, 2005, p. 39), “the absence of independent compensation committee is akin to the CEO writing his pay check with one hand and signing it with other”.

To ensure long-term positive performance, it is imperative that executive and director compensation is properly aligned with the interests of the firm. Since the compensation committee determines executive compensation, affiliated directors on the compensation committee may be under the power of top executives and thus will not set compensation in an optimal manner (e.g., focus on short-term financial performance or excessive incentive based compensation). The importance of this argument extends to banks based on recent claims that executive compensation was a key factor underlying the subprime crisis (Grove Hugh, 2009). Thus, presence of affiliated compensation committee members is considered as a factor of weak corporate governance.

2.3.2 Director and Executive Compensation

2.3.2.1 Directors’ compensation

Companies become compensated their Directors with stock options. Companies that use director incentive plans have low CEO stock ownership, independent board and greater institutional ownership (Perry T, 2000). This result suggests that boards adopt incentive plans to better align the directors’ interest with that of shareholders. Perry further state that boards react more quickly to poor performance by replacing the CEO when director is compensated in stock and the board is independent. The result suggests that directors who receive pay may oversee management more actively.

Reward policy should be appropriate and sufficient to attract, retain and motivate directors of the quality required running the company successfully, but company should avoid paying more than is necessary for the purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance (Carey, 2008)

2.3.2.2 Executive Compensation

The board of directors is specifically responsible for the determination of the structure and level of compensation of the top executives of the firm. The compensation issue that is of greater interest from corporate governance perspective is the degree to which executive compensation aligns top executives' interests with those of shareholders; i.e. the sensitivity of executive pay to performance. The research surveyed by (Murthy, 1999) and (Core et al., 2003) cited by (Keasey, 2005) on the existing evidence of executive compensation in the US supports several broad conclusions. First, the sensitivity of pay to performance has increased in the country. Second the vast majority of the sensitivity comes through executive ownership of common stock and option on common stock.

On the other hand, some research finding indicated that CEO compensation is typically comprised of a mix of salary and annual bonuses. However, since meeting a bonus puts an emphasis on the short-term, stock based incentive plans are used to emphasize long-term performance in order to align the interests of the CEO with that of the firm. Consistent with the argument that stock based incentives align the interest of the manager with the firm. (Hanlon et al., 2003) found that executive stock options promote positive performance in terms of future earnings. More recently, it has been argued that stock based compensation may actually promote unethical behavior as evidenced by the behavior of top executives and significant presence of this compensation type at firms involved in recent frauds. Peng and Roell (2008) quoted by (Grove Hugh, 2009) argue that stock options cause executives to focus on the short-term stock price as evidenced by a higher likelihood of securities class action suits when executives are compensated with options. Yet, Erickson et al. (2006) cited by (Grove Hugh, 2009) did not find any difference between exercises of stock options for fraud versus non-fraud firms.

When contracts are incomplete and managers possess more expertise than shareholders, managers typically end up with the residual rights for control giving them enormous latitude or self-interested behavior. In some cases, this resulted in managers taking highly inefficient actions,

which cost investors far more than the personal benefits to the managers. Moreover, the managers' fiduciary duty to shareholders makes it difficult to contract around this inefficiency ex post.

Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low. Incentive contracts are indeed common in practice. A vast empirical literature on incentive contracts in general and management ownership in particular dates back at least to (Means, 1932), who argue that management ownership in large firms is too small to make managers interested in profit maximization.

2.4. Shareholders' Roles, Right and Key Ownership Structure

2.4.1 Shareholders' Role

The role of shareholders in corporate governance is to appoint the directors and auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information, in transparent fashion, of the activities and progress of the company.

2.4.2 Shareholders' Right

The corporate form involves the creation of a new entity that is largely distinct from both the owners of its share capital, who nevertheless retain many of the rights normally associated with ownership, and its management. Hence, the "corporation" is a flexible and reliable business model which separates the ownership of a company from its management and enables capital to be raised from many different sources (Keasey, 2005). But the "corporate model" only works if the rights of shareholders are clearly defined and enforceable. The main rights of shareholders relate to ownership and transferability of shares; a pro rata right to dividends and to corporate assets in the event of liquidation; and defined rights to participate in certain corporate decisions.

However, different shareholders may have different objectives and the managers of a firm may have access to information that the shareholders do not have. This could lead management to make decisions which are different from those owners of the business.

Good corporate governance tries to reconcile these potentially conflicting interests (differences within the shareholders between shareholders as a whole and management of the firm). It also

guides the way in which controlling shareholders and managers treat other shareholders, and ensures that decisions affecting shareholders are applied and communicated uniformly. There needs to be an appropriate method of legal redress in case abuses occur.

2.4.3 Ownership Concentration

Among the various corporate governance mechanisms that have been studied around the world is ownership structure and the effects it has on firm performance are theoretically complex and empirically ambiguous. Degree of Ownership concentration is inside ownership, namely ownership of the CEO, executive officers, and inside directors on the board, is strongly (and most often positively) related to operating performance and equity value, in a manner consistent with the curvilinear relationship hypothesized by (Morck S. R., 2008). Furthermore, increased ownership of outside directors has a positive relation with the firm's operating performance and market value. Results suggest that increasing the size of outsider directors without increasing their share ownership can have an adverse impact on the firm's market value.

According to (Core et al., 2001), ownership structure (whether board members have ownership right or not) is one kind of monitoring mechanism. The firm can implement this monitoring mechanism by increasing the incentive for board members to monitor firm managers. With increasing proportion of firm ownership, board members will have a personal wealth incentive to monitor managers, in addition to their fiduciary responsibility as members of board of directors.

As the CEOs personal wealth is increasingly dependent on firm value, the cost to the CEO of pursuing activities that do not increase shareholder value will increase. These managers may have an incentive to accept these additional costs only if there are significant personal benefits. As their ownership stake in the firm increases, however, any actions that managers take should be increasingly oriented toward maximizing firm value. That is, there should be a closer alignment between the managers and outside shareholders' interests as the proportion of share owned by the CEO increase (Coles, 2001)

The ownership structure is a response to firm-specific and environmental factors such as size, risk and regulation (Demetz and Lehn, 1985) quoted by (Keasey, 2005). They find that each of these constructs affects ownership structure, but that profitability does not necessarily depend on this structure. They conclude that ownership structure adjusts to other factors in a manner that is

consistent with value maximization. In general, both ownership structure and governance arrangements play a role in mitigating agency problem and promoting value maximization.

2.4.4 The Growing Influence of Institutional Owners

In the continued corporate governance debate, there has been an increased emphasis over the last two decades on the need for institutional shareholders to play an active role in the governance of the companies. (Cadbury Report, 1992) stated that, ‘because of their collective stakes, they use their influence as owners to ensure that the company in which they have invested need to comply with the code’. Similar views were expressed by Greenbury, Hampel and Higgs. Institutional owners are financial institutions such as stock mutual funds, pension funds and other companies that control large-block shareholding positions. Because of their prominent ownership positions, institutional owners, as large-block shareholders, are a powerful governance mechanism.

Institutional owners have both the size and the incentive to discipline ineffective top-level managers and can significantly influence a firm’s choice of strategies and overall strategic decisions. Research evidence indicates that institutional and other large-block shareholders are becoming more active in their efforts to influence a corporation’s strategic decisions. Initially, these shareholders activists and institutional investors concentrated on the performance and accountability of CEOs and contributed to the ouster of a number of them. They are now targeting what they believe are ineffective boards of directors.

2.5. Management Accountability and Agency Relationship

The responsibility of the management is to undertake the managing of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board monitor the accountability of management.

2.5.1 Separation of Ownership and Control

The corporate governance issues, arising from the separation of ownership and control and inability to write complete contracts for all possible future eventualities (Hart, May 1995); (Shleifer, 1997) have been recognized for many decades, if not centuries (Means, 1932); (Marshall 1920); (Smith 1976). Although a long standing issue, the debate was given fresh impetus due to a number scandals and business failures across the world.

Various studies have been conducted on the agency problems and associated costs. For (Meckling, 1976), the separation of ownership and control leads to an agency problem whereby management operates the firm aligning with their own interests, not those of shareholders. As owners of companies (principals) no longer controlled the management of companies, the responsibility for control shifted to the managers (agents) of the company. The problem created in this situation was that directors (or managers) of companies could abuse their control function to their own advantage and to the detriment of the owners. Corporate governance was thus introduced to ensure that the agents of the owners control the firm's in the ways that will serve the interests of the shareholders.

High level understanding has been reached that managers may take actions that hurt shareholders. These managers exert insufficient effort when over committing themselves to external activities, that they find it convenient by accepting overstaffing, even overlooking internal control. They are promoting their own financial interests at the expense of the shareholders. There is recurring criticism that many corporate managements often do not behave in a manner even remotely consistent with stockholder objectives (Kenser, 1985).

Firm value is reduced due to the added cost of monitoring. These agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. Problems also arise when an agent makes decisions that result in the pursuit that conflict with those of the principals. Thus, the separation of ownership and control potential allows divergent interests (between principals and agents) to surface, which may be referred to as managerial opportunism (Hitt et al, 2001). Opportunism is defined as the seeking of self-interest with guile or deceit. It is both an attitude and a set of behaviors. It is difficult for principals to know in advance which agents act opportunistically or not. Even the reputations of top executives are imperfect predictors, and opportunistic behavior cannot be observed until it occurs. To increase firm value, one must therefore reduce agency costs. This is one way to view the linkage between corporate governance and corporate performance.

There are roles that shareholders have to play to reduce the above agency costs. They can play an active role in nominating and electing directors and thus influence the selection of the managers who run the company. The introduction of managerial ownership and incentive packages has similar effect on agency problem and on the alignment of managerial interest with that of owners.

Shareholders should put in place other influencing mechanisms like firing those managers who failed to fulfill firms' objective.

Similarly, the responsibility of BODs is high. The directors have to properly carryout their functions, which include direction, executive action, supervision and accountability (Reinecke, 1996:11). The BODs consequently is being held responsible for determining the strategic direction of the company as well as for taking those decisions that will steer the company in that direction.

2.5.2 Management Accountability

The accountability of management for sound corporate governance practices is summarized by (Charkham,1994) cited by (Keasey, 2005). The author identified that management must be able to drive the enterprise forward free from undue constraint caused by government interference, fear of litigation or fear of displacement. This freedom to use managerial power or patronage must be exercised with a framework of effective accountability.

Corporate governance failure may essentially come about for two reasons. First management may operate the firm inefficiently, resulting in an overall decrease in firm profits, compared to the potential profit of the firm. Second while manager may operate the firm efficiently and generate 'maximum' profits, they may divest a proportion of those profits from shareholders through the consumption of excessive perquisites. This diminishes the accountability of management to shareholders.

2.6. The Role of Supervisory and Other Stakeholders

2.6.1 The role of supervisor/Regulators

It is very clear today, more than ever, that regulators also have a key role to play in achieving good Corporate Governance. As hypothesized by (La Porta et al.,1998) cited by (Keasey, 2005) the legal system is fundamentally important corporate governance mechanisms. They in particular argue that the extent to which country's laws protect investor rights and the extent to which those laws are enforced are most basic determinants of the ways in which corporate finance and corporate governance evolve in that country. Their empirical evidence indicates that there are significant differences across countries in the degree of investor protection, and that countries with low

investor protection are generally characterized by a high concentration of equity ownership within firms and a lack of significant public equity markets.

For the banking organizations particularly all regulations are intended in one way or another, to enforce prudential requirements on key areas of affairs of institutions to mitigate identified risks. Regulations on ownership, related party transactions, and fitness and propriety tests for directors are directly based on modern Corporate Governance principles. The primary responsibility to ensure sound corporate governance practice rests on the individual firm itself. Hence, regulatory oversight is not a substitute, but rather a complement to corporate governance (Adams and Mehran, 2003). This external regulation is assumed to prevent firms from panics.

2.6.2 The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises (Basel committee for bank supervision, 2006). It is, therefore, in the long-term interest of corporations to foster wealth-creating cooperation among stakeholders. The governance framework should recognize that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long-term success of the corporation.

2.7 Disclosure and Transparency

Transparency is essential for sound and effective corporate governance. It is difficult for shareholders, depositors, other relevant stakeholders and market participants to effectively monitor and properly hold accountable the board and senior management when there is insufficient transparency. Transparency and disclosure of information are key attributes of good corporate governance for banking organizations which they must cultivate with new enthusiasm so as to provide stakeholders with the necessary information to judge whether their interest are being taken care of (Anameje, 2007).

Information disclosure rules go some way to remedying the information asymmetry between the professional managers and large and increasingly defused body of shareholders. The legal responsibilities of the board of directors are managing the business in accordance with that benefits

the shareholders and to comply with the financial reporting and other disclosure requirements stipulated by company law (Keasey, 2005).

2.7.1 Disclosure of Financial and Operating Results

The financial reporting standard on the basis of which the financial information is prepared and reported determines the quality of financial disclosure. In most circumstances, the financial reporting standards required for corporate reporting are contained in the generally accepted accounting principles recognized in the country where the entity is domiciled. The International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board provide a widely recognized benchmark in this respect.

The code of best-practices urges the board of directors to provide disclosures on significant related-party transactions and any related-party relationships where control exists; disclosure of the nature, type and elements of the related-party transactions; and related-party relationships where control exists (irrespective of whether there have been transactions with parties under common control). The decision making process for approving related-party transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company. The board's responsibilities regarding financial communications should also be disclosed.

2.7.2 Non-Financial Disclosures

Non-financial disclosures required by code of best practices include but not limited to; company objectives (commercial objectives, governance objectives), Ownership and Shareholder Rights, Changes in Control and Transactions Involving Significant Assets, Governance Structures and Policies (The structure, role and functions of the board, Board committees, Ethics policy and support structure). And also Members of the Board and Key Executives (Duties and qualifications, Evaluation mechanism, Directors' remuneration, Conflict of interest). Other matters to be disclosed include material Issues Regarding Stakeholders, and Environmental and Social Stewardship, Material Foreseeable Risk Factors, Independence of External Auditors, Internal Audit Function and others.

2.8 Risk Management and Internal Control

The quality of sound corporate governance framework is judged by application of robust risk management system in a firm which includes independent risk management function with sufficient authority, resources and access to the board. (Cebenoyan, 2004) Find evidence that banks which have advanced in risk management have greater credit availability, rather than reduced risk in the banking system. The greater credit availability leads to the opportunity to increase the productive assets and bank's profit.

Internal controls are arrangements within a corporation that aim to minimize risk by defining the relationships between managers, shareholders, board of directors, and other stakeholders. There is an opinion that for internal control measures to have meaningful effect, they must be supported by a variety of extra-firm institutions tailored to a country's environment (external controls). The corporate governance framework depends on the legal, regulatory, and institutional environment.

2.9 International Governance Codes and Principles

2.9.1. Development of International Codes of Governance

The development of the governance codes is mainly in UK from creating of the Cadbury committee in 1991 (who produce the final report in 1992) to the combined code.

2.9.1.1 The Cadbury Report 1992

The Cadbury Report represented the first attempt to formalize and codify corporate governance best practice in a written document. This includes issuing of aspects of governance specially related to financial reporting and accountability. (Ezzamel and Watson, 1997) argue that the Cadbury report assumed that accountability to shareholders was the primary objective of corporate governance. According to this report Boards should have checks and balances to ensure that no single individual could have "unfettered powers of decision". The board of directors is required to produce at annual general meeting externally audited accounts to enable shareholders to assess the adequacy of the directors' stewardship.

On the other hand, the report recognized the role and importance of institutional investors in influencing corporate governance standards at the individual firm level. There would create need for greater director dialogue and engagement with this group to understand, appreciate and respond to the needs of other stakeholders. The report addressed the importance of transparency in ensuring

good communication and disclosure with both shareholders and stakeholders. It is reconsidered as accountability through disclosure. This code subsequently became the foundation of the modern combined code of the Financial Services Authority (FSA).

2.9.1.2 Greenbury Report 1995

Based on the shortcomings in the recommendation of Cadbury report, the second committee was formed to investigate shareholder concerns over subject of directors' remuneration mainly focusing on disclosure aspects. The report focused on providing a means of establishing a balance between salary and performance in order to restore shareholder confidence. Transparency or lack thereof in directors' remuneration disclosure. (Ernst and Young, 1996) argues that a huge increase in the amount of remuneration related disclosure led to accusation that the volume of information had become a barrier to effective communication and provide more fuel for those who argued that the governance codes led to increased bureaucracy and burdens on companies without providing real benefits to shareholders.

2.9.1.3 Hampel Report 1998

It is the successor to Cadbury, which was a consolidating report that tried to deal with the criticisms arising from the previous two reports. It requires companies to provide disclosure statement on their adherence to the principles of good governance. It can be considered as first combined code. The Combined Code is the currently applicable code of best practice for UK listed companies. The Code is mainly focused on two areas such as companies' directors' role, directors' remuneration and relations with shareholders accountability and audit. Second it is on institutional investors; shareholder voting, dialogue with companies and evaluation of governance disclosure.

2.9.1.4 Turnbull Report 1999

Turnbull report is to provide guidance to assist companies in the implementation of the requirements of the combined code on the reporting system of internal control which states the need for directors to review and report their internal control to shareholders. Turnbull represented an attempt to formalize an explicit framework for establishing internal control in organizations. This framework can be used to help establish systems of internal control without being overly prescriptive. It further provides guidance as to how to develop and maintain internal control systems to manage risk appropriately, rather than to eliminate it, and the purpose of the report is

to develop practical and robust guidance that companies can tailor to their own individual circumstances.

2.9.1.5 Higgs Report 2003

The publication of this report came about on the wake of regulatory pressure following the governance scandals at US firms Enron and WorldCom. Its focus was on the role and effectiveness of non-executive directors (NEDs). Building on from the central role of NEDs in corporate governance as set down in combined code, the report was to investigate the current operation of the board of directors and contribution of NEDs. It helps to identify actions which could strengthen the quality, independence and effectiveness of NEDs in representing the needs of shareholders and operate as a cautionary voice on the board. Its conclusions include at least half the board should be made up of NEDs; they should be remunerated appropriately for taking on a functional role; they should act as a link between the board and shareholders to reduce the agency problem, and they should communicate regularly to important shareholders.

2.9.1.6 Smith Report 2003

Likewise, Smith report was also developed from the Higgs Report. The report was to produce guidelines to help audit committees to increase their effectiveness. It deals with the relationship between auditor and the companies they audit, and the role and responsibilities of the audit committee.

2.9.1.7 The Combined Code 2003

Following the criticisms of the Higgs Report, the Financial Reporting Council (FRC) approved a new draft of the Combined Code (usually known as combined code II) to incorporate these new ideas. Reasons for developing codes include. First it should reduce instances of fraud and corruption improving shareholders' perception and market confidence. Second there is statistical evidence that poor governance equates to poor performance.

2.9.1.8. Sarbanes-Oxley Act

One of the most prominent corporate scandals of recent years which resulted the Sarbanes-Oxley Act of 2002 (Often referred to as SOX). This Sarbanes-Oxley has increased transparency and reduced the risk of corporate fraud by making it more difficult for the dishonest to hide their acts and mislead the public and by increasing the penalties from doing so.

Accountability has taken on new meaning in most public companies, and both directors and officers have enhanced roles in financial reporting, disclosure, and controls. The act addresses perceived weaknesses in auditing, reporting, and corporate governance of U.S.

The board is charged with establishing standards addressing auditing, quality control, ethics, and independence relating to the preparation of audit reports for public companies. Sarbanes-Oxley also address penalties and broadened sanctions for corporate criminal or fraud as well as provisions for increasing the independence of firms that audit the financial statements of public companies.

2.10. Corporate Governance Principles

2.10.1 Basel Committee on Banking Supervision- Principles

The Basel Committee on Banking Supervision(The Basel Committee) published guidance in 1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organizations in their countries, and revised it in 2006, and prepared a consulting document on Enhancing Corporate governance for Banking Organizations. The following are the principles put forward in that document;

Principle 1. Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organizations.

The board should establish the strategic objectives and ethical standards that will direct the ongoing activities of the bank, taking into account the interests of stakeholders. The board should take the lead in establishing the “tone at the top” and approving ethical standards and corporate values for itself, senior management and other employees. It is especially important that the standards address corruption (including bribery), self-dealing and other unethical or illegal behavior in banks’ internal and external activities.

Principle 2. Setting and enforcing clear lines of responsibility and accountability throughout the organization.

Effective BODs clearly define the authorities and key responsibilities for themselves, as well as for senior management. They also recognize that unspecified line of accountability or confusing, multiple lines of responsibility may aggravate a problem through slow or diluted response. The BODs is responsible for overseeing management’s actions and consistency with board polices as part of the checks and balances embodies in sound corporate governance.

Principle 3. Ensuring that board members are qualified for their positions have a clear understanding of their role in corporate governance and are able to exercise sound independent judgment about the affairs of the bank.

The board of directors is ultimately responsible for the operations and financial soundness of the bank. BODs and their individual members add strength to the corporate governance of a bank when they understand their oversight role and their fiduciary “duty of loyalty” and “duty of care”, avoid conflicts of interest, are able to commit sufficient time and energy to fulfilling their responsibilities.

Principle 4. Ensuring that there is appropriate oversight by senior management

Senior management consists of a core group of individuals (for example, the chief financial officer and division heads) responsible, under the guidance of the board of directors, for the day-to-day management of the bank such as the establishment of effective system of internal controls. These individual should have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individual in these areas.

Principle 5. Effectively utilizing the work conducted by internal and external auditors, as well as other control functions, in recognition or their critical contribution to sound corporate governance.

The role of independent, competent and qualified auditors and other control functions (including the compliance and legal functions) is vital to the corporate governance process in order to achieve a number of important objectives. It is a sound practice to consider direct reporting of the internal audit function to the board of directors through and audit committee as well as direct (but not exclusive) reporting from the compliance and legal staff to the boards, It may be beneficial for independent directors to meet in the absence of bank management at least annually with the external auditor and the head of the internal audit, compliance and legal functions. This can strengthen the ability of a bank’s BODs to oversee management’s implementation of the board’s policies and to ensure that a bank’s business strategies and risk exposures are consistent with risk parameters established by the bank’s board of directors.

Principle 6. Ensuring that compensation policies and practices are consistent with the bank’s ethical values, objectives, strategy and control environment

The board of directors should determine or approve, where appropriate subject to prior shareholders' approval, the compensation of members of the board, senior management and other key personnel, and should ensure that such compensation is consistent with the bank's culture, control environment, and long-term objectives and strategy.

Principle 7. Conducting corporate governance in a transparent manner

Transparency is essential for sound and effective corporate governance. It is difficult for shareholders, other stakeholders and market participants to effectively monitor and properly held accountable the BODs and senior management when there is a lack to transparency. That is when stakeholders do not receive sufficient information on the structure and objectives of the bank to judge the effectiveness of the board and senior management in governing the bank. Both publicly-traded and privately-traded and privately-held banks should be required to provide full, accurate and timely disclosure of material information to investors, supervisors, and as appropriate under national law, to other stakeholders.

Principle 8. Maintaining and understanding of the bank's operational structure including operating jurisdictions, or through structures, that impede transparency (i.e "know-your-structure").

Corporate governance challenges arise where bank operate through structures that lack or impair transparency. Banks may choose to operate in a particular jurisdiction or may establish complex structures e.g. special purpose vehicles or corporate trusts, often for legitimate and appropriate business purposes. Operating in such jurisdictions or through such structures may, however, pose financial, legal, and reputational risks to the banking organization, impede the ability of the board of directors and senior management to conduct appropriate business oversight; and hinder effective banking supervision.

Consequently, banks' board of directors should have in place policies and procedures to ensure that such structures or activities comply with relevant law and regulations, that the board considers appropriate.

2.10.2 OECD Principles of Corporate Governance

The organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance were originally developed in response to a call by OECD Ministers in 1999 to develop

a set of corporate governance standards and guidelines. Since then become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. The principles are intended to assist governments in their effort to evaluate and improve the legal, institutional and regulatory framework in their countries. “The OECD has identified the following corporate governance principles built on some common elements.

I. Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

II. The Rights of Shareholders and Key ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders’ basic rights. Equity investors have certain property rights such as to sell, buy or transfer an equity share in a publicly traded company. Shareholders are also entitled to participate in the profits of the corporation, with liability limited to the amount of the investment. They should have the opportunity to participate effectively and vote in shareholders general meetings and should be informed of the rule, including voting procedures that govern the general shareholder meetings. In addition, all shareholders including institutional investors have to exercise their ownership right to influence the corporation and its management.

III. The Equitable Treatment of Shareholders.

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same series of a class should be treated equally. Investors’ confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members or controlling shareholders is an important factor in the capital markets. Corporate boards, managers and controlling shareholders

may have the opportunity to engage activities that may advance their own interests at the expense of non-controlling shareholders like insider trading.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. It is, therefore, in the long-term interest of corporations to foster wealth-creating cooperation among stakeholders. The governance framework should **recognize** that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long-term success of the corporation.

V. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Public disclosure is considered as a minimum requirement at certain intervals preferably on an annual basis. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. A strong disclosure system that promotes high transparency is basic characteristic of market-based monitoring of companies and is central to shareholders; ability to exercise their ownership rights on an informed basis.

VI. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. The board should fulfill certain key functions, including reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestments (if any). The board is also responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfill their responsibilities they must be able to exercise objective and independent judgment.

2.11. Applicable Laws and Directives on Corporate Governance in Ethiopia

2.11.1 Commercial Code of Ethiopia 1960

The relevant regulations dealing with share companies (corporate bodies) governance are given in the 1960 commercial code of Ethiopia. The related codes to these share companies are from article 304 defining share companies to article-428 which states about Quorum and major shareholders in special meetings, where shares and rights and duties of shareholders, directors, auditors and shareholder meetings are clearly stated. However, in this section only the major provisions are mentioned.

Formation by public subscription (Art. 317) - This article states that when a company formed by public subscription, the provisions of **Art. 318-322** shall be applicable.

Shares, rights and duties of shareholders (Art. 325) Shares shall be registered in the name of the shareholder where the bearer shares are prohibited by law, by the memorandum or articles association.

Register of shareholder (Art.331) - Every share company shall keep at its head offices a register of shareholders, the register shall contain the names and address of the shareholders, the number and numeration of shares, the amount paid up and the date of entry of the shareholder in the register. The register may be inspected by any shareholder without charge, it may also be inspected by any other person upon payment of the prescribed fee.

Classes of shares (Art. 335) - All share of the same class have the same par value and the same right.

Preference of shares (Art.336) - The issue of shares with a preference as to voting right is prohibited.

Rights arising out of shares (Art.345) - Every share shall confer a right to participation in the annual net profits and to a share in the net proceed on the winding-up, and to allotment of cash shares issued on an increase of capital. Subject to the provision of Art.336, every share shall confer voting rights.

Directors, Auditors and shareholders' meetings

Directors (Art.347) - Only members of a company may manage the company. A company shall have not less than three or more than twelve directors who shall form a board of directors. Bodies (companies) corporate may be directors; the chairman of the board of directors shall be a person.

Chairman (board) - General Manager (Art.348) - The board may elect a chairman from its members where no chairman is elected by meeting of subscribers or shareholders. A general Manager is an employee of the company who shall be appointed by the board and may not be a director.

Appointment of directors (Art. 350) - The first directors may be appointed under a memorandum or article of association and submitted to the meeting of subscribers for confirmation. Subsequent directors shall be appointed by a general meeting. Directors may not be appointed for more than three years.

Rights of a minority (Art. 352) - where there are several groups of shareholders with a different legal status, the articles of association shall provide for each group to elect at least one representative on the board of directors.

Remuneration(Art.353)- Directors may receive fixed annual remunerations, or share in the net profit (not exceeding 10%) the amount of which shall be determined by a general meeting and charged against general expenses. The sub-art (6) of this article, however, states that the director's share in the net profit shall not be paid where no dividend has been distributed to the shareholders.

Removal (Art. 354) - Notwithstanding any provision to the contrary, directors may be removed at any time by a general meeting, provided that a director who was removed without good cause may claim compensation.

Dealing between a company and its directors (Art.356) - any dealings made directly or indirectly between a company and a director shall receive prior approval of board of directors and notice shall be given to Auditors. Approval and notice under sub-art. (1) Shall be required in respect of any dealings where one of the directors of the company is owner, partner, agent, director or manager of such concerns.

Decisions of board of directors (Art.358) - No decision may be taken by the board of directors unless a majority of directors is present.

Duties of directors (Art.362) - directors shall be responsible for keeping regular records of management and meetings, accounts and books, submit accounts to the auditors and an annual report of company's operations including a financial statement to the meetings and others.

Powers of directors (Art. 363) – The directors shall have such powers as are given to them by law, the memorandum or articles of association and resolutions passed at meeting of shareholders.

Nomination and Appointment of Auditors (Art 368 & 369)-Auditors shall be elected by the meeting of subscribers and thereafter by the annual general meeting.

Persons Not Competent (Art 370) - Auditors may not be appointed directors or managers of the company which they audit, nor one of its subsidiaries or its holding company within three years from the date of the termination of their functions.

Voting right attached to shares (Art.407) - the voting right attached ordinary or dividend shares shall be in the proportion of the amount of capital represented and every shares at least carries one vote.

2.11.2. Overview of Banking Business Proclamations

Following the liberalization of monetary system, the government of Ethiopia has proclaimed laws to guide the corporate governance of banks in the country. Among those proclamations are the

one considered most important is the Banking Business Proclamation No. 592/2008, which has a relevant provision on shares and shareholder meetings, and directors and employees of a bank.

The National Bank of Ethiopia (NBE) issued directives pursuant to the authority vested on it by Article 41 of the Monetary and Banking proclamation No.83/1994 and by Article 36 of the Licensing and Supervision of Banking Business Proclamation No.84/1994. The relevant directive for this research includes Directive No. SBB/39/2006, which stipulates on areas like the appointment of board and the chief executive officer (CEO). Another one is Directive No.SBB/49/2011 which sets limits on Board Remuneration and number of Employees Who Sit on a Bank Board. Accordingly, board members annually remuneration is fixed to be birr 50,000 per a board member and birr 2000 per month per individual board member. With regard to employee representation on the board, this Directive prohibited any employees from being a board member.

2.11.2.1 Overview of the Banking Business Proclamation No.592/2008

As per the Art.10 of the proclamation, bank share shall be of one class and shall be registered as ordinary shares of the same par value. It also proclaims that every bank shall keep register of shares as determined by the NBE which shall show the names and voting right of shareholders. Any transfer of shares that makes a person influential shareholder shall be approved by the NBE before such transfer is recorded in the register of shares.

Article 11 stipulated that no person other than the Federal government of Ethiopia, may hold more than 5% of the bank's total shares, and an influential shareholder may not acquire shares in other banks. Similarly, Art. 12 give authority to NBE to assign observers to attend any general shareholders' meeting, and where it finds necessary to call general shareholders meetings of the banks. Regarding the calling of the meeting, however, the commercial code of Ethiopia 1960 give authority to the directors or Auditors(if the directors failed to do so) .

Art. 14 - A Director shall be of a person with honesty, integrity, diligence and reputation to the satisfaction of NBE. This in line with commercial code art.347 of 1960.The appointment of any director, CEO, senior executive officer of a bank many not be valid unless a written approval is granted by NBE. The NBE may issue directives on qualification competency, minimum number of directors, duties, responsibilities and good corporate governance of the bank, the maximum

number of years a director may serve and condition for his re-election, and maximum number the employees at that may serve on the board.

As per Art.15 -persons convicted of any offence involving breach of trust or fraud is prohibited from getting appointment as directors and officers. Persons worked in a failed bank require prior approval of the NBE for appointment to work in the management position. A director or CEO of a financial institution may not, at the same time, serve as a director of a bank, nor a business in which such a director has more than 10% equity may not serve as a director of a bank. An employee of a bank may not be a chairperson of a board of directors of the bank or a director of any other bank. This promotes the separation of the position of CEO and chairperson of board of directors.

Under Art. 17 it is provided that the NBE can suspend and remove a director, CEO and senior executive officer for sufficient cause. However, art.354 of commercial code of 1960 states that the director is removed by the shareholders general meeting.

2.11.2.2 Overview of Banks Corporate Governance Directive No SBB/62/2015

The Bank corporate governance directive composed of articles related with general requirements, board of directors, shareholders, Chief Executive officer, Meeting and disclosure have been approved by the council of Ministers and became operational effective September 21, 2015. This directive also repealed directive number SBB/54/2012.

Article 5 of Banks Corporate Governance Directive states that a bank shall have at least nine directors. The board of a bank shall comprise non influential shareholders whose numbers shall not be less than: one third of the total board members elected separately by such shareholders provided that such shareholders hold at least 30% and above of the subscribed share capital of the bank; or one fourth of the total board members elected separately by such shareholders provided that such shareholders less than 30% of the subscribed share capital of the bank no matter what the proportion of their shareholding in the bank.

Article 6 General meeting of Shareholders: Establish nomination committee by shareholders from shareholders, composed of not less than five shareholders, that is accountable to it, independent from the board of the bank, and shall not have a seat on the board of the bank. At least two of

nomination committee members no matter what the committee's size is, shall be non-influential shareholders.

Article 7 Representing by a voter in person and by proxy in any shareholders meeting shall be limited to the aggregate, including the voter's own shares, of a maximum of 10% of the subscribed share capital of a bank.

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter deals with the methodology and design that was used during the course of research work. The chapter describes and discusses different steps of methodological assumptions used.

3.1 Choice of subject

Corporate governance practice is one of the most important business concept that must be practiced in corporate firms. Billions of shareholders dollar have been lost, giant corporations were collapsed, famous CEOs' were sent to jail as a result of poor corporate governance practices. As an emerging market, and a welcoming political will from the country leadership, Ethiopia will soon may become home to international corporate firms. In its current conditions, among organizations that Ethiopia's legal system allows to work in corporate form are banks. Due to the irreplaceable role banks play in the financial system of the country, clearly observed and media issues of corporate governance breaches, the importance of corporate governance to the success of the firms, it is important to study the level of practice of corporate governance in the industry to provide input and feedback to the wide range of stakeholders. This will finally improve the governance system in the industry by increasing investors' confidence and economic growth to the country.

3.2 Research design

Research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. The research design is the conceptual structure within which the research is conducted; it constitutes the blueprint for the collection, measurement and analysis of data and outline of what the researcher will do from writing the hypothesis and its operational implications to the final analysis of data. (Kothari, 2004). Research design should indicate the various approaches to be used in solving the research problem, sources and information related to the problem and, time frame and the cost budget. (S. Rajasekar, 2013)

Under this study, a descriptive research design method has been used because the research aimed at assessing corporate governance practice of private commercial banks in Ethiopia against international standards and best practices is a compliance check.

3.3 Research approach

Under this research mixed approach (the combination of both qualitative and quantitative approach) is used to provide a detail information about the current status of corporate governance practice. The reason for choosing qualitative approach is due to the aim of receiving in depth information regarding the level of corporate governance practice. The researcher used the benefits of a mixed methods approach by mitigating the bias in adopting only either quantitative or qualitative approach and to get the advantages of collecting both closed-ended quantitative data and open-ended qualitative data to best understand a research problem.

3.4 Type and source of data

Identifying an appropriate source of data is the main determinant of carrying a successful research. Basically there are two sources of data that can be used to make a research which are primary sources of data and secondary sources of data (Kothari, 2004).

Under this research both primary and secondary data has been collected from various source like distributing questioner, NBE publications, Magazines issued by banks, websites of individual banks, others various research papers, articles and journals issued by researchers.

- a) Primary data has been collected from board of directors of private commercial banks included under the research sample through questioner. The primary data has been used to answer main objectives stated under this research paper
- b) Secondary data has been collected from NBE publications, Magazines issued by banks, websites of individual banks, others various research papers, articles and journals issued by researchers, proclamations and directives. This secondary data has been used to address the role of regulatory and supervisory bodies on corporate governance practice of private banks.

3.5 Data collection

The questionnaire used under this research included both open ended and close ended questions and it has been distributed to all private banks to obtain their answers for the questions. The main reason to select a questionnaire is that it helps to get a clear picture on the level of corporate governance practice of private commercial banks in Ethiopia.

The closed ended questionnaire was developed based on Dichotomous (Yes or No) with 2 choices. The reason for choosing to use a dichotomous question is because it is suitable for measuring compliance to certain standard.

Structured questionnaires were used to collect primary data. Company documents were also analyzed. For data considered not sufficient and also difficult to access through questionnaire, unstructured interview were conducted as a complement. Related published secondary documents, journals and other related references were also used for the study.

A review of related literature was used to serve as a background in questionnaire design and subsequent analysis. More specifically, questions which incorporate the international corporate governance practices, Basel committee guidelines for banking supervision and standards used by Organization for Economic Co-operation and Development (OECD) and other code of best practices were distributed to board members.

3.6 Sampling Techniques

All privately owned commercial banks in Ethiopia, which are operating in the country are the population of this study. The population under study thought to be homogenous in nature due to the legal as well as the business environment they are in.

The researcher tried to conduct a census study, however, the response rate from the questionnaires distributed is only 50% of the total population from the target of 16 private banks in the country.

3.7 Sample Description

The following is brief description of the samples under study so as to provide some characterization during discussion of the study.

Abay Bank S.C.

Abay bank S.C is one of the recently established bank in the finance sector of Ethiopia, on July 14th 2010. The bank has a paid up capital of 372 million birr. The bank has currently around 79 branches which may increase as a result of alarmingly increasing trend of bank branches in the current market setting. The bank has a total asset of around 3.2 billion birr, and the total loan and advance given to its customers is around 2.5 billion and 1.5 billion birr respectively. In 2013/14

profit before tax is around 75 million birr. In 2013/14 the bank has around 741 employees in all its branches.

Addis International banks S.C.

The other newly established bank in Ethiopia is Addis International Bank in 2011 having a paid up capital of 261 million birr. The bank has eighteen branches by the end of 2013/14 fiscal year. For the same reason of deposit mobilization and exerting their capacity to reach to its customers, banks in Ethiopia are working hard in branch expansion as a result Addis International Bank S.C. may have different number of branches at this time. The total asset of the bank is around 1.2 billion birr and the total loan and advance is around 505 million birr. In 2013/14 profit before tax is around 60 million birr. Addis international bank has around 184 staffs.

Awash International Bank S.C.

The first private bank in Ethiopia after the fall of Derg regime which lead the country to command economy and confiscate all privately owned financial institutions to be controlled by government. Established in 1994 immediately after the first proclamation was enacted allowing citizens of the country can join the finance sector under some form of jurisdiction. The bank is one of the highly profitable and pioneer in many aspects. In 2013/14 the bank has made around 861 million profit before tax in its 191 branches across the country. The bank has the highest number of network compared to other private banks.

Bunna International Bank S.C.

Bunna is also one of the newly established private banks in Ethiopia. It was formed and begun operation in 2009. In 2013/14 the bank has around 72 branches. It made a profit of around 109 million birr for 2013/14 fiscal year.

Dashen Bank S.C.

Relatively one of the oldest private bank, established in 1996. It has close to twenty years of business experience. One of the most profitable private bank in Ethiopia. It has around 146 branches in 2013/14 and earned a profit of 928 million birr.

Lion International Bank S.C.

Incorporated in 2006, Lion international Bank S.C. has a total of 67 branches and made a total profit of 128 million birr in 2013/14.

United Bank S.C.

Incorporated in 1998, United bank S.C. has a total of 108 branches and made a profit of more than 350 million birr during 2013/14.

Wegagen Bank S.C.

Established in 1997, Wegagen Bank S.C. has a total of 98 branched and earned a profit of 394 million for the year 2013/14.

3.8 Sampling

The objective of this study is to comprehensively assess and present the level of Corporate Governance practices of private banks operating in the country. However, because of inaccessibility of board which could require additional time and also limited availability of data, the study is confined to eight privately owned banks from the population of 16. A total of 8 respondents were willing to respond, from 16 privately owned commercial banks. In addition to primary data collected from selected commercial banks, secondary data gathered from National bank of Ethiopia were used for the research to have an understanding of the role of National bank of Ethiopia in corporate governance practice of private banks. Besides, interview also conducted to get some additional information which is not part of the administered questionnaire.

3.9 Data Analysis Method

To analyze the raw data collected from private banks, the researcher used SPSS 20 version which is specialized statistics program that can provide sufficient tools for analyzing the collected data and excel application for graphic presentation of the SPSS outputs. Therefore, the quantitative data from the questionnaires were analyzed using simple descriptive statistics (frequency and percentage) and presented in the form of graph and table. This enabled the researcher to make the analysis and to see the level of corporate governance practice of banks in light of OECD principles and Basel committee banking supervision guidelines.

The major reason not to use quantitative analysis method like regression and correlation was the size of the data is very small to use the regression as well as the correlation methods in a manner

that can show meaningful figure for analysis interpretation. In addition, in most of the cases the responses collected from the respondents were too similar to see any correlation among the variables and between observations.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND DISCUSSION

4.1 Introduction

This chapter presents, analyzes and discusses data collected from private local banks operating in Ethiopia on Corporate Governance Practices. Structured questionnaires was employed in the study with a mix of close- ended and open ended types of questions.

Since this study planned to see overall corporate governance practice of private banks in Ethiopia, an effort was made to include all the population in the study. However, only fifty percent of the banks were willing to fill and return the questionnaire submitted despite efforts exerted to increase the response rate.

Good corporate governance principle puts major responsibility of governing a corporate body on the board of directors who receives the mandate from the general meeting of shareholders to oversee the overall business operation of the bank. There are also important components of good corporate governance like Shareholders, Senior Management, Supervisory Organs, Risk management and Internal Control and Disclosure and Transparency. Taking this fact into consideration, a questionnaire was prepared and distributed to the board of directors to help to better understand the governance framework practiced by a particular bank. Accordingly, a total of 16 questionnaires were distributed to board of directors of all private banks in Ethiopia. Of which, only eight of them were returned and included in the study.

Since governance is the way organizations are managed and directed, it promotes a well management system to the benefit of the owners/shareholders. Accordingly, it is the shareholders general meeting that stood on the top of the management structure of banks who provides power to the remaining stakeholders to administer the affairs of the bank. Shareholders appoints board of directors, on the general meeting to act on their behalf as a balancing figure to managers/executive directors who decides and controls the resource of the firm. A term allowed for directors to be in the same position is three years, and a retiring directors are also eligible for re-election for an addition one term, but, to the maximum of one third of the outgoing directors can join the newly elected directors as per the newly issued directive number SBB/062/2015.

4.2 BOARD OF DIRECTORS

4.2.1 Board Size

Data collected from websites, magazines' and from the questionnaires distributed to eight banks covered in the study shows that, they have a board size of 9 to 12 members which constitutes all non-executive board of directors.

As indicated in the figure below, the size of the board in these banks are within a prescribed range which is supported by code of best practice which suggests that the typical corporate board is in range of 8 to 16 directors. (Jensen., 2003) Argue that an overcrowded board is less likely to function effectively and is easier for CEO to control. When a board gets too big, it becomes difficult to co-ordinate and often creates social loafing. Smaller boards also reduce the possibility of free-riding by CEO, and increase the accountability of individual directors.

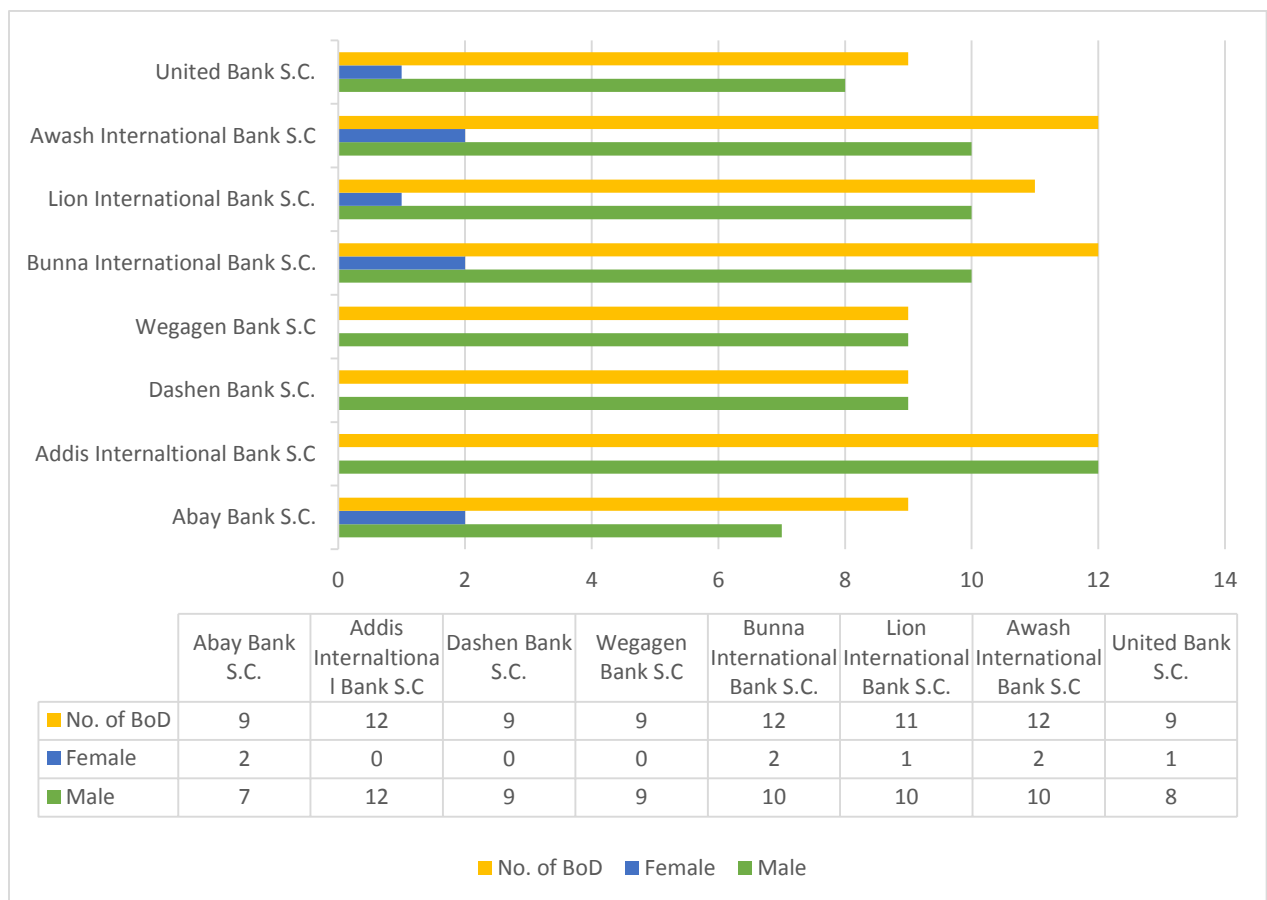


Figure 2: Board members size

Based on the figure above, four of the banks under study have a board size of 9 and three of the banks have a board size of 12 and only one bank have 11 board of directors who are all non-executives.

All of the board members who are serving in the banks under study aged more than thirty years which is in line with the directives on banking supervision which dictate banks to elect board members aged more than thirty years.

4.2.2 Board Composition

Board composition is one of the most important component that must be address when dealing with corporate governance. Since it is a principle laid down by most corporate governance guideline having a major number of outside director and chairing the board must be held by external board members. It was found out that all board members in the country's private banks are external entities, who have no employment contract with the bank. As per directive number SBB/49/2011, banks shall form board members composed of all external entities.

However, the directive and the practice is a debatable issue in terms of international standards and best practices as board members need not be from outside of the bank, though most of codes of best practices suggest the majority of directors to be elected from independent outside dominated individuals with no connection to the company other than a seat on the board and possibly owning a share to minimize any conflicts of interest. Except stating rule of the land and the practice in Ethiopia, there is no ground rule that asserts executives must be part of board members and comment on the directive to be reformed accordingly. Besides, no research work has indicated on board members' composition that constitutes all non-executive directors to be ineffective in terms of better corporate governance practice, rather there is a clear assertion on good corporate governance best practices in which non-executive board members to have majority seat in the board. To assert this, Basel committee banking supervision clearly indicated that, it doesn't advocate any of the board composition structures, but recognizes all forms of board composition as boards in the country laws and jurisdictions.

4.2.3 Board Qualification

As shown in the figure below, of the total 83 board members in eight privately owned commercial banks covered in the study at least 78% of the Board of Directors have Master's degree or above,

and the remaining 22% of board members which constitutes 21% goes to first degree and only 1% goes to Diploma. As per the information gathered, it is a very encouraging practice from private banks, educational preparedness is found to be high and well above the minimum requirement of the country's law. Educational advancement enables board members to effectively execute their responsibility and add value to good corporate governance practice.

On the other hand, apart from its effect on governance, the level of training among board members and managers could have a strong influence on the performance of the firm. (Lybaert N, 1998) in this regard argues that better performance is due to the proven positive relation of higher levels of education among entrepreneurs and their willingness to use external information, develop networks, and make use of consultant to develop more detailed accounting and monitoring.

Apart from the scientific support of attainment of better education on performance of a bank, the National bank of Ethiopia directive requires at least 75% of board members to have minimum first degree qualification, even though the minimum requirement to be a board member is completion of high school. In effect the local requirement also promotes educated people to hold seats of directorship in the banking industry.

Qualification composition of board members basically dominated by professionals in the area of business, accounting, finance, management, engineering and Law. In some banks, professionals in the area of agriculture also participate in the board of banks. Overall, it can be deduced that the banks are managed and overseen by professionals having the required level and relevant qualification.



Figure 3: Board members educational qualification

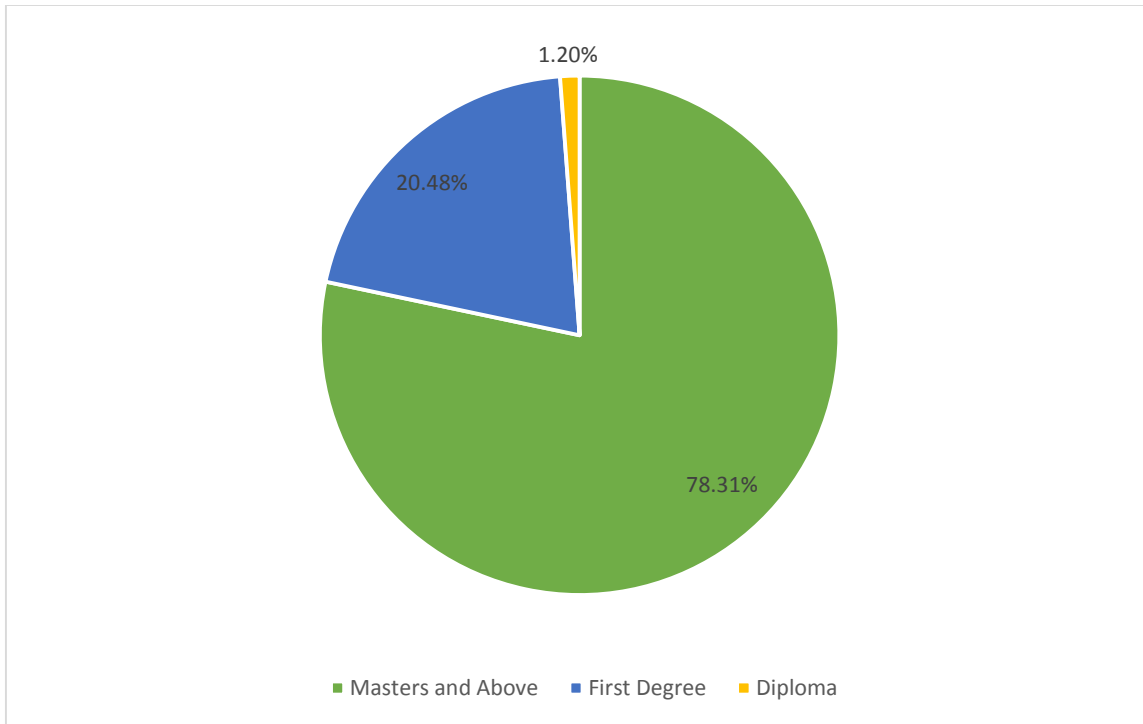


Figure 4: Board members educational qualification percentage

4.2.4 Orientation and Training to Board members

In order for board members to discharge their responsibility and serve the purpose, there must be a well-organized sessions for induction on the current conditions and set up of the business by the outgoing board members and formal training must also be organized to keep them up to date to the current business need.

In line with this, to enhance board effectiveness, all (100%) of the respondents revealed that new board members in these banks have been provided with a formal orientation program and majority (75%) of them responded that organized training sessions were also scheduled and conducted for the existing ones in order to keep them up to date with the modern banking business.

Induction and trainings programs in a bid to enhance directors' effectiveness has become recognized valuable by both practitioners and academicians. Directors must be adequately competent, skilled and informed to offer a large and high contribution to the task of the board and, ultimately, to the process of creating value for the firm.

One of the area which also increase board effectiveness is having accurate information on the status of their organization. Employees are the key stakeholders in running the day to day activity of the business and they are also the one who have firsthand information. Thus, Boards needs to create a link with them to get any information that is a concern. However, 75% of the banks don't have any means to receive feedbacks and concerns from its employees, including whistle blowing. These practice must be changed and improved. Boards that has a link with their employees use different communication medias to get the information from its employees. Email, post, and telephone are the major ones. Almost all of the banks affirms that they have all the protection mechanism to protect staffs who shared value adding information to boards for good corporate governance practice by keeping anonymous of the person who provided the information. Even if this response seems contradicting with not having system of receiving concern from their employees, it is understood that, boards have the mechanism to protect whistle blowers in case they get informal feedback.

4.2.5. Board Meeting

Board meetings are the venue for board members to discuss and pass strategic decision that will have a long term impact to the success of the firm. Based on the importance of this issue, there are clauses in the directive issued by NBE which sets the minimum frequency of meeting expected from board of directors. A question was asked to know how often board meeting have been conducted in their respective banks. As per the response received, the frequency of board meeting varies from biweekly to monthly, noting that, there might be emergency meetings for any matter that requires board attention and gathering. The responses given were intended to indicate only regular meetings conducted by the board members excluding the emergency one. The practice in these banks is in line with the suggestion outlined by combined Code, that the board should meet sufficiently and regularly to discharge its duties effectively. Furthermore, there should be a formal schedule of matters specifically for board meetings and the directive of National bank of Ethiopia which states Board meetings shall be held at least once in a month.

Board meetings serve as a key forums where executives and directors share information on company performance, plans, and policies. Frequent meetings allow for better communication between management and directors. The frequency of board meetings is suggested to indicate active monitoring by the board (Conger et al, 1998). However, it is arguable that frequent meetings might also distract the firm's managers from their day-to-day operational responsibilities and may

deter the board participation of some of the most desirable directors with other time-consuming responsibilities.

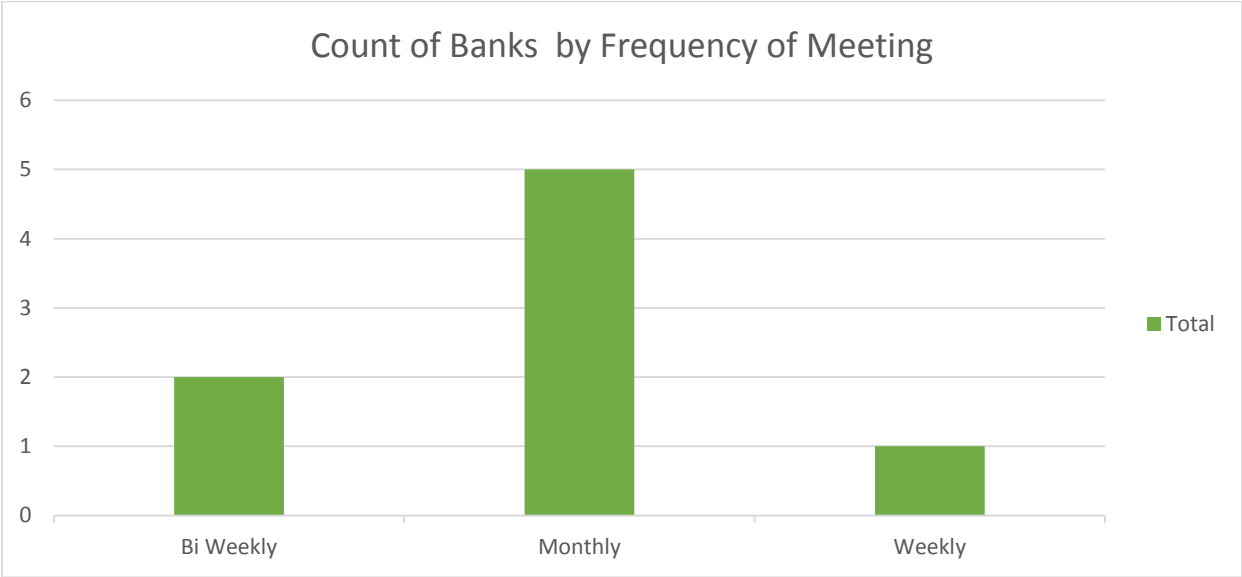


Figure 5: Board meeting frequency

4.2.6. Setting and Enforcing Lines of Responsibility

It is unarguable fact that the board is the one who sets the tone at the top by clearly setting lines of responsibility to senior managers. To gauge this practice, a question was raised to board members to respond to this practice, accordingly, all respondents indicated it’s the duty of board of directors. Based on an interview held on this topic with board secretaries; it was clearly indicated that for the CEO or the president and the senior management it is the board who set clear line of the responsibility and accountability and enforcing it. For other staffs below this line, it is the responsibility of the president (CEO) and other senior management.

Referring to this issue, the Basel committee for banking supervision recommends that the act of setting and enforcing clear lines of responsibility and accountability throughout the organization should be done and applied accordingly. Senior management is responsible for delegating duties to the staff and establishing a management structure that promotes accountability, while remaining cognizant of senior management’s obligation to oversee the exercise of such delegated responsibility and its ultimate responsibility to the board for the performance of the bank.

4.2.7. Board Vs Senior Management Interaction

Board of directors are responsible in taking good care of the overall business of the organization. In doing so, boards should make frequent interaction with senior management. Boards always ensure the action of senior management is in line with the strategy, set and monitor performance and put in place succession planning. As per the responses collected 100% of the banks are practicing these strategic points. However, there seems contradiction in practice on some of the issues, on recently published capital magazine, National Bank of Ethiopia has denied Wegagen Bank S.C. request for the approval of one of vice president post due to lack of the required level of experience set out by the regulatory body. If there is a clear succession planning this challenge shouldn't have occurred.

4.2.8. Setting strategies and overseeing the implementation

Board of directors are the one who sets strategies, financial goals and properly oversee its implementation. In respect of this all of respondents indicated that the board sets strategies and financial goals for the bank and follows its implementation accordingly.

This is one of the areas where good corporate governance is practiced in private banks in Ethiopia in line with those practices proposed by the codes of best practices. Basel committee for banking supervision also requires board of directors to establish strategic objectives, financial goals and professional standards that will direct the ongoing activities of the bank, taking into account the interests of all stakeholders and should take steps in ensuring these objectives and standards are implemented accordingly. The board should always take the lead in establishing the leadership and instill corporate value for itself, senior management and other employees.

4.2.9 Board Independence

Board of directors must be independent in all respects that compromise the role they are playing as a director. The question referring to board independence which is reflected in identifying and selecting external specialists when the needed expertise is not possessed by existing directors and or staff in general. Accordingly, all (100%) respondents replied for the question 'yes' noting remarks that boards in all banks have been identifying and propose for hiring professionals with proven ability and rich experience. And the respondents also indicated that the board does not hesitate to replace poor performing executives as boards are there to safeguard shareholders interest and maximize the value of the firm.

Sound corporate governance depends critically on whether there is independent board or those share some affiliation with management. Virtually every study on the topic finds that the board needs to have a majority of independent outsiders to enhance shareholder value. Independent directors with no personal or professional relationship to the firm or firm management are more effective in protecting shareholders' interest eventually resulted in higher performance. In all cases of Ethiopian private banks board composition, the board members are mostly composed of shareholders which is the practice widely seen in the industry. The effect of board composition which constitutes individual shareholders might be one area which needs further study in terms of promoting corporate governance practice as well as increasing firm value.

4.2.10 Sitting in Multiple Boards

Board members are not allowed to sit in multiple board position in the same industry. Both the country NBE directives and international best practices prohibit multiple board sitting. In line with this a question was forwarded to get information about the practice of a board member of one bank sits on other bank's same position. The respondents unanimously replied to the question that, there is internal policy that prohibits board members from having similar position in another bank. On top of this, most of them cited the directive of NBE which prohibits the same practice. However, in an interview conducted with one of the board secretary, it was noted that board members who had served in another bank and completed the term is currently serving as board member for a different bank. From the national bank directive on licensing and banking supervision, there is no clause that prohibits board members who completed service in one bank to be appointed as a director for other banks or limit the period to be appointed as director. It is clear that there is stiff competition in the banking sector given the product and service homogeneity they are availing to their customers, as a result, there might be leakage of classified information if directors served in one bank has a chance to be reelected in another bank without time lapse or some other restriction.

4.2.11 Board Committees

Board of directors play the role of policy making and overseeing the soundness of the business. In so doing, there are recommended committees the board needs to establish and tackle strategic issues. Thus, the board can extend its oversight capacity by forming specialized committees to oversee specific areas of the bank's operations. In line with this, a question was forwarded to respondents to indicate how many different board committees exist in their bank. Accordingly,

100% of the respondents replied they have risk and compliance committee, this shows the level of emphasis and attention banks have given to the business they are in and how well they are prudent to avoid unwanted consequences that might arise as a result of lack of risk management. 75% of the banks indicated that they have Audit Committee, while 62.5% of the banks have Human Resources Committee and other committees like, Loan Approval Committee, Resource Mobilization Committee and Business Development and IT Committees are also available with in private banks.

However, among the Committees which is strongly recommended by code of best practice is nomination Committee which is nonexistent in any of the banks under study. The Common practice unilaterally by all the banks is to appoint nomination committee in the annual general meeting and at the same time to nominate candidate directors which is by far contrary to the OECD principle as well as code of best practice. Ethiopian privately owned commercial banks need to improve this practice to a great extent. Fortunately, the good hope in respect to this disobedience might be the approval of the draft Corporate Governance Practice directive to be issued by national bank of Ethiopia which makes establishment of nomination committee one of the mandatory requirement of private banks. The draft Bank Corporate Governance Directive has been approved and become effective starting from September 21, 2015 and the problem related with nomination committee seems to be resolved, unless there is a gap in the practice.

4.2.12 Board's Performance Evaluation Mechanisms

Board of Directors must set plans to which the organization follow over the course of the business, the plan must also be evaluated against the actual performance. A question was forwarded to the banks to know whether the board has clear plans and objectives in place, and monitoring system of its performance against the targets. 100% of the respondents replied yes to the question, as they have clear plan and objectives in place.

In this respects the banks are working in line with the code of best practices, Basel committee guidelines for banking supervision and OECD principles. However, since the question doesn't address the quality of the plan and monitoring tool, it is thought that there is a room in terms of maximizing the benefit from adherence to good corporate governance culture by increasing the quality of the plan, the monitoring tool and finally to create a positive impact on the performance in terms of fulfilling the interest of shareholders.

4.2.13 Board Remuneration

It is not an arguable fact that the board of private banks adds value in terms of performance enhancement and promoting corporate governance practice. Thus, the next logical question that follows is how board members have to be compensated or who determines director remuneration? This issue has been a media concern as well when a directive was issued by the central bank back in 2011 to limit the compensation of the directors.

According to directive no. SBB/49/2011 individual board member will receive birr 50,000 per year and birr 2,000 per month. National Bank of Ethiopia set a limit on the compensation to arrest the war on campaign to hold the post of board of directors and protect the banking sector from instability. However, all agree that the amount is not sufficient and needs revision.

According to OECD principles of corporate governance, good corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders, and should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring.

4.2.14 Compensation Strategy

Almost in all of the banks, there is no clear and well documented compensation strategy, the banks rather act based on the industry practice. Almost all of the banks have similar compensation package, it is difficult to identify one with differing strategy to attract best talent.

Regarding the level of sufficiency of compensation to attract, and motivate directors of the required quality, 100% of the respondents replied "no". They explained that the fixed remuneration is not enough to attract the required talent to board membership. Proper level of remuneration plays a significant role in enhancing good corporate governance and adds value to the banks as it would have positive impact on performance. Even if board of directors' attraction factor may not only be compensation scheme, it is logical for anyone to get paid for the contribution they have made. Most of the respondents commented on the amount of the compensation in comparison with the level of responsibility and accountability placed on the board of directors. Thus, National Bank of Ethiopia, who is the regulator as well as the supervisory organ should look into this case and appropriately respond to the issue in a way that will address requests from the generation to come and the future potential of the country in terms of business organizations that will be established

in the form of share company as this industry will be the most mature and experienced sector that can be role model for the other sectors to emerge in the coming years.

Even if the next statement refers to executive directors, it also applies for non-executive directors that have an irreplaceable role in good corporate governance. “Code of best practices” across the globe suggests that the level of remuneration should be sufficient to attract, retain and motivate directors of the required quality to run the company successfully, but companies should avoid paying more than is necessary for the purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance (Carey, 2008).

4.2.15 Related party Transaction and Response to Findings

All of the banks under study confirmed that all related party transaction legitimacy is reviewed by board members. However, none of them reported on the financial statements published to the public that discloses the amount and type of related party transaction despite its mandatory requirement by Ethiopian Income tax proclamation irrespective of its materiality. It is found out that the board has good culture in terms of responding to audit findings and recommendations from internal auditors, external auditors, and supervisory authority and follows its corrections in good time.

4.3 SHAREHOLDERS

4.3.1 Equitable Treatment of all shareholders

Only one from eight respondents replied ‘no’ to the equitable treatment of shareholders. Shareholders basically have the right to vote up to their investment amount. This is justified by all shareholders having equal voting right based on the number of shares they own and have a means for redress to the board if they feel didn’t get equitable treatment. The fact that major shareholders have more voting right by its very nature gives them upper right while voting based on the number of shares they own, but this doesn’t mean that there is partial treatment of shareholders.

OECD principles of corporate governance states that corporate governance framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders. All

shareholders should have the opportunity to obtain effective redress for violation of their rights; all shareholders of the same series of a class should be treated equally. As per the OECD principle it can be concluded that Banks in Ethiopia practice good corporate governance in terms of fair treatment of shareholders. But this doesn't mean that shareholders exercise their right, this needs further study on the level of awareness of shareholders and participation in the governance process.

4.3.2 Influential Shareholders

In most corporate firms, there are owners who claimed to be influential based on the percentage of share they own relative to the majority one. In such cases, influential shareholder can influence the whole system in different ways. Banks under study were requested to list the percentage of at least top five influential shareholders; only one respondent provided answer to this question by listing the percentage of the first six influential shareholdings without indicating their cross ponding names. The other seven replied the requested information has a confidential nature. This response however, is contrary to banking business proclamation, No. 592/2008 Art. 10, sub (2) which requires every bank to keep a register of shares as determined by the NBE and which shall show the names and voting rights of shareholders, and sub Art (5) states that the register maintained shall be open to the public without charge. This is another weak area of corporate governance of these privately owned banks that lacks transparency.

Percentage share of influential shareholders

Lion International Bank S.C.	
S.NO.	Percentage of Shareholding
1	3.38%
2	3.29%
3	3.27%
4	3.07%
5	3.04%
6	2.86%

The aim of this question was to find out if there are institutional owners, large-block shareholders and the degree of their ownership in that particular bank. This would help to know the degree to which corporate governance framework of the banks is shaped by these institutional owners and large-block shareholders because of their dominant ownership right. National bank of Ethiopia Directive limits the maximum amount a given shareholder can invest in a banking industry is up

to a maximum of 5% of the total capital of the bank. In these respect all major shareholders are with the limit of the prescribed ceiling.

4.3.3 The Impact of Influential Shareholders

It is believed that influential shareholders usually affect the governance system of an organization in some way. Accordingly the banks were requested to indicate whether the major institutional shareholders use their voting right as vehicle to create influence in nominating and electing board of directors of the bank. Accordingly, 100 percent of the respondents replied “Yes”. In effect, institutional shareholders have direct or indirect influence on the strategies and operational decision of the bank due to their influence on the nomination and election of shareholders.

International practices indicate that institutional and other large-block shareholders are becoming more active in their efforts to influence a corporation’s strategic decisions. Institutional investors that control large-block shareholding positions are increasingly focusing their attention on the quality of the board as a whole-including the independent directors. Despite the influence created by major shareholders, directors appointed in the board must demonstrate professionalism by acting in a fairer manner when it comes to their role as a director than working to the party voted for them. But the level of influence on minority shareholders needs further independent study.

4.3.4 Auditors’ Independence vs. Promoting Shareholders Interest

For the question asked to indicate whether the auditors’ are independent and are promoting shareholders interest, 100% of them replied that auditors are promoting the interest of shareholders but they lack independence. As majority of respondents replied auditors in their bank lacks independence, due to the very nature of organizational structure and being employee of the bank, it is hardly possible to achieve independence, however, the board should facilitate utmost condition to empower and exercise internal auditors to exercise independence.

As given in the Basel committee for banking supervision, the role of independent, competent and qualified auditors and other control functions (including the compliance and legal functions) is vital to the corporate governance process in order to achieve a number of important objectives. That includes identifying problems with a company’s risk management and internal control

systems and ensuring that the bank's financial statements fairly represent the financial position and performance of the company in all respects.

4.3.5 Rights and Obligations of Shareholders

For question provided to respondents to indicate whether shareholders can freely exercise their voting right on significant issues facing the bank such as changing the terms and conditions of bank's shares, or governance documents and others, 100% replied that shareholders can freely exercise their rights to vote, share in the net profit, governance documents and others rights. A question also raised whether shareholder have the right to sell their shares to the public, since the current Ethiopian market is devoid of secondary market, this right seems to have some obstacles for shareholders to get buyers. But all the banks understudy ascertains that shareholder have the right to sell their shares.

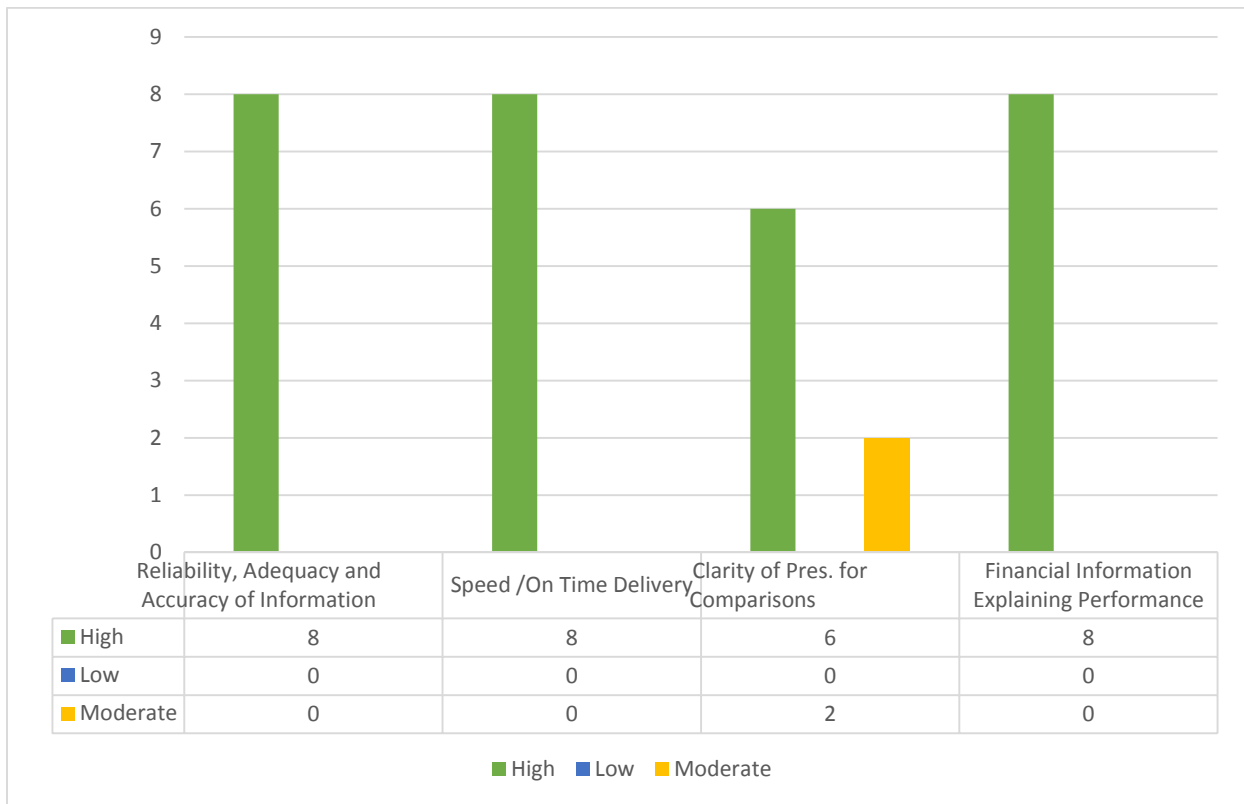
In this regard, Basel committee on banking supervision states that corporate governance framework should protect and facilitate shareholders' to exercise their rights. Moreover, equity investors have certain property rights such as to sell, buy or transfer an equity share in a publicly traded company or as per the rule of the land.

4.3.6 Information Provision to Shareholders

Information provision to shareholders is the most important corporate governance responsibility of board members. Shareholders know the success and failure of their investment upon getting accurate and timely information from the bank. The practice of this issue must also be seen in order to understand the issue on the ground and to suggest any solution if there is any gap observed. A question was raised to know the practice of providing timely and relevant financial information and operational results to shareholders related to the affairs of the bank so as to follow up the progress of the bank, all of the respondents indicated that the reliability, adequacy and accuracy of information is 'high'.

Similarly, all of the respondents with regard to timeliness of the financial and operational information rated as 'high'. Clarity of the presentation of information provided to the shareholders, rated it as 'high', by all respondents except two who rated the clarity of presentation as 'moderate'.

Again all respondents on banks' financial information provision which explains about the performance is rated to be 'high'. This can be judged as an excellent practice.



However, being rated 'high' on information provision by board of Directors doesn't mean that the required level of disclosure was made adequately and appropriately to shareholders and the public. This can be evidenced by the refusal of all banks except one who were requested to provide major shareholders in their bank despite clear legal responsibility levied on them. This is one of the major drawback of corporate governance practice by Ethiopian private banks, as a result, it needs the attention of supervisory organs and government to improve and avail these information to the public.

4.4 RISK MANAGEMENT AND INTERNAL CONTROL

4.4.1 Internal Control and Compliance

Among the committee that are recommended by international standards and best practices, having Risk management and Control Committee is one. Among the areas where this committee can function with a very good integration is Compliance and internal control unit. A question was

raised to know whether there is a formal Compliance Unit with a mission to ensure that employees understand and implement the bank's internal procedure and plays their role in discharging external obligation of the bank, all of the respondents replied that there is a risk and compliance department in all of the banks under study.

The investigator have of the opinion that the contemporary requirements for banking organization is the establishment of independent Compliance Unit which is in charge of following and ensuring the compliance of the banks' employees with internal procedures, external requirements and principles of best practices. This fulfillment is an indication of embracing sound corporate governance practices and principles. The bank should maintain sound internal control functions, including an effective compliance function that, among other things, routinely monitors compliance with corporate governance rules, regulations, codes and policies to which the bank is subject and ensures that deviations are reported to an appropriate level of management or, if appropriate, to the board of directors.

4.4.2 Risk Management Practice

Identifying and assessing the risks inherent in the business is one of the responsibilities of the board which indicates its strength and the practice of good corporate governance. Accordingly, all of the respondents revealed that there is regular risk assessment practice to evaluate internal and external business environment situation of their bank. As part of the risk management system, it has been noted that almost all of the banks under this study reveals that they have Risk management and compliance committee. This has helped the banks to have a good risk management and control framework and practice. Risk management and control is one of the major component of good corporate governance concept. According to Basel banking supervision guideline, it is indicated that banks should have an effective internal control system and risk management function with sufficient authority, stature, independence, resources and access to the board. In line with this, private banks in Ethiopia are in a commendable track to achieve this practice. However, there seems a loophole in terms of reporting the finding of risk management system to the board and senior management. One of the respondents indicated that, findings from the risk identification process were not reported properly to the senior management and board. Since the apparatus of the whole risk management system is in place, a practice that enhances complete process of risk

management system must be promoted by reporting the findings to the appropriate body for further action and consideration to give direction on the issues.

4.4.3 Established Risk Mitigating Mechanisms

In a system of risk management, there is a process to be followed. The one which comes first is there must be risk management system in place. Then the system should function in the following manner. Risk should be identified, the identified risk will then be assessed to measure the risk level, and then the measured risk will be categorized according to the organization risk categorization culture as high, medium or low. The bank should decide the appetite level of risk taking by measuring the cost and benefit. Finally for the measured and categorized risk, a mitigating mechanism will be placed so as to put in place a protection mechanism in order to safeguard the organization from unwanted risk. In this case the banks have unanimously responded to have a risk mitigation mechanism that is well documented for reference that the management or board can be guided accordingly for any decisions to be made. According to the responses collected, all banks have a system of identifying risk, measuring the identifying risk and reporting the output to the concerned level, even if there is some gap on the reporting level, as 25% of the banks lack the culture of reporting.

4.4.4 Audit Committee Experience and Exposure

Basel committee suggests that at a minimum, the chairman or at least one other member of the audit committee should possess expert knowledge- commensurate with the complexity of the banking organization and duties performed – in financial reporting, accounting or auditing, and all members should have background compatible with the duties of the committee.

In this regard, all respondents indicated that the existing members of the audit committee have relevant and up to date exposure and experience of financial reporting, auditing and accounting standards. This is supported by international requirement of Sarbanes-Oxley that requires all members of the audit committee to have or become financially literate by the time of their appointment and at least one audit committee member has some specified financial expertise or experience because this vital committee basically oversees the accounting and financial reporting process of the company and audits of the financial statements.

4.5 EXECUTIVE MANAGEMENT

4.5.1 CEO (Insider) Ownership in the Bank

With regard to question designed and distributed to the respondents to know the degree of relative ownership concentration of the CEO, all respondents replied that the CEO's holds a share in a bank. But for those who responded that there is ownership of shares by CEO another question was asked to indicate the level of ownership, 33% of respondent who replied that the ownership is smaller than most of individual shareholders whereas the rest 67% of respondents claims the CEO to have similar ownership amount with most of minority shareholders.

Insider ownership, namely ownership of the CEO, executive officers, and insider directors on the board, is strongly (and most often positively) related to operating performance and can be taken as good governance. Since CEO ownership stake in the firm increases, actions that managers take should be increasingly oriented toward maximizing firm value.

4.5.2 CEO Compensation

Regarding question presented to the respondents to explain the manner in which the CEO is compensated, 67% replied that Salary, bonuses and other incentives packages like free medical care (including abroad medical coverage), representation allowance and others. 33% of respondents indicated that bank's executives are compensated by salary only. But it is a normal and industry standard to compensate CEO by providing Company Car, Medical coverage and annual bonus across the industry. It is noted that none of the banks under study indicated stock option as a compensation means for CEO.

The board of directors are specifically responsible for the determination of the structure and level of compensation of the top executives of the firm. The compensation issue that is of greater interest from corporate governance perspective is the degree to which executive compensation aligns top executives' interests with those of shareholders.

4.6 DISCLOSURE AND TRANSPARENCY

4.6.1 Disclosure by Bank

Referring to what matters are disclosed by their banks, seven respondents or banks replied only financial reports and results are disclosed to the shareholders and the public. However, referring to the respondent who replied related party transaction, major shareholders and governance structure have been disclosed is also not practical on the ground while I reviewed two consecutive years annual report of the bank made to the shareholders and the public. From the response and annual report of the banks, disclosure is one of the area where privately owned commercial banks greatly deviate from best practices and international standards. As per the annual financial statement report published in the website of banks and most circulated magazines in the country, it is noted that all the banks disclosed only financial situation and performance for a given fiscal year. This practice is the one which needs attention by all stakeholders to promote good corporate governance practice in the industry.

In a move to bring personal accountability to the act of financial reporting, Sarbanes- Oxley requires that the CEO and the CFO must certify the completeness and accuracy of financial reports and results in each reporting period. OECD principles require the corporate governance framework to ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. However, in most of financial reports it is noted that the CEO and the board chairman are the one who signs on the financial statement of the banks which is contrary to international standards. Since board members are not the one who involves on the day today operation of the banks CFO must certify and ensure the correctness of the financial statement presented to the public.

4.7 SUPERVISORY/REGULATORY ORGAN

4.7.1 Legal Framework in Protecting Internal Abusive Practices

In order to ensure equitable treatment of shareholders, it is essential that there is a legal framework providing shareholders a means to seek redress for any abuses which they might face. In line with this the respondents were asked to reveal the extent to which the legal framework of the country protects shareholders against abusive practices, 33% of the respondents replied that the framework is highly protective of such practices, while 50% of the respondents declare the legal framework

of the country moderately protect shareholders from abusive practice, the rest 17% responded shareholders poorly protected from abusive practices by the country legal system. This is the area where legal professionals can study deeply and see where are the gaps in protecting shareholders from abusive practice of their own organization.

The availability of such framework is considered to be essential in enhancing investors' confidence in general, and credibility of bank board and management, which resulted in high resources mobilization and company performance.

4.7.2 Control Environment Vs Bank's Strategic Plan

For the question designed to know whether their banks are doing their banking business as per the strategy formulated, 17% of respondents replied 'no' our bank have difficulty to carry out its business as per the strategy. The rest 83% replied they are doing their business according to the strategic plan endorsed by the board and it is the framework for all activities of the banks and its strategic directions. Setting strategic direction is one of the top responsibilities of the Board in which banks should know where to go, how to go and when to go to achieve the best out of the available opportunity with in the business environment.

4.7.3 Clause in the Proclamation and Directives that needs Improvements

Banks are operating in the country's legal framework, all the activities of the banks are either flourished or impeded by the rules prevails in the land they operate. A questions intended to know whether there is any clause in the banking business proclamations and directives that impede proper governance in the banking industry, the following responses were given, 87.5 % replied 'Yes' while 12.5 % of respondents replied 'No. For those who indicated there are some clauses which needs improvement further explain that to enhance the level of governance practice and competition, the proclamation need to be revisited. The regulation of 40% short term loans from the total loan portfolio and the requirement of 27% bond purchase on each fresh short term loan is creating stress on the liquidity of the banks and also indicated that the interest rate for the bond purchase amount doesn't even cover the interest cost of the fund which is 5% Vs 4.5%.

4.7.4 Suggestions to Improve Governance Practices

An open ended question was raised to know the suggestion made by board of directors to improve the overall corporate governance practice of banks, the respondents gave their opinion as follows: continuous awareness creation program should be organized to make clear the importance and benefits of corporate governance in the banking sector. Policy support need to be provided and similarly the existing policies as much as possible should be revisited in a way that support both the profitability of banks and helps them promote good governance culture. Shareholders must show and enhance their commitment, not only in investing their money in the bank, but they also have to follow and provide useful advice and information as to how to improve the governance system of the bank. As most of these shareholders do not properly know their right, awareness creation should be conducted so that they could play their active role in governance of the bank. The role of the regulators should be enhanced and need to focus more in banking business operations and their strategies .While drafting rules, regulations and principles, NBE should consider the existing business condition, the sizes, nature, condition of the banks operating in Ethiopia. International best practices need to reviewed and adopted in the regulation and supervision of the banking system. The capacity of supervisory bodies both in human and other resources need to be given due attention so as to cope with the dynamic nature of the business in the world. Ethiopia has applied to be member of World Trade Organization, as part of this process one of the sector that needs liberalization to international market is the financial sector, this will have a significant influence in the regulation as well as supervision of banks, as a result regulatory body need to equip itself for any business need that may arise in the future.

4.8 GENERAL COMMENTS AND COMPLEMENTS

The respondents were asked to give overall comments and complements about corporate governance practice in the country and its present status, what aspects are not embraced in the governance of these banks. In line with this the respondents tried to indicate weakness and strong sides of governance of the banks' under study. They also attempted to give their opinion on the rules and regulations governing the financial sector in Ethiopia.

In the banking business of the country, there is a blurred demarcation between the board of directors' role and executive management. As it is clearly stated in best practices and principles of corporate governance literature, the board of the company is mainly focus on policy issues,

approval of appropriate operational manuals, ensure companies including banks compliance with relevant laws, directives, its own policies manuals and guidelines, and board decision from time to time. In private banks of Ethiopia, boards, apart from the above practices, they interfere in operational activities of the bank which is entirely must be left for management of that bank. As a result, there is undue and heavy handed influence of boards on the decisions of the management group. More autonomy should be given for executive management. All must play their role appropriately and effectively.

It is known that Supervisory authority of the bank have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of a bank and may adversely affect the bank's risk profile if not implemented effectively. However, some directives regulating the banks are excessive which have adverse impact on overall performance of these private banks. With regard to this as most of the banks are on growing stage. The necessary policy support should be in place so as to enable them provide a variety of new financial services and products that attract both investors and consumers. Similarly, NBE needs to follow issues like integrity, ethical concerns, malpractices and others by both board and management members of the bank which diminishes the quality of corporate governance practices and firm reputation.

Awareness creation about corporate governance should be aggressively conducted for all participants including the general public. Ongoing orientation and training programs for board members should be continuously scheduled which could bridge the gap on overall operation of the bank, which can be translated into performance of the bank.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

This paper assessed corporate governance practices of private banks in Ethiopia based on major determining factors for sound corporate governance in the banking industry. In today's business world the importance of good corporate governance is undisputable by all stakeholder including the public at large due to the very nature of corporate firms operating in our living world that separates ownership from the day to day control and decision making on resources. Due to precedence observed on lack of good corporate governance practice that resulted major business collapse in recent years, has made the issue a global concern. Due to the increasing trend in the number of corporate firms in Ethiopia and some poor strategic decisions, malpractices and other concerning issues are begin to emerge, stakeholder are forced to question the overall corporate governance framework and regulators begin to be curious on how to improve the legal framework. Before dealing on the adequacy of legal framework and other issues, it is imperative to assess the level of corporate governance practice in the country. Governance is a broad concept that specifies the distribution of rights and responsibilities among different participants such as the Board, Management, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs.

Studies conducted in the area of corporate governance in the context of Ethiopia focused on the adequacy of legal framework rather than on the practice of corporate governance principles and best practices. These include adequacy of legislative provisions on governance issues related to the separation of ownership and management responsibilities, on the composition, independence and remuneration of board of directors in share companies, and also on the overall corporate governance standard adequacy by citing different factors such as limited legislative framework, inadequate shareholders protection law and ineffective judicial system, absence of an organized share market and discrimination on implementations of regulatory framework on banks, etc.

Thus, the focus of this paper was on major dimensions of corporate governance system which are Shareholders, Board of Directors, Executives, Supervisory Organs, Risk management and internal control and Disclosure and Transparency. Based on those factors, the study comprehensively assessed corporate governance practice of privately owned commercial banks in the country in

light of OECD principles and Basel committee banking supervision guidelines. Following the analysis of the questionnaires distributed to board members a conclusion and recommendation that will have value for all interested stakeholders including policy makers were forwarded.

The number of board of directors in eight private banks are all composed of independent outsider directors with board size ranging from 9 to 12 and also have the required age, relevant educational qualification that enabled them to accomplish their responsibility in corporate governance and capable to handle issues that arise as a result of their responsibility in a more efficient way.

Clear line of responsibility and accountability for senior management have been set by boards to all senior management as per the best practice requirement. The board also set strategies, financial goals and follow its implementation. This is one of the areas where good corporate governance is practiced in the country's commercial banks in line with those practices proposed by the codes of best practices. BODs are also carrying out the evaluation of its performance against target.

The practice of providing financial and operating results to the shareholders is moderately practiced and limited only once in a year to those who participated in the annual general meeting, since this is the only formal way of gathering and interaction between owners and managers. Not excluding the fact that financial performance of banks are disclosed in magazines and website of respective banks. However, the disclosure of non-financial information like risk exposure, performance, governance of the bank and ownership concentration to owners and external party, related part transaction are found to be nonexistent which needs major focus from the supervisory organ to enforce its implementation and from the banks themselves to promote good corporate governance practice.

In all private banks under study; both internal and supervisory policy and directive prohibit board members to sit on multiple boards of other banks in addition to the directive issued by national bank of Ethiopia that prohibits directors from sitting in more than one bank directorship at a time, the same practice in adherence to their own internal policies as well as the National Bank of Ethiopia directive is practiced in all banks.

All board members are composed of unaffiliated external personnel. There are different board committees in these banks and all composed of outside non-executive directors with written terms

of reference showing their role, function and power. Audit committees have relevant and up to date experience and exposure in auditing, accounting and financial reporting.

Boards exercise the responsibility of identifying and assessing the risks inherent in the business which indicates its strength. It is found that, there is a regular risk assessment practice. But though there is a well-documented risk mitigating mechanisms but how effectively these important documents are used seeks further study.

Board compensation is controlled by the supervisory authority and the amount and type of compensation for the board has been set by NBE. It is found that determining and fixing the amount of compensation by central bank is considered to be unfair and inappropriate and also is not adequate to attract, retain and motivate directors of the required quality for such high profile and demanding responsibility.

The study attempted to find the percentage list of few top influential shareholders. However, only one bank is willing to provide the information, the rest majority of seven banks indicated it is confidential. This is another weak area of corporate governance practice of private banks which needs improvement.

Individual shareholdings right is not more than 5% of the total capital as per the collected information from one bank. This is in line with the supervisory directive that states in any bank the percentage share of influential shareholder should not be greater than 5% of the total share capital of the bank.

The supervisory organ in the country seems to have dual role acting as a regulator and supervisor. These has given NBE ultimate power to make or break the banks given the power it has .Based on the information gathered NBE regularly supervised corporate governance compliance of banks and provide the required feedback.

The study found that shareholders in these private banks freely exercise their voting right in most matters such as changing the terms and conditions of shares and governance documents.

It is found out that there is insider ownership of shares specifically by CEO in these banks. However, the percentage share held is found to be similar or smaller than individual shareholders and hence, it is difficult to relate the level of shareholdings of executive directors with bank performance. On the other hand, CEOs are compensated by salary, bonuses and other incentives packages like free medical benefit (including abroad medical coverage), representation allowance

and others in all of the private banks. And also the study found that there is no stock based compensation system but sometimes banks found out to offer equity incentive package on irregular basis.

The research finds out that private banks under study have faced difficulty to carry out their business as per the strategy due to unpredictable environment which impedes their activities. This is the areas which require farsighted and talented board members who can easily refocus or change their focus when there is event of change in business environment and regulatory requirements.

It is found that in all of the banks there is no designated nomination committee for overseeing the appointment of board members and ensures that the process is formalized and transparent. Fortunately, before the completion and submission of this paper corporate governance directive has been issued on September 21, 2015 by National Bank of Ethiopia. The directive stipulates establishment of nomination committee as a mandatory requirement for all privately owned banks. Disclosure practice of banks found to be at its infant stage. The information communicated to shareholders, and other stakeholders including banks are very restricted which is limited to financial position and performance. This is one of the area which the regulation as well as the self-regulation needs to see and improve. Most of the banks feel insecure in disclosing information to the public in the sense of losing their competitive advantage. However, this doesn't sound logical, if one bank discloses its major shareholders to the public, there is nothing to lose on its competitive advantage.

Overall, the study indicated that the awareness of embracing good corporate governance practices is found to be at its early stage in private banks in Ethiopia. In addition, since banks are among highly regulated industries, their governance mechanisms are influenced by law, proclamation and NBE's directives. As a result, their play ground is limited. From these perspectives, the homogeneity of population is characterized in the banks. Therefore, similar governance practices would likely be expected in the rest of the banks operating in the country.

It can be concluded that all of the adherences of privately owned commercial banks in comparison with other best good corporate governance practices is due to the country laws and provisions that are mandatory to operate legally. None of the samples under this study went extra mile to fulfill any of good corporate governance practices that are not part of the national legal requirement. This indicates that the supervisory organ and the government needs to work hard in adopting best

practices into the legal system of the country and enforce its implementation in order to boost good corporate governance practice with in the banking sector.

5.2 Recommendations

Based on literatures reviewed and data collected, discussion, presentations and conclusions made the following recommendations were made:

1. Disclosure of information is one of the most severe problem the industry is facing in terms of good corporate governance practices. Only Financial Position and performance of the banks are disclosed on annual basis to the public as per the commercial code of Ethiopia proclamation requirement. But other non-financial disclosures like foreseeable risk factors, related party transactions, major share ownership and voting right, remuneration policy and governance structure are not disclosed to shareholders and to the public. Good culture of disclosure signifies good leadership and transparent system in the industry. In a recently enacted directive of corporate governance of banks, I don't see any strong clause that transforms the current trend of information disclosure to a better level than stating the current practice of reporting financial figures to the public as requirement. The central bank shall make a meaningful change towards the importance of this big milestone to bring a culture that will help the industry as well as the country by inculcating non-financial information to be part of a disclosure requirement as stipulated in OECD as well as Basel guideline.
2. Board remuneration set by National Bank of Ethiopia is not sufficient to attract the required quality of board members for the banks in Ethiopia. Even if it is arguable that there are still competent board members who are interested to serve their bank within the framework of the current fixed remuneration, it is not logical for one to be compensated less than its contribution. One of the manifestation of corporate governance is also introducing a logical compensation system for the directors as well, NBE may establish some sort of framework that can be used as a guideline for banks to follow by setting a limit that can be acceptable by all stakeholders. The noise that is heard from all the banks may indicate an area of concern which must be addressed to the smooth functioning of the most important industry and for its future development. Therefore, NBE should revisit and relax its directives in this regard to a point which fulfills both the regulatory/supervisory as well as the banks objectives.
3. All banks strive to fulfill the requirement of local laws and directives. There is an inclination that focus on mandatory requirements than adopting best corporate governance

practices. As a result, the regulatory organ and the government needs to work hard in adopting best practices of corporate governance into the legal system of the country and enforce its implementation in order to boost good corporate governance practice with in the banking sector, until the industry players understand the value of adopting best practices than enforcement.

4. One of the manifestation of good corporate governance is shareholders participation in the directors' nomination process. The current practice of banks in this regards doesn't seem appropriate in terms of providing the opportunity for shareholders to participate in voting directors in a more informed and transparent way. In order to improve shareholders participation in this process, having nomination committee in the banks must be a mandatory requirement. This will boost the standard of corporate governance practice in the industry. Luckily, before the submission of this paper a new corporate governance directive number SB/62/2015 has come into effect starting from September 21, 2015 which makes formation of Nomination Committee a mandatory requirement for banks. This will have a paramount importance in promoting good corporate governance practice for banks.

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