

# **Towards a Better Understanding of Banks' Corporate Governance in Developing Countries: Analysis and insights from the Egyptian context**

**M. Karim Sorour <sup>1</sup>**

## **Abstract**

Developing countries' banks have peculiar characteristics that make their corporate governance model of a special nature and makes unconditional copying from traditional corporate governance models prevailing in developed countries inappropriate. Although, this issue has been addressed in the literature at the conceptual level; no previous research has empirically explored this issue and provided evidence for this. Based on a grounded theory study, this paper identifies the contextual factors surrounding banks' corporate governance in Egypt. Two contextual factors have been identified within the Egyptian banking context: first, corporate governance identity as determined by management control, organizational perception of corporate governance and employees' competence. Second, laws and regulation as determined by corporate governance content and enforcement. This paper makes a contribution to the scant empirical research into the corporate governance of banks within developing countries context, provides an in-depth understanding of such context and how it differs from the traditional corporate governance models. Additionally, this paper assesses recent corporate governance reforms in the light of the Egyptian banking corporate governance model, and accordingly reaches important policy recommendations to guide future corporate governance reforms.

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<sup>1</sup> Dr. Sorour is a Lecturer in Accounting and Financial Management, Faculty of Business & Law, Newcastle Business School, Northumbria University, Newcastle Upon Tyne, UK. NE18ST. email: [karim.sorour@northumbria.ac.uk](mailto:karim.sorour@northumbria.ac.uk)

## 1. Introduction

Historically, banking scandals for example in East-Asia and Russia (Barth et al, 2007; Nam and Lum, 2006; Sorour et al, 2012) and more recently the global financial crises have had a basic common factor which is weak corporate governance. However, this paper does not aim addressing the importance of bank corporate governance (BCG) or its special features that justify special attention and design of relevant corporate governance structures. As these issues have been already addressed by a growing stream of literature especially within the context of developed countries (for example see Peni and Vähämaa, 2012; Ciancanelli and Gonzalez, 2000). Meantime, previous work has also addressed the importance of BCG within developing countries context and identified some additional common characteristics of these countries that makes an effective system of BCG an urging priority for reformers within these countries (Arun and Turner,2004; Das and Ghosh,2004; Levine,2003; Gandy *et al*, 2006; Sorour et al, 2012). That said, examples of these characteristics include: first, the dominant position of banks in a developing financial system and its role banks in economic growth given the usually under-developed financial markets of developing countries (Capri and Leveine,2002; Barth *et al*,2007). Second, the recent liberalization of banking sectors in developing countries through privatization and divestment along with the reduction of economic regulation which has given bank executives more freedom in determining management practices and in setting priorities for interests' serving (Nam, 2007). Third, the relative governmental interference in banking operations in the form of directing credit granting, setting portfolio restrictions, and determining liquidity levels (Nam, 2007) coupled with higher government ownership of banks leading to higher chances of conflict of interests (Mullineux, 2006).

For Egypt, BCG is even more important because of the following specific reasons: firstly, 85-90% of business financing is provided by the banking system (El-said, 2009) which means that banks are the principal players in the Egyptian economy. This puts a huge burden on the banking sector to be properly governed to avoid failures. Secondly, there have been recently (since 2002) many government initiatives to improve the Egyptian investment climate, with strong corporate governance structures being its backbone. Here the role of banks in these initiatives have been emphasised in the Egyptian corporate governance codes (2005; 2011) which assigned banks a major role in ensuring adherence of business organisations to the code provisions by considering its standards a precondition for credit extension (Egyptian Code of Corporate Governance, 2005; 2011). Performing such a role means that banks have to be a model of high quality corporate governance themselves, in order to insist on high standards from others. Thirdly, corporate governance of the Egyptian banks has been central to the reform programme of the EBS itself. Those reforms were initiated to address many areas of

improvement amongst is to enhance banks' governance especially since weak governance was a main reason for the late 1990s' bank failures and the associated problem of non-performing loans (CBE, 2008). In summary, in Egypt in the late 1990's bank failures can to a great extent be blamed on failure of corporate governance that included: corruption in lending (Kalhoefer and Salem,2008), inadequate risk management, weak internal controls, improper transparency and disclosure measures and imprudent boards(Mohieldin and Nasr, 2007). Though the deterioration of the macro-economy has aggravated the problem of NPL by increasing the number of bankruptcies (Mohieldin and Nasr, 2007).

Despite the above-mentioned importance, still the BCG reform in developing countries is an area that requires further exploration. On one hand, the global financial crisis has demonstrated that it is difficult for developing countries to copy corporate governance systems (based on the traditional Shareholding v. Stakeholding corporate governance models) prevailing in more developed countries, especially that these prevailing systems have been themselves subject to review and scrutiny post the financial crisis (Mehran et al.,2011). On the other hand, a greater attention is now given to understand the BCG phenomenon as dynamic context specific rather than a static phenomenon (Ratnatunga and Ariff, 2005; Lubatkin *et al*, 2005; Rwegasira, 2000). Moreover, it must be noted that although the international banking community calls for a pluralistic model of corporate governance to ensure consistency with internationally agreed standards for BCG, this does not necessarily mean that the factors shaping corporate governance have to be similar from one country to the other or even within various banking sectors, as such this can only be known by empirical corporate governance research that examines the institutional environments in which these banking organisations operate (Durisin and Puzone, 2009; Letza *et al*, 2008; Smallman, 2007; Ratnatunga and Ariff, 2005; Lee and Yoo, 2008). Nonetheless, the influence of the international banking community on BCG reform in Egypt can be observed from the statements of the Central bank on progress in BCG reform "*Recent years have witnessed considerable efforts by the Central Bank of Egypt to increase the soundness and to modernize the Egyptian Banking Sector... CBE has made considerable progress in developing its supervisory framework... CBE complied with most of the Basel Core Principles for Effective Banking Supervision... In support for the efforts done to modernize this sector, further reforms need to be introduced... Enhancing and monitoring corporate governance in all banks*"(CBE,2003). Moreover "*After the successful completion of the first stage of the banking reform plan, launched in September 2004, the Central Bank started to make the necessary preparations for the second stage (2009-2011). The reform program at this stage is centred on a number of pillars.11..(5) reviewing and firmly applying international governance rules for banks and CBE*"(CBE,2008). Here, the application of

*international rules is apparent.* However, it must be mentioned that the Egyptian government follows a customization approach to include local realities within the corporate governance reform. Here, understanding the local context becomes an inevitable step towards drawing effective reform strategies. An objective that this paper seeks to fulfil.

That said and based on a grounded theory study of BCG within the Egyptian banking sector (Sorour, 2011), this paper reports the nature of the BCG context within Egypt and identifies the factors shaping it. This paper is organised as follows; section 2 discusses the methodology and methods of this paper, section 3 presents the coding and identification of contextual factors, while, section 4 assess the recent Egyptian BCG reforms in the light of the findings of the paper and finally the conclusion and further policy recommendations are reached.

## **2. Methodology and methods**

This paper reports on the contextual factors shaping the BCG phenomenon within a developing country context (Egypt). The study is based on a grounded theory methodology (Strauss and Corbin, 1990b; 1998). Grounded theory is based on comparative analysis and aims to build a theory on the basis of “*general categories*” (Howell, 2000: 28). It does not assume that the inquirer knows the substantive areas better than those involved in it; neither assumes that a theory will be a finished product (ibid). Indeed, it attempts to generate theory based on data collected and analyzed simultaneously as the research progresses (ibid). Grounded theory is an “*inductive qualitative methodology that allows the researcher to identify the main concern of a group of subjects and the behaviours they use to resolve their main concern*” (Artinian et al, 2009: 3).

This study adopts Strauss and Corbin's (1990b, 1998) grounded theory approach, According to Strauss and Corbin (1990a, 1990b, 1998) coding is the principal analytical process within grounded theory research. It is “*the analytical processes through which data are fractured, conceptualized, and integrated to form theory*” (Strauss and Corbin, 1998:3). There are three types of coding processes: open, axial and selective coding. Open coding is the “*interpretive process by which data are broken down analytically*” (Strauss and Corbin, 1990a: 12). Open coding aids the researcher to view the phenomenon studied in a non-traditional approach. Within the open coding the researcher compares instance one another grouping similar concepts that emerge from the data collected to form higher level abstract categories and sub-categories (ibid). While, axial Coding refers to “*bringing the analysis together and provides unity*” (Howell, 2000:33). In axial coding data are put back together in new ways by making connections between categories. This is done by utilizing a paradigm model which provides a framework to identify the phenomenon and link it with sub-categories namely: conditions,

context, action/interactional strategies and consequences (Strauss and Corbin, 1990b). Finally, selective coding aims to “ *selecting the core category, systematically relating it to other categories, validating those relationships, and filling in categories that need further refinement and development*” (Strauss and Corbin, 1990b: 116). It involves identifying of the core category which reflects the “*central phenomenon of the study... the other categories will always stand in relationship to the core category as conditions, action/interactional strategies, or consequences*” (Strauss and Corbin, 1990a:14). Selective coding involves the important aspect of relating categories to the core category; this should take place as well by the means of the paradigm model (ibid).

It must be noted here that although the study has implemented the three coding techniques (see Sorour, 2011) the main objective of this paper is to discuss the contextual factors where BCG phenomenon is embedded and as such provide and empirically driven exposition of these factors and how they shape the phenomenon rather reporting the substantive theory of BCG is the focus, this goes in line with Strauss and Corbin (1990b) recommendation on reporting the results of grounded theory studies, by focusing on one or two categories, as this would help to clearly discuss the selected categories in more details and show how they emerged. As such, it is not intended here to present the ultimate output of the grounded theory study, especially that reporting of the detailed analysis of grounded theory research would entail a lengthy exposition (Suddaby, 2006). This is acceptable in grounded theory research and has been advocated by Strauss and Corbin (1990b) as above-mentioned. These factors will be utilised to assess the recent BCG reform developments in order to arrive to relevant policy recommendations that enhance further BCG reform.

## **2.1 Methods**

This study follows the logic of theoretical sampling, which seeks obtaining data that are theoretically relevant, as such it assists the researcher to predict where and how to find necessary data to fill gaps and saturate emergent categories (Charmaz, 2006). Regarding research sites, commercial banks were the primary site for conducting this research, but application of theoretical sampling has directed the researcher to other relevant research sites namely: CBE, auditing firms, the Egyptian stock market, the Egyptian banking institute and the Egyptian institute of directors.

Although a combination of data collection methods were used to undertake the grounded theory study of BCG within the Egyptian banking sector. Firstly, a survey was implemented to assess the BCG practices of banks. This was important to allow access to data and inform questions formulation in the semi-structured interviews

(A). The semi-structured interviews (A) with bank directors and executives from various banks and governmental officials and auditors was the basic data collection method employed in this study and contributes in open, relational / variational, and discriminate sampling. Finally another round of semi-structured interviews (B) were carried at the stage of selective coding to identify the core category, discover its properties and dimensions and verify its relationship with sub-categories, interview (B). Indeed, this semi-structured interview (B) is related to discriminate sampling. However, as the contextual factors reported in this study are primarily related to data pertaining to interviews A, appendix 1 show only questions of interview A. 44 interviews were undertaken during interview (A) stage. Participants included board directors, executive managers, Big four auditors and government officials.

### **3. Exploring the context of the Egyptian BCG phenomenon**

According to Strauss and Corbin (1990b), context represents “*The particular set of conditions within which the action/interaction strategies are taken to...respond to a specific phenomenon*” (p.101) They are specific sets of conditions that intersect dimensionally at this time and place to create the set of circumstances or problems to which persons respond through actions (Strauss and Corbin, 1998). Generally, context refers to “*surrounding associated with phenomenon*” (Cappelli and Sherer, 1991: 56). These surroundings play a crucial role in determining the pace and the degree of organizational change (ibid.). As such contextual factors can include internal as well as external elements. The contextual factors category here is based on two categories: *Corporate Governance Identity and Laws and Regulations*. The former represents *the internal element, while the latter represents the external element*. These two categories can be explained in details as follows:

#### **3.1 Corporate Governance Identity**

This open category emerged in relation to the analysis of responses to the following questions:

***Q1: To what extent does the bank's ownership identity affects its quality of corporate governance practices?***

***Q5: On what basis a bank considers corporate governance reform?***

The term identity refers to the questions of *who are we? What kind of business are we in? And what do we want to be?*” (Albert and Whetten, 1985). It is a self reflection question that refers to the “*features that distinguish the organization from others with which it may be compared ... (or) features that exhibit some degree of sameness or continuity overtime*” (ibid, author brackets). According to Williamson (1998):

*Things are identical if they are one thing, not two. We can refute the claim that they are identical if we can find a property of one that is not simultaneously a property of the other. The concept of identity is fundamental to logic. Without it, counting would be impossible, for we could not distinguish in principle between counting one thing twice and counting two different things...Knowledge of what directions are involves knowledge that parallel lines have identical directions (Williamson, 1998:3841).*

In the context of the EBS, the category *corporate governance identity* reflects what various participants from the banking field<sup>i</sup> refer to when they express their opinion regarding similar corporate governance practices prevailing in a particular group of banks. Indeed, this is based on the four ownership types<sup>ii</sup> of banks within the EBS: Foreign, Private, Arab and State. Because “*identity has to exist in relation to some other thing*” (Howell, 2003:5) as advocated by Hegel (1971). Corporate governance identity exists in relation to the ownership type. This was clearly asserted by participants from the banking field, the following quotes reflect this:

*“Yes, for sure ownership identity affects the quality of corporate governance” (Director, Foreign bank).* Similarly an executive manager of a State bank mentioned that “*corporate governance quality is related to the ownership type of the bank*”. Another executive manager of a Private bank adds “*Yes, the bank type does affect the quality of corporate governance*”. As such this indicates that the same banking type shares similar corporate governance practices and therefore the term corporate governance identity refers to similar corporate governance features shared by a particular banks’ type.

To summarize, bank directors and executives from various banks agreed upon four corporate governance identities corresponding to the four bank ownership types (Foreign, Private, Arab, State). This reflects that every ownership type shares common corporate governance features that distinguish it from other types. As such it reflects a particular corporate governance identity.

Here the participants spoke of the foreign bank corporate governance identity as the best and most committed to high quality corporate governance practices, followed by Private and Arab banks. While, State banks are perceived as the least committed to high quality of corporate governance practices. An executive manager from a State bank admits this reality when he/she says:

*Corporate governance quality is related to the type of the bank, foreign banks have the best corporate governance practices, private banks are okay but to a lesser extent, followed by Arab banks, while we come at the end of the list ( Executive, State Bank).*

Another Foreign bank board director agrees to the same categorization of corporate governance identities.

*Ownership identity affects the quality of corporate governance; you will find that the State-owned banks have the least corporate governance quality (Director, Foreign bank).*

Another executive manager from a Private bank confirms the categorization of corporate governance identity based on banks' ownership type as follows:

*The bank type does affect the quality of corporate governance, so if we divide the present structure of the EBS according to the ownership type, you will find that Foreign banks have the best corporate governance practices and State owned banks have the worst practices, while other banks (Arab and Private) come in between ( Executive, Private bank).*

The open category *corporate governance identity* was observed in terms of its conceptual properties of *management control, organizational perception of corporate governance and directors' and executives' competence*. These properties can be discussed in the following subsections.

### **3.1.1 Management Control**

Management control refers to *"the means by which the actions of individuals or groups within an organization are constrained to perform certain actions while avoiding other actions"* (Encyclopaedia of Management, 2009:510). Management control was observed as a main property of the *corporate governance identity category* with dimensions ranging from loose to tight management control. Indeed, bank directors and executives from various banks have indicated that tight management control is essential for high quality corporate governance practices.

Bank directors and executives have agreed on the vital role that management control plays in defining the corporate governance identity of the bank. In fact this agrees with the basic definition of corporate governance as *"how companies are directed and controlled"* (Cadbury report, 1992: Para: 1.9). Thus absence of control indicates that a basic feature of corporate governance would be missing. An EBI official stated *"Lack of control provides individuals with the chance to behave in unfavourable way"*.

Participants from the banking field emphasized the importance of management control in defining corporate governance identity, referring to banks with low management control that had collapsed during the late 1990s. Indeed, behind failures was poor corporate governance<sup>iii</sup> based on weak management control. This facilitated transgression especially in loan granting function. The following quote shows this meaning:

*Lack of control was a main reason behind the famous banking failures in the 1990s, at these times a loan was granted by a phone call to a bank manager from a high-rank official (CB official).*

Bank directors and executives from various banks commented on their corporate governance systems in terms of management control system. This reflects their own experience from two perspectives: as employees whose



behaviour is controlled by management control systems, and as the personnel responsible of running the control system of the bank. For instance a foreign bank director states:

*Foreign banks have effective corporate governance because these banks know how to put good controls in place. Foreign banks are very serious about corporate governance and control. On the contrary, the reason why state banks have ineffective corporate governance is because they suffer from relaxed control systems (Director, Foreign bank)*

Another important aspect here is the phenomenon of widespread corruption in Egypt. According to the Transparency International Organization, corruption is an incident that occurs when individual with public powers uses these powers for private benefits (2010) [online].

*This include...bribery of public officials, kickbacks in public procurement, embezzlement of public funds, and questions that probe the strength and effectiveness of public sector anti-corruption efforts, thereby covering both the administrative and political aspects of corruption (ibid).*

Indeed, banking organisations are very sensitive to such activities; this was obvious from the CB official quote mentioned above. Essentially, this reflects a case of government officials abusing their public power<sup>iv</sup> exploiting the weak control environment in State banks to commit corruption. According to corruption perception index<sup>v</sup> (2009) Egypt was ranked at the world rank of 111<sup>th</sup> in terms of freedom from corruption. This index indicates that in Egypt “corruption is widespread, where bribery of low-level civil servants seems to be a part of their daily life and there are allegations of significant corruption among high-level officials” (IOEF, 2009:58).

Bank directors and executives considered that corporate governance identity is highly affected by management control, because in such corrupted environment constraining individuals’ behaviour is crucial to have successful corporate governance. The following quote reflects this meaning:

*Having effective control system in a bank makes the differences in corporate governance practices of the four banking organizations types. This occurs because banks with relaxed control are not protected from the negative aspects in the business environment, while banks with good controls have higher immunity to these types of infections (Executive, State bank).*

This also explains the CBE’s emphasis to improve banks’ control function by setting it as a primary objective of the banking sector reform. This became obvious following the 1990s bank corporate governance failures related to weak controls especially in State banks. It also explains the reason why newly hired management of State banks consider reforming the control function as a first priority. An EBI official clarifies this “*They consider*

*that control system is their eye on the whole bank, as such improving control system was their first move before they sit in their positions” (EBI Official).*

### **3.1.2 Bank Directors’ and Executives’ Competence**

Board of directors and executive management of a bank have crucial roles in corporate governance. The board of directors:

*is ultimately responsible for the soundness of the bank... Continue to develop and maintain an appropriate level of collective expertise as the bank grows in size and complexity... Select, monitor and, where necessary, replace key executives... Promote bank safety and soundness... Provide sound and objective advice, and recommend sound practices gleaned from other situations... Contribute special expertise in overseeing a bank’s activities” (BCBS, 2006:10).*

Similarly, the executive management consisting

*...of a core group of individuals responsible for the day-to-day management of the bank...contribute a major element of a bank’s sound corporate governance by overseeing line managers in specific business areas and activities consistent with policies and procedures set by the bank’s board of directors” (BCBS,2006:12).*

Therefore, competence of both board members and the executive management team is essential for effective corporate governance of a bank. Competence<sup>vi</sup> refers to “*the degree of fit between the ability requirements of a certain task and the corresponding abilities possessed*” by the person in charge of this task (Brinckman, 2007:20).

Here, Bank directors, executives and external auditors have agreed upon the important role that competence of board members and management play in the quality of corporate governance. They mentioned that competent board and management will be capable of putting into place proper arrangements whether it is corporate governance related or not. As such, the identity differences and the associated variation in corporate governance practices quality can be explained in terms of the notion of bank directors’ and executives’ competence.

From the due course of his work auditing various banks in Egypt, an auditing firm executive has explained the variation between bank types in terms of board and management competence. This signifies that it is not only corporate governance systems that impact corporate governance quality but also the competence of those responsible of implementing these systems<sup>vii</sup> counts. This is shown by the following quote:

*One reason why Foreign banks come on the top of the list in terms of their corporate governance practices is that the application of systems adopted by their headquarters is carried out here in Egypt by professional and competent management (Executive manager, International auditing firm).*

In fact, executives' and directors' competence level is affected by the recruitment practices of the bank. Banks of the same type with similar recruitment practices are likely to attract staff of similar competence level; the following quote clarifies this meaning:

*Foreign banks have high level of corporate governance, one reason is that they employ high calibre employees, in State owned banks they do not have such high standards of corporate governance, people they employ needs much training and education to be able to deal with corporate governance issues. These banks need to change their recruitment policies and their management style in general. Concerning us I think we are following foreign banks and now we are doing much better (Executive manager, Private bank).*

Another Arab bank director mentioned that:

*We have a problem that 90% of directors and key executives are opportunists, while 10% are competent and do their job" (Director, Arab bank).*

These quotes would indicate that foreign banks are characterized by high competent staff<sup>viii</sup> followed by Private, Arab and State banks. However, attracting competent employees is not enough for maintaining high level of effectiveness, but training and further development is quite important as well. A Foreign bank director asserted this perspective by stating:

*Employees are offered training courses when they are recruited and as needed during their career with us, to make sure that they understand their jobs' responsibilities and are able to carry them out, this point is important when we speak about corporate governance (Director, Foreign Bank).*

In the context of State and Private Banks corporate governance improvements started with changing the recruitment policies especially in relation with directorship and key executive positions. Indeed, new directors and executives were more competent. This indicates that competence can be a driver towards better corporate governance.

*Corporate governance reform started in state banks by selecting highly competent people who were well trained in American and British banks. Now they are known by name in the EBS, they are on the top of State banks while others hunted by Private Banks (EBI official).*

As such competence of board members and executive managers is one factor that affects the corporate governance identity of a bank, and because banks of the same type (Foreign, Private, Arab, State) share relatively similar recruitment and training policies. This leads to attracting and maintain employees of a

particular level of competence that in turn determines how successful a bank is in implementing corporate governance system.

### **3.1.3 Organizational Perception Of Corporate Governance**

Organizational perception refers to the image of an organization (Elsbach, 2006). Here, an image refers to a “*relatively current and temporary perceptions of an organization, held by internal audiences, regarding the fit of an organization with particular distinctiveness categories*” (*ibid*: 14). Notably, legitimacy is one of the most studied forms of organizational images, it refers to “*a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed systems*” (Suchman, 1995:574).

Organizations can achieve pragmatic legitimacy when they are perceived as legitimate because they serve some practical interests, such as increasing shareholders’ wealth. Also, organizations can achieve moral legitimacy “*because their actions are in line with social norms*” (*ibid*).

Bank directors and executives have identified that achieving a legitimate organizational image is a main reason for adopting corporate governance by various banks. Obviously, banks of the same type of ownership adopts corporate governance to signal a certain organizational image (legitimacy) to a particular group of stakeholders, on such basis the organizational perception of corporate governance is another property of the corporate governance identity. In other words, banks agreed that corporate governance is important to them because it conveys a message to particular stakeholders that they are legitimate.

Thus banks ‘organizational perception of corporate governance can vary on the basis of the legitimacy type sought. It can be either pragmatic legitimacy or moral legitimacy.

Notably, participants from the banking field have all agreed that corporate governance is not well-known in Egypt “*Corporate governance is a new concept in Egypt and its banking sector*” (*EBI official*). This indicates that corporate governance has recently begun to gain attention of professional and academic circles. As for customers or the general public it is not positioned to affect the organizational image of the bank. For them what is more important is that their funds are protected. As such in the case of the EBS the prevailing type of legitimacy is pragmatic rather than moral legitimacy. This can be discussed within the context of every bank type as follows.

Firstly, State banks' directors and executive managers have agreed that their banks consider that adopting corporate governance is a way to show pragmatic legitimacy to the CBE especially that the CBE<sup>x</sup> has considered "enhancing and monitoring corporate governance of all banks as an objective of the wide EBS reform" (CBE, 2004:3). A state bank executive stated that:

*State banks, such as our case, just started to improve corporate governance and use this term in the banking life. This is a part of a wider policy of the CBE to reform the State-owned banks (Executive, State bank).*

State banks focus on achieving pragmatic legitimacy as they serve the interests of the CBE by following its directions. While the moral legitimacy here is not applicable as corporate governance as abovementioned is a new issue and does not yet constitute a social norm of appropriateness<sup>x</sup>. As such state banks are perceived by the public as legitimate and safe regardless of their corporate governance practices. More precisely, if moral legitimacy do exist, we would see that state banks have small market share based on the perception that they are illegitimate, however, the contrary is true and state banks have a relatively large share of the market equivalent to 35% regardless of their poor corporate governance practices. The following quote clarifies this issue:

*Although State banks have poor corporate governance quality, they have a market share of about 35% of total deposits. People consider these banks as secured by the government which is not true, there is no legislation that guarantees this backup for any bank. It is just a myth. But this can be understood as corporate governance is new in Egypt and is not well-known to the public. Overtime, corporate governance awareness would be developed. But now it makes no difference for the public if you have high quality corporate governance or not! (Director, Foreign bank).*

Secondly, Arab banks' directors and executives have agreed that these banks also seek achieving pragmatic legitimacy. So corporate governance is adopted to serve shareholders interests who want to maximize their wealth and indeed this can only happen through compliance with the corporate governance requirements enforced by the CBE.

*In our case, the most important aspects is to maximize profits to satisfy the owners and this cannot happen without following the CBE instructions (Executive, Arab bank).*

Thirdly, Private banks' directors and executives have seen their banks proactive and keen to increase their expansion potential. Therefore adopting corporate governance is not limited to meet the regulator requirements or meet the shareholder wealth maximization only, but includes adopting corporate governance in a more comprehensive manner, beyond the CBE requirements, thus, signalling to international investors that their investments will be protected.

*There is no choice for banks but to adopt CBE corporate governance requirements. But in our case, we strive to have stronger corporate governance structures beyond the CBE requirements. I consider we are successful in this respect because to us, corporate governance is important to protect current and potential shareholders (Executive, Private bank).*

So, to private banks, it is also pragmatic legitimacy that drives corporate governance adoption. They seek pragmatic legitimacy towards the CBE as well as current and potential shareholders.

Finally, Foreign banks also adopt corporate governance to achieve pragmatic legitimacy, but in this case the practical interests include their home country owners (headquarters) and indeed the CBE.

*Talking about the case of (name omitted), Egypt. The bank has an in-house corporate governance system, applied in all branches world-wide, but with certain aspects customized to some local differences. Here in Egypt we must comply with this corporate governance system. It is a comprehensive system that includes much more than that what is required by the CBE. However, sometime we need to restate how things are done to match the CBE requirements (Director, Foreign bank).*

To summarize, the open category corporate governance identity has emerged to signify the existence of features that are shared between banks owned by the similar type of ownership (Foreign, Private, Arab, State). Three properties were observed to significantly characterize each banking group: Management control, directors' and Executives' competence and organizational perception of corporate governance.

### **3.2 Laws and Regulations**

This open category has emerged in relation to the following question

***Q2: To what extent do laws and regulations effectively promote corporate governance in banks?***

This open category refers to laws and regulations governing the banking sector in Egypt. Here regulations refer to those issued by the CBE as the sole regulating authority of the banking industry.

In particular, this category discusses these frameworks and how the participants from the banking field consider them effective in driving banks towards high quality corporate governance. According to Basel committee (2006) governments can play a vital role in promotion of good corporate governance in banks, specifically through "*laws, regulations, enforcement*" (BCBS: 2006:19).

This category was observed in terms of two properties *corporate governance content* and *enforcement*. These properties can be discussed as follows.

### **3.2.1 Corporate governance Content**

An effective legal and regulatory framework is essential to promote good corporate governance practices within any banking sector (BCBS, 2006). Here, participants from the banking field have evaluated the current legal and regulatory framework on the basis of its corporate governance content. Most of them have referred to the law of Central Bank, The Banking Sector and Money number 88/2003 as the principal legal document governing the banking sector.

*The leading document governing the banking industry in Egypt is the new banking law number 88/2003 and its executive rules. In addition, to the regulations issued by the CBE in the form of board decrees and governor decrees (CB official).*

However, with most of the participants focusing only<sup>xi</sup> on the banking law number 88, the particularity of the banking sector is signified. So if a legal framework is to promote corporate governance of the banking sector it should explicitly be issued for the banking sector. Most of the directors and executives from various bank types mentioned the requirement of the law number 88/2003 that banks should have an audit committee as an example of corporate governance regulations “*The unified banking law has some aspects that deal with good corporate governance such as the requirement to create an audit committee in every bank*” (Director, Private bank).

Notably, none of the participants have mentioned the ECOCG (2006), which is applicable to the banking sector “*It is also applicable to...Banks, insurance companies, and real-estate financing companies*” (ECOCCG, 2005:5). This indicates that corporate governance regulations that address the banking sector amongst a number of organizations do not have a strong impact, especially if they are voluntary and not endorsed by the CBE, whereas those endorsed or enforced by the CBE are more effective in bringing change.

Reviewing law number 88/2003 and its executive regulation indicates the absence of the term corporate governance from both documents. With few aspects that can be considered corporate governance related such as ownership rules, audit committee formation, the role of auditors in reviewing internal controls of banks. Meanwhile, some new corporate governance related regulations are enacted by the CBE such as the guidelines of evaluation of creditworthiness of customers and the control and supervision manual. However, none of these regulations deal with BCG in a comprehensive manner. An executive manager from a private bank indicates this

*“Laws and regulations touch the concept of corporate governance lightly; corporate governance needs to be dealt with in a more comprehensive manner”.* This clarifies that the corporate governance scope within the current banking laws and regulations is quite limited.

On the other hand, a Foreign bank executive states that *“The role of the CBE is to set standards that equally applies to all banks, it is the minimum standards, and this is expected due to the variation between banks”.* This would indicate that it is less likely that the CBE introduces a compulsory comprehensive corporate governance rules, rather it can be in a more voluntary or comply or explain based regulations. This is meant to accommodate the differences between banks in terms of size and capabilities necessary to adopt comprehensive corporate governance principles.

Still some bank directors and executives see that a corporate governance code is needed to fill the current corporate governance gap in the applicable regulations. Moreover, participants agreed that this code must be endorsed by the CBE

*It is essential to have a unified code of corporate governance for the EBS to be applicable on all banks. This code should be issued and backed by the CBE (Director, Foreign bank).*

However, opinions conflict even between the participants from the same type of banks (Foreign bank) indicates the sort of problem expected by the CBE if a comprehensive compulsory corporate governance rules are issued. This issue is discussed in more details in the following section.

### **3.2.2 Enforcement**

According to Electronic Longman dictionary enforcement refers to the ability to achieve obedience to a rule or a law. Enforcement requires having coercive power that refers to the ability to force someone to comply with an order (law) through the threat of punishment (French and Raven, 2001). Here, enforcement refers to the ability of the CBE to force banks to comply with relevant corporate governance laws and regulations.

Indeed, participants from the banking field spoken of enforcement as an essential property of laws and regulations required to promote good corporate governance within the EBS. The following quote refers to this meaning:

*In my opinion laws and regulations play an important role in corporate governance reform of banks, however, this should not be taken for granted because it can be dealt with by what is known*



*as “tick the box” phenomenon. Here enforcement and examination are essential components that bring about compliance with corporate governance (Corporate Governance Expert<sup>xii</sup>).*

Directors and executive managers from various bank types have clarified the need for a corporate governance code in the EBS. In fact, and as abovementioned, issuing such a code without proper enforcement would not bring about compliance. To these participants enforcement begins with issuing a compulsory code, then supervising implementation. However, participants from the CBE oppose this opinion because they claim that the concept of enforcement is seen differently from the CBE perspective.

*I cannot produce a compulsory code, enforced on banks, because this will create many practical problems. This is also against the approach of the central bank, after law 88 has been issued the perception of enforcement has changed towards setting boundaries but keeping flexibility. We are very serious about improving corporate governance within the banking sector (CB official).*

This two conflicting points of views regarding issuing a compulsory code of corporate governance for banks, reflects the compromise that the CBE wants to achieve. The CBE seeks enhancing corporate governance quality in banks, as a prerequisite to achieve better protection of depositors, especially that weak corporate governance have caused bank failures previously in Egypt and lead to a major NPL problem (Oldham and Bennadi, 2005).

However, still the CBE faces another pressures from the government to achieve the political agenda as an agent, this includes sustaining the stability of the banking sector. From a CBE point of view this would be affected if they enforced too tight corporate governance measures. So, the CBE tries to achieve the balance between the banking sector safety and stability. Adopting Basel II in the EBS is a good example that clarifies the CBE approach towards enforcement. One central bank official stated *“If we enforce the adoption of Basel II in the EBS, banks will be unable to lend a single pound”*. This reflects that although, Basel II is quite important to mitigate risks faced by banks, the CBE is reluctant to enforce the accord rigidly because they fear operational problems that may arise. They tend to be realistic as they know that not all banks have the capabilities to apply advanced concepts such as risk management or corporate governance.

In this respect the CBE signed a technical assistance from the European Central bank to prepare the EBS to comply with the Basel II. So, the approach of the CBE is to modernize the bank sector, endorse good practices guidelines but do this gradually after assuring that the CBE itself have the capabilities to support the new concepts. This is essential to avoid collapses or technical problems in the EBS. So on a dimensional range of rigid to flexible enforcement, the CBE favours a flexible approach.

Consistent with this gradual approach, the CBE has recently shifted their role from only supervising the compliance with banking laws and regulations to include a forward looking risk based component, this is clarified by a CB official as follows: *“Now, The CBE emphasis is on adopting a more forward looking approach of assessing the risks associated with banks they supervise, in the way that helps avoiding problems before they rise”*. As such one government official refers to a proposed corporate governance code *“we are working with an international agency experienced in corporate governance, to prepare corporate governance code for the banking sector. This code will be issued soon; will be endorsed by the CBE, but we are still thinking whether it will be issued on voluntary basis for initial period then be compulsory, or it will be issued on a comply-or-explain basis”*

So, the CBE is keen to enhance corporate governance in the EBS to protect depositor and maintain safety of the banking sector, while avoiding operational problems that would be encountered if the code is compulsory. Alternatively the CBE will follow the same flexible approach followed in enforcing credit operations for instance, where every bank is allowed to have its own credit rules, which are approved by the CBE (Law 88, 2003), and depend on other mechanisms such as on-site examination and the external auditors’ scrutinizing of the adequacy of control systems of every bank and the compliance with the regulations (Law 88, 2003: article 84).

Moreover, CBE considers that corporate governance should be based on mutual collaboration between the regulator and banks *“we want to see banks trying to improve their corporate governance practises and the CBE will of course offer help and guidance “(CBE official)*.

In summary, the internal contextual factors, corporate governance identity delineates a main property pertaining to the phenomenon of *evolving BCG practices*. In other words, corporate governance identity shapes banks' corporate governance practices. Basically, each of the four corporate governance identities (Foreign, Private Domestic, Arab, State) determined previously in chapter five affects the way or strategy of handling and changing BCG practices.

As discussed above, three elements determine the corporate governance identity firstly; the degree of management control<sup>xiii</sup> which affects the degree to which a bank can enforce internally certain rules such as those corporate governance related. For instance, tight management control at foreign banks is associated with a relatively better corporate governance practices compared with state-owned banks where management control is

more lose. This is because foreign banks have better corporate governance rules enforced on all employees through tight management control. The second element of corporate governance identity is competence of board directors and executive managers of the bank, who hold the responsibility to design and run corporate governance systems. As such the more competent they are the better corporate governance practices will be and the easier a bank adopts corporate governance requirements. This also affects how successful the bank will be in designing appropriate corporate governance strategies and implement them successfully. While, the third element of a bank's corporate governance identity is the organizational perception of corporate governance. Banks consider BCG to appear legitimate in the eyes of the CBE and shareholders. As such this also constitutes a part of the context where evolving BCG phenomenon is embedded. In essence the organizational perception of corporate governance affects the strategies towards handling the bank's BCG practices.

External contextual factor is represented here by *laws and regulations* which represent the regulatory framework governing the banking sector. The changes to the regulatory framework with the introduction of the new banking law 88/2003 have included the introduction of corporate governance related issues, although on implicit basis<sup>xiv</sup>. It was observed that banks corporate governance practices are basically affected by codes especially issued to the banking industry. As such none of the bank directors or executives mentioned the ECOCG (2005), although it addresses banks amongst other companies. Meanwhile, the issue of enforcement was an important aspect that determines the degree of compliance with corporate governance requirements.

Therefore, laws and regulations shape the phenomenon of *evolving BCG practices* through the corporate governance scope within the regulatory framework and the degree of its enforcement. This is why the CBE officials have been conservative on endorsing a compulsory corporate governance code as they know the significant change regulations can introduce to the banking sector.

In conclusion, corporate governance identity and Laws and regulations constitute the context where the phenomenon of evolving BCG practices is embedded. Indeed, they *both* affect how each bank draw its strategic response to arising BCG requirements. This comprises the very basis of variation in BCG practices between banks.

#### **4. Assessment of BCG reform within the EBS in the light of the prevailing corporate governance model**

This section aims to assess the BCG reform in Egypt in the light of the prevailing corporate governance model outlined with the findings of this paper discussed in the previous section. According to Sorour et al. (2012)

improving BCG in Egypt has far reaching advantages beyond the banking sector; these areas of improvement include borrowers' screening procedures through including client corporate governance as an element of screening. This would provide a practical approach to improving corporate governance in the Egyptian business environment. This would hold, as most of the corporations in Egypt are family owned and not listed on the stock exchange. Consequently, banks are the principal source of financing for most of these corporations. Here banks can insist on good corporate governance from their side, but they can only do that if they are themselves a good model of good corporate governance. Towards this end, Sorour et al. (2012) and Sorour (2011) have assessed the corporate governance reform efforts and identified that a major step towards improving BCG was by issuing a code of corporate governance to be adopted by all banks, especially that the 25<sup>th</sup> January revolution has opened the door to change. Meantime, Sorour et al. (2012) identified the importance of implementing the regulatory changes announced by the CBE that are directed towards enhancing its independence, work on capacity building in the field of corporate governance and finally maintain a robust supervisory role of the CBE. Interestingly, more recently, the CBE has implemented these recommendations and issue a set of corporate governance instructions applicable to all banks registered with the CBE (BCG instructions, 2011). However, to accommodate differences between banks within the EBS, the CBE has given the flexibility to banks to apply these rules in accordance to each bank's size, complexity, policies and its risk appetite (BCG instructions, 2011).

Despite the fact that these recent reforms can be considered as a milestone on the road to BCG reform, it is essential to consider the relevance of these recent developments in the light of the previous analysis. In other words, it is necessary to consider the effectiveness of issuing this corporate governance rules within the context of the corporate governance model prevailing within the EBS. Here the above-mentioned analysis shows that the corporate governance model within the EBS is neither a shareholding nor a stakeholding corporate governance model for two reasons: firstly, the Egyptian model shows that the objective of corporate governance is not serving shareholders alone as advanced by the shareholding perspective ( Letza et al., 2008), while at the same time it does not set the corporate governance objective to serve a wide range of stakeholders as advocated by the stakeholder perspective of corporate governance (Letza, et al.,2008). Alternatively, the model is based on serving recognised stakeholders namely: shareholders, regulator and indirectly depositors. Indeed, this is consistent with the prevailing definition of corporate governance as per the Basel committee and adopted by the new Egyptian BCG instructions (2011). Which puts the BCG as the system that involves the setting of corporate objectives that include the generation of economic returns to owners taking into account “the interests

of other recognized stakeholders most importantly supervisors, governments and depositors due to the unique role of banks in national and local economies and financial systems” (BCBS,2006:4). Secondly, this model is not based on the notions of economic efficiency or rationality as the traditional shareholding and stakeholding perspectives, rather adoption of corporate governance within the EBS is based on achieving legitimacy and more precisely the pragmatic legitimacy.

As such, although issuing the BCG rules can be perceived as major positive step towards enhancing BCG within the EBS, the special nature of the corporate governance model as shown above, makes it quite important that stringent enforcement should be in place, to avoid the phenomenon of ticking the box (ceremonial adoption) as the objective here of adopting corporate governance rules will be achieving legitimacy as shown above. At the same time, it is still essential to enhance the independence of the CBE as announced earlier (Sorour et al., 2012) as this will contribute to strengthen the concept of good corporate governance within the EBS, and minimize any potential conflict of interests between the CBE’s role as regulator and as agent of the government (Banking Law NO. 88, 2003).

It must be mentioned that the new rules of BCG in Egypt has included six sections as follows: Bank Board of directors, relationship between board and executive management and clear identification of duties and responsibilities, optimum utilisation of both internal and external auditors work and the internal control functions of the bank, relationship of the board and shareholders, strict control on structures and complex operations within the corporate governance context. Indeed, these rules were highly influenced by the Basel committee report on enhancing banks corporate governance (2006). One interesting point here is the emphasis of the rule on internal control function, which also reflects the importance of internal control as main factor shaping the context of corporate governance ( as above-mentioned). While, the competence aspect has only been touched in relation to board members and in a generic fashion as “technical skills of board members should be developed continuously especially for members with non-banking experiences and by various means” (BCG instructions, 2011:8). Here, this rule would not be satisfactory to enhance this important factor, because it does not address corporate governance competence but rather focus on general technical skills, allegedly, the assumption here that no board member should be nominated and eventually selected for this role unless he/she has these technical skills. It would be useful here to re-consider this point and focus on developing the corporate governance skills of all members regardless of the type of expertise they bring to the board, the assumption here is that corporate governance is relatively new to Egypt and its banking sector as reflected by this set of rules issued in 2011 and that some of the board members would need to enhance their competence as shown in the

study earlier. While, the rules has not mentioned the corporate governance competence of executive management, which is not less important as shown earlier as executive managers are those who will be responsible for applying the corporate governance systems as outlined by the rules.

## **5. Conclusion**

This paper can be considered a showcase of BCG reform in developing countries; here an interpretative study has been carried-out to identify the unique factors that shape the phenomenon of BCG within a developing country's context (Egypt). The study has shown that this context is shaped by two major factors: corporate governance identity and laws and regulations. The earlier factor is determined in terms of level of management control, the organisational perception of corporate governance and employees' competence. While, the latter is determined by the corporate governance content within the banking legal and regulatory framework as well as by enforcement of these laws and regulations. The study has shown that copying from corporate governance systems of the more developed countries would not be an effective strategy, because corporate governance systems within these countries are themselves subject to scrutiny in the aftermath of the global financial crisis. Additionally, these traditional models posits that corporate governance adoption is based on the notions of efficiency and rationality, while, the study has shown it is rather based on achieving legitimacy in the case of Egypt, regardless of efficiency or rationality notions. Moreover, the paper has assessed the recent BCG reform developments in the light of the corporate governance model prevailing in the EBS and concluded that effectiveness of the new corporate governance rules will be dependent on stringent enforcement and supervision. Here, the importance of internal control has been emphasised within the new corporate governance rules which agrees with the findings of the study. However, these rules still need to address corporate governance competence of board members and executive managers, an issue that needs to be addressed urgently. Essentially, for the reality of BCG to change within the EBS, independence of the CBE needs to be enhanced as announced earlier. Finally, it must be noted here that another aspect of uniqueness of the EBS model lies in combining both the two approaches of designing corporate governance systems, the rule based and principal based systems (Solomon, 2007). However, this issue needs to be analysed separately and as such would be a venue for future research.

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## Appendix 1: INTERVIEW (A) QUESTIONS\*

### INTERVIEW (A) QUESTIONS\*

1. Does the type of bank ownership affect its quality of corporate governance practices? (Ownership type of the bank);
2. Do laws and regulations effectively promote bank corporate governance? (shareholder and stakeholder interests);
3. To what extent corporate governance affects competitiveness of the bank?;
4. What are the mechanisms used by the CBE to enhance bank's corporate governance practices? (shareholders and stakeholders interests);
5. On what basis a bank considers corporate governance reform? (shareholders and stakeholders interests);
6. What bodies play an important role in bank's corporate governance? What are these roles? (Bank Corporate Governance);
7. Whose interests do banks' corporate governance mechanisms protect? (shareholder and stakeholders interest);
8. What role does the board have in the corporate governance of the bank and how effective is this? (The role of the board in corporate governance practices);
9. How does the board (in general) ensure that members (of the board) understand their role in corporate governance? (The role of the board in corporate governance practices);
10. What are the corporate governance mechanisms that banks utilize? (The role of the board in corporate governance practices);
11. To what extent the bank insists on good corporate governance in credit operations and what benchmarks does the bank uses in this respect? (The role of the board in corporate governance practices);
12. What impact does the Egyptian business culture have on corporate governance of banks? (Corporate governance culture);
13. What is the basis to determine the risk management policy of the bank? (The role of the board in corporate governance practices);
14. Have the accounting standards adopted enhanced transparency? (Transparency and disclosure).

*\*The Brackets at the end of each question shows the areas emerged from survey analysis and were further investigated in semi-structured interview (A)*

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<sup>i</sup>Bank directors and executives, Central bank officials, Egyptian Institute of directors' officials, Egyptian Banking Institute officials, and Egyptian Stock market officials.

<sup>ii</sup>Foreign banks are banks owned and affiliated to foreign banking organizations; principally their headquarters are located in Western or Asian countries. Similarly, Arab banks are banks owned by banking organizations of headquarters in Arab countries. Private Banks are owned by domestic banking organizations with no affiliation to external banking organizations. Finally, State banks refer to banks owned by state.

<sup>iii</sup>Here, corporate governance failures were evident in many cases especially in the state-owned banks which dominated the EBS during this period. Obviously, credit was allocated to "*privileged and connected private sector not on commercial basis*" (Mohieldin and Nasr, 2007:711), many cases of insider lending were reported as board members facilitated loans granting to their friends and network of clients, thus breaching their supposed supervisory and monitoring role on executive management (ibid).

<sup>iv</sup>This refers to the methods managers and leaders utilize to influence their employees, basically power in this case can be coercive power: "the ability of a manager to force an employee to comply with an order through the threat of punishment" (Encyclopaedia of management, 2009:460). Or reward power, the case in which the manager or the leader will reward the employee for complying with a certain order. Here, the case of state banks, the earlier base of power coupled with weak control, can lead to corruption. Additionally, the latter coupled with weak control can tempt the employee to take a course of action that serves his/ herself interest like being promoted for instance.

<sup>v</sup>The survey includes 180 countries with the rank 1 indicating the best country in terms of freedom from corruption, while rank 180 signifies that the country is the worst country from the same respect.

<sup>vi</sup>Competence can be seen as the sum of knowledge and skills accumulated during a person's lifetime (Pickett, 1998 cited in Brinckman, 2007:21).

<sup>vii</sup>Here the auditor was focusing more on executive management, however, board members competence are covered in more details separately under question 8 of the interview analysis.

<sup>viii</sup>Here competence is related to corporate governance responsibilities

<sup>ix</sup>There is no distinction between the CBE and the Egyptian government, especially that article 24, Chapter 5 of the banking law 88/ 2003 states that "*The central bank shall act as a financial advisor and agent for the government*". This defies the CBE independence totally.

<sup>x</sup>Moral Legitimacy is based on normative grounds and focuses on the extent on which organization is judged as doing the "*right thing*" rather on the extent a given activity that the organization carry-out benefits to the evaluator (Suchman, 1995). So taking into consideration that corporate governance has been introduced to the Egyptian context recently, it is not yet established as a norm or value equivalent to "*right thing*". As such, it is too early that banking organizations seek achieving moral legitimacy when adopting corporate governance.

<sup>xi</sup>Few participants have considered other laws such as commercial laws for instance as influential on the banking sector as well "*other laws may be considered as part of the regulatory framework governing banks, improvements in these laws would also affect the corporate governance banks. For example upgrading the commercial laws would affect the regulations regarding checks*" (Executive, State bank). But this opinion was not popular amongst various participants.

<sup>xii</sup>This is one of the foreign bank executives who worked for an international agency involved in corporate governance reform. But here he / she was speaking about his / her capacity as a corporate governance expert. This participant is counted once.

<sup>xiii</sup>Refers to "the means by which the actions of individuals or groups within an organization are constrained to perform certain actions while avoiding other actions" ((Encyclopaedia of Management, 2009:510).

<sup>xiv</sup>The term corporate governance has been completely absent from Laws and regulations governing the Egyptian banking sector. Although some aspects are corporate governance related. For instance the banking Law 88/2003 require banks to form an audit committee.