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Corporate governance in the financial services sector of Pakistan

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ABSTRACT

The main purpose of this paper is to overview the goal and objectives of corporate governance from the theoretical perspective within the financial sector of Pakistan. This sector has experienced some high profile corporate scandals in all over the world, for example BCCI, Baring Bank, and Equitable life. The corporate governance structure set the rules and regulations for the distribution of rights and responsibilities among different stakeholders to avoid fraud. In this conceptual paper first the broad parameters of corporate governance are discussed, from a theoretical perspective, and specific characteristics are derived from theoretical knowledge that is applicable to financial services sector of Pakistan. Different issues are examined and the extent to which they have been addressed by contemporary academic or policy-related studies is considered. The main focus of this paper is banks. The key issue arising is the rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems. External regulators, SECP, and auditors should play significant role to minimize these risk and should encourage sound governance practices. One avenue of future research would be to assess the effectiveness of compliance in the Pakistan; given that financial companies have obligations concerning code provisions. Some key issues pertaining to corporate governance in financial services are addressed, highlighting their significance to encourage further research by academic and practitioners in the field.

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Introduction

This paper aims to examine the objectives of corporate governance in the financial services sector through literature review or from theoretical perspective. Prime focus is corporate governance in the financial sector of Pakistan.

This paper is used to analyze the tensions which can be caused by the need to balance risk management in dynamic economy and by the existence of different stakeholders.

The paper proceeds as follows. First, address basic concepts regarding what corporate governance is, and the issues/challenges affecting the financial services sector of Pakistan. Next section explains the role of the sector regulator, and then discusses some academic and policy-related studies in this area. The final two sections are conclusions, and future research, respectively.

Corporate governance, Theoretical considerations:

The term corporate governance is a relatively new one both in the public and academic debates. Although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776), the definition of corporate governance differs from country to country. For the case of Continental European countries such as Germany, the term refers to all the stakeholders of a firm while for Anglo-American countries corporate governance focuses on generating a fair return for investors (see Goergen, Manjon and Renneboog, 2005).

According to Cadbury Report (1992), Corporate governance is “the system by which companies are directed and controlled.” It is concerned with structures and the allocation of responsibilities within companies. More specifically, discussions

on corporate governance have concentrated on the relations between the directors and managers of the corporation and other parties.

The OECD (1999) hints at a wider network of relationships, while maintaining the emphasis on the relationship between shareholder and director, defining corporate governance as: “A set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”.

The oecd also explains the role of stakeholders:

“The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises”.

Two observations on the OECD’s perception of the role of the corporation can be made here. First, it is assumed that the corporation serves purely as an agency for wealth-maximization for all concerned. The shareholders’ interests are assumed to be synonymous with those of the company (“objectives that are in the interests of the company and shareholders”) and the role and interests of stakeholders are narrowly defined in terms of

economic activity (“wealth, jobs, and the sustainability of financially sound enterprises”). Second, stakeholders are carefully defined in close legal terms: only rights protected by law – whether through contract or by statute – need be respected. Wider, non-statutory or non-contractual relationships are not considered in this framework.

In the context of the financial services industry, the first observation above relating to the OECD’s conception of corporate governance has a great deal of merit. Financial institutions do indeed exist to maximise wealth. The use of agency theory and legalism in the OECD’s Principles to define a range of stakeholders also has advantages over the very specific agency approach adopted in the UK’s corporate governance reports. The UK approach privileges the shareholder’s interest to a degree not justified in classical agency theory, in which an agency relationship is defined as:

Why do we require Corporate Governance in the Financial Sector?

Corporate governance is one of the key elements in improving economic efficiency and growth. It serves as a deterrent to mismanagement and infuses discipline in the decision making process of boards of directors. Good corporate governance encourages companies and those who own and manage them to achieve their corporate aims through a more efficient use of resources.

Corporate Governance has become critical for all entities and, therefore, the codes of Corporate Governance or legislations are being adopted increasingly by the organized sectors in the developed and developing countries. However, there are some additional reasons that are unique to the financial sector which necessitate attention to this issue.

These are:

- The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems.
- The failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.
- Private sector banks are motivated by profit maximization and their own financial stakes are limited and relatively low and they are therefore prone to excessive risk taking with the depositors’ money. Strong corporate governance is, therefore, required to discourage them from following this course.

Good Governance In Bank

Good governance consider many factors for example, The Board Members should be qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.

The Board must play a leadership role in approving the objectives, strategy and business plans of the bank, monitoring the performance of management and ensuring that the internal control and risk management systems of the bank are effective. The strategy, vision, missions, goals and the values should be communicated throughout the organization. The Board must also make sure that the Bank conducts its affairs with integrity and in accordance with high ethical standards. The Board is part of the system of checks and balances that ensure that neither large shareholders nor management abuse their power and that decisions are taken with the Bank’s best interests in mind. If the Board does not play its full part, a vacuum in leadership will be created. This vacuum may be filled by the shareholders becoming directly involved in running the Bank’s affairs or by

the Executive Management acting more or less in isolation. In either case, the Board of Directors is bypassed and checks and balances are lost.

The day-to-day running of Banks should be left in the hands of the Management but the Board should set and enforce clear lines of responsibility and accountability throughout the organization. The Board must also ensure that there is appropriate oversight by Senior Management.

The Directors should have fair understanding of the banking business, the nature of its risks and its strategic direction. It should be clear that ultimate responsibility for ensuring that risks are properly identified monitored and controlled lies in the Boardroom.

There is considerable importance attached to having an adequate representation of non executive and independent directors on the Board and a clear separation of the position of Board Chairman and Chief Executive Officer.

Directors should ensure individually and collectively that potential conflicts of interest are avoided or, at least, managed in ways that do not compromise the interests of the company.

Rigorous and independent internal and external audit arrangements are at the heart of corporate Governance debate. The work conducted by internal and external auditors in performing an important control function should be effectively utilized by the Board in discharging its oversight function.

Strong emphasis should be placed on regular, timely, comprehensive, meaningful and reliable financial disclosures of affairs. This disclosure should specify the following information:

- Board structure (size, membership, qualifications and committees);
- Senior management structure (responsibilities, reporting lines, qualifications and experience);
- Basic organizational structure (line of business structure, legal entity structure);
- Information about the incentive structure of the Bank (remuneration policies, executive compensation, bonuses, stock options);
- Nature and extent of transactions with affiliates and related parties

What has been done so far in pakistan?

The need for good corporate governance in Pakistan is unmistakable. Over the last many years, the economy has been largely volatile and marred with low investor confidence, tough global competition and lack of foreign investment. Among others, one of the major causes has been the lack of transparency and accountability in the corporate sector. The companies are largely closely held and managed in ways contrary to the interests of shareholders. Minority shareholders are exploited, adequate disclosures are missing and corporate information is not accessible to all.

The Asian Financial Crisis in the late 1990s revealed the vulnerability of economies to structural weaknesses in governance systems. It has become evident that prudent management and sound code of ethics could have prevented the economic meltdown in the Newly Industrialized Countries (NICs). It therefore became imperative that preventive measures should be readily introduced in Pakistan to avoid any economic shock. An initiative was undertaken in this regard. The Pakistan Institute of Corporate Governance (PICG) has been set up as a not-for Profit Company, limited by guarantee and without share capital. It has been licensed under Section 42 of the Companies Ordinance, 1984. The PICG has been formed through initial

sponsors, which comprise a balanced representation of major stakeholders from public and private sectors. The promoters of PICG are as follows:

Corporate Regulator

- Securities and Exchange Commission of Pakistan
- Banking Regulator
- State Bank of Pakistan
- Corporate Sector
- Federation of Pakistan Chambers of Commerce and Industry
- Overseas Investors Chambers of Commerce and Industry Non-banking Financial Sector
- Modaraba Association of Pakistan
- Leasing Association of Pakistan
- Mutual Funds Association of Pakistan
- Investment Banks Association of Pakistan
- Banking Sector
- Pakistan Banks' Association
- Stock Exchanges
- Karachi Stock Exchange
- Lahore Stock Exchange
- Islamabad Stock Exchange
- Academia
- Institute of Business Administration
- Lahore University of Management Sciences
- Professional Institutions
- Institute of Chartered Accountants of Pakistan
- Institute of Cost and Management Accountants of Pakistan
- Institute of Corporate Secretaries of Pakistan
- Institute of Chartered Secretaries and Managers
- Management Association of Pakistan

The Institute of Chartered Accountants of Pakistan (ICAP), under the auspices of the SEC, drafted a "Code of Corporate Governance". The Code, like other corporate governance models, specifically addresses the national requirements for good governance practices. The Code was subjected to a consultative process and developed on the basis of recommendations received from various quarters. In March 2002, the SEC directed the stock exchanges to incorporate the Code into their listing regulations. Accordingly, the listing regulations were amended to include the recommendations of the Code, whereupon these recommendations became applicable to all listed public companies (including modarabas and mutual funds).

Prudential regulations defining the Responsibilities of the Board of Directors have been issued and enforced. Fit and proper test for Chief Executive Officers (CEO's), Board Members and key Executives have been laid down. Those who do not fulfil the criteria laid down in the test are not allowed to hold the respective office.

Minimum Disclosure requirements (quarterly and yearly) have been prescribed for banks. Family representation on the Boards has been limited to 25 percent and the remaining Directors have to be independent non-executive non-family members.

Securities & Exchange Commission of Pakistan (SECP) Code of Corporate Governance has been applied to banks/DFIs (where no conflict with the State Bank of Pakistan's (SBP) Guidelines/Directives).

○ "Conflict of Rules have been explicitly laid down barring stock brokers, money changers, etc. and all those having any potential conflict from becoming involved in the management and oversight of banks.

○ A Handbook on Corporate Governance for Banks/DFIs containing International Best Practices and SBP's Instructions on the subject has been compiled, published and disseminated.

○ A Conference on Corporate Governance for Chief Executives and Board Members of Banks/DFIs was organized to train them.

○ An Institute of Corporate Governance has been established and the SBP is among its Founder Members.

○ Corporate Governance requirements for Banks/DFIs are continually reviewed to adopt internationally recognized best practices.

○ External audit firms are screened, categorized and rated for the purpose of auditing the financial institutions. Wherever they are found deficient, they are delisted or even black-listed".

The impact of these measures could be summed up as follows:

_ Market players are disciplined.

_ Risk Management has improved.

_ Quality of Board Members and Chief Executives is taking a turn for the better.

_ Ingredients of a stable banking system are taking roots.

_ Self Regulation is beginning to take shape.

What are the challenges ahead?

The most pressing challenges facing the banking sector arise mainly from the adoption of Basle II Accord and consequential management of risks. Early adoption of the Basle II Accord presents an unparalleled opportunity for banks. Those that embrace the new standard will find they enjoy a distinct competitive and high-performance advantage in international markets. Idle capital is freed up, ready to be put to best use. The main challenges ahead are:

○ "Induction and retention of highly skilled human resources and keeping their skills in home will be the number one priority for all organizations – the regulators, the shareholders, the educational institutions and the Chief Executive Officers. In this respect, those who are aspiring to join the financial sector have to equip him with the knowledge, skills and attitudes required for professionalism. The difference between the successful and not so successful graduates will lie in the acquisition for life long and continuous learning. Those who keep up with the times and strive to improve themselves throughout their career, through learning, will have bright and promising future. Those who become smug and complacent and adopt short cuts may have immediate gains but will find it hard to survive in competitive financial markets over the long run.

○ The other challenge is that the banks will have to automate and reengineer their business processes, move to E-banking and multi channel delivery modes and use technological solutions to reduce transaction costs providing satisfaction to the customers. The record of the banking system in adoption and diffusion of technology has been mixed so far but greater efforts will have to be made in the future.

○ Credit, market and operational risks should be identified, quantified and mitigated instead of dealing with credit risks only as was the case under Basle I. Strong Internal Rating Systems and Management Information Systems are essential for managing these risks

○ The increased transparency provided by Basle II means that clients, regulators and investors all will have a clear understanding of the institution's operations.

○ Consumers and commercial clients will benefit from more timely and accurately assessed lending decisions leading to increased customer satisfaction and loyalty in a highly competitive market. The fog created by best guesses has to be replaced by an objective historical track record and reliable data on which future decisions can be made. Regulators will also

have access to stronger sets of historical data and transaction trails for detailed examination and policy decisions. Finally, investors will reward banks that capitalize on the advantages afforded by the Accord.

- Market discipline will have to be strengthened to make governance effective in Banks. Credit ratings, listing on the Stock Exchanges, raising funds through capital markets are some of the mechanisms that can fortify market discipline.

- Lower capital requirement for lending to good rated borrowers will improve the overall Governance emphasis amongst the corporations.

- Good internal controls will be established which are essential for capital assessment process.”

Recent Studies

Federal Reserve Bank of New York There is relatively little extant analysis of the field of corporate governance as it applies to the financial services sector in the academic literature. An important paper addressing this issue is Macey and O'Hara (2003), part of a special study on corporate governance for the Federal Reserve Bank of New York.

In their overview of the corporation “as a contract”, Macey and O'Hara (2003) suggest that fiduciary duties should be owed by corporations and their directors not only to shareholders, but also to “nonshareholder constituencies”, to redress an overemphasis in law and economic theory on fiduciary duties owed to shareholders. They state that there are many situations in which non-shareholder constituencies, such as uninsured depositors in banks, might value a contractual right more than shareholders value it. Moreover, they observe that banks have, relative to other sectors, high gearing, or debt in proportion to equity, levels, creating a public interest case for accountability to fixed claimants (including depositors) as well as to equity holders.

Macey and O'Hara also comment on the potential for any bank failure to affect the wider banking system and on the danger of liquidity crises at banks (bank runs) arising from the banks' role as providers of long-term liquidity through loans backed by short-term deposits. This has given rise to the use of deposit insurance to give sufficient confidence to depositors to prevent panic-led bank runs. However, Macey and O'Hara warn of the danger of moral hazard, where this safety net encourages shareholders and managers of insured banks to engage in excessive risk-taking, especially if insurance is subsidised by the taxpayer, although they add that this can be mitigated by minimum capital requirements. Finally, Macey and O'Hara suggest that market forces backed by effective accountability mechanisms may be more effective than external regulations, as depositors with funds at risk have an incentive to monitor bank activity and banks competing for deposits have an incentive to gain competitive advantage through improved controls.

Macey and O'Hara's proposition that banks' accountability should properly be to a wider grouping (not just shareholders), due to their particular characteristics, is supported by Adams and Mehran (2003), who provide statistical, non-econometric, analysis. This compared corporate governance variables for a sample of bank holding companies with the same variables for a sample of manufacturing firms. They find differences in some key corporate governance variables: board size and composition, board activity, CEO compensation, CEO ownership, and block (large, typically institutional) share ownership.

These differences are a result of different industry characteristics, including formal external regulation of banking firms, such procedures not being applicable to manufacturing firms. The policy implication is that banks require different,

more extensive corporate governance arrangements than manufacturing firms.

Basel Committee

In terms of formal pronouncements, the Basel Committee on Banking Supervision (1999) has been active in drawing from the collective supervisory experience of its members in issuing supervisory guidance to foster safe and sound banking practices. Reinforcing the importance of the OECD (1999) Principles, for international corporate governance, it produced *Enhancing Corporate Governance for Banking Organisations*. The Committee recommended a number of “sound corporate governance practices” for banks, which are consistent with UK corporate governance findings – including: the need for clear lines of responsibility and accountability throughout an organisation (e.g. Cadbury), ensuring board members are properly qualified and not subject to undue influence from management (Higgs), and effectively utilising the work of internal as well as external auditors (Turnbull).

In addition, they stress the importance of ensuring an environment supportive of sound corporate governance; and the role of supervisors. The significance of other stakeholders is emphasised, which is consistent with discussions above.

Reserve Bank of New Zealand

Mortlock (2003), in a study for the Reserve Bank of New Zealand discusses the need for appropriate banking supervisory arrangements and specific financial disclosure and external auditing arrangements. He identifies two particular features of banks that suggest the need “for a more intensive focus on corporate governance” than some other industry sectors: reliance on debt funding; and complexity of their risks.

Mortlock, like Macey and O'Hara (2003), argues that corporate governance in banking is a crucial determinant of financial stability: . . . although poor quality macroeconomic policy and economic shocks often play a major part in contributing to financial instability, it is fair to say that inadequate risk management within banks and other financial institutions is the root cause of most episodes of financial system distress. And a frequent cause of poor risk management is inadequate corporate governance.

Barings, is a prominent example of precisely those corporate governance weaknesses of which Mortlock warns, namely failures in risk management systems and internal controls, risk-management training for staff, including directors and senior managers, structures to encourage bank directors to take responsibility for risk management and effective external periodic reviews of banks' risk management systems and internal controls (Mortlock, 2003). Mortlock also argues for frequent disclosures of the market value of banks' credit exposures and suggests the disclosure of directors' and managers' conflicts of interest and the board's rules for handling them, as well as an attestation that the directors are satisfied with the bank's risk management.

Mortlock stresses the importance of effective market disciplines in promoting financial stability and sound risk management/corporate governance practices. Market disciplines can be strengthened by encouraging competition. It will be interesting to follow the progression of the implementation of Basel II (Basel Committee on Banking Supervision, 2004) for likelihood of reducing competition through possible increased concentration of banking firms. Another potential competition issue is deposit insurance (Macey and O'Hara, 2003), as deposit schemes must be designed to avoid allowing deposit-takers with high-risk-high-return strategies insuring their depositors at the expense of customers of lower-risk institutions.

Myners Review of the governance of life mutual

Myners' investigation into the governance of life mutual was instigated following the Penrose (2004) enquiry into events at Equitable Life. Myners reported in December 2004.

The terms of reference were to: "consider the governance framework for mutual life offices in comparison with that for comparable companies". In particular the following were examined: the level of member involvement in the governance of life mutual offices; board accountability for mutual life offices; and the level of regulation by the FSA to which mutual life offices are subject.

Myners perceived a "gap" in the formal rules to which life mutuals are subject. For example, unlike proprietary listed companies, life mutuals are not subject to requirements of the Companies Act and Listing Rules, and are not required to publish a statement on compliance with the Combined Code. Similarly, life mutuals are not subject to uniform obligations governing their relationships with their members.

Mutual companies tend to provide longer-term financial services, such as mortgages and life insurance. The customer relationship is paramount, and, because they do not have to be concerned with remunerating shareholders, they have a potentially lower cost of capital, although the concomitant of this is an enhanced risk to policyholders, well illustrated by the case of Equitable Life.

Myners notes that, as with proprietary companies, potential for conflict of interest exists for life mutuals also – between owner (members) and managers, which, in the case of poor accountability, can lead to inefficiency. In the case of Equitable Life, corporate governance weaknesses led Lord Penrose to conclude that "... the Board was a self-perpetuating oligarchy amenable to policyholder pressure only at its discretion" (Penrose, 2004).

The Myners Review (2004) recommends that: "life mutuals should adhere to a version of the Combined Code that is annotated with guidance that does not alter Code principles but aims rather to promote interpretations that best uphold these principles in this sector. The principal guidance offered by the annotations is:

- firms should make a governance statement in their annual report;
- firms should publish a directors' remuneration report;
- For non-executive directors to receive appropriate information and pro-active support; and boards should consider how dialogue with members can best be conducted".

Conclusion

To conclude, good Corporate Governance is something we have to live with and in the financial sector the imperatives are even stronger than the rest of the corporate sector. In Pakistan, financial sectors have made a modest beginning but the challenges ahead are still quite daunting. They have to continue the journey on the path i.e. to strengthen the Corporate Governance in Financial Sector. The paper reviews some of the recent reforms of corporate governance, such as the introduction of the Corporate Governance. It also comments on reforms that target the banking industry such as the privatization of financial institutions and the strengthening of its financial structure.

The paper also unveils some interesting patterns in terms of the control and ownership structure of Pakistani banks. While about half of the Pakistani banks have concentrated control, similar to that of Continental European firms, others have a relatively high dispersion of ownership more in line with that of Anglo-American firms. This mix of opposing control structures creates a challenging environment for reformers of company law

and corporate governance. Corporate governance has evolved in a rapid fashion from the initial Cadbury report in 1992, and subsequent Code of Best Practice, to the revised Combined Code of 2003. The Code has emerged partly as a response to corporate misfeasance involving large companies within financial services, including BCCI and Barings. These reports have failed, however, to give any special attention to banks, or other financial firms. Moreover, their main concern has been the relationship between company directors and their shareholders, thus largely ignoring the (often competing) interests of other stakeholders, including bondholders and mutual customer/owners.

In this paper we have highlighted the distinctive attributes of financial services firms that result in particular owner-manager relationships and distinctive corporate governance arrangements, resulting in the following key points:

In financial services, the FSA's rule-making, investigatory and enforcement powers are vital. External auditors also have additional responsibilities in connection with financial services clients, including reporting breaches of laws and regulations, and assisting the FSA as independent experts in their investigations. These externally-imposed compliance requirements should support and complement effective internal corporate governance structures

In the case of the banking sector, which was the main focus of this paper, the structure of bank's financial statements especially bank balance sheets and the mismatch in their assets and liabilities, highly leveraged condition should be considered for decision making– In particular, fiduciary duties properly extend beyond shareholders to non-shareholder groups, means that it is imperative that banks maintain the confidence of their creditors and implies a wider duty of care for bank directors.

Future Research

This paper points to some key questions requiring future research:

Given the breadth and depth of the financial services sector, analysis of the corporate governance features/requirements of specific sub-sectors is appropriate. Much attention has been devoted to banks in this paper, but different organizations and financial institute can also follow the basic concepts of corporate governance. While listed financial companies in the Pakistan have to meet FSA compliance, they also have to disclose compliance or otherwise with the Combined Code. One avenue of future research would be to assess, through survey, how financial companies viewed these arrangements in practice, and the perceived effect on firm operations/performance. An interesting issue to explore is to gauge to what extent the regulation and Code provisions are regarded as a compliance hurdle, rather than a feature that can be effectively integrated into a firm's overall strategic management.

Future research needs to consider carefully what corporate governance practices financial companies may be expected to adopt in the Pakistan in view of official pronouncements on the subject, such as the Basel Committee on Banking Supervision, or Myners Review of the Governance of Life Mutuals. However, more efforts need to be made in terms of improving levels of compliance with the Code. Given its crucial role in promoting and sustaining economic development, Pakistan's banking industry needs to be aware of its role as a leader in high corporate governance standards.

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