Nedal Ahmed Al-Fayoumi (Jordan), Bana M. Abuzayed (Jordan)

# Assessment of the Jordanian banking sector within the context of GATS agreement


## Abstract

This study assesses the Jordanian banking sector within the context of the General Agreement on Trade in Services (GATS) agreement. We start this study by providing an overview of the main characteristics of Jordan's banking system to date and pursue to analyze how the Jordanian regulatory environment is developing significantly to meet the new changes in the banking sector. Consequently, we evaluate the level of compliance of the Jordanian banking sector with the rules and requisites of the GATS, present CAMEL benchmarking, carry out opportunity scan; and prepare a SWOT analysis that gives additional insight into the current strengths and weaknesses of the sector. Finally, we analyze the constraints for the sector development and present specific recommendations for remedial action.


**Keywords:** GATS, WTO, CAMEL, benchmarking, SWOT, regulation, concentration, banking.
**JEL Classification:** G2.

## Introduction

Banking sector plays an important role in an economy to improve stability and increase economic growth. Banks play a central role in the money creation process and in the payment system. Moreover, bank credit is an important factor in the financing of investment and growth. Therefore, regulators have a special interest in maintaining banking system stability (Hartmann et al., 2005). However, a recent strand of literature maintains that stronger competition may improve stability (Nagarajan and Sealey, 1995; Caminal and Matutes, 2002) and concludes that competition among firms tends to produce a more efficient outcome and a lower probability of failure. Therefore, the degree of competition in the banking sector has been in the frontier of policy making.

Both developed and developing banking systems are being transformed as a result of the global forces for change which include: technological innovation, the deregulation of financial services at the national level and opening-up to international competition. While developed financial systems are believed to be capable to withstand with these changes, less developed economies are required to reform their economies, international improvement agreements and correct their systems of corporate governance, competition policy and other similar institutional structures.

With respect to the competition policies, this paper analyzes the competitiveness of one emerging banking sector, namely Jordanian banking system, within the context of General Agreement on Trade in Services (GATS) agreement. Although, a number of studies have been conducted to examine the Jordanian banking sector, most of them have concentrated on the technical aspect of the sector (e.g., Bdour and Al-khoury, 2008; Abuzayed et al., 2009). Therefore, this paper examines the GATS agreement signed by the Jordanian government in 2000 in order to assess how this agreement helped to encourage the competitiveness and the openness of the Jordanian banking sector.

We start this study by providing an overview of the main developments of Jordan's banking system to date. Currently, the banking industry is seeing the advent of new products with the boom in retail banking. E-banking is also flourishing, and investing in information technology and human resources is the path that most banks have taken (Jayawardhena and Foley, 2000). We also analyze how the Jordanian regulatory environment is improving considerably to meet the developmental needs of the banking sector. The new banking regulations, which stem from the Basel II, encourage banks to meet the new capital requirements, which would indirectly enhance competition. Moreover, the new regulations aim to improve corporate governance, banks' control, and anti-money laundering procedures (Bdour and Al-khoury, 2008).

Consequently, we evaluate the level of compliance of the Jordanian banking sector with the rules and stipulations of the GATS; present an opportunity scan of the banking sector in Jordan; and prepare a SWOT analysis that gives additional insight into the current strengths and weaknesses of the sector. Finally, we highlight the opportunities and threats that should be taken into consideration in strategizing for the development of the sector in a manner consistent with best practices and the Jordanian development drive.

## 1. Sector analysis

Financial transactions in Jordan are primarily intermediated through the banking sector. Jordan's banking sector is fully privately owned, well-developed, and profitable. The number of banks operating in Jordan currently stands at 25 banks, of which two are Islamic banks and eight are branches of foreign banks.

Jordanian banks carry out their operations through a network of 558 branches and 79 representative offices throughout the Kingdom. Accordingly, the index of population to the total number of operating branches was about 10.2 thousand citizens per branch at year-end 2007. On the other hand, the number of branches of the Jordanian banks operating abroad at the end of 2007 was 129 branches and 24 representative offices, of which 57 branches and 12 representative offices were operating in Palestine (CBJ, 2008).

Jordan's favorable economic conditions in 2007 have had positive spillovers on a banking sector that continued to grow and post double-digit growth rates in practically all major aggregates. The licensed banks' balance sheet displayed a growth of JD 2,578.0 million, or 10.6 percent, at the end of 2007 compared to JD 3,151.1 million, or 14.9 percent, and JD 3,265.4 million, or 18.3 percent, in 2006 and 2005, respectively. On the asset side, domestic assets grew by JD 2,264.9 million, or 12.6 percent, accounting for 87.9 percent of the overall increase in total assets during 2007 compared to a growth amounting to JD 2,309.5 million, or 14.7 percent, in 2006 (CBJ, 2008).

On the liabilities side, the deposits of the private sector (resident) were up by JD 1,232.4 million, or 10.9 percent, accounting for 47.8 percent of the total increase in liabilities. The item of "foreign liabilities" increased by JD 577.3 million, or 13.7 percent, accounting for 22.4 percent of the overall increase in liabilities. Further, the items of "unclassified liabilities" and "capital, reserves and allowances" were up by JD 356.4 million, or 9.4 percent, and JD 339.7 million, or 10.7 percent, respectively (CBJ, 2008). The results indicate that Jordanian banks have expanded their operations in recent years.

Credit facilities were a major and much stronger impetus for the expansion of banking sector activities. They have been on a steady and solid rise in recent years and are increasingly catering to the growing funding needs of economic agents at large and thereby enticing a much wider customer base for banks, ranging from individuals seeking personal loans to large corporations with substantial liquidity. The outstanding balance of credit facilities extended by licensed banks stood at JD 11.3 billion by the end of 2007; increasing by JD 1,533.7 million, or 15.7 percent, compared to an increase in the amount of JD 2,017.6 million, or 26.1 percent, during 2006. The increase in credit facilities was concentrated in the facilities extended to the general trade sector, which recorded an increase amounting to JD 518.1 million, or 33.8 percent of the total increase in the facilities, followed by the increase in credit facilities extended to the construction and industry sectors, which were up by JD 381.3 million and JD 255.0 million, accounting for 24.9 percent and 16.6 percent of the total increase in credit facilities, respectively (Audi Bank, 2008).

In parallel, banks' total equity continued to grow in 2007 to fund their increasing activity, though at a lower pace than last year. Total equity of banks in Jordan reached JD 3,523 million at year-end 2007, increasing by 10.7% from JD 3,183 million at year-end 2006. This rise could be attributed to increased non-distributed bank earnings but also to equity raised in anticipation of the new JD 100 million minimum capital requirements that should be gradually introduced by the sector regulator, i.e. the Central Bank of Jordan, by JD 20 million (Audi Bank, 2008).

According to a survey conducted for this study as of November 25, 2008, the number of foreign minority-ownership banks is 9, while the number of foreign majority-ownership banks is 6. The banking sector employs 15853 people and the share of the banking labor force employed by the foreign banks equals 11%. The ratio of the number of employees to operating income equals 0.003% for nationally-owned banks, 0.002% for foreign branches and 0.004% for foreign-owned subsidiaries. The non-performing loans, as a percentage of total bank assets, equal 1.72% for nationally-owned banks and 1.99% for foreign banks.

Tables 1 and 2 provide the basic characteristics of the 6 largest banks in the market in terms of deposits and loans and return on equity. The numbers presented in these two tables confirm the concentrated situation in the Jordanian banking sector, where most of deposits and loans are concentrated in small number of banks.

Table 1. Characteristics of the 6 largest banks in the market for deposits in 2007

| Name of bank | Year of establishment | Domestically owned equity (%) | Foreign equity (%) | Market share in total deposits (JD million) | Return on equity (%) |
|---|---|---|---|---|---|
| Arab Bank | 1930 | 41.4 | 58.6 | 25.15 | 13.5 |
| The Housing Bank | 1974 | 21.1 | 78.9 | 18.88 | 12.40 |
| Jordan Kuwait Bank | 1977 | 39.3 | 60.7 | 6.32 | 27.80 |
| Jordan Ahli Bank | 1956 | 68.7 | 31.3 | 5.33 | 5.29 |
| Bank Of Jordan | 1960 | 72.9 | 27.1 | 5.29 | 14.10 |
| International* Islamic Arab ank | 1997 | 100 | 100 | 3.76 | 23.40 |

Note: * Completely owned by the Arab Bank.
Source: *Banks Association of Jordan, Annual Report 2008*, and *Amman Stock Exchange Annual Report,* 2008.

The Jordanian banking sector (JBS) is highly concentrated, as shown in Table 2 below, with only one large international bank, the Arab Bank, and a number of small national and foreign banks. The three bank concentration ratios for total assets, total deposits, and total equity in 2007 amounted to around 47.80%, 50.35%, and 47.86%, respectively; which rates are considered high relative to other countries. More importantly, in 2007, the total assets concentration ratio of the largest bank (the Arab Bank) relative to all other banks was 43.78% (authors' own calculations).

Table 2. Characteristics of the 6 largest banks in the market for loans in 2007

| Name of bank | Year of establishment | Domestically owned equity (%) | Foreign equity (%) | Market share in total loans (JD million) | Return over equity (%) |
|---|---|---|---|---|---|
| Arab Bank | 1930 | 41.4 | 58.6 | 18.83 | 13.5 |
| The Housing Bank | 1974 | 21.1 | 78.9 | 14.34 | 12.4 |
| Jordan Kuwait Bank | 1977 | 39.3 | 60.7 | 8.82 | 27.8 |
| Bank of Jordan | 1960 | 72.9 | 27.1 | 6.27 | 14.10 |
| Jordan Islamic Bank | 1978 | 24.4 | 75.6 | 6.24 | 18.48 |
| Jordan Ahli Bank | 1956 | 68.7 | 31.3 | 5.97 | 5.29 |

Source: *Banks Association of Jordan, Annual Report 2008*, and *Amman Stock Exchange Annual Report,* 2008.

Table 3 provides the concentration ratios of the banking sector in Jordan relative to a sample of developed and developing countries. The findings indicate that the structure of the banking sector in Jordan follows the protocol of Structural Conduct of Performance (SCP), whereby heavily capitalized banks, though few in number, enjoy the better share of banking activities and gain the largest portion of sector profits. Meanwhile, the majority of banks, which are small-to-medium capital banks, do not enjoy the benefits of the larger banks, regardless of their core operational capabilities.

Table 3. Concentration ratios 3 and 1 in 2007

| | Concentration ratio for the three largest banks (%) | | | Concentration ratio for the largest bank (%) | | |
|---|---|---|---|---|---|---|
| | Total assets (%) | Total deposits (%) | Total equity (%) | Total assets (%) | Total deposits (%) | Total equity (%) |
| Jordan | 47.80 | 50.35 | 47.86% | 24.32 | 25.15 | 16.94 |
| Saudi Arabia | 47.76 | 47.35 | 49.64 | 19.95 | 19.49 | 19.11 |
| Egypt | 53.82 | 54.33 | 38.14 | 27.60 | 27.90 | 19.30 |
| Lebanon | 45.51 | 46.60 | 49.18 | 17.54 | 18.28 | 18.26 |
| Tunisia | 28.64 | 27.54 | 29.42 | 10.02 | 9.26 | 11.45 |
| Turkey | 21.30 | 24.49 | 27.39 | 7.37 | 8.18 | 9.69 |
| Germany | 22.27 | 22.44 | 17.47 | 9.60 | 9.93 | 7.23 |
| US | 10.52 | 11.70 | 10.88 | 3.67 | 4.00 | 3.78 |
| Japan | 25.81 | 25.25 | 24.65 | 9.78 | 9.25 | 9.69 |
| UK | 25.88 | 25.35 | 29.20 | 10.39 | 9.80 | 11.87 |

Source: Author's calculations based on the Bank Scope Database, 2008.

Note that based on the three largest banks concentration ratio in Table 3, the Jordanian banking sector is the highest among comparators in terms of assets and deposits concentration. It is second highest in terms of equity concentration. In terms of the Concentration Ratio for the largest bank, Jordan is second only to Egypt in the assets and deposits categories and is among the highest in the sample in the third category.

## 2. Legislative and regulatory environment

The Jordanian banking sector is regulated by the Central Bank of Jordan (CBJ), which was established in 1964. Currently, the number of professional regulatory and supervisory staff working at CBJ is eighty. Although the government is main source of financing for the CBJ, the CBJ operates independent of regulatory oversight.

In recent years, the Jordanian commercial banking industry has undergone numerous changes in laws and regulations for the purpose of bringing the banking sector operations in line with international standards. After 1993, the CBJ largely de-regulated interest rates and the allocation of credit, liberalized entry into the sector, and introduced modern prudential regulation and supervision (Bdour and Al-khoury, 2008).

The CBJ exercises strict controls to ensure that Jordanian banking sector regulations are broadly consistent with international norms. These regulations include bank payments, foreign currency positions, government securities transactions, commercial papers, large and internal loans, capital adequacy, risk-based provisioning, internal controls, liquidity management, payments issued by debit/credit cards, and deposit insurance. Within this regulatory environment, there are no controls on deposit or lending rates.

Any new entrant (domestic and foreign) banks must fulfill a number of conditions: registration as a public shareholding companies, payment of license fee, presentation of detailed business plan, minimum capital of 40JD million for domestic banks and 20JD million for branches of foreign banks, compatible home country regulation, in addition to other conditions (see articles 6-20 of Jordanian Banking Law, 2000). Once licenses have been allocated, there are restrictions on banks ability to sell or dispose these licenses.

Foreign banks are subject to additional licensing requirements. For example, the bank must be licensed to accept deposits in its home country, enjoy good reputation and strong financial position, and have the approval of the competent authority in the country of its head office to operate in the kingdom.

A number of banking classification institutions (such as Fitch, a banking risk classification institute) view the CBJ as a relatively active and competent regulator. Furthermore, banking supervision has been strengthened in recent years, and has shifted to a risk-based rather than rule-based approach. Prudential regulations are in place to limit banks' exposure to certain sectors such as construction, the CBJ has strict loan classification and provisioning guidelines, and prudential regulations place relatively conservative limits on banks' liquidity ratios. Accounting standards have been brought into line with international best practice, and the Basel II framework was introduced in January 2008. The quality of disclosure is high by regional standards.

Key aspects of regulations include minimum capital adequacy of 12 percent, which is higher than the 8 percent, but consistent with BIS guidelines to factor in higher levels of market risk in places. Loan classification requirements are set at 90 days, which refers to the number of days after which unpaid loan has to be classified as a non-performing loan.

According to regulation No. (37/2007) dated 11/11/2007, all banks should achieve 100 per cent liquidity ratio, which refers to the percentage of assets to be held against deposits for liquidity purpose. Additionally, the regulations limit exposure to single borrowers. Thus, Jordanian banks should consider improving their liquidity positions and the level of diversification of their credit operations.

All banks are required to join the deposit insurance scheme and publish their financial statements annually and semiannually. It's worth noting that the CBJ, Jordan's lender of last resort facility, is available for nationally owned banks and foreign owned branches and subsidiaries to buttress their positions. Therefore, the banks are subject to annual on-site inspections and frequent off-site inspections. The CBJ requires banks to disclose critical information related to performance, changes in ownership, and risk. Additionally, all foreign banks supervisory systems are subject to these controls, and service providers are consulted in advance of regulatory decisions. The laws and regulatory decisions are made public through the CBJ website, Official Gazette and the media (see: www.cbj.gov.jo).

The structure of domestic supply of the banking sector is open for competition from private sector firms, although banking services are restricted to licensed banks. Non-banking financial services are open to service providers of foreign origin. Supply of all money market services is regulated by the Central Bank of Jordan’s regulations, which is, as in the rest of the world, the ultimate authority on money supply in Jordan and the Jordanian Dinar’s maintenance of convertibility and exchange rate inside and outside the country.

The recent turmoil in the international banking industry following the deterioration of mortgage-backed securities, which culminated in the present Global Credit Crisis and the consequent melt down in financial systems across the developed economies, has intensified the centuries-old debate on whether banks are properly governed and regulated.

Note that when bank managers are subject to sound regulations and proper governance mechanisms, the likelihood that banks will efficiently mobilize and allocate savings is enhanced, and sound governance of the firms they fund is encouraged. Appropriate regulations and governance systems can reduce bankruptcies, lower the cost of capital to firms, and accelerate economic growth (Thorsten et al., 2008).

On the other hand, the changes in regulatory frameworks, advances in technology and market enlargements impose increasing pressures and, therefore, aggravate concerns for competition and efficiency within a deregulated industry. The deregulation and liberalization of financial market have transformed the banking systems in many countries. The global reforms will most likely to have a profound effect on the development of the banking sector in Jordan and its overall macroeconomic performance.

## 3. GATS / Restrictiveness measures

GATS requires the removal of capital account restrictions in order to facilitate cross border supplies and consumption abroad (Srinivasan, 1999). Thus, in principle, by facilitating the international flow of capital, GATS ensures that investment flows internationally to those enterprises where it will be most productive in terms of risk and returns in the new world trading regime. In theory, freer capital flows are an opportunity for producers to attract the new investment necessary for development, and an opportunity for domestic savers to invest in projects anywhere in the world.

GATS defines trade in banking services by way of four service supply modes (Backović and Prica, 2007):

Mode 1 (cross-border supply) allows for provision and transfer of financial information, financial data processing etc., as well as advisory, intermediation and other auxiliary financial services.

Mode 2 (consumption abroad) indicates that the consumer travels into the country in which the services are delivered by the foreign services supplier for all banking and other financial services.

Mode 3 (commercial presence) provides that the country shall allow financial service providers of another member to establish commercial presence and to expand within the host territory. Established commercial presence of another member shall be allowed to provide new financial services, as well as transfer and processing of financial information and transfer (importation) of equipment necessary for business operations of a financial services supplier.

Mode 4 (presence of natural persons) provides that temporary entry shall be allowed for necessary personnel. For these four modes of supply related to the banking sector, Table 4 summarizes Jordan's specific commitments that must afford market access and national treatment to foreign services suppliers, except as indicated in its GATS schedule.

The following details the determinations in Table 4:

- Mode 1: Jordan has fairly liberal regimes regarding cross-border supply (Mode 1) with no limitations on market access or national treatment for deposit taking, guarantees and commitments, money broking, lending for all types, financial leasing, advisory and other auxiliary financial services, provision and transfer of financial information and all payments and money transmission services. The only limitation is related to real property which may not be mortgaged to banks outside Jordan. Moreover, there are no limitations for trading of securities/financial services, except derivatives products, which is unbound. The other unbound financial services are underwriting of securities, asset management and settlement and clearing services due to technical limitations.
- Mode 2: For consumption abroad (Mode 2) the financial services that are classified without limitations under Mode 1 are also classified to be without limitations under Mode 2, but without any exception. Moreover, there are no limitations for trading of securities/financial services, except derivatives products, which is unbound. However, the other financial services (underwriting of securities, asset management and settlement and clearing services) become unbounded, except for issuance and public offer of securities outside Jordan by foreign service providers abroad, and for management by service suppliers outside Jordan of assets which are not traded in the Amman Stock Exchange or in Jordan.

Table 4. Summary of Jordan's specific commitments in banking services

| Sectors or subsectors | Modes of supply | | | |
|---|---|---|---|---|
| | (1) Cross-border supply | (2) Consumption abroad | (1) Commercial presence | (1) Presence of national treatment |
| | Market access/National treatment | | | |
| Deposit taking | NL/OP | NL/NL | NL/NL | Uex/ Uex sp |
| Guarantees and commitments | NL/OP | NL/NL | NL/NL | Uex/ Uex sp |
| Money broking | NL/OP | NL/NL | NL/NL | Uex/ Uex sp |
| Lending of all types | NL/OP | NL/NL | OP/NL | Uex/ Uex sp |
| Financial leasing | NL/OP | NL/NL | OP/NL | Uex/ Uex sp |
| All payments and money transmission services | NL/OP | NL/NL | OP/NL | Uex/ Uex sp |
| Trading of securities/financial instruments | OP/NL | OP/NL | OP/NL | Uex/ Uex |
| Underwriting of securities | U/ U | pU / pU | OP/NL | Uex/ Uex |
| Asset management | U/ U | pU / pU | OP/NL | Uex/ Uex |
| Settlement and clearing services | Utf/ Utf | NL/NL | OP/OP | Uex/ Uex |
| Advisory and other auxiliary financial services | NL/NL | NL/NL | OP/NL | Uex/ Uex |
| Provision and transfer of financial information | NL/NL | NL/NL | NL/NL | Uex/ Uex |

Notes: NL – No limitations, i.e. Jordan agreed to place no constraints on the services in question. U – Unbound, i.e Jordan made no commitments with respect to the service in question. Uex – Unbound, except as provided by Jordan's horizontal commitments. Uex sp – Unbound, except as provided by Jordan's horizontal commitments and special provisions apply. pU – Partially unbound (certain financial services). Utf – Unbound due to lack of technical feasibility. OP – Other provisions apply.
Source: WTO, World Trade Review, 2008, WT/TPR/S/206, P118.

♦ Mode 3: Jordan's GATS schedule of commitments includes commitments on most financial services sub-sectors in all GATS 'modes of supply'. The 'commercial presence' mode of supply (Mode 3) has the most significant commercial application for banking services because national regulators can most effectively oversee banks established on their territory. Jordan's GATS schedule defines the scope of banking services subject to WTO discipline, and describes permissible limitations or conditions on foreign investment, the forms of establishment permitted for foreign financial institutions, and limitations that Jordan may apply to restrict market access by foreign financial institutions. Foreign banks in Jordan act as licensed Jordanian banks or Jordanian branches of foreign banks, but they are practically foreign banks operating in Jordan. These banks are allowed to open subsidiaries, branches and representative offices. There are no restrictions on, accepting deposits, guarantees and commitments, the number of foreign banks branches and ATMs to be opened by the foreign bank.

According to securities services, all banks and financial services companies have the permission to trade, for their own account or for the accounts of customers, the following: Money market instruments, derivative instruments, exchange rate and interest rate instruments, transferable securities, and other negotiable instruments and financial assets. In this area, Jordan has limitations on market access (Mode 3).

The most usual limitation is "legal form of entry" which means that Jordan requires a certain type of domestic legal incorporation (e.g., banks and financial services) in order to achieve domestic market access. This finding is directly comparable with that reported recently for a number of countries in south east Europe (Backović and Prica, 2007).

All banks operating in Jordan are allowed to participate in the issue of all kinds of securities, and asset management. However, some limitations exist on market access. For settlement and clearing services for financial assets, the most common limitation is the access regarding these assets. This access is restricted to the Depository Center at the Amman Bourse and the Central Bank of Jordan for other financial instruments. Also, banks can provide advisory and other auxiliary financial services. The most usual limitation is "legal form of entry" which means that Jordan requires a certain type of domestic legal incorporation. Finally, lending, financial leasing provisions and transfer of financial information can be provided without restrictions.

Foreign competitors enjoy an open market, and according to financial services intermediaries, the market is more open to foreign competitors than what the official commitments exhibit (as restrictions) in the Jordanian services schedules. In this sector, competition is a prominent feature of trade-in-service in banking and financial services. Issues related to market access and services trading are not a problem for the providers in this sector, but for the other Jordanian services exporters that rely on these services to engage in more export transaction, there are problems in the supply/offer of credit, financing, funding, lending, and facilities.

- Mode 4: Under Mode 4, the limitations on market access and national treatment for all banking financial services, are unbounded, except as provided by Jordan's horizontal commitments and special provision which indicate that branches of foreign banks in Jordan are required to have a resident regional manager (see Table 4 ).

## 4. CAMEL benchmarking

Table 5 presents the benchmarking of Jordanian banking sector based on the CAMEL system, which consists of: Capital adequacy, Assets quality, Management quality, Earnings quality, and Liquidity.

Table 5. CAMEL factors for banking sectors in the region in 2007

| Country | Capital adequacy | Assets quality | Management quality | Earnings quality | Liquidity |
|---|---|---|---|---|---|
| Jordan | 15.06 | 1.35 | 43.41 | 1.60 | 4.60 |
| Lebanon | 8.50 | 1.30 | 55.49 | 0.91 | 64.36 |
| Saudi Arabia | 15.77 | 0.52 | 31.89 | 1.63 | 7.80 |
| Bahrain | 15.76 | 0.74 | 58.00 | 1.85 | 14.43 |
| UAE | 9.55 | 0.74 | 34.00 | 1.92 | 7.29 |
| Egypt | 5.38 | 1.43 | 56.38 | 0.91 | 18.52 |

Note: All numbers presented are in percentages.
Source: Bank Scope DataBase, UK.

Jordanian banks have adequate capital adequacy (the ratio of total capital over total assets) and improved financial profiles. Jordanian banks, already benefiting from high capitalization levels by international standards, have adopted the Basel II requirements as of early 2008. Preparations in 2007 for this included the bolstering of risk management systems and practices, ameliorated disclosure and transparency in terms of financial reporting, the introduction or upgrading of compliance units in several banks and of a new code of corporate governance late in 2007 by the regulator, in addition to the creation of an Anti-Money Laundering Unit at the Central Bank. At the end of 2007, the percentage of total equity to total assets reached around 15%, which is much higher even than some other mature banking systems in the region.

Additionally, asset quality indicators, with the ratio of the system's total problem loans to total assets reaching 1.32% in 2007. Even the value of this ratio seems acceptable by the managers of the Jordanian banking sector, it has low ranking among the ratios achieved by the banking sectors in the region.

According to management quality, which is measured by cost to income ratio, equals around 43%. Based on this result, Jordanian banks are located in the middle position among the banking sectors in the region. This should motivate the Jordanian banking managers to improve the level of operating efficiency at their banks.

The earnings quality, which we measure by the return on assets (ROA), equals 1.60. This means that ROA for the Jordanian banking sector is better than ROA for banking sectors in Lebanon and Egypt and worse than the banking sector in the Gulf area (particularly, the United Arab Emirates, Bahrain, and Saudi Arabia).

The liquidity ratio, which is measured by liquid assets to total deposits and borrowing, is the lowest among the banking sector in the region. Therefore, the Jordanian banks should improve the level of liquidity.

Based on these results, it can be argued that, while the Jordanian banking system capital is sound compared to other banking sectors in the region, it has to improve its asset quality, operating efficiency, profitability and liquidity.

## 5. SWOT analysis

The following table below provides the SWOT analysis for the Jordanian banking sector.

Table 6. SWOT analysis

| Strengths | Weaknesses |
|---|---|
| • Offering a wide range of banking and financial products and financial services to corporate and retail customers through a variety of delivery channels.<br>• Focusing on customization of products that are designed to meet the specific needs of customers.<br>• All Jordanian banks have complied with international capital adequacy requirements and prudential norms.<br>• Wide distribution of banks' branches and accessibility of the banking facilities on the local level.<br>• Better than acceptable percentage of non-performing loans.<br>• Diversified ownership, where different investors from the region participate in banks capital.<br>• Acceptable efforts to cope with GATS requirements.<br>• Modern regulation and institutions for the private sector development and privatization. | • Most of banks lack strong and direct regional presence.<br>• Insufficient hedging tools applied. The banks resort to diversification among sectors by giving weights to these sectors when granting facilities as a measure of hedging but disregarding country risk, which accordingly would affect the value of all of their portfolios.<br>• A large number of local banks in small economy. The market remains over-banked, with 23 full commercial banks serving a population of 5.9 million.<br>• The banking sector remains dominated by the Arab Bank, which, together with the Housing Bank for Trade and Finance, account for over 35% of total system assets. Therefore, the Jordanian banking sector can be considered as a highly concentrated market.<br>• Most banks are below international standards of operating efficiency. |
| **Opportunities** | **Threats** |
| • Mergers with or acquisitions of other banks.<br>• An opportunity for more expansion of the banks' retail services, this segment still has room for growth. Historically, Jordanian banks concentrated on wholesale operations because they think that this type of business is more profitable comparing with retail operations.<br>• Efficient employees and good working conditions enable these banks to reduce the operating cost of the functions and increase return on investments.<br>• Expand banks' operations to cover countries in the region.<br>• Mastering new strategies and techniques in risk management and competition.<br>• Discovering the advantages of economies of scale and scope in addition to management efficiency. | • Increasing volatility in local and regional markets.<br>• Net Interest Margin (NIM, differential between interest on time-deposits and loans) pressure is likely to continue from intensifying foreign competition.<br>• Most Jordanian banks – with the notable exception of Arab Bank – are focused on the local market, which means that they should expand their operations outside Jordan.<br>• Fluctuations in economic variables including decreased purchasing power and higher inflation rates. This could have two negative effects in terms of increased costs and higher possibility of payment default.<br>• The Central Bank of Jordan (CBJ) has encouraged consolidation in the system, although so far there have been few signs that banks are keen to consolidate, partly reflecting a culture of family ownership in Jordan.<br>• Applying new methods of information technology and upgrading the skills of staff and management. |

## 6. Opportunity scan

To support Jordanian enterprises to expand abroad, Jordanian banks should develop an appetite for international business and should make room for their own expansion overseas. While some Jordanian banks have grown externally by simply increasing the number of their branches in the region, the time may soon come for Jordanian banks to consider merger and acquisition options to improve their market presence abroad. Breaking new ground in a foreign market can be very slow and expensive for foreign banks in Jordan and also for Jordanian banks in foreign countries; therefore, some foreign banks entering Jordan would have to cooperate with local banks to foreign partners' help.

With 25 sector banks, a consolidation exercise in the Jordanian banking industry cannot be kept in cold storage. Due to diversified operations and varying credit profiles of banks, merger and consolidation would serve as a risk mitigation or risk sharing mechanism, besides increasing the potential for growth. Owing to greater scale and size, consolidation can help save intermediation cost and improve efficiency. Experts in the Jordanian banking industry have long been contemplating on the consolidation leading to 6-7 major players in the market. What Jordan needs is a roadmap for managed consolidation. Banks need to find ways for voluntary mergers so that the shareholder value is maximized for both the entities. Government is also planning to kick-off consolidation in the sector by lining up a series of merger and acquisition proposals for the sector banks.

There are two main reasons for the banks not to merge, which should be addressed by the banking regulatory authorities:

- ♦ Purveyance of ownership of banks by families that have a wide investment portfolio and thus benefit from banks in financing own expansion in other sectors.
- ♦ The non-implementation of the Credit Law of 2002 as the Central Bank has not allowed the creation of credit bureau(s) in Jordan as of yet. Each bank maintains its own banking credit history of its customers, which it does not share in a national database or with other banks. The impact is that customers who wish to switch banks may suffer the loss of their banking credit history. Hence, a case of "adverse selection" emerges: the customer, albeit dissatisfied with the bank, remains with the bank in order not to lose such a long established history – the other bank does not know the client. Furthermore, a "moral hazard" results from lack of efficiency being not an incentive to merge; thus, banks have no internalized incentives to merge with other banks.

Jordanian banking market (both by domestic and foreign banks) needs further internationalization, leading to better identification of both foreign investment opportunities and improved portfolio allocation. The likely effects are that the absolute level of savings and deposit rates will rise, but the effects on borrowing interest rates and investment is ambiguous. It may be the case that domestic investment may fall and foreign investment may rise but this will be determined by the market and represent the correct balance between domestic and foreign investment in accordance with the optimal diversification and growth strategy of Jordan. Furthermore, improvements in the regulatory regimes, and competitively driven improved financial procedures are likely to promote a greater willingness to invest in the Jordanian economy and through improved confidence reduce contagion effects from any likely domestic financial crisis (UNCTAD, 2005).

## 7. Constraints to development

By increasing market access, or even by simply creating the possibility of access to foreign banks, there is likely to be an increase in the competitiveness of the domestic market. Furthermore, foreign banks will now have to receive equal treatment. Therefore, domestic banks will be further exposed to competitive pressures and the need to improve efficiencies.

The financial liberalization under the GATS is likely to address moral hazard, adverse selection and reduce the scope for corruption problems. This will occur both through the marriage of superior international expertise in project monitoring and assessment and local knowledge and through increased competition, reducing the scope for malpractice on the part of previously favored domestic financial institutions. In part these benefits rely on the wider aspiration of the GATS that signatories will take steps to ensure that the regulatory and supervisory regimes conform to international best practice, concomitant liberalization in the provision of business services, as well as proper application of equal treatment provisions (Murinde and Ryan, 2003).

Within the region, Jordan has a high potential to become a major growth market for traditional banking, investment banking and securities growth given its rapidly growing economy and banking industry. This clearly indicates a one-sided flow, which needs to be changed for the Jordanian banking sector to have visibility in the global market; in other words, inward and outward flows of banking services have to be addressed. However, as banks compete for globalization, it might become difficult to propagate social sector and government policy signals through them.

Foreign banks, from the 1980s, have created a wide range of new products, including financial futures, options, swaps, bill facilities, e-business, all kinds of derivates and securitized financial assets. There will no longer be clear dividing lines between raising money for corporations through commercial paper or through share issues, through long-term or through short-term instruments, depending on regulation and requirement. Instead, debt will become interchangeable, an endless stream flowing one currency to another and from one type of paper to another without difficulty (Murinde and Ryan, 2003). One result of lagging behind in innovation capability is that, Jordanian banks are gradually marginalized in the global value chain. That is: they have to cling to their traditional banking products, especially lending business, which bring most of their profits; whereas, high-growth products and other traditionally lucrative products such as syndicate loans, asset management, Internet-banking will be lost to their foreign competitors.

The most direct result of the above changes is increasing competition and narrowing of spreads and its impact on the profitability of banks. The challenge for Jordanian banks is how to manage with thinning margins while at the same time working to improve productivity. This is particularly important because with dilution in banks' equity, analysts and shareholders now closely track their performance. Thus, with falling spreads, rising provision for non-performing assets and falling interest rates, greater attention will need to be paid to reducing transaction costs. This will require tremendous efforts in the area of technology and for banks to build capabilities to handle much bigger volumes.

The GATS environment brings in its wake risks along with profitable opportunities, and technology plays a crucial role in managing these risks. In addition to being exposed to credit risk, market risk and operational risk, the business of Jordanian banks would be susceptible to country risk, which will be heightened as controls on the movement of capital are eased. In this context, Jordanian banks are upgrading their credit assessment and risk management skills and retraining staff, developing a cadre of specialists and introducing technology driven management information systems.

The changes in the banking and financial sector require upgrading of the employees skills in this sector. To meet increased competition and manage risks, the demand for specialized banking functions, using information technology as a competitive tool is set to go up. Special skills in retail banking, treasury, risk management, foreign exchange, development banking, etc., will need to be carefully nurtured and built. Thus, the twin pillars of the Jordanian banking sector, i.e. human resources and information technology will have to be strengthened.

In today's competitive environment, Jordanian banks will have to strive to attract and retain customers by introducing innovative products, enhancing the quality of customer service and marketing a variety of products through diverse channels targeted at specific customer groups. Besides using their strengths and strategic initiatives for creating shareholder value, Jordanian banks have to continue improving their efforts towards the application of corporate governance. Following financial liberalization, as the ownership of banks gets broad based the importance of institutional and individual shareholders will increase.

Introducing internationally recognized best practices and observing universally accepted standards and codes are necessary for strengthening the domestic financial architecture. This includes best practices in the area of corporate governance along with full transparency in disclosures. In today's globalized world, focusing on the observance of standards will help smooth integration with world financial markets.

For banking supervision, Jordan needs to adopt more advanced early warning systems, improved reports from the banks, and address additional training needs for supervisory staff in new risks that are likely to emerge as the system becomes more competitive and complex. However, for now, the central bank of Jordan has made substantial progress since 1990s, and it is viewed as adequate relative to the risks being assumed by the banks at the moment. However, as noted, these are expected to become more challenging in the coming years, and Jordanian bank systems and staff will need to adapt (UNCTAD, 2005).

## Specific recommendations for remedial action

- The bankers must recognize that innovation or evolution of financial services is crucial to retaining customers. Therefore, they should create new services and products beyond the classical services (e.g., expanding electronic services, reaching new regions outside Jordan, and improve the investment in off-balance sheet activities).
- Even though the regulations of the CBJ are consistent, to a large extent, with the international standards, it needs to train its supervisory staff on the new dimensions in regulation especially those related to financial crisis, advanced risk management techniques, mergers and acquisitions, and competition.
- To support Jordanian enterprises that wish to expand abroad, Jordanian banks should develop an appetite for international business and should make room for their own expansion overseas. They can start looking for joint venture projects or full-subsidiaries outside Jordan.
- The CBJ should organize the banking sector within a more competitive environment than a concentrated one. As mentioned before, the banking sector in Jordan is highly concentrated. Therefore, CBJ can encourage banks in terms of mergers and acquisitions in order to improve the financial strength and the competition level in the sector.
- A number of Jordanian banks have an opportunity to enter the Islamic Banking that's been growing rapidly through the past few years. They can analyze and evaluate the new Islamic financial products. There is a good opportunity for Jordanian banks to coordinate with other foreign banks that are interested in these products. Recently, many foreign banks start thinking about these Islamic products because they expect to generate attractive return with reasonable level of risk.
- Develop new strategies to deal with increasing volatility in local and regional markets. This can be achieved by concentrating on product and location diversification.

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