HAWKAMAH

THE INSTITUTE FOR CORPORATE GOVERNANCE

Corporate Governance Seminar

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Presented by:

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AGENDA

- Corporate Governance Basics
- Hawkamah Institute for Corporate Governance
  - Regional Challenges: Survey Results
- Importance of Corporate Governance in Various Sectors
- Shariah Compliant Corporate Governance
- Moving Forward: Specific Initiatives to Improve the Corporate Governance Environment
- Hawkamah and the IDB

The Challenge of Implementing Corporate Governance

"There is nothing more difficult to carry-out, nor more doubtful of success, more dangerous to manage than to introduce a new system of things.

An innovator has as enemies all those who were doing well under the old order, and only hesitant defenders in those who would benefit from the new system."

***Source**: Niccolo Machiavelli*

MENA: Sustaining Growth

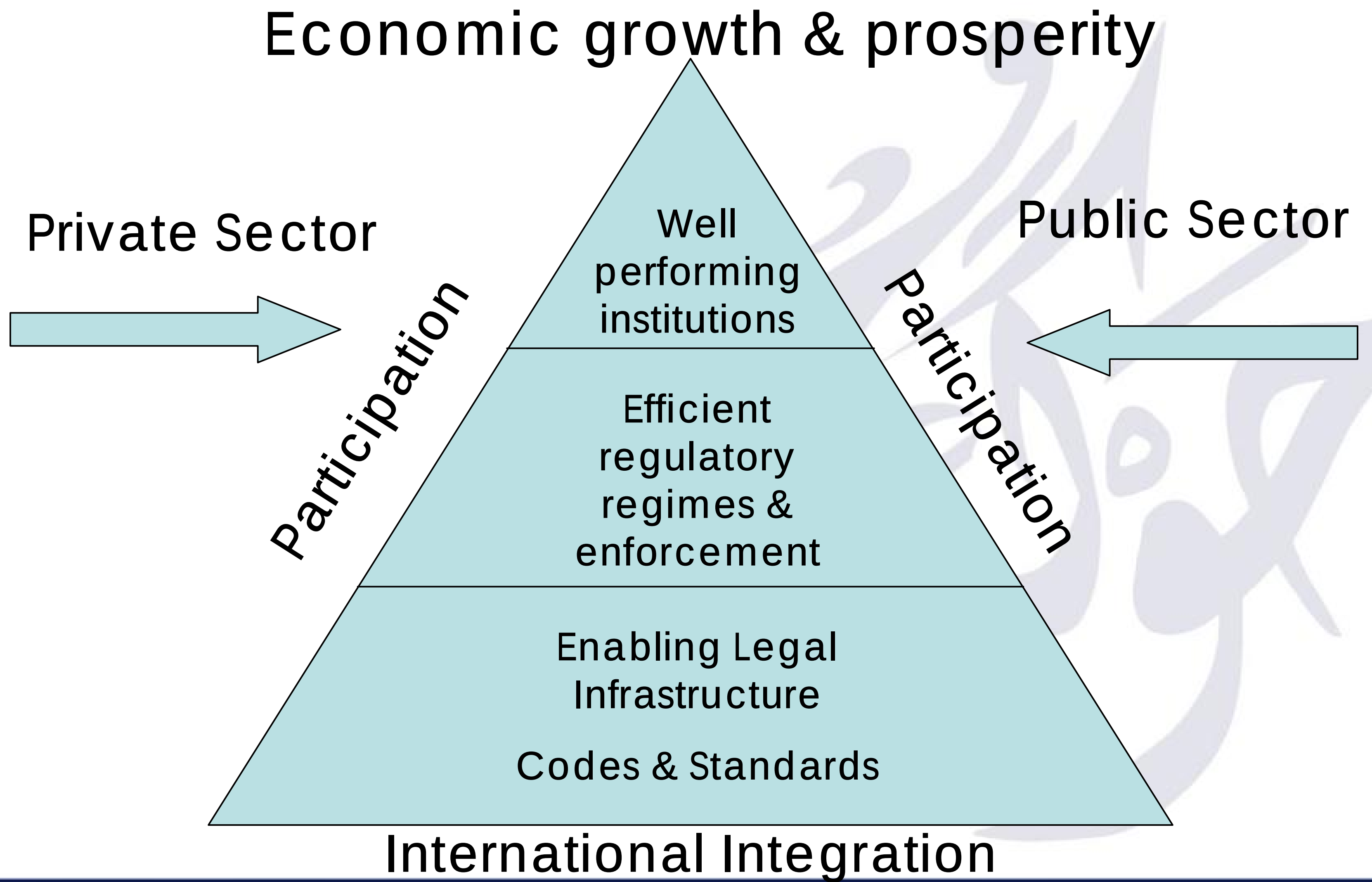
- Region is experiencing above trend, investment-led, growth and improved macroeconomic environment and supportive global economic & financial developments
- Economic reforms, liberalization, diversification and state divestment and privatization are generating attractive prospects across many sectors. But will reforms be sustained?
- Growing private sector investment (FDI, portfolio) across MENA countries.
- ↑ Labour flows to oil exporters → ↑ remittances to labour exporting countries (Egypt, Jordan, Lebanon, Morocco)
- Sizeable infrastructure developments with an estimated value of projects planned or under development in GCC & Iran in excess of USD 1.4 trillion.
- Greater regional and international economic integration
- Central challenge is to use oil wealth and demographic dividend to create economic and financial incentives for sustained growth.

But key to sustaining growth is addressing governance challenges.

“Good Governance”

- Well performing institutions, enabling legal infrastructure, regulatory regimes and enforcement, “good governance” are major contributors to economic growth & prosperity and democracy
- Public Governance matters for effective CG:
    - **Control of corruption**
    - **Regulatory quality**
    - **Rule of law**
    - **Government effectiveness**
- “Good governance” is required by both the public sector and the private sector in the MENA
- There is a Governance ‘gap’ in the region

Effective CG: integral element of sustainable economic growth & development



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Corporate Governance Defined

"Corporate governance is the system by which companies are directed and controlled."

Source: *Sir Adrian Cadbury, UK Combined Code*

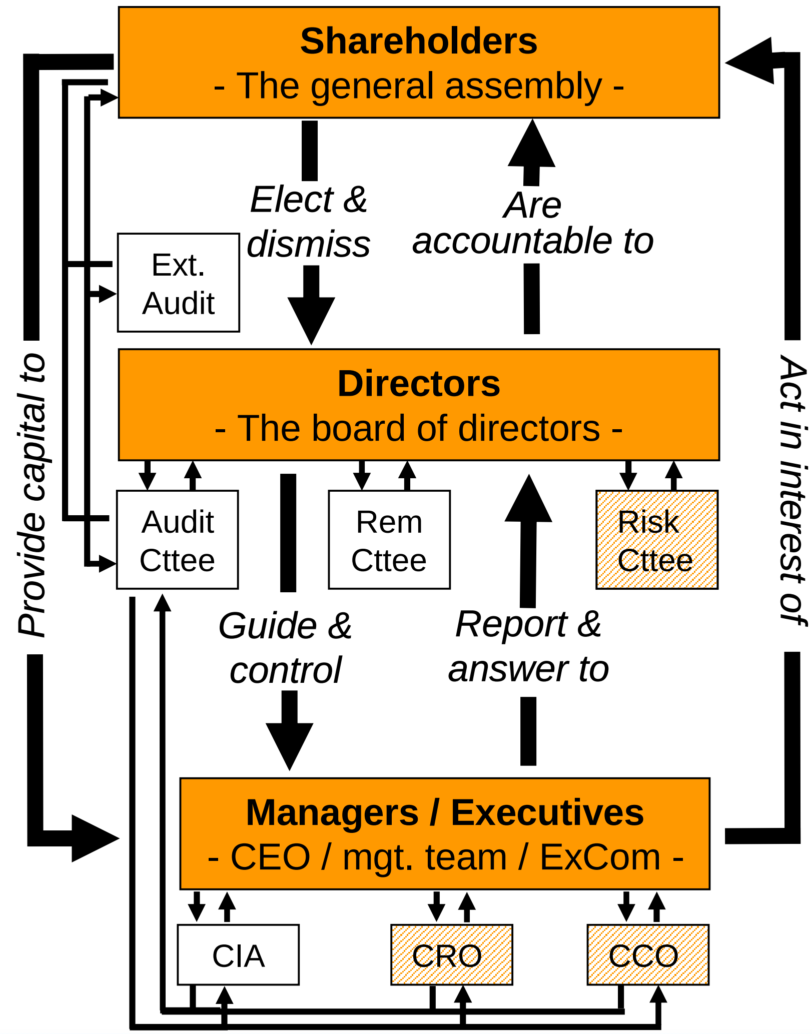
"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

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."

Source: *OECD Corporate Governance Principles, 2004*

The Internal vs. the External Perspective

Internal—Corporate—Perspective



External—Stakeholder—Perspective

Intermediaries

Stakeholders

Reputation Agents

- Accounting firms
- Law firms
- Investment banks
- Credit rating agencies
- Financial analysts
- Financial media
- Research institutes
- Educational institutions
- Corporate governance institutes
- Institutes of directors

Law- & rule makers

- Company, Banking, Securities Laws
- Regulations, Listing rules
- National CG Codes

Capital & Financial Markets

- Debt & equity markets
- Competitive forces
- Market for corporate control

Civil society

- CSR
- HSE

External and Internal Framework Affecting a Company's Corporate Governance

External Laws, regulations

Mandatory:
- Civil Law
- Company Law
- Specialized—Securities, Banking—Law
- Listing rules

Voluntary:
- National corporate governance code

Internal company documents

- **Articles of Association**
- **Corporate governance code**
- **Code of ethics or conduct**
- **Board charter**
- **By-laws/charters/ToRs on:** (i) board Committees; (ii) general assembly; (iii) corporate secretary; (iv) internal auditor, etc.
- **Policies and procedures on:** (i) dividends; (ii) information disclosure; (iii) enterprise risk management; (iv) internal controls; (v) internal audit procedures; etc.

The 'Look & Feel' of Corporate Governance

The five key elements of good corporate governance

Good board practices	Appropriate Control environment & processes	Strong regime of disclosure and transparency	Protection of (minority) shareholder rights

Strong commitment to corporate governance reforms

Principles of Corporate Governance

As put forth in the 2004 OECD Principles of Corporate Governance

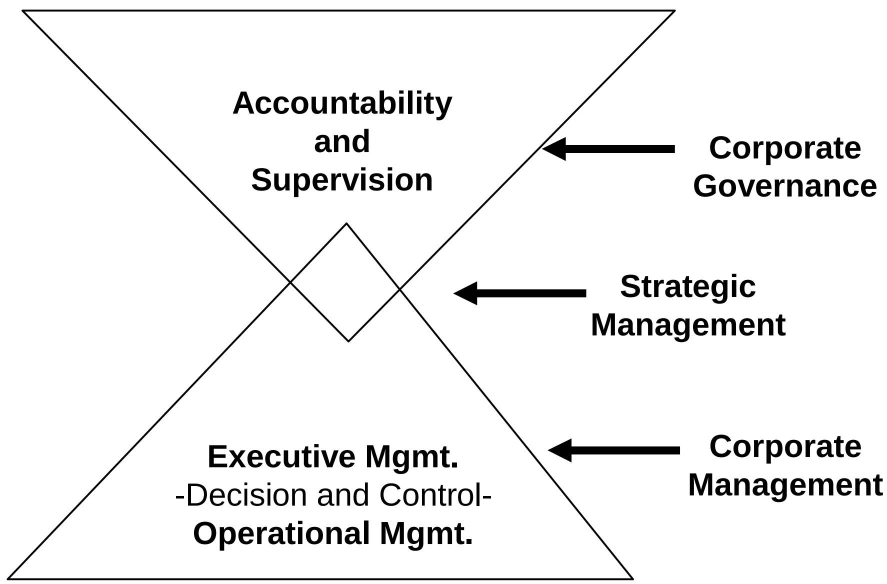
Accountability	Fairness	Transparency	Responsibility
§ Ensure for mgmt.'s accountability to the Board § Ensure for the Board's accountability to SHs	§ Protect SH Rights § Treat all SHs, incl. minorities, equitably § Provide for effective redress for violations	§ Ensure for timely and accurate disclosure § On all material matters, incl. the: ü Financial situation ü Performance ü Ownership ü Governance	§Recognize the legal rights of stakeholders §Encourage co-op. between the Co. & stakeholders in creating ü Wealth ü Jobs; and ü Sustainability

These Principles should: (see table above)

And while corporate governance issues will vary from company to company, these principles hold true for all companies.

Important to Distinguish Corporate Governance From Other Concepts

Corporate governance [1] corporate/financial management



Source: *Robert Tricker,Corporate Governance, 1984*

Corporate governance [1] corporate social responsibility or business ethics

If management is about running the business, corporate governance is about seeing that it is run properly. All companies need managing <u>and</u> governing.

Why is the World Talking About Corporate Governance?

- § **Corporate failures**
- § **Executive greed**
- § **Economic stagnation**
- § **The pension bomb**
- § **Globalization**
- § **Privatization**
- § **Internal awareness of business case,** i.e. creating long-term growth & shareholder value

Benefits of Implementing Corporate Governance… from the corporate's perspective

Optimizes Operational and Financial Efficiency

- **Streamlines business processes, leading to better operating performance & lower capital expenditures**
  à Gompers, Ishii and Metrick, corporate governance and Equity Prices, August 2001
- **Improves the company's ROCE, with firms in the top cg quartile avg. 33% & in bottom quartile 15%**
  à Credit Lyonnais SA, 2001
- **Better share price performance, higher profitability, larger dividend payouts & lower risk levels than peers**
  à Lawrence Brown, Georgia State University, Sept. 2003

Improves Access to Outside Capital

•Global Institutional Investors managing more than 1 trillion of assets state that they will pay a premium for well governed companies. Premiums avg. 30% in Eastern Europe & Africa and 22% in Asia and Latin America
à McKinsey Global Investor Opinion Survey on corporate governance, 2002

Improves Valuation and Lowers the Cost of Capital

•Over 10 years, well-governed companies across a wide range of sectors have seen superior valuation multiples of more than 8% over their badly governed peers.
à Metrick, Ishi and Gompers, Corporate Governance and Equity Prices, August 2001

•One standard-deviation improvement in governance brings an improvement in valuation multiples that ranges from 18% for companies in major OECD markets to 33% in emerging markets.
à Clapper and Love, World Bank, 2002

Builds/Improves the Company's Reputation and Trust

- **CG can make or break reputations by creating confidence, establishing goodwill and building/restoring investor trust**

Shareholder Value & Competitiveness

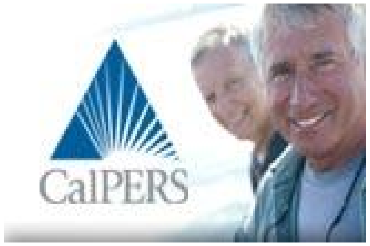
Benefits of Implementing Corporate Governance… from the investor's perspective

- **Corporate governance can provide for higher returns on investment**

- **For example:** Calpers' biggest return came from its investment in corporate governance funds aimed at turning around failing companies.

Guess how? ……………… **by pressuring Boards**

Guess by how much? … **by 69%**



Source: *CalPERS, 2005*

Benefits of Implementing Corporate Governance… from the public-sector's perspective

- **Corporate governance can help reduce vulnerability to crisis**

- **The most solid relationship in economies and economics:**
  the positive link between investment and economic growth

- **But it is not only quantity but quality of investment that matters**

- **Growth will depend on how investment is:**
  - Stage 1: Mobilized
  - Stage 2: Allocated; and finally
  - Stage 3: Monitored.

And corporate governance plays a key role in all three stages

Corporate Governance and Access to Capital

- "Good" corporate governance is essential for:
  - safeguarding company assets
  - maintaining and enhancing investor confidence
  - reducing the potential of fraud

- "Poor" corporate governance companies
  - will find it harder to access external capital
  - will face higher financing costs
  - will see their credit ratings downgraded
  - will have weak investor confidence

Corporate Governance Quality: Trends and Real Effects

- Study constructed a composite index of corporate governance quality, over 1994 through 2003 in selected emerging and developed economies, and assessed its impact on aggregate and corporate growth and productivity

- The research established that improvements in corporate governance quality have a positive and significant effect on all measures of macroeconomic outcomes considered (GDP growth, Total Factor Productivity (TFP) growth, and on the ratio of investment to GDP).

- Corporate governance quality was measured as an index of simple average of three indicators, called Accounting Standards (AS), Earning Smoothing (ES), and Stock Price Synchronicity (SPS).

Source: Corporate Governance Quality: Trends and Real Effects, Gianni De Nicolò, Luc Laeven, Kenichi Ueda, IMF Working Paper, December 2006, WP/06/293

Corporate Governance Quality: Trends and Real Effects (Cont.)

- More specifically one-standard deviation increase in the CGQ index in the current year results in an increase in the following year of:
  - About one percent in GDP growth
  - About half percent in TFP growth
  - 16% in the ratio of investment to GDP

- In addition, the paper found that improvements in corporate governance appear to positively affect the performance of industries that depend on external finance. This result is consistent with the idea that improvements in corporate governance quality benefit most those industries whose growth crucially depends on external finance.

Source: Corporate Governance Quality: Trends and Real Effects, Gianni De Nicolò, Luc Laeven, Kenichi Ueda, IMF Working Paper, December 2006, WP/06/293

Without Good Corporate Governance …

- Too much power is centred on one individual without proper oversight
  … e.g. Enron

- You enter markets that you do not understand and fail to properly set strategy and manage your risks
  … e.g. HSBC

- Board fails to ensure controls are robust or question the unusual or the unrealistic
  … e.g. Barings/Amaranth

- Poor disclosure and transparency becomes commonplace
  … e.g. WorldCom

- Shareholder rights are mistreated
  … e.g. Parmalet et al

Corporate Governance Codes

- CG Codes and Principles have been developed for major sectors of modern economies
  - Listed Companies (OECD, WB)
  - Banks and financial institutions (BIS)
  - Insurance Companies (IAIS)
  - Investment managers (IOSCO, Hermes, ICGN)
  - Family enterprises (Cadbury)
  - State Enterprises (OECD)
- Need to adapt to national legal and institutional conditions

OECD Corporate Governance Principles

1. Ensuring the basis for effective Corporate Governance framework
2. The rights of the shareholders and key ownership functions
3. The equitable treatment of shareholders
4. The role of stakeholders in CG
5. Disclosure and transparency
6. The responsibility of the board

OECD CG Principles (2004)

- Stronger role of shareholders: institutional investors
- Conflicts of interest and self dealing
- Abuse of related companies
- The role of stakeholders including creditors
- Executive and director remuneration
- Financial market integrity: audit and accounting
- Transparency; also intermediaries
- Ensuring the basis for an effective corporate governance framework: effective enforcement

1. Regulatory Environment

- Credible and transparent regulatory environment
- Regulatory environment must not be perceived to be under control or influence of any particular interest group
- Regulators should be independent

2. Minority shareholder protection

1. **Protect the rights of minority shareholders:**
   1. Right to vote on important matters
   2. Right to buyback shares
   3. Right to formally present an issue to the board of directors
2. **Treat foreign shareholders equally with domestic shareholders**: non-discrimination principle

3. Responsibilities of the Board

- A majority of board members should be independent from management
- Boards should establish subcommittees to monitor & control
- All material information should be publicly disclosed – Transparency
- Develop an investor relations program that fully informs all shareholders of corporate activities

4. Accounting and auditing

- Firms should conform to accounting and auditing practices and standards i.e. comply with IAS (IFRS)
- Audit committee should have a majority of independent directors, who should be able to read and understand fundamental financial statements
- All communications between the committee and external auditors should be without the company management present

5. Transparency of Ownership and Control

- Who controls a company?
- Who has significant ownership?
- Firms should disclose accurate, adequate, and timely information so as to allow investors to make informed decisions about acquisitions, ownership obligations and rights, and the sales of shares

Insurance Core Principles on Corporate Governance

Essential criteria:

The Board of directors
The supervisory authority requires and verifies that the insurer complies with applicable corporate governance principles.

Suitability of persons
The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfill their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

Changes in control and portfolio transfers
The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer.

Internal control
The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations

On-site inspection
The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

Risk assessment and management
The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.

Information, disclosure & transparency towards the market
The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

Source: International Association of Insurance Supervisors

BIS: Sound CG Principles for Banking Organizations I

- **Principle 1** Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
- **Principle 2** The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation.
- **Principle 3** The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.
- **Principle 4** The board should ensure that there is appropriate oversight by senior management consistent with board policy.

BIS: Sound CG Principles for Banking Organizations II

- **Principle 5** The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.
- **Principle 6** The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.
- **Principle 7** The bank should be governed in a transparent manner.
- **Principle 8** The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").

BIS Sound CG Principles for Banking Organizations: The Role of Supervisors

- Supervisors should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place.
- Supervisors should consider corporate governance as one element of depositor protection.
- Supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices.
- Supervisors should assess the quality of banks' audit and control functions.
- Supervisors should evaluate the effects of the bank's group structure.
- Supervisors should bring to the board of directors' and management's attention problems that they detect through their supervisory efforts.

OECD CG Guidelines for SOEs

- Ensure a level-playing field with the private sector.
- Reinforce the ownership function within the state administration.
- Improve transparency of SOEs' objectives and performance.
- Strengthen and empower SOE boards.
- Provide equitable treatment of minority shareholders

Regional Trend: Corporate Governance is a New But Growing Reality

- Corporate governance conferences across region
- OECD MENA Corporate Governance reform initiative underway
  - Policy advice to governments to improve frameworks
  - Surveys, studies, handbooks
- Corporate governance codes:
  - **Finalized**: Oman, Egypt (firms, SOEs), Lebanon (SMEs), Saudi Arabia
  - **In process**: Morocco, Egypt (revision), Lebanon (listed companies), Jordan (banks, companies), WB&G, UAE, Qatar
  - **Being launched**: Tunisia
- Institutes of directors launched
  - Hawkamah Institute for Corporate Governance
  - Institutes of Directors in Egypt, UAE and Lebanon (planned)
- Listing rules being tightened: **Egypt, UAE (ADSM)**