



HAWKAMAH

THE INSTITUTE FOR CORPORATE GOVERNANCE

...an autonomous international association promoting corporate governance in the Middle East North Africa, Central Asia and beyond

Corporate Governance in the Banking Sector

@ Leadership and CG Challenges in the Financial Sector

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AGENDA

- Why Bank CG?
- BCBS Guidance on Enhancing CG for Banking Organizations
- Key Players in Governance of Banking Sector
- Focus Efforts to Address CG of the Banking Sector
- Hawkamah and OECD – Task Force on Banks
- Hawkamah

Why Bank CG?

*CG for Banking Organisations is arguably of **greater importance** than for other companies, given **the crucial financial intermediation role** of banks in **economy...and...is essential** to achieving and maintaining **public trust and confidence** in the banking system."*

The Basel Committee

Why Bank CG?

- Lessons from Financial Crises
- Pressure from Analysts and Investors
- Renewed emphasis on environmental, social and governance issues
- Higher return on assets and significant market premiums
- Increased access to financing
- Better allocation of credit
- Deepening of financial markets
- Financial system stability

Why Bank CG?

- Banks' dominant position in financial and payment systems
- Banks dominate both credit & investment process for economy and majority of firms
- Government ownership and concentration of ownership in banking sector
- Strengthen prudential regulation and supervision
- Strengthen Transparency, Disclosure & Reporting
- Face challenge of external competition
- Liberalization & opening up is providing greater latitude to banks

Basel Committee on Banking Supervision (BCBS) Guidance on Enhancing CG for Banks

Sound CG Principles

- 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 organization
- Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization
- Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy

Basel Committee on Banking Supervision (BCBS) Guidance on Enhancing CG for Banks

- 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")

Basel Committee on Banking Supervision (BCBS) Guidance on Enhancing CG for Banks

The Role of Supervisors in Corporate Governance

- 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.

Key Players in the CG Framework for Banks

Internal Players

Shareholders

Board of Directors

Executive Management

Auditors

External Players

Regulators and Supervisors

Legislative and Regulatory Framework

Supervisory Authority

The Market

The Public

Depositors

Reputational Agents:

- Accountants
- Credit Rating Agencies
- Financial Media
- Research Analysts

Focus Efforts to Address CG of the Banking System

1. Central Bank and Bank Supervisors
2. Banking sector and financial institutions
3. Non-bank corporate sector
4. Shari'a compliant financial institutions

1. Central Banks and Banks Supervisors

- Develop a credible and transparent regulatory environment
- Address Central Bank governance to ensure its independence and accountability
- Regulatory environment must not be perceived to be under control or influence of any particular interest group
- Follow BIS principles for sound banking CG

2. CG of Banking Sector and Financial Institutions

- Understand and implement BIS standards
- Address institutional barriers from implementing BIS standards
- Be transparent and disclose:
 - Board and senior management structure
 - Organizational structure
 - Incentive structure of the bank
 - Related party transactions
 - Annual financial statements with supporting notes and schedules
- Develop codes of ethics and CG handbooks for banks, as guidance for directors and staff

3. Banks have a role in extending CG to non-bank corporate sector

- Establish 'cascading effect' of CG to banks' corporate clients.
- Over 90% of firms in emerging markets are FOEs and are mostly dependent on banks, not capital markets, for source of capital.

Implementing CG in Non-Bank Financial Sector

Two-step process:

1. Develop a mandatory bank CG Code

- Monitored by bank supervisors and reported on by board
- Reporting on compliance in bank annual report

2. Central Bank issues a circular relating to CG code for non-bank corporate clients of the banking system

- Develop effective monitoring by banks (i.e. market based monitoring)
- Support monitoring by development of credit bureaus and credit rating agencies
- Create incentives (such as lower risk assessment for capital adequacy requirements) for CG-compliant corporate clients thereby also providing incentives for banks.

Reinforcing Institutions for a CG regime for bank and non-bank corporate sector

- **Central Credit Reporting Organizations**
 - Provide information on bank and non-bank credit (including supplier credit)
 - Local CCRO's can collect, organize, and analyze valuable material information in an efficient manner
- **Companies Houses**
 - Act as a corporate registrar and reliable source for publicly available information about corporations
 - Provide and disseminate financial reports and info on board & management actions
- **Credit Rating Agencies**
 - Risk assessments and credit ratings for companies and governments
 - Important for capital market development, and implementation of Basel II by providing credit benchmarks for local markets

4. Shari'a compliant Financial Institutions

- Islamic Financial Services Board developed seven guiding principles, divided into four parts, on CG for institutions offering only Islamic financial services (IIFS).
- Complements current CG principles issued by OECD, BCBS and other international standard setting bodies.
- Recognizes that specific CG practices will vary in scope and content
- Prudential regulations covering aspects of capital adequacy, risk management, investor protection, transparency and market discipline, accounting practices will have CG dimension on structure and business practice. Focus is on holistic compliance of regulations.

4. Islamic Financial Institutions Guiding Principles (Draft)

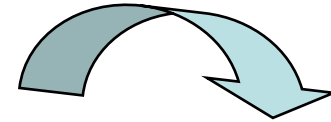
- General Governance Approach of IIFS
 - Establish comprehensive governance policy framework
 - Reporting of financial and non-financial information meets international standards
- Rights of investment account holders (IAHs)
 - Recognizes IAH's rights to monitor performance of investments
 - IIFS shall adopt sound investment strategy
- Compliance with Islamic Shari'ah rules and principles
 - Put in place an appropriate mechanism for obtaining Shari'ah rulings, application of fatwa and monitoring of Shariah compliance
 - IIFS shall comply with Shari'ah rules and principles
- Transparency of financial reporting
 - IIFS shall make adequate and timely disclosure to the IAH and the public on investment accounts that they manage

Hawkamah – Task Force on Banks

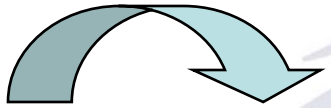
- With the OECD, established a Task force on the CG of Banks,
- in the process of developing a Policy Brief on CG of Banks addressing the challenges faced by MENA Banks to include:
 - The characteristics of MENA banks
 - Family-owned banks
 - State owned commercial banks
 - Role of the Board
 - Internal controls
 - Disclosure
 - Take over of banks

The Characteristics of MENA Banks

Banks dominate the Financial Systems in the MENA countries.



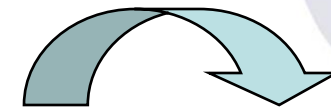
Bank loans and equity are the most important forms of external finance. Too much reliability on Bank Financing.



Commercial banks are often shareholders in non-financial listed companies, sometimes ranking among the five largest shareholders



Governance interferes in credit allocation.



Need for CG of Banks

Need to develop the capital markets

Need for particular attention to CG with special focus on related lending and sound risk management policies

Need for a sound lending strategy.

Family Owned Banks (FOBs)

Key Problem:

Related Lending

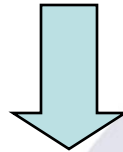


Need for special attention to regulatory frameworks and board practices:

- 1- Ensure that lending policies are conducted on market terms and conditions, and are consistent with sound risk management and prudential practices
- 2- Review of related party transactions should be undertaken by Non-Executive Board members

State Owned Commercial Banks (SOCBs)

- A significant percentage of MENA banks is owned by the state.
- State owned banks tend to extend loans on non commercial grounds and to roll over soft credit to borrowers approaching default.
- Tendency for corruption and abuses



- Establish mechanisms that allow government agencies (in government ownership functions) to be active account holders while at the same time avoid day-to-day interference in the management of the bank.
- Recognize the importance of sound CG of SOCBS as a prerequisite for their successful privatization.
- Good Governance of privatized banks may lead to better CG of other banks.

Role of the Board

•Controlling Shareholders in the MENA (especially in the FOB), often appoint all directors, which can undermine the independence and objectivity of the board.



•Need for **Independent Directors:**

Independent Directors' role in:

- monitoring the management
- countering political interference
- preventing abusive related party transactions

The data collection and feedback sought by WG members also stressed the:

- Role of the Board of Directors in **protecting the interest of depositors**
- Need for a **regulatory institution** with a power over the board and the executives of banks
- Specialized board committees'** role in supporting decision making in Boards of Banks

Take over of Banks

- MENA Banks play a dominant role in corporate financing and often wield power over borrowing companies
 - ➡ Role of Banks in the CG of their clients
- Sound CG through market pressure is not functioning in many MENA economies due to the fact that their capital markets are still developing.
 - ➡ the Assessment and Monitoring function of banks deserve special attention from banks, policy makers and banking supervisors as an effective tool for improving CG in a country.

Hawkamah, the Institute for Corporate Governance

MISSION: Assists the countries and companies of the region to develop and implement sound and globally well integrated corporate governance frameworks.

VISION: Drives institution building, corporate sector reform, good governance, and sustainable economic development and growth in the region.

Activities...

WHAT WE DO:

- Provide technical assistance on regulatory and firm levels to develop the optimal corporate governance environment
- Conduct CG assessments and prepare CG improvement plans
- Provide advisory services
- Conduct consultations with various stakeholders
- Develop and implement training programs: Board Development Programme, Board Secretary Programme
- Serve as a knowledge centre and clearinghouse for corporate governance best practices from the region and beyond.
- Monitor & Report on the state of corporate governance

Strategic Partners

International Partners

- **Organisation for Economic Co-operation and Development (OECD)**
- **World Bank-International Finance Corporation**
- **WB Global Corporate Governance Forum**
- **Center for International Private Enterprise**
- **Institute of International Finance (IIF)**
- **Financial Services Volunteer Corps (FSVC)**
- **INSOL (Insolvency Professionals)**
- **Information Systems Audit and Control Association (ISACA)**
- **Amsterdam Institute of Finance**

Other Institutions

- **Arab Monetary Fund**
- **Dubai School of Government, Young Arab Leaders**
- **Countries participating in the MENA-OECD Investment Program**
- **Corporate Governance centers, universities**

Regional Partners

- **Dubai International Financial Centre**
- **UAE Ministry of Economy**
- **Yemen Ministry of Finance**
- **Emirates Securities and Commodities Authority**
- **Oman Capital Market Authority**
- **Union of Arab Banks**
- **Abu Dhabi Chamber of Commerce and Industry**
- **Dubai Chamber of Commerce and Industry**
- **Jordanian Corporate Governance Association**
- **Central Bank of Jordan**
- **Jordan's Insurance Commission**
- **Egyptian Institute of Directors/Central Bank of Egypt**
- **Egyptian Banking Institute**
- **Economic Research Forum**
- **Oman Economists Association**
- **Corporate Governance Association of Turkey**
- **Lebanese Corporate Governance Task Force**

Hawkamah

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