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: Issues & Challenges

## @ 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
- Extending good CG to non-bank corporate sector
- Hawkamah& OECD: Bank CG Task Force
- Hawkamah: role & activities

# 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 Institutional Investors & Analysts
- Renewed emphasis on environmental, social and governance issues
- Increase access to finance
- Better allocation of credit
- Deepening of financial markets
- Financial system stability & systemic risk

# Why Focus on Bank CG in MENA?

- Banks' dominant position in financial and payment systems in MENA countries
- 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 e.g. cross-border investments

# Financial Stability and its Three Pillars

**Financial System Stability**

Macroeconomic Conditions **(Pillar 1)**

- Monetary Policy
- Debt Structure
- Exchange Rate Regime
- Economic Growth

Regulatory and Supervisory Conditions **(Pillar 2)**

- Regulatory Framework
- Supervisory Efficacy
- Safety Nets
- LOLR and Contingency Planning

Market Infrastructure Conditions **(Pillar 3)**

- Money and Exchange Markets
- Payments and Settlements Arrangements
- Accounting and Audit Arrangements

**Regulatory Governance**

Public Sector Governance

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Source: IMF Working Paper – Udaibir S. Das, Marc Quintyn, and Kina Chenard
Does Regulatory Governance Matter for Financial System Stability?

# Corporate Governance Codes/Guidelines

- CG Codes and Principles have been developed for major sectors of modern economies
  - Listed Companies (OECD, ICGN)
  - Banks and financial institutions (BIS)
  - Shari'a compliant institutions (IFSB)
  - Insurance Companies (IAIS)
  - Investment managers (IOSCO, Hermes, ICGN)
  - Family enterprises, SMEs (Cadbury, King, OECD)
  - State Owned Enterprises (OECD)
- No 'one size fits all'
- 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

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

**P1**: 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

**P2**: The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization

**P3**: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization

**P4**: The board should ensure that there is appropriate oversight by senior management consistent with board policy

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

**P5**: The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions

**P6**: 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

**P7**: The bank should be governed in a transparent manner

**P8**: 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")

# BCBS Guidance on Enhancing CG for Banks: Role of Supervisors in CG

**S1**. Supervisors should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place

**S2**. Supervisors should consider corporate governance as one element of depositor protection

**S3**. Supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices

**S4.** Supervisors should assess the quality of banks' audit and control functions

**S5**. Supervisors should evaluate the effects of the bank's group structure

**S6**. 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
- Increase public awareness
- Build CG supervisory capacity

# 2. CG of Banking Sector and Financial Institutions

- Understand and implement BIS standards
- Address institutional barriers for 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
- Extend good CG from banks to non-bank corporate sector is a win-win, incentive compatible system:
  - Improves credit risk and lowers capital requirements
  - Improves access and terms of credit for borrowers

# Implementing CG in Non-Bank Corporate 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 for non-bank corporate clients of the banks
   - 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**
  - Ø Provide information on bank and non-bank credit (including supplier credit)
  - Ø Local CCRO's can collect, organize, and analyze valuable material information in an efficient manner
- **Companies Houses**
  - Ø Act as a corporate registrar and reliable source for publicly available information about corporations
  - Ø Provide and disseminate financial reports and info on board & management actions
- **Credit Rating Agencies**
  - Ø Risk assessments and credit ratings for companies and governments
  - Ø 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-OECD CG Task Force for Banks

- CG of banks more compliant with international standards than non-bank corporate sector
- Central banks have been pro-active
- Hawkamah & OECD, established a Task force on the CG of Banks including Central Banks & Banks
- Bank CGTF is developing a Policy Brief on CG of Banks addressing the challenges faced by MENA Banks to include:
    - **Characteristics of MENA banks**
    - **Family-owned banks**
    - **State owned commercial bank**
    - **Role of the Board**
    - **Internal controls**
    - **Disclosure**
    - **Take over of banks**
- Policy brief to be published by November 2007

# The Characteristics of MENA Banks

Banks dominate the financial systems in the MENA countries.

Need for CG of Banks

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

Need to develop the capital markets

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

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

Governance interferes in credit allocation.

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 also stresses 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

# 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.

# Hawkamah 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

- 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-IIF GCC CG reports

- Conducted an assessment of the corporate governance environment in the GCC from an investor's perspective.
- *Hawkamah/IIF GCC Comparative Corporate Governance Survey* and six country specific reports are available

# *Majlis, Hawkamah Institute of Directors*

- Mission is to develop and train effective, knowledgeable and competent directors for MENA region
- Build capacity and strengthen institutions
- Membership organization
- Open to private and public sector companies, family businesses, entrepreneurs of start-up companies, and people responsible for the strategic direction of a business organization
- Services offered include:
  - Training and certification program
  - Executive coaching
  - Workshops, seminars and conferences

# MENA CG Challenges & Priorities

- CG in MENA is 'work in 'progress'
- Focus on banking and financial sectors for adoption, implementation and enforcement of CG principles.
- Banking system should spearhead CG reform
- Central banks & bank supervisory authorities should introduce CG principles in banks & financial institutions as mandatory:
  - Effective monitoring
  - Effective enforcement
  - Integral part of external audit
- Establish 'cascading CG" approach: guidelines for CG for corporate clients of banks and financial system as part of risk mitigation strategy
- Good CG in banks:
  - Complementary to and strengthens Basel II guidelines
  - Improves CG in corporate sector
  - Banks benefit from better CG in markets

# 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."*

*Niccolo Machiavelli, The Prince*

# Thank you

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