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**FINANCIAL CRISES & CORPORATE GOVERNANCE:  
SOME LESSONS FOR EMERGING MARKET  
ECONOMIES & MENA**

**ESCA Forum  
Abu Dhabi, UAE  
January 2009**

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# Agenda

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- **Financial Crises and MENA, GCC**
- **Corporate governance and the Financial Crisis**
- **Corporate Governance Issues to be addressed**
- **Corporate Governance Reform in MENA: Next Steps**

## **Analysis Global Situation**

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- **Origins of crises: US loose fiscal and monetary policies, leading to lower than required interest rates, to increase in housing starts and housing boom and to excessive risk taking**
- **Despite a historic coordinated intervention of all major central banks and a series of unprecedented, wide ranging and extensive government intervention the financial sector remains fragile and a return to normality is slow. Damage assessment is still underway**
- **Authorities, financial intermediaries and corporations are bracing for at least three quarters of deep recession and widespread weakness until end 2009 as the credit crunch spreads to the real economy. Forecasts have been corrected sharply downwards from even a few weeks ago.**
- **Lower consumption, cuts in investment projects and corporate downsizing in the wake of sharply reduced credit availability will in all likelihood prevail until the deleveraging comes to an end and trust in financial markets is restored.**
- **At present nobody can be sure for how long markets will remain dysfunctional and what results the stimulus packages will produce**

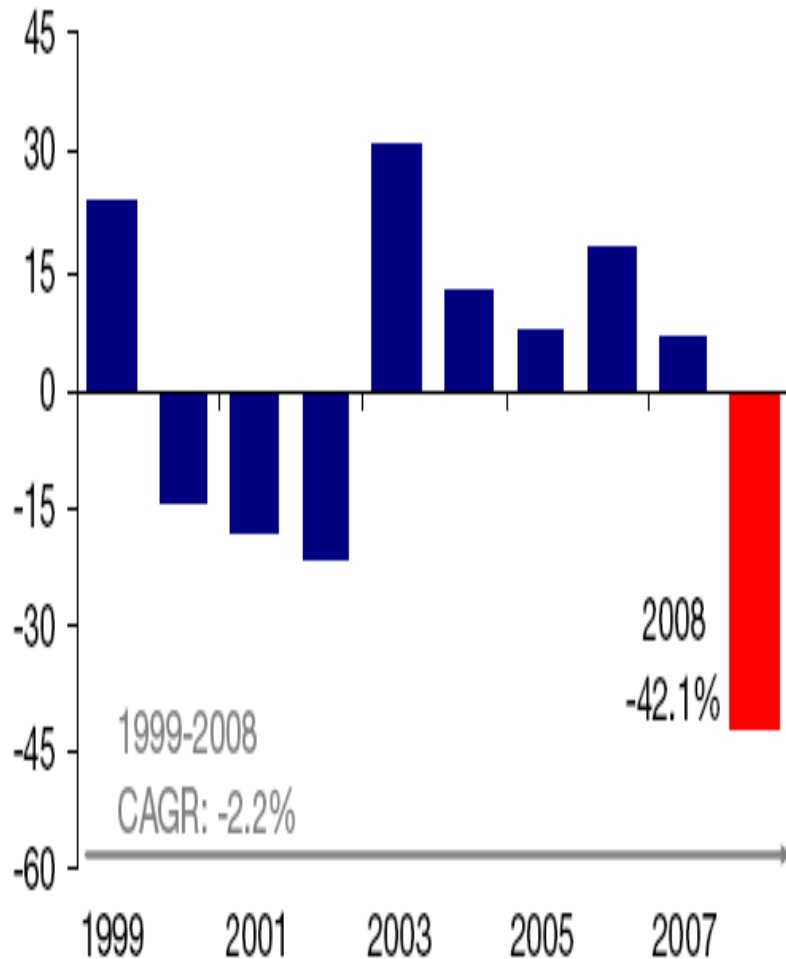
# Global Equity Market Meltdown

(Source IIF 2009)



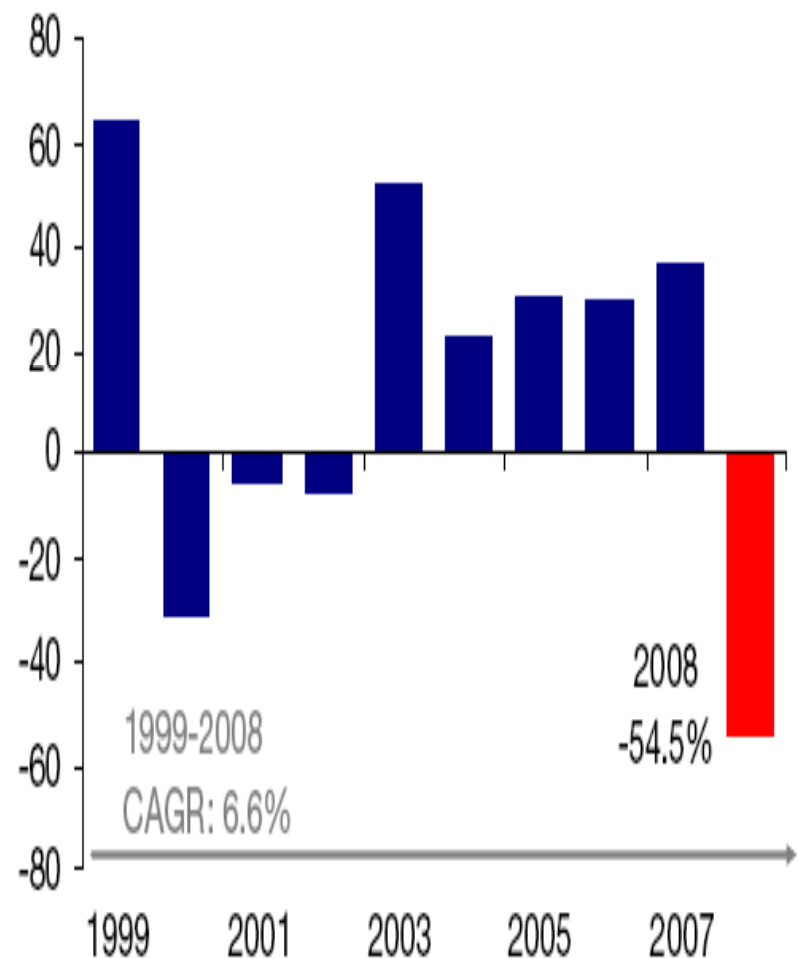
## 1 Mature Market Annual Equity Market Returns

MSCI World Index, US\$ terms, percent



## 2 Emerging Market Annual Equity Market Returns

MSCI EM Index, US\$ terms, percent



# Stylised Facts on the Aftermath of Severe Financial Crises

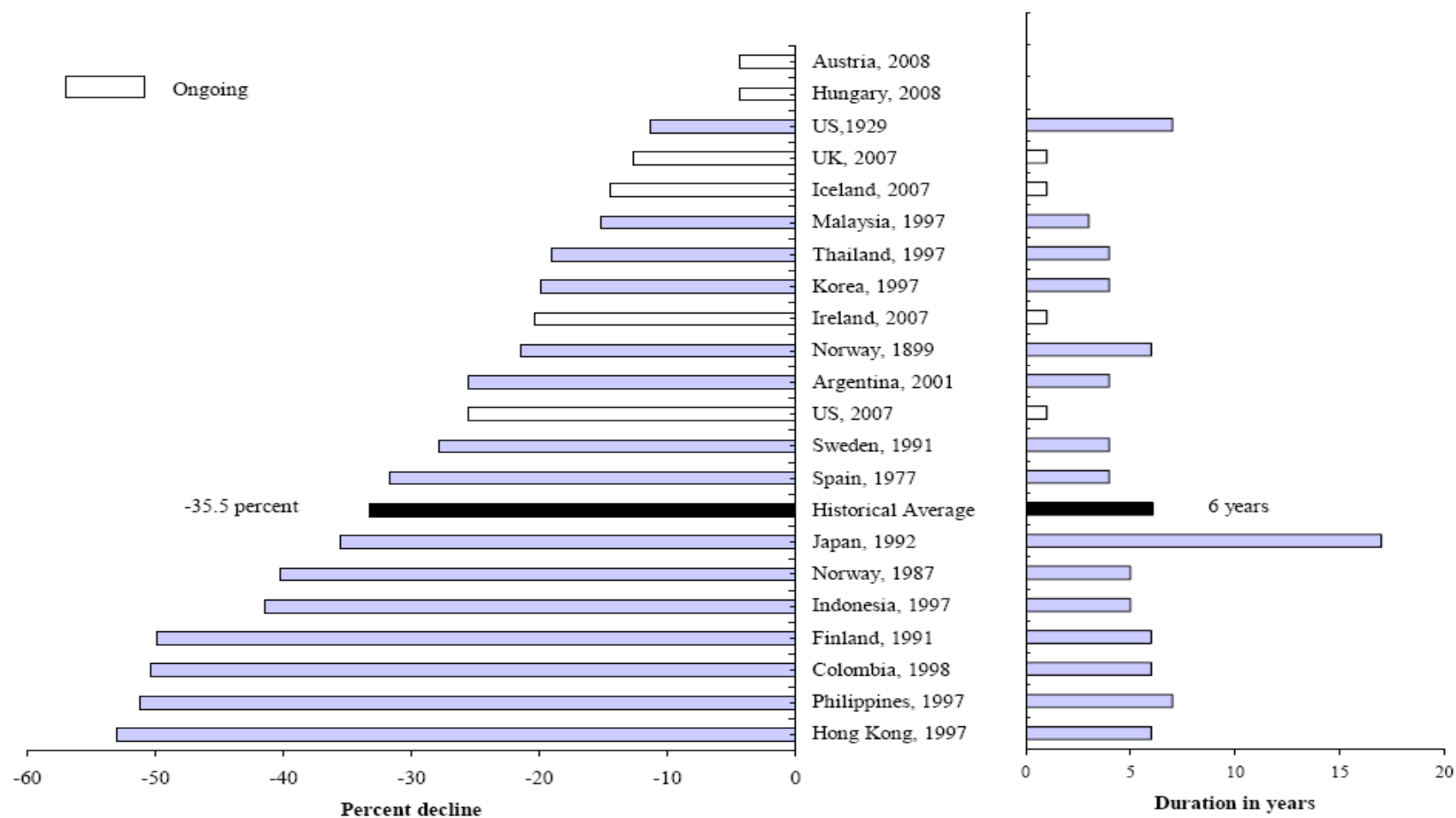
C. Reinhart & K. Rogoff (2008)



- 1. *Asset market*** collapses are deep and prolonged. Real housing price declines average 35 percent stretched out over six years. Equity price collapses average 55 percent over a downturn of about three and a half years.
- 2. *Aftermath of banking crises is*** associated with profound declines in output and employment. Unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is shorter than for unemployment.
- 3. *Real value of government debt tends to*** explode, rising an average of 86 percent in the major post–World War II episodes. Main cause of debt explosions is not the costs of bailing; the big drivers of debt increases are the collapse in tax revenues as a result of recession.

**Past and Ongoing Real House Price Cycles and Banking Crises:**

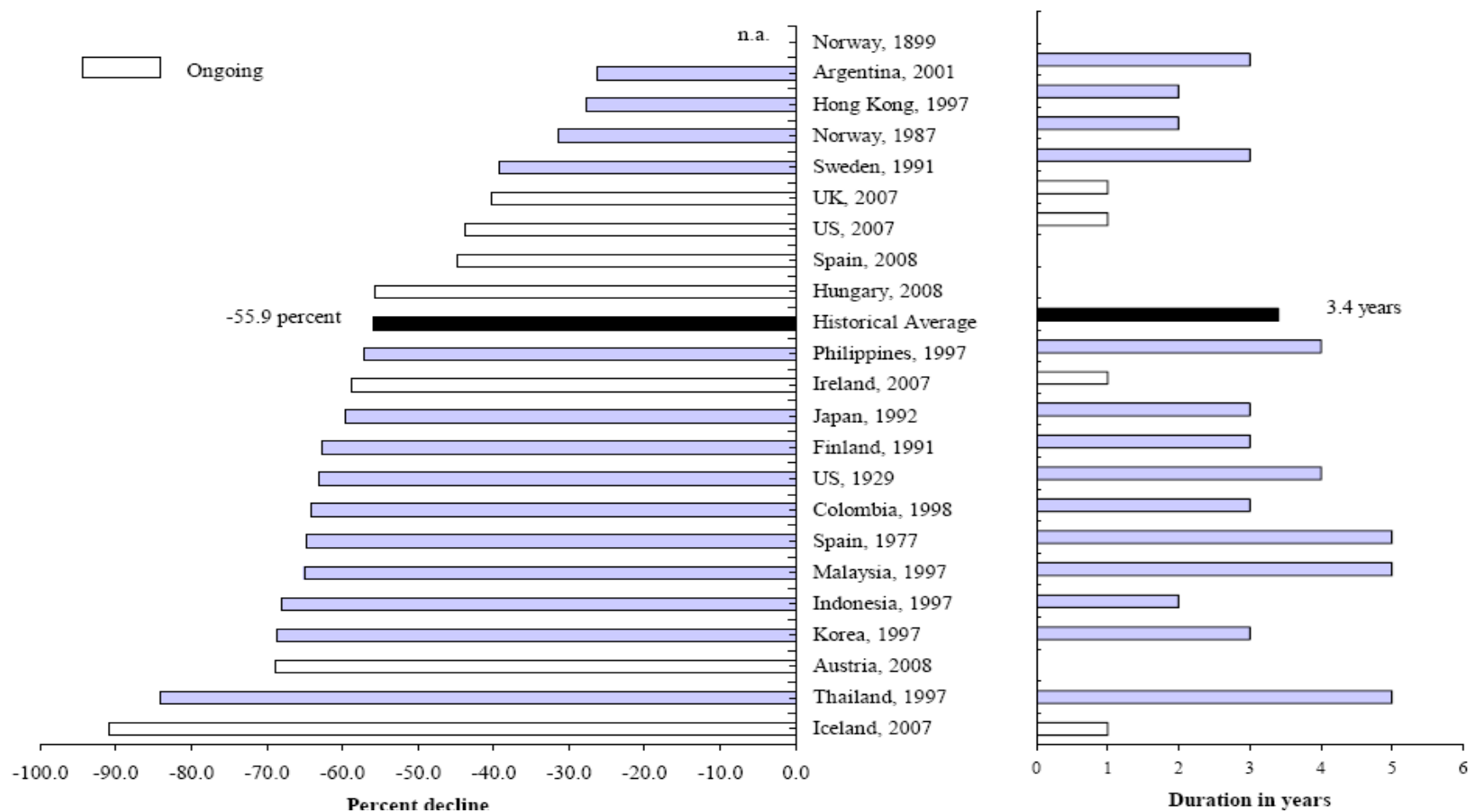
**Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)**



**Sources: Reinhart and Rogoff (2008b) and sources cited therein.**

**Past and Ongoing Real Equity Price Cycles and Banking Crises:**

**Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)**



**Sources: Reinhart and Rogoff (2008b) and sources cited therein.**

# GCC - Limited Repercussions to date

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- Contagion Effects of the financial crisis on GCC were mitigated and effects were moderate due to:
  - Strong macroeconomic fundamentals
  - Fiscal discipline and sizeable stock of foreign assets
  - Profitable domestic markets
  - Small stock of outstanding securitised/structured products
  - Limited expertise in managing structured investment products
  - Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
  - Growing importance of and compliance with Shari'a
  - Available liquidity from the return capital flows and from oil exports
- However real effects from increasingly global recession and lower oil prices will lead to lower growth and lower inflation



# Policy measures in the GCC

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- **Monetary Policy easing:**
  - CBs have cut discount and REPO rates
  - Extensive deposit and inter-bank credit guarantees
  - CB liquidity facilities
  - SWFs requested to intervene including through bank capital support
- **Fiscal Stimulus:**
  - Increased expenditure
  - Focus on infrastructure & public works
- **Structural changes**
- **The policy mix combination of monetary easing, fiscal stimulus from increased government productive spending and structural changes is likely to result in a 'soft landing' scenario for the GCC**

Banking and Financial crises have uncovered major failures in corporate governance standards and their implementation in 3 main areas:

- Boards, their composition and competence
- Risk Management procedures, processes and implementation
- Regulators

- ***“Underlying much of the credit crunch has been a fundamental failure in corporate governance. While the financial institutions involved may have been in compliance with local requirements and codes, they have ignored the key point – Good corporate governance is about boards directing and controlling the organisations so they operate in their shareholders interests....The use of overtly complex financial products, which thwarted effective supervisory control, and the unethical advancement, at the point of sale, of loans to people with little realistic hope of repaying them shows a lack of basic corporate governance.”***
- Association of Chartered Certified accountants “Climbing out of the Credit Crunch”, September 2008

# Risk Management Failures

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Examples of shortcomings in internal management and in the role of the board:

- According to a recent survey of 150 UK audit committee members and over 1000 globally: only 46 % satisfied that their company had an effective RM system (KPMG, 2008)
- Senior Supervisors Group (2008):
  - Almost all 11 banks reviewed failed to anticipate fully the severity and nature of recent market stress. However, marked difference in how they were affected determined in great measure by their senior management structure and the nature of their RM system.
  - Failures in a number of financial companies: Crédit Suisse, Lehman Brothers, Société Générale, Citibank, UBS.

## Composition of Boards & Risk management

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- One third of surveyed European banks not confident that their strategy and planning functions had a detailed understanding of their companies RM methodology.
- Of 11 surveyed European banks, only half staffed their committees with non-executive directors. (Lapido, 2008)
- Quality of BoD: « fit and proper » tests do not fully address the issue of competence in overseeing a significant business. Bank BoD often lack banking and financial experience
- Guerra and Thal-Larsen, 2008: two thirds of directors in 8 US major financial institutions did not have banking experience
- Lehman Bros: four of the ten member board were over 75 and only one had current financial sector knowledge
- Difficulties in recruiting high-level non-executive directors with financial expertise for risk and audit committees (many potential candidates often already working for the competition; independence requirements rule out many competent people)
- Politicians lacking knowledge on BoD of state-owned banks

***“The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The directors pursued a reckless business model which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk”***

House of Commons Treasury Committee, (January 2008) “The Run on the Rock”

# CG & related issues to be addressed

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- **Board Composition and Competence**
- **Risk Management process and governance**
- **Executive Compensation & Incentive structures**
- **Accounting and Disclosure issues**
- **Role, Regulation & Oversight of credit rating agencies**
- **Corporate Governance in the banking and financial sector**
- **Scope of the regulatory frontier**
- **Role of central banks as lenders/rescuers of last resort and the nature of collateral**
- **The Basel II framework & Liquidity Risk Management**
- **Macro-Prudential risk management**

- **CG Policy has lagged: development and refinement of Corporate Governance standards has followed the occurrence of Corporate Governance failures**
- **Beware the political backlash...**
- **Corporate Governance deficiencies facilitated or did not prevent practices that resulted in poor performance**
- **GCC are not immune to risks and crisis has impacted the markets of the region: stock market value losses, credit cost increased, liquidity tightening, reduced lending, international investors offloading GCC & MENA positions due to financial crisis**
- **Pressing CG issues: related party ownership, related party lending, stock market regulation, disclosure & transparency, accounting standards**

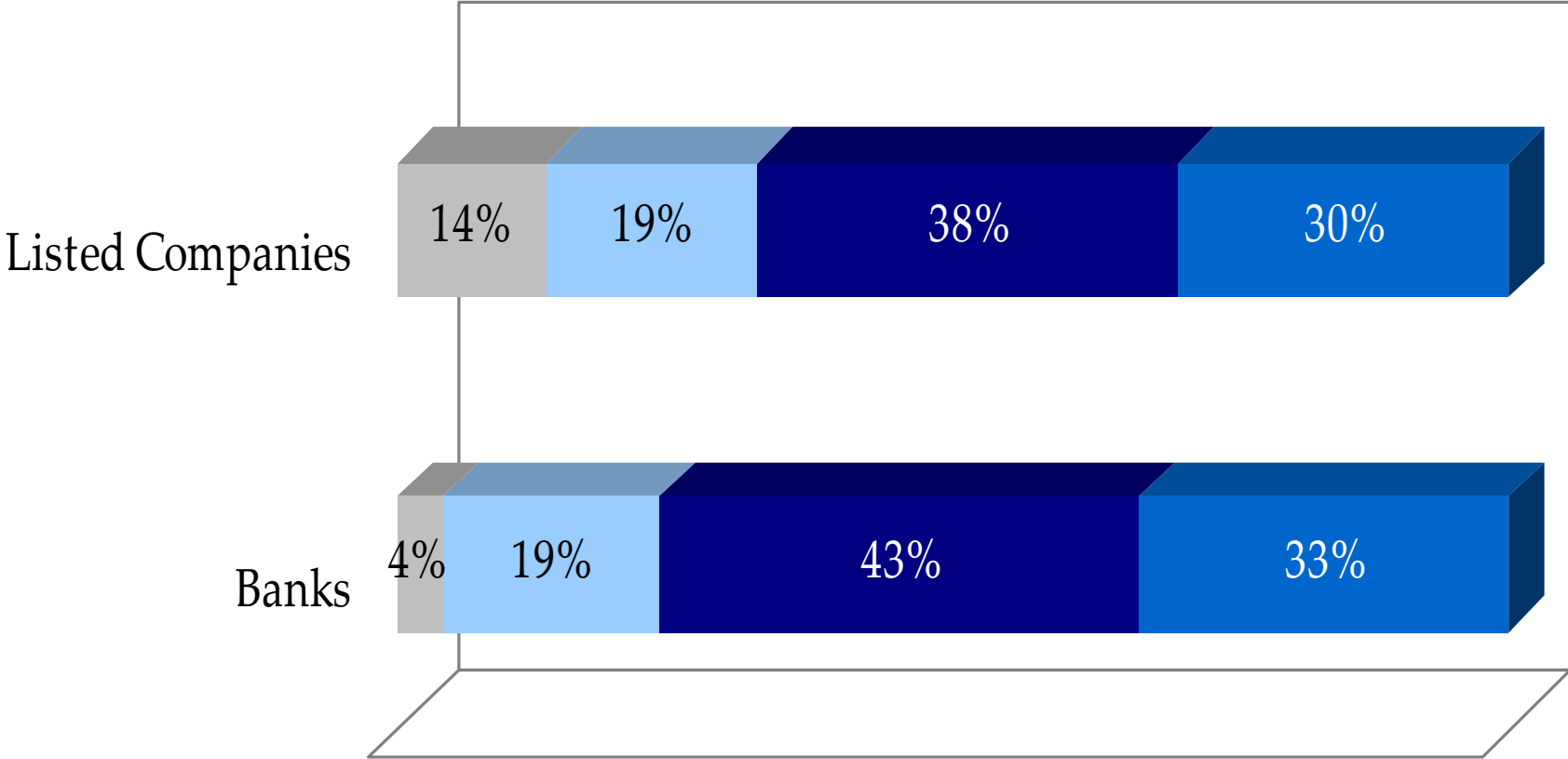


# Hawkamah-IFC CG Survey 2007-08



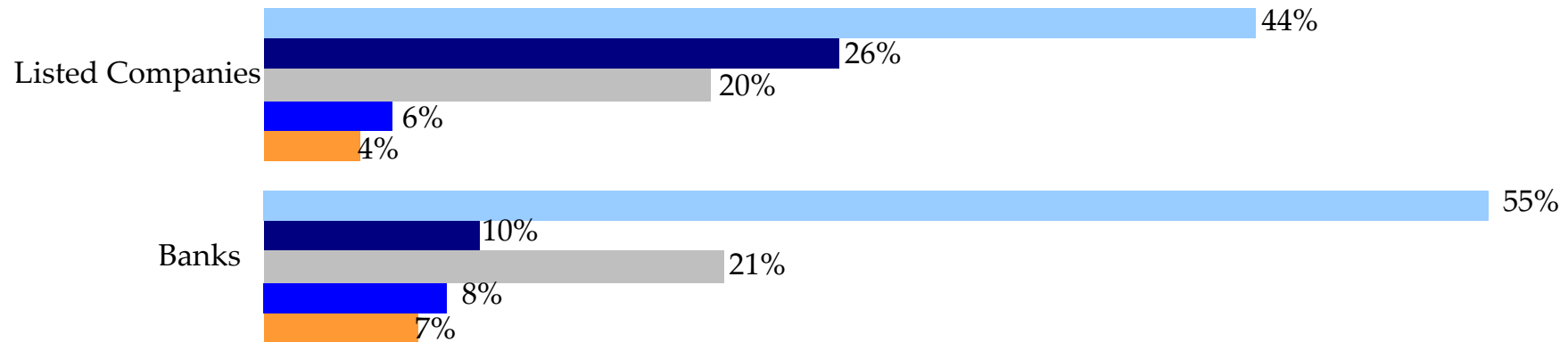
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- <http://www.hawkamah.org/publications/IFC/>
  - 42.3% of companies that still combine the function of chairman and CEO should separate these roles to comply with best practice.
  - Only 25% of banks and listed firms provide information on their dividend policies online, and just 12% have online information on key executives remuneration.
  - Most respondents view disclosure from a compliance point of view, rather than see it as an effective tool for managing stakeholder relations and adding value to their business.
  - Only 50% of listed family-owned enterprises (FOEs) had adopted a family constitution, while only 25% had family councils in place. Three-quarters of FOEs said their boards are composed of a majority of family members.

**71.9% State that Corporate Governance is Important or Very Important (Hawkamah-IFC Survey, 2007-08)**



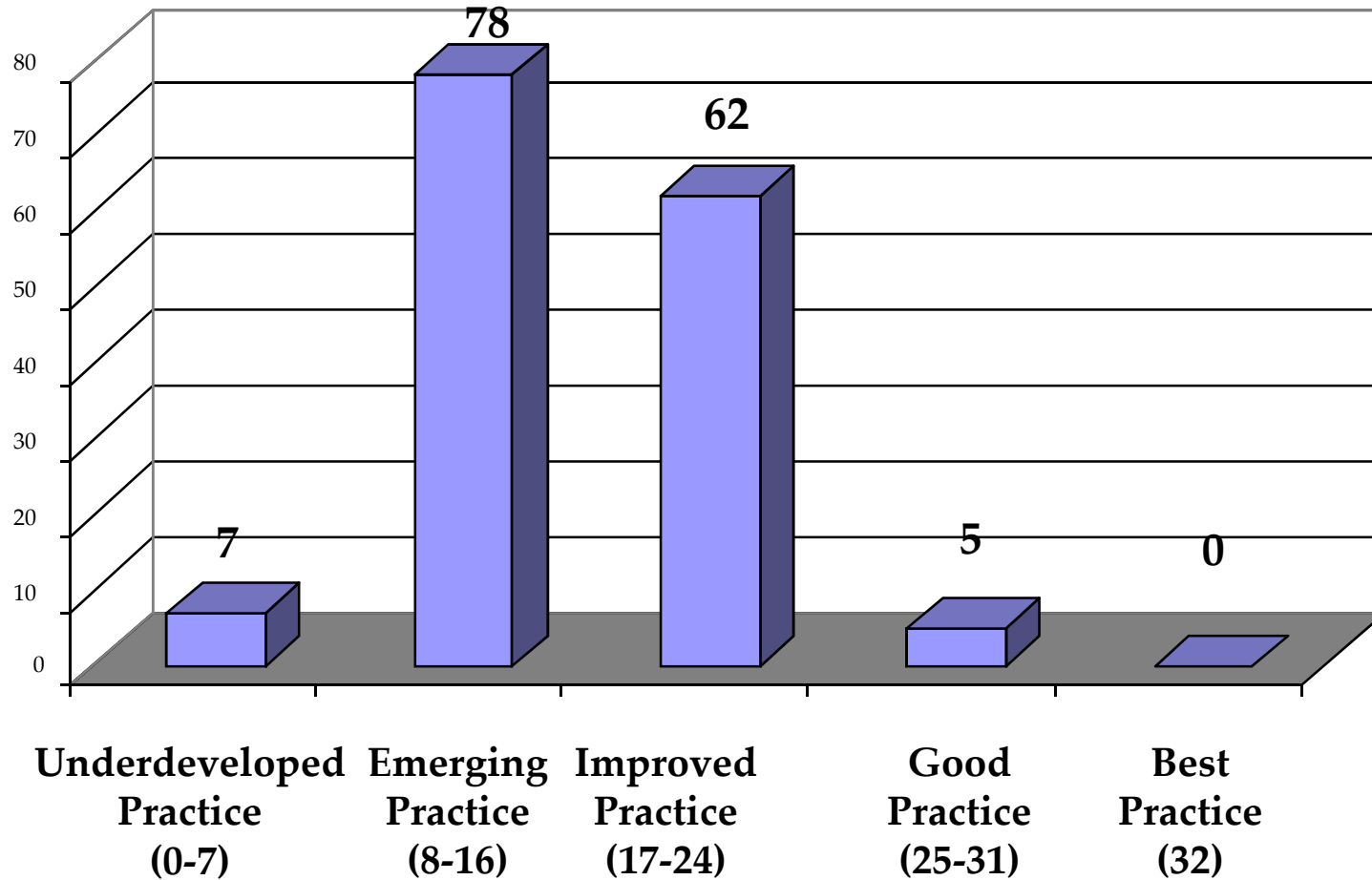
■ Irrelevant ■ Of average importance ■ Important ■ Very important

## However: 50.3% of Respondents Were Unable to Properly Define Corporate Governance

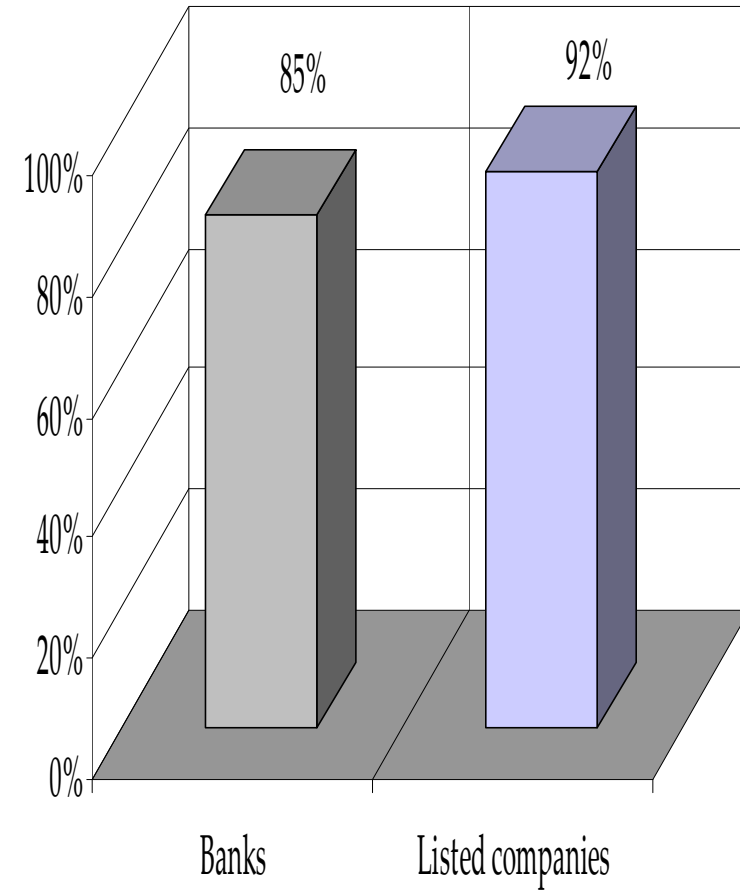


- A system by which companies are directed and controlled
- A commitment to contribute to sustainable economic development
- The company's internal structure that will allow it to comply with domestic laws and regulations
- A set of tools to help management run the day-to-day activities
- It is the same thing as Corporate Social Responsibility

# Hawkamah-IFC MENA CG Survey: Key Findings



*Do you have an Internal Audit Function?*



- **Internal Audit is well-established in the Region**
- **Risk Mgt and Internal Control functions need improvement**
  - **Less than half have a risk mgt function (43%), likewise less than half have internal control function (47%)**
- **Most have external auditor, but rotation remains an issue**
  - **Only about one-third have rotation policy (32%)**

## Transparency & Disclosure

- **Most provide financial statements, but could improve non-financial disclosure.**
  - **Minority include Management Discussion (28%)**

## Shareholder Rights

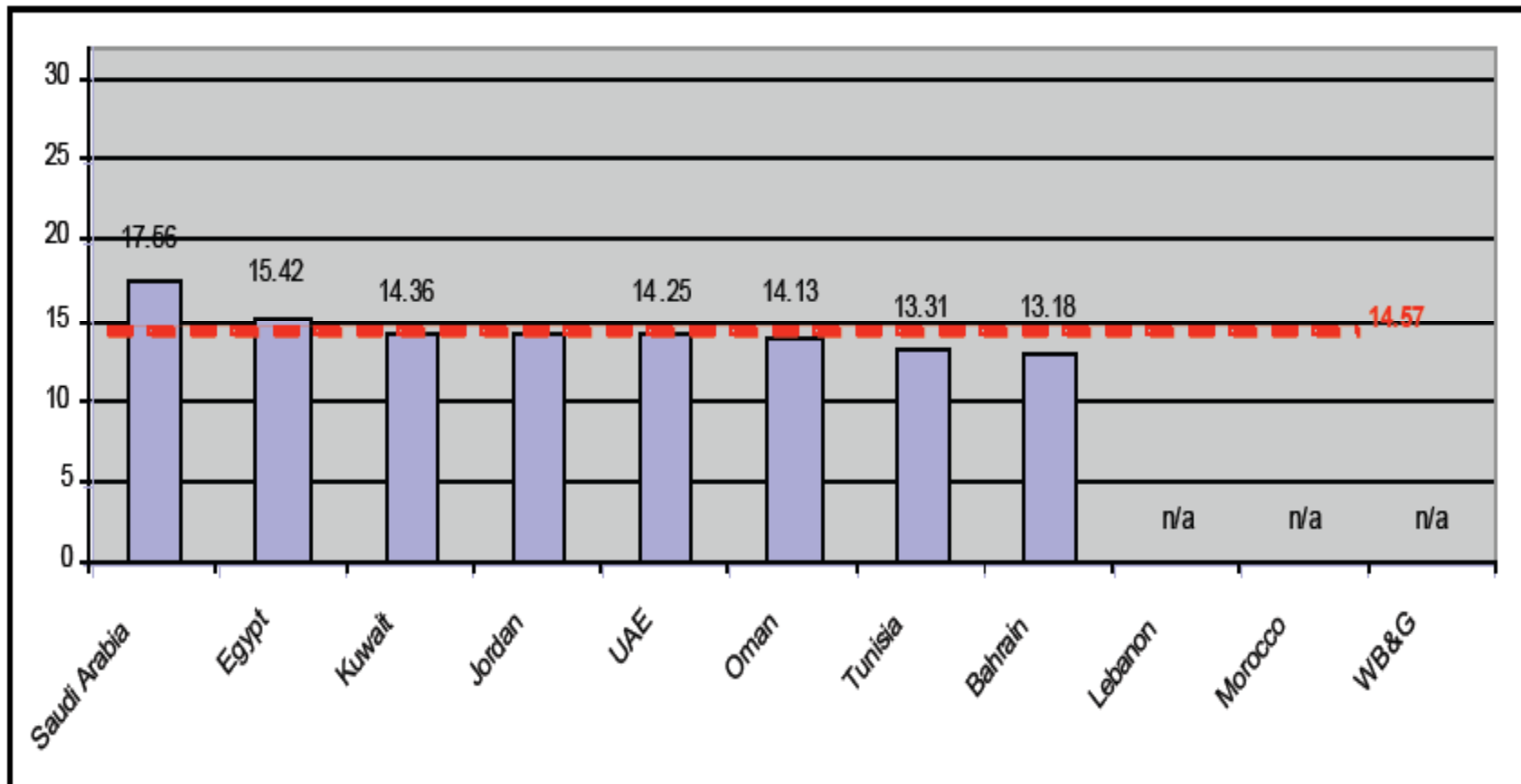
- **General Assemblies are well-attended (75%); Directors are elected by shareholders in most organizations (81%).**
- **Conflict of interest & related party transaction policies are common (~75%); but perception is that not always put into practice.**
  - **Significant percentage believe directors fail to avoid conflict of interest (55%) or use insider information (67%)**

## Hawkamah-IFC Survey: Information contained in Annual Reports



	<b>% of respondents</b>
<b>Report of the chairman</b>	<b>85</b>
<b>Financial statements</b>	<b>82</b>
<b>Market share, sales and marketing</b>	<b>77</b>
<b>Ownership structure and dividend policy</b>	<b>72</b>
<b>Future plans of the company</b>	<b>64</b>
<b>Dividend history</b>	<b>54</b>
<b>Remuneration</b>	<b>44</b>
<b>Biographical details of the board</b>	<b>41</b>
<b>Beneficial owners</b>	<b>36</b>
<b>Management discussion/analysis</b>	<b>30</b>
<b>Corporate governance policies</b>	<b>28</b>
<b>Environment, social and economic sustainability</b>	<b>27</b>
<b>Share options policy</b>	<b>13</b>

Figure C-5: Corporate governance practices aggregated on a country-by-country level

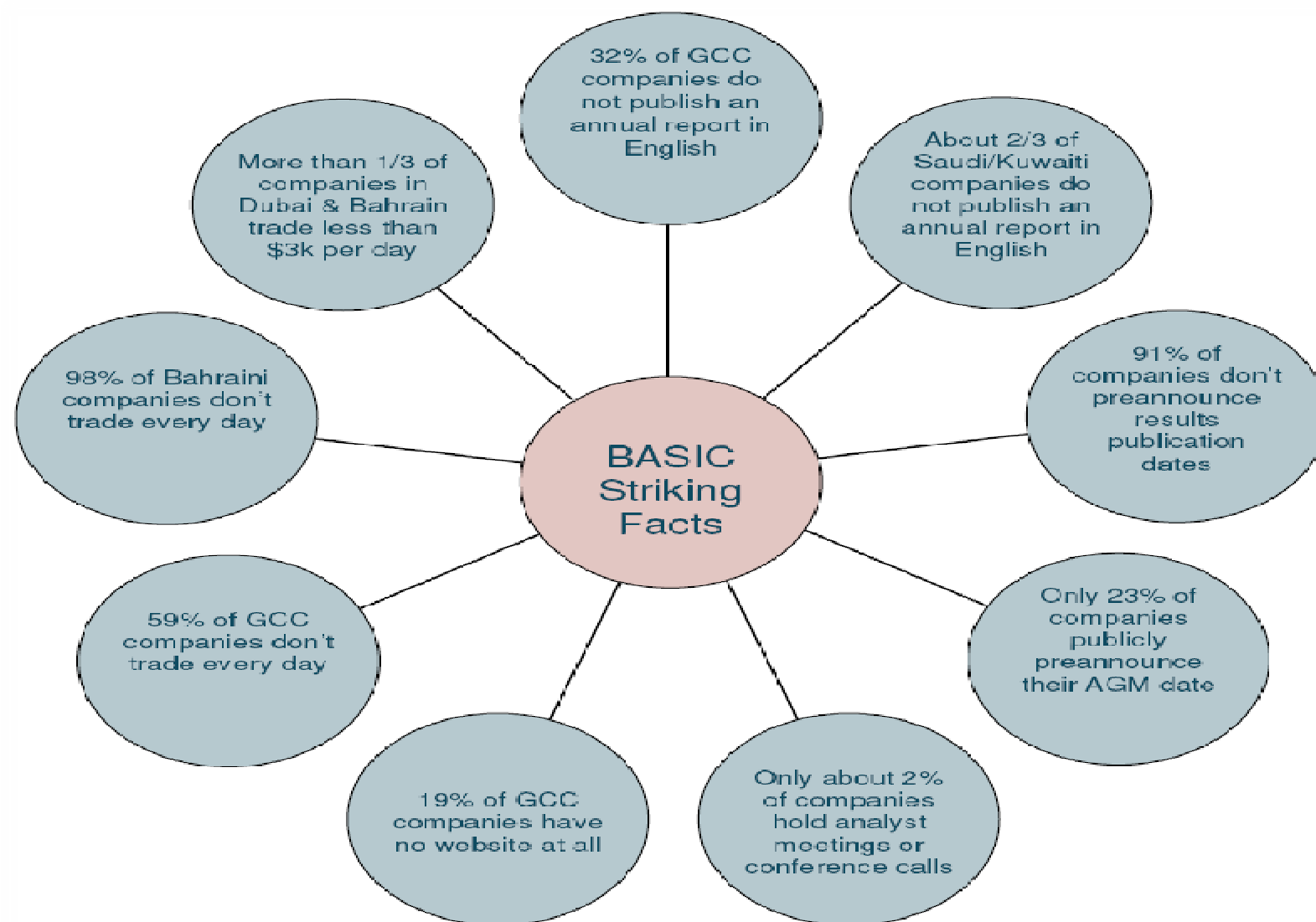




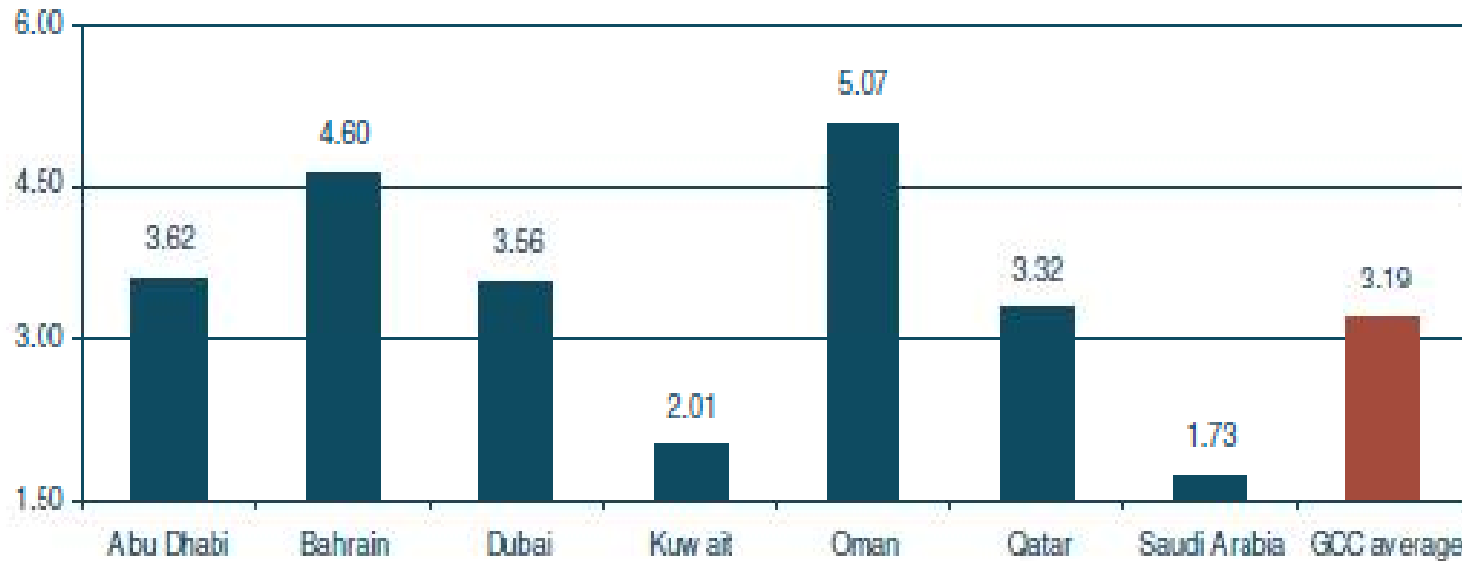
- **Behavioral Assessment Score for Investors and Corporations**
- **Scope: 581 GCC Listed Companies**
- **Measures 43 parameters across 3 categories: Trading History, Corporate Communication and Disclosure.**
- **CG Tool for Investors**
- **CG Benchmarking tool for Corporations**

[\(http://www.hawkamah.org/publications/cg\\_reports/\)](http://www.hawkamah.org/publications/cg_reports/)

# Hawkamah-TNI Survey, August 2008



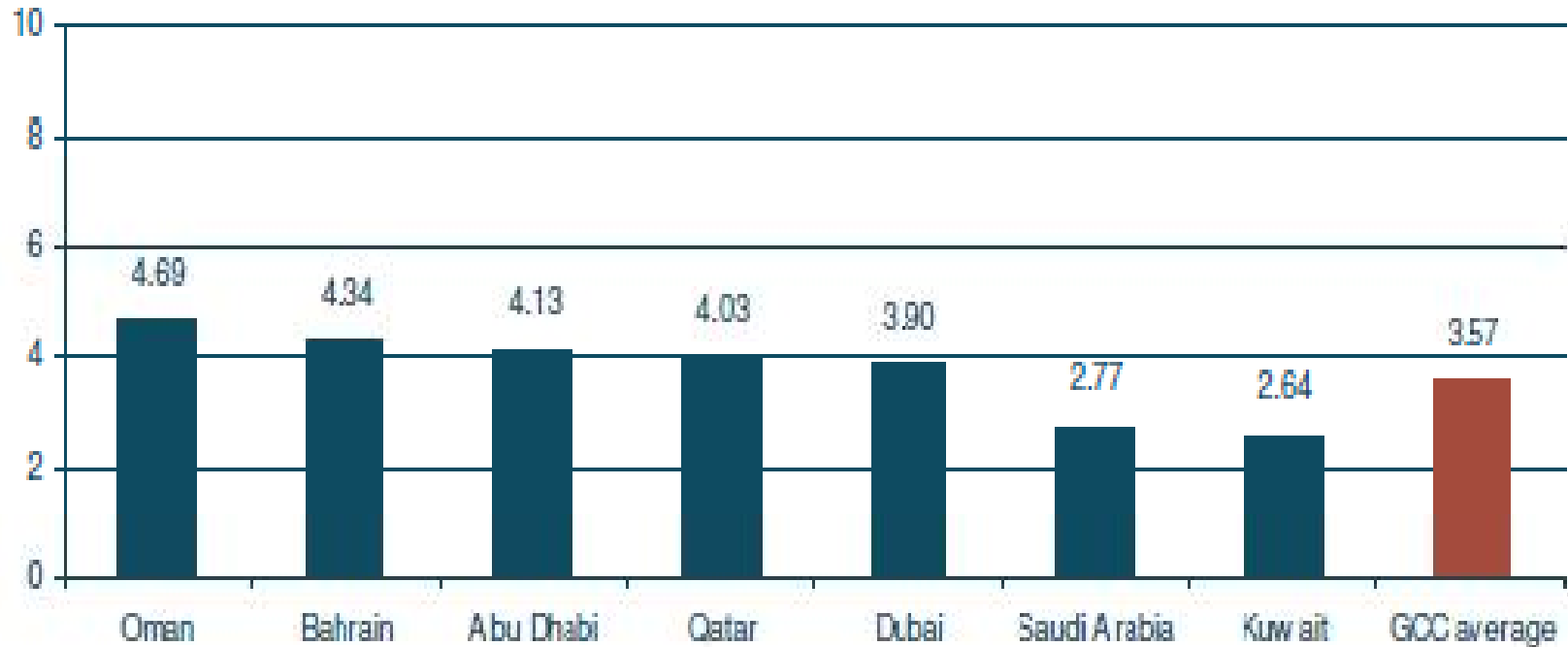
# BASIC Survey: Disclosure Scores, GCC



Source: TNi Investment Research

- On average, 1/3 of companies don't have a publicly available annual report in English
- Disclosure is lacking in the region and there is much room for improvement on behalf of listed companies

# BASIC Survey: GCC Scores by Market



Source: TNi Investment Research

- Oman and Bahrain lead the way
- Saudi Arabia and Kuwait which are the most liquid and mature markets score the lowest

# DOHA DECLARATION November 2008 I

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- ❑ **The regulatory and supervisory powers of central banks in coordination with the capital market authorities should be extended** to investment banking and related non-bank financial intermediation.
- ❑ **Risk management frameworks, processes, and implementation practices require reform** in order to redress the shortcomings revealed by the turmoil.
- ❑ **The role and form of regulation of credit rating agencies** needs to be addressed.
- ❑ **Executive remuneration and incentive structures need to be linked to long-term performance and risk profile of firms.** More disclosure on executive remuneration schemes is required and companies should put their remuneration schemes to shareholder scrutiny and approval.
- ❑ **Corporate governance practices need to be strengthened, in particular by increasing board competence and responsibility.** Board members need to have up-to-date knowledge on financial issues and risk management to fulfill their functions and training should be required when necessary. Boards should conduct annual evaluations of their performance and report to shareholders.
- ❑ **Governance and accountability of regulators are equally essential** and the region should adopt and implement existing guidelines on good practices as promoted by the Bank for International Settlements and IOSCO.

## DOHA DECLARATION November 2008 II

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- ❑ **Islamic finance** is a viable and credible complement to conventional financing and has been resilient to date to banking and financial crisis, as a result of equity sharing arrangements and its focus on ethical investment practices. Islamic finance institutions should continue improving their corporate governance by focusing specifically on the disclosure rights of Investment Account Holders, the role of Shari'a boards, their integration within the corporate governance structure of the Islamic Finance Institution. The development and implementation of a **harmonized Corporate Governance Framework Regulation and market oversight should fully cover these institutions.**
- ❑ **Effective creditor rights and insolvency systems and the development of strong rescue and restructuring frameworks** are important for the region. Based on the survey of existing frameworks and practices in the MENA, these should be modernized as a matter of priority to allow effective rescue and restructuring of viable enterprises facing temporary and potential distress. Countries in the region should avail themselves of international guidance, such as the World Bank Principles on Insolvency/ROSC Diagnostic program and the UNCITRAL Legislative Guide on Insolvency for reforming domestic insolvency systems.
- ❑ **Good corporate governance** is important not only for listed companies, but **also for State and Family-Owned enterprises.** To successfully address potential issues of succession of family-owned enterprises and preservation and protection of wealth, their progressive integration into capital markets should be encouraged.

## DOHA DECLARATION November 2008 III

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- ❑ **Investments of Sovereign Wealth Funds (SWFs) taking a long-term perspective can contribute to financial stability.** The “Santiago Principles” of the International Working Group (IWG) on SWFs coordinated by the International Monetary Fund provide a welcome contribution to improved transparency and sound management of these funds. They should be followed up by a continuous dialogue and review within the IWG. An open investment climate should be maintained by recipient countries in line with OECD guidance and instruments.
- ❑ Private equity has recently emerged as a popular alternative asset class in the region supporting regional economic development and small and medium-sized enterprises. **Private equity managers should play a critical role in diffusing corporate governance principles and best practices** across their portfolio companies in terms of board structures, administrative procedures, disclosure requirements and minority interest protection.

# Hawkamah Regional Task Forces

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- Hawkamah has launched a series of **Regional Task Forces**, aiming to build momentum for corporate governance reform in the region.
- ❖ **Corporate Governance of Banks** (implement the policy recommendations from the policy brief)
- ❖ **Corporate Governance of State-owned Enterprises** (assess state of corporate governance of state-owned enterprises and build momentum for SOE CG agenda)
- ❖ **Insolvency and creditor rights** (assess insolvency regimes in the region with the aim towards modernization)
- ❖ **Insurance Industry** (develop a policy brief for increased corporate governance implementation in the industry)
- ❖ **Corporate Governance of Shari'a Compliant Institutions**



# Some concluding remarks



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- **Corporate Governance failures & mal-governance facilitated or did not prevent practices that resulted in poor performance leading to banking & financial crises**
  - **Political backlash will lead to new Regulatory framework and Corporate Governance reforms**
  - **Emerging Markets lessons: develop local financial markets & focus on banking sector soundness**
  - **CG reform should be an economic policy imperative to address pressing CG issues in MENA/GCC: related party ownership, related party lending, stock market regulation, disclosure & transparency, accounting standards**
  - **Major opportunity:**
    - **GCC countries growing economic & financial integration can be main driver of monetary and financial policy reforms;**
    - **Gulf Monetary Union and Gulf Common Currency leading to a new global currency and contributor to new international financial architecture**