Improving Bank Corporate Governance in the Arab Countries*

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During the 'globalizing eighties' and 'roaring nineties' the Arab countries and the wider Middle East and North Africa (MENA) region failed to become more regionally or internationally integrated, either economically or financially.The Greater Arab Free Trade Area and initiatives advanced by the EU and the US to encourage greater international integration of the MENA region have largely focused on achieving a free trade area in goods. However, those strategies have yet to show any payoffs.

The international community and the Arab countries should give priority to an alternative approach based on: (a) regional economic integration to develop markets and create the potential for increased specialization and potential benefitsfromeconomiesofscaleand scope, and (b) liberalization of trade in services and (c) the development of the financialmarkets of the region and their international integration. However, the sound development of the banking and financialmarkets,theirinternational integration and the ability of the Arab countries to attract foreign capital is predicated on effective corporate governance frameworks.

This brief paper is organised under three main headings:

• The importance of corporate governance (CG) principles and standards in an increasingly inter-connected world, and the relationship between corporate governance and economic efficiency,investmentandgrowth.

• The special governance problems of the banking and financialsectorandtheroleofthe banking and financialsectorintheadoptionof good CG practices in the non-bank sector.

• The role of the monetary and bank supervisory authorities and the recently established Hawkamah Institute for Corporate Governance in promoting CG in the banking sector. Hawkamah proposes a two-part bank CG regime to strengthen CG in both the bank and non-bank corporate sector.

CG and the financialmarkets:sinequanon

The crisis that swept the financialmarkets and economies of the major Asian economies in the late 90s did not result from macroeconomic mismanagement or weak economic fundamentals, nor did it result from extraneous shocks. The underlying problem was one of governance, of the range of institutions and practices by which authority was practiced in both the public and private sector. Specifically,theAsiancrisisexposed the severe weakness in financialsectorgovernance as well as corporate malfeasance and that financial crises, banking and exchange rate (or balance of payments) crises were linked to governance. The Asian crisis illustrated the dangers and systemic risks that arise when banks are subject to political influence,andwheremanagementisweakand lacks accountability and responsibility.

The costs of 'mal-governance' induced financialcrisescanbehigh.Inthecaseof Indonesia, one of the hardest hit by the crisis, the fiscalcostforthegovernmenthavingtomakegood on the obligations of the private banks exceeded 100% of GDP [1]. In addition, the financialcrises induced severe recessions and increase in poverty rates, threatening social and political stability.

Mal-governance and corporate malfeasance have not been limited to the emerging markets of Asia. Russia and many of the countries of

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1 See the discussion in Litan et al. editors, (2002), "Financial Sector Governance". The Brookings Institution, Washington, DC.

the former Soviet Union countries discovered that the costs of adjustment and transition to a market economy were made higher as a result of bad governance. A major lesson from the Russian experience is that privatization and divestment of state owned assets (SOAs) and state owned enterprises (SOEs) requires the prior compliance of SOAs and SOEs with the basic principles of sound corporate governance.

However, it was the recent experiences of corporate malfeasance in the developed economies of the US and Europe that revealed the magnitude of governance problems. 'Bad governance', the concealing of information along with inadequate monitoring and supervision, fraud and the dissemination of incorrect and deceitful information on financial status and corporate actions, underlies the demise of Enron, WorldCom, Tyco, Vivendi, Marconi, Ahold, Arthur Andersen, Shell, Parmalat and other household names.

Corporate malfeasance and mal-governance in the US made investors, worldwide, lose confidence in the financial information and statements disclosed by corporations and the ability of market regulators. The result was a sharp decline in securities prices, loss in financial wealth and decline in investment and real economic growth. The official reaction included the passage of the Sarbanes-Oxley Act in the US in 2002 and similar legislation in other countries. At the international level, institutions including the World Bank, the IMF, the OECD, the BIS and IOSCO reacted by proposing codes and principles intended to incorporate lessons learned from banking and financial crises and lead to the reform of corporate governance practice.

Corporate governance is one of the "12 Key Standards for Sound Financial Systems"[2], developed by the Financial Stability Institute and intended to promote the sound and efficient functioning of financial markets and prevent financial crises. The Standards cover the conduct of macroeconomic and monetary policy, data transparency, institutional and market infrastructure; and financial regulation and supervision. The Standards are intended to address the governance problems faced by uninformed investors investing in securities without access to adequate, reliable information: the inadequate provision of information, inadequate disclosure and dissemination, and poor transparency by firms and governments. The aim is also to remedy weak governance and poor quality of regulation of the banks and capital markets in emerging markets; improving the incentives to avoid excessive risk-taking in private and public institutions, and addressing the inadequacy of insolvency regimes[3].

Market economies require a 'soft' infrastructure of formal rules including codes to protect shareholder rights, bankruptcy statutes, and protection of property rights and enforcement of contracts. However, these also cannot be a substitute for reputation and trust. Reputation, honouring one's word is fundamental to the economic value of corporations. That intangible is capitalised into the 'goodwill' on some balance sheets[4].

Progress has been achieved in the corporate governance of the banking sector in the Arab countries, by complying with the BIS Core Principles for Effective Banking Supervision and related prudential and regulatory measures, instituting effective bank supervision authorities, as well as acting to ensure market integrity through anti-money laundering and counter terrorist financing legislation and instituting AML/CTF commissions.

Indeed, a recent survey of the financial systems in the MENA countries by the IMF[5] provides evidence that MENA bank regulatory authority practices are in line with international best practice and benchmarks. Indicators relating

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2 See the FSF - Financial Stability Forum: 12 Key Standards for Sound Financial Systems.

3 See the discussion of the consequences of the failures of governance in R. Litan et al., "Financial Sector Governance", 2002.

4 See the Remarks by Alan Greenspan on corporate governance, at the Conference on Bank Structure and Competition, Chicago, Illinois, 2003.

5 See Creane S. et al., "Financial Sector Development in the Middle East and North Africa" IMF Working Paper (2004) and comments by N. Saidi, "Financial Sector Development in MENA and Remedial Policy Action", 2004.

to the regulation and supervision of the banking and financialsectorshowgoodperformancefor the majority of the Arab countries with developed banking sectors. However, countries with "repressed" financialsystemsordominatedby state-owned institutions, show weak governance of the financialsector.

The OECD has issued a revised set of Principles of Corporate Governance [6] aiming to provide a framework for sound corporate governance. The Principles cover: (1) ensuring the basis for an effective corporate governance framework; (2) rights of shareholders and key ownership functions; (3) equitable treatment of shareholders; (4) role of stakeholders; (5) disclosure and transparency; and (6) responsibilities of the board. These set a standard for corporate governance for listed companies, i.e. where do we stand compared to this international benchmark?

Recent surveys and reports agree that there is a CG gap in the MENA region, with available indicators suggesting that the companies and countries of our region stand far behind in terms of the implementation of principles and standards vis à vis the benchmark of the OECD CG Principles and practice in industrialized countries.[7] The corporate sector –including the banking sector- in the Arab countries has to initiate a "mise à niveau" process for implementing CG. However, a CG action plan and corporate sector reform programs require information and detailed assessment in order to prioritize actions and formulate remedial government policy responses.

Table 1 shows that only seven countries in the region (Algeria, Bahrain, Jordan, Kuwait, Morocco, Tunisia and the UAE) have completed and published Reports on the Observation of Standards and Codes (ROSC), an initiative of the IMF and the World Bank. Only three countries, Egypt, Jordan and Morocco have undertaken overall governance surveys. Some countries (including Egypt and Lebanon) have undertaken and completed reports on a number of topics (e.g. payment systems, data dissemination, and banking supervision in the case of Lebanon) but have not published the reports or made them widely available. Unfortunately, the lack of wide availability and dissemination of the reports reduces their usefulness in leading to change in policies, reform and modernization.

Similarly, though a number of countries have undertaken a Financial System Stability Assessment (FSSA), only one country, Kuwait, has undertaken and published a Financial Sector Assessment Program, which the IMF and the World Bank undertake with countries to assess the strengths and remedy the weaknesses of a country's financialsystem,includingobservance and compliance with relevant financialsector standards and codes.

With respect to CG, only two countries (Egypt and Morocco) have finalizedandpublisheda CG survey and introduced CG Codes, though Lebanon, Jordan and Tunisia are committed to undertaking and publishing CG assessment surveys and introducing good CG codes.

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6 See the OECD principles an discussion on: http://www.oecd.org/document/56/0,2340,en_2649_34813_31530865_1_1_1_1,00.html

7 See reports of the OECD-MENA Working Group on Corporate Governance available on the OECD website, [MENA-OECD Investment Programme: Working Group 5 on improving corporate governance practices] and the discussion in N. Saidi., "Corporate Governance in MENA Countries: Improving Transparency & Disclosure",2004. available on http://www.oecd.org/dataoecd/17/42/33944145.pdf

Table 1: MENA Published ROSC Reports*

TOPIC	COUNTRY	DATE OF PUBLICATION
ROSC Report on Banking Supervision	Algeria	May 17, 2004 & June 23, 2001
	Kuwait	May 24, 2004
	Morocco	July 17, 2003
	Tunisia	June 17, 2002, January 29, 2001 & September 30, 1999
	United Arab Emirates	January 27, 2003
ROSC Report on Monetary & Financial Policy Transparency	Algeria	May 17, 2004
	Morocco	July 17, 2003
	Tunisia	June 17, 2002, January 29, 2001 & September 30, 1999
	United Arab Emirates	January 27, 2003
ROSC Report on Data Dissemination	Jordan	February 10, 2004 & October 16, 2002
	Morocco	April 4, 2003
	Tunisia	January 29, 2001 & September 30, 1999
ROSC Report on AML/CFT	Kuwait	May 24, 2004
ROSC Report on Accounting & Auditing	Egypt	August 15, 2002
	Lebanon	May 7, 2003
	Morocco	July 25, 2002
ROSC Report on Securities Regulation	Kuwait	May 24, 2004
	Morocco	July 17, 2003
	Tunisia	June 17, 2002, January 29, 2001 & September 30, 1999
ROSC Report on Insurance Supervision	Morocco	July 17, 2003
	Tunisia	June 17, 2002
ROSC Report on Payment Systems	Morocco	July 17, 2003
	Tunisia	June 17, 2002
	United Arab Emirates	January 27, 2003
ROSC Report on Fiscal Transparency	Tunisia	January 29, 2001 & September 30, 1999
	Iran, Islamic Republic of	December 10, 2002
ROSC Report on Governance Survey	Egypt	2001 & 2003
	Morocco	2003
Financial System Stability Assessment (FSSA)	Algeria	May 17, 2004
	Kuwait	May 24, 2004
	Morocco	July 17, 2003
	Tunisia	June 17, 2002
	United Arab Emirates	January 27, 2003
Financial Sector Assessment Program (FSAP)	Kuwait	November 8, 2004

*As available on the IMF and World Bank sites on 12/01/05

Source: IMF, World Bank

Bank CG in the MENA region

Banks face special governance problems[8] because their activities are opaque and diverse, making them

difficulttomonitorandassessthevalueatrisk in their portfolios and activities. As a result, disclosure and transparency are at a premium for good banking corporate governance. For this reason it is important to impose financial disclosure standards in accord with International Financial Reporting Standards (IFRS) and international auditing standards. The OECD states the disclosure and transparency principle clearly: " *The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financialsituation,performance,ownership,andgovernance of the company* ." Banks are also a sector subject to extensive government regulation, which limits or prevents takeovers and other measures for corporate control and accountability.

Government ownership and intervention in the banking and financialsectorintheMENA countries has been a major contributor to its lack of development. It is a result of pursuing an interventionist paradigm that resulted in nationalization policies during the period of the 1950's and 1960's in many of the countries in the region. Restoring freedom of entry and adopting principles of reciprocity –as would be required under WTO rules- would favor financialsector development, entry of foreign financialfirmsand the introduction of new banking and payment technologies.

In addition, government ownership of the financialsectorhasresultedinnegativespillovers and distortions in the credit market, including: a high share of credit to government in total domestic credit, leading to a crowding-out of the private sector (examples include, Algeria, Egypt and Syria), limited availability of financialinstruments and secondary markets, high transactions costs, lack of transparency in government financing decisions, non-market pricing of assets and of credit and administered interest rates.

In MENA countries, as in many emerging markets, extensive government ownership of banks prevents competition and the contestability of banking and financialmarkets.Publicsector banks play a role in this respect, channeling soft financetotargetsectors.Governmentdeposit insurance programs and other financialsafety nets imply greater incentives for risk taking by banks and fewer incentives for depositors or investors to monitor their activities. Implicit and explicit state guarantees and bail-outs of failing corporations lead, in some countries, to a moral hazard problem for corporations and banks alike. To remedy these distortions, the role of banks in imposing financialdisciplineshouldbegiven special attention. Moreover, national insolvency systems need to develop, so that there is a credible threat of insolvency and in order to provide effective protection of creditor rights.

Improving bank CG: role of the regulators and supervisors

To remedy and offset the distortions from past government interventions and related problems, the MENA's governments, monetary and bank supervisory authorities should encourage more market discipline by encouraging entry into the banking system, and the rating and stock market listing of banks. The other main structural reform is for divestment, for the privatization of State owned banks and financialinstitutions,asis currently being attempted in Egypt. Privatization would establish a level regulatory playing field, avoid conflictsofinterestandpreventtheabuseof the banking and financialsystembygovernment and politicians.

For the banking sector, the road to implementing the provisions of Basel II passes through the implementation of CG principles in the banking system and at the level of the corporate clients of the banking system. Basel II is essentially about monitoring, controlling and managing risk. It requires the implementation of a well-functioning credit rating process and system. The implementation of CG at the level of the banks' corporate clients facilitates the process of risk assessment, of estimating the value at risk in the loan and investment portfolios of banks, a major requirement in the implementation of the Basel II principles.

8 See the discussion in Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence", Global Corporate Governance Forum, July, 2003.

Hence, our banking systems have an important stake in (a) the implementation of CG principles in the banking system and (b) at the level of the corporate clients of the banks. The financial systems of the MENA countries are dominated by the banks, which channel public savings to the corporate sector. If banks are not in a position to assess the viability of debtor companies, they risk accumulating non-performing loans and be forced into direct or indirect re- nationalisation to avoid systemic risk.

The BIS has recently issued [9] guidance in the form of principles for corporate governance in banking organisations, which include guidelines for the role of bank supervisors (see accompanying box), effectively bringing corporate governance within the framework of oversight and supervision by the regulatory authorities. The principles conform to the more general OECD CG principles and adapt them to the banking sector. The BIS notes that the "guidance is not intended to establish a new regulatory framework layered on top of existing national legislation, regulation or codes, but is rather intended to assist banking organisations in enhancing their corporate governance frameworks, and to assist supervisors in assessing the quality of those frameworks".

Though, I would not, as a general rule, advocate more regulation, nevertheless the achievement of an effective CG framework requires the imposition of mandatory CG principles on the banking system. Enforcement of good corporate governance by bank supervisors requires clear standards. We need a rule-based regime for corporate governance in our banking system.

Banking CG is an essential prerequisite for financialsoundnessandforthehealthinessof the corporate non-bank sector. Implementing international CG principles means that our banks enhance their level of CG and influencethenon-bank corporate sector to follow their lead, signalling by example and good management practice. In particular, legal, regulatory and supervisory policies, with a special focus on related lending and sound risk management policies should be put in place throughout the region.

For the emerging markets of the Arab countries, CG has the potential to be an instrument for corporate reform. In particular, good CG: (1) is a source of financialhealthforthedevelopment of non-bank corporations; (2) is an effective anti-corruption tool; (3) requires sound internal and external environments; (4) has as a major pillar, disclosure; (5) helps promote transparency; (6) emphasizes that banks have a key role in promoting better governance and (7) involves the interrelation of transparency, disclosure, and the implementation of the Basel II accord. [10]

Instead of simply monitoring compliance with prudential rules and avoiding risks, MENA banks should shift to more pro-active credit risk policies and management. Banks have a responsibility for the effectiveness and integrity with which the enterprises they are financingarebeingdirected and controlled. Consequently, bank credits should flowtocompanieswithhighCGstandards. The next section proposes a two-part process to achieve that goal.

A two part bank CG regime for the bank and non-bank corporate sector

Effective CG in the banking sector and its corporate clients is a matter of imposing standards and investing in institution building: a mandatory, rule-based regime for CG. Central banks and bank supervisors can provide an important mechanism for the implementation of CG and ensuring transparency and disclosure in financial statements and other material information, by issuing regulations and directives to:

(1) Request, through a regulation, the implementation of agreed CG principles for the banking system and other regulated financial entities, based on the international standards such as the BIS and OECD CG principles.

(2) Request through ancillary regulation that the non-financialcorporateclientsofthebanks comply with appropriate CG principles as part of the process of bank credit risk management and mitigation. Higher risk weightings would be

9 See Bank for International Settlements, [Enhancing corporate governance for banking organisations] Basel Committee on Banking Supervision report, bcbs122, February 2006.

10 See the discussion in N. Saidi., "Corporate Governance in MENA Countries: Improving Transparency & Disclosure", 2004.

assigned to low CG regime compliant corporate clients. Companies maintaining high CG standards, deemed less risky, would benefit from improved credit terms and conditions.

The above two-part bank CG regime would provide an incentive-compatible regime, a self-reinforcing mechanism for improving CG standards and improving transparency and disclosure in both the bank and non-bank corporate sector. Bank supervisors along with the banks' auditors –both internal and external – would be responsible for ensuring compliance with CG principles in the banking sector. Banks would have the incentive to encourage higher CG standards from their non-bank corporate clients. Importantly, the proposed mechanism would also help in addressing the issue and challenge of implementing CG in the SME and FOE sector.

The two-part bank CG regime can be reinforced by fostering the set-up of institutions that improve market information:

1) The availability of corporate credit and financial information can be enhanced through the establishment of 'Central Credit Reporting' organizations in the countries of the region, providing information on bank and non-bank credit (including supplier credit) provided to companies and individuals' thereby increasing transparency and disclosure. Local centralized credit reporting agencies can collect, organize and analyze valuable, material information in an efficient manner, increasing the efficiency of the credit markets.

2) The establishment of 'Companies' Houses' in the various countries of the region which would act as a corporate registrar and provide and disseminate financial reports and information on board and management actions and act as reliable sources of publicly available information about corporations.

3) 'Credit Rating Agencies' (CRAs) which would provide risk assessments and credit ratings for the companies and governments of the area, leading to an improvement in the availability and dissemination of information and helping the banking systems and corporate sector in their process of compliance with Basel II standards. CRAs have an important role to play in improving transparency and disclosure. Credit rating agencies should aim to be objective, in order to have greater utility, power, and impact on the capital market. The establishment of credit rating agencies is important for capital market development and for the implementation of the Basel II accords, by providing credit benchmarks for the local markets and increasing transparency and disclosure for listed and non-listed companies.

In the above context, the Hawkamah Institute for CG, hosted by the Dubai International Financial Centre, aims to promote CG in the banking sector of the MENA countries (see the accompanying box). Hawkamah will work with the banking sector stakeholders, including the monetary authorities, bank supervisors, banks and bank associations in order to strengthen CG in the MENA banking sector. Hawkamah will provide a regional CG forum, advisory services and technical assistance. Implementing and complying with CG is a matter of institution-building and establishing a rule-based CG regime. The two-part bank CG regime based on international CG standards would enable the banks and non-bank corporate sector of the MENA region to increase transparency and disclosure, reduce credit risk, and provide more confidence to depositors and investors. Increased transparency and disclosure would enable businesses in the MENA region to attract foreign investment and technology and become internationally competitive, reducing political and sovereign risk.

It is in the self-interest of the banking sector to promote high CG standards because good CG is part of the institutional infrastructure (laws, regulations, institutions and enforcement mechanisms) underlying sound economic performance. Better CG is correlated with better operating performance and higher market valuation and lower credit risk of companies. By preserving and protecting property rights –in particular those of minority and foreign shareholders- it encourages innovation and long-term investment in human and physical capital, foreign direct investment, as well as the creation of intellectual property. By stimulating performance, generating higher returns and profitability of companies, it encourages higher total factor productivity growth, a major source of economic growth. By limiting

the abuse of power by corporate insiders, it creates an efficientmechanismfortransferringwealth between generations. By setting CG standards, monitoring managers of companies and making them accountable for their actions, it protects investors' interests; in turn, this encourages both domestic and foreign direct as well as portfolio investment.

The MENA financialsectormustdevelop the capacity to channel a significantproportion of savings into long-term productive investment. Domestic financialsystemsandinparticular, the banking sector, have undergone important reforms in recent years in order to address this challenge. However, progress has been uneven and related reforms need to be bolder if they are to bring a more modern credit culture and greater competition among sources of financing,andface the competition of a global business and regulatory environment. Implementing the principles of corporate governance will be a major building block for sound financialmarketsandbanking industry. The stakes are high: better corporate and public governance improves the investment environment and leads to better institutions and higher, sustainable economic growth.

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BIS: Sound Corporate Governance Principles for Banking Organizations and the Role of Supervisors

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.

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").

The Role of Supervisors

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

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

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

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

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

VI. Supervisors should bring to the board of directors' and management's attention problems that they detect through their supervisory efforts.

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HAWKAMAH INSTITUTE FOR CORPORATE GOVERNANCE

Mission:

To assist the countries and companies of the region to develop sound and globally well-integrated corporate governance frameworks.

Hawkamah is an independent international association that will efficientlycoordinate and sequence the designing, planning and implementation of corporate governance reforms and monitoring the outcome of corporate governance policies at the private sector level.

Partners:

Hawkamah was launched in partnership with the Organisation for Economic Cooperation and Development (OECD), the International Finance Corporation (IFC), the Dubai International Financial Centre (DIFC), the Center of International Private Enterprise (CIPE), the Union of Arab Banks (UAB), Young Arab Leaders (YAL), Dubai School of Government (DSG) and the countries participating in the OECD-MENA Investment Programme.

Hawkamah will work in partnership with the government authorities, bank and capital market regulators, the private sector and civil society in the MENA countries and with international and regional organisations.

Hawkamah - A Resource Centre:

Hawkamah is a resource centre to provide technical assistance at the level of countries (focusing on laws, institutions, regulations, codes and principles) and at the level of corporations and enterprises (undertaking corporate governance assessments and providing technical assistance for reform).

Hawkamah Programmes

Hawkamah is developing fiveprogrammes related to the requirements of the region:

• Listed companies, funds, capital markets and regulatory authorities

• Banks, financialinstitutionsandbank supervisory authorities

• Non-listed companies, including family-owned enterprises and small and medium enterprises

• Public sector, with a focus on state-owned enterprises

• Regional media and universities to increase public awareness and build knowledge

Being a regional initiative, it will strengthen institution-building and build capacity through the set-up of a regional Institute of Directors.

Hawkamah and the Dubai International Financial Centre (DIFC):

The Dubai International Financial Centre (DIFC) is hosting Hawkamah within its premises along with the Institute of Directors for the countries of the region.

The DIFC-Hawkamah strategic partnership will generate substantial synergy with a mutual reinforcement of vision and mission. It will also ensure that the governance of the corporate sectors in the region conforms to international codes, standards and best practices.

For more information, contact: Hawkamah ICG, DIFC, The Gate, Level 14, Dubai, UAE, info@hawkamah.org