



**HAWKAMAH**  
THE INSTITUTE FOR CORPORATE GOVERNANCE

**Linking Governance and  
Competitiveness**

Oman Economic Association Conference  
Muscat, Oman March 24-25, 2007

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# Agenda

- Building Sound Financial Markets Key to Competitiveness and Improving Corporate and Regulatory Governance
- Driving forces of CG reforms
- CG principles for POEs and SOEs
- CG of Banks and of Regulators
- Improving market performance: Reforms & Recommendations

# Role of Financial Sector Development for Arab countries

- Invest, Manage and Control region's financial wealth of \$2 trillion and growing as a result of high energy prices:
  - Financial sector can be an engine of growth
  - Strategic issue: security and safety of assets.
- Role in Economic Development & Diversification
- Financing Infrastructure & Regional Economic Integration
- Develop new markets and instruments:
  - Shari'a compliant financial sector & market
  - Bond market
  - Housing Finance & Mortgage markets
- Enable & support economic and financial reforms:
  - Enable separation of oil revenue management from economic policy
  - Privatisation and Private sector Participation in Infrastructure

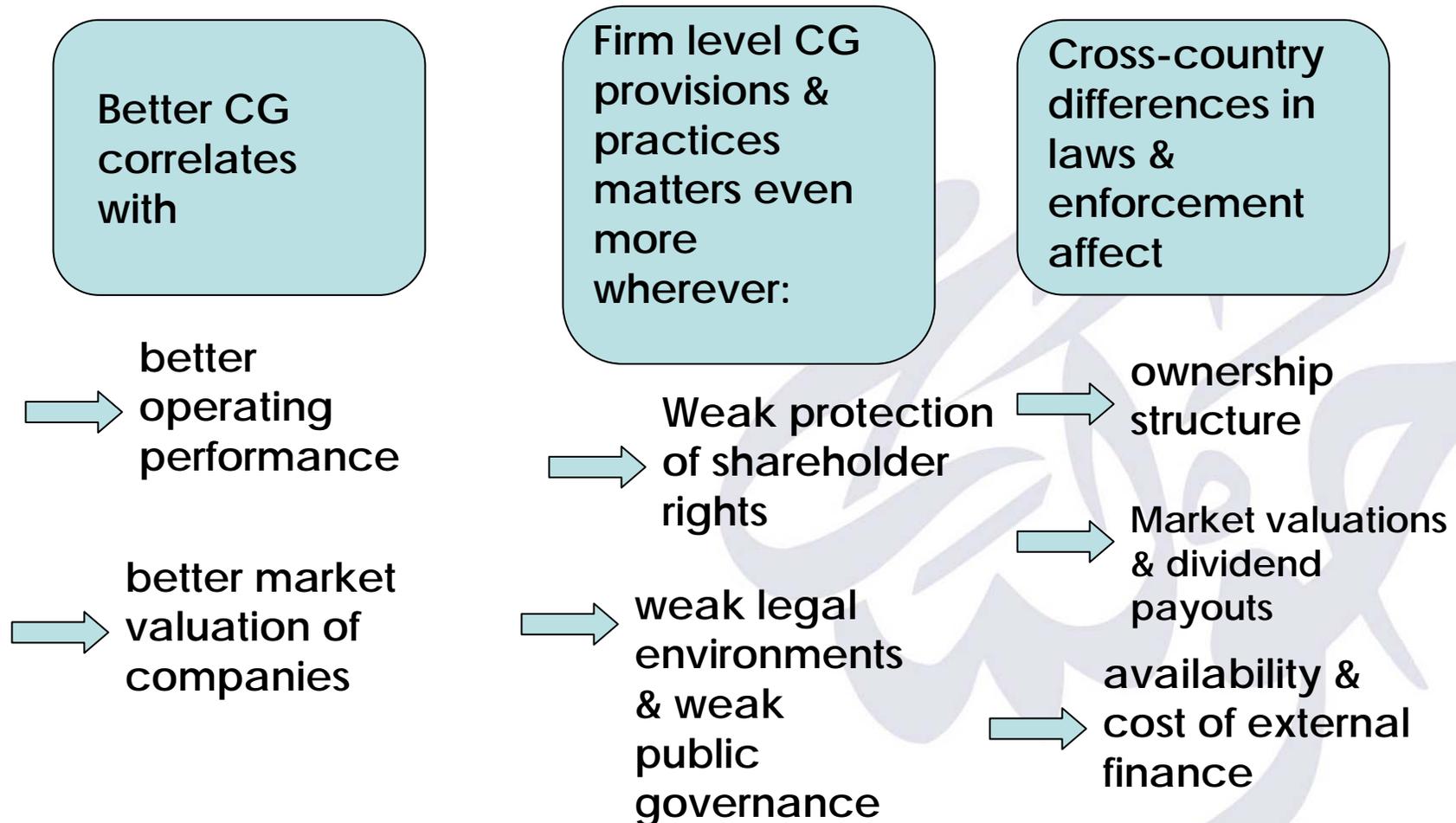
# Building Financial Markets to Sustain Growth, Development and Competitiveness

- Developing Financial Markets priority for Arab countries: good CG is a major building block
- New Institutional Economics (T. Beck, R. Levine, R. LaPorta, A. Schleifer and others):
  - Historically determined differences (including colonial heritage and implantation) in legal tradition influence national approaches to private property rights protection, the support of private contractual arrangements, and the enactment and enforcement of investor protection laws
  - Resultant legal institutions shape the willingness of savers to invest in firms, the effectiveness of corporate governance, and the degree of financial market development
- Lack of financial development and financial deepening are increasingly a barrier to MENA growth and development

# Impact of Good CG

- At the country level, countries with strong shareholder rights and investor protection tend to have larger capital markets, companies with less debt and perform better during periods of crisis
- Public Governance matters. In particular:
  - **Control of corruption**
  - **Regulatory quality**
  - **Rule of law**
  - **Government effectiveness**
- At a company level, companies with good governance tend to have higher values in the market, better access to finance & higher credit ratings
- Institutional investors consistently express preferences for companies with good governance.
- [Sources: WB, OECD, CIPE]

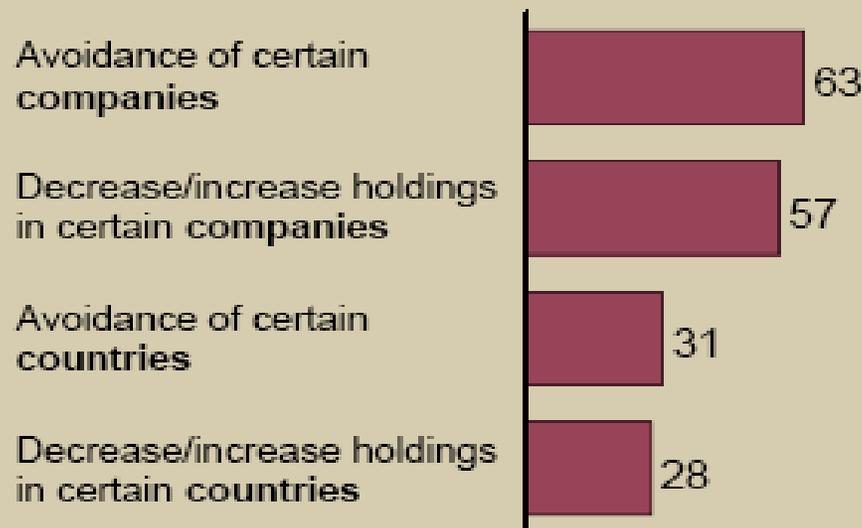
# Corporate Governance : Performance in Emerging Markets



# Corporate governance is now an established investment criterion

**How does corporate governance affect your investment decision?**

**Percentage of investors selecting this option; multiple responses possible**



"Our investment group would never approve an investment in a company with bad governance"

U.S. investment manager,  
USD 20 billion private equity fund

"Good governance" is a qualitative cut-off criterion"

– Analyst, USD 62 bn  
European Asset Manager

"I simply would not buy a company with poor corporate governance"

– CFO, USD 3 bn  
European Private Bank

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002

# A significant majority of investors say they are willing to pay a premium for a well-governed company\*

Percentage of investors

Yes  
No

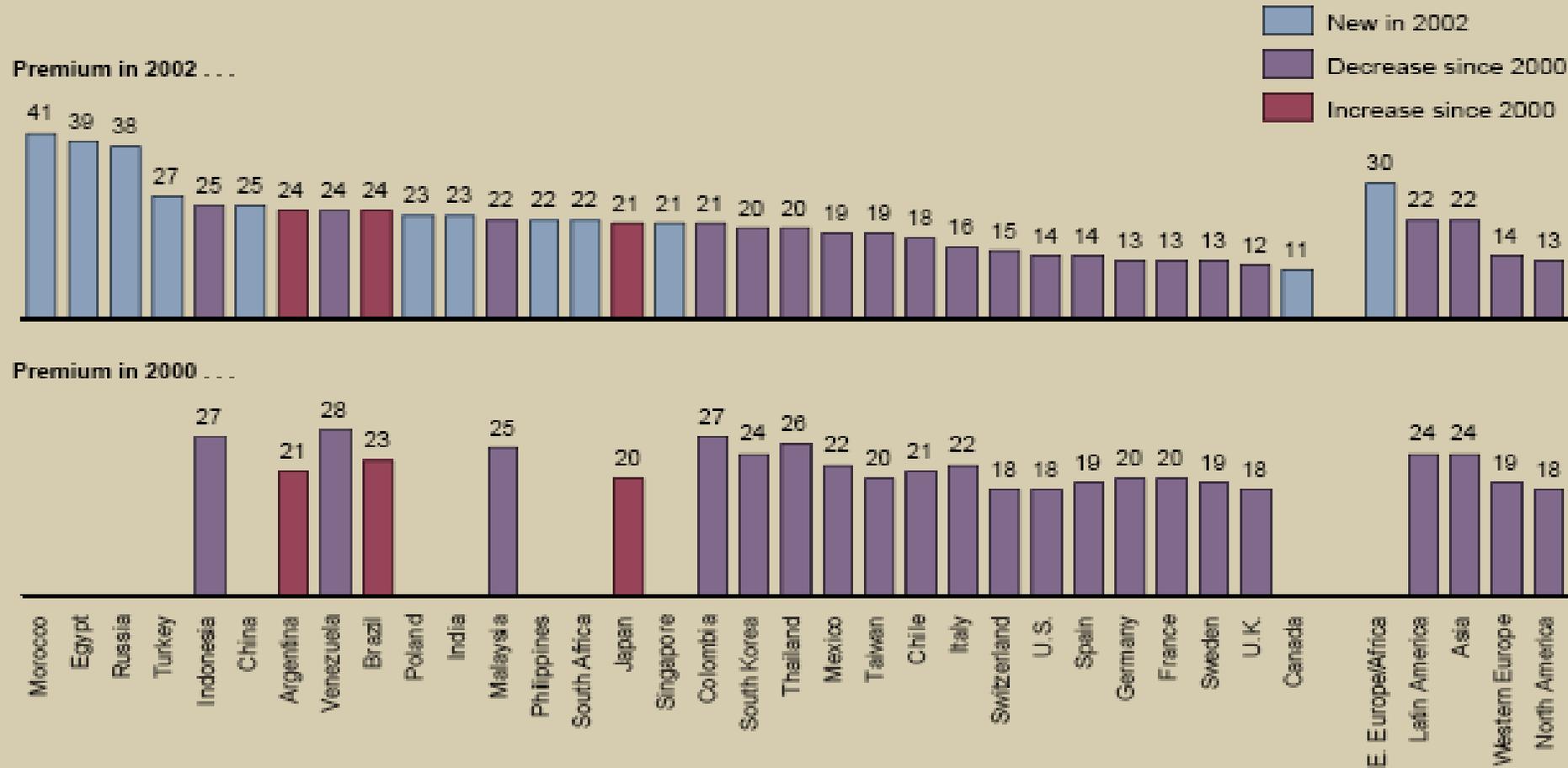


\* Refer to Exhibit 11 for full survey question

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002

# The premium investors would pay for a well-governed company varies by country and region\*

Average premiums of those investors willing to pay premium



\* Refer to Exhibit 11 for full survey question

Source: McKinsey Global Investor Opinion Survey on Corporate Governance, 2002

# Why CG matters – Macro side

- Poor Corporate Governance means inefficient use of capital by firms - the misallocation of available savings
- Higher over-all cost of capital, lower investment, resulting in slower growth
- Poor Corporate Governance identified as an important contributor to financial instability and crisis (Asia, Russia, Latin America)

# Why CG Matters for Companies

- Good CG at the firm and the country level results in higher company valuations and higher credit ratings
- Efficient Operation / Profitability
- Access to finance & increased variety of financing instruments
- More competitive market for mergers & acquisitions

# Impact of Good Governance & Transparency

- Recent survey of 4,411 firms in 29 countries looked at relationship between foreign investment and corporate governance
- Survey showed that foreign investors invest less in less governed companies
- Investors look at country level disclosures and governance practices AND firm level improvements in governance or information flows in making investment decisions.

[Source: Leuz, Lins, Warnock, "Do Foreigners Invest Less in Poorly Governed Firms?" 2005]

# Drivers for Corporate Governance Reform

- International convergence of prudential and regulatory codes and standards: e.g. AML/CTF, Banking CPs,
- Drivers for modernisation and change are varied:
  - Intellectual: new institutional economics
  - International obligations and agreements: WTO, RTAs and FTAs
  - Competitive pressure and emulation
  - Role of IFIs: WB, IMF, WIPO, WTO
  - High volatility and turbulence in equity markets
  - Pressure from globalisation, liberalisation and inter-connectedness of markets and regional/ international investors
- MENA countries have been slow in adopting or complying with international codes and standards, apart from Basel CPs and AML/CTF

# What Good Corporate Governance should do

- Align interest between shareholders and board of directors/management
- Promote accountability throughout the company
- Win and retain confidence of investors and other stakeholders
- Ensure fair treatment of minority shareholders
- Enhance transparency & disclosure within the company and to the outside world
- Ensure responsiveness to stakeholder concerns, consistent with long-term shareholder value creation

# 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)
  - Family enterprises (Cadbury, King)
  - 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

# 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**

# Why Bank Corporate Governance Matters in MENA

- 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

# 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:  
Insurance sector being a priority
4. Shari'a compliant financial institutions

# 1. CG of Central Banks and Bank 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 for implementing BIS standards
- Be transparent and disclose:
  - Board and senior management structure
  - Organisational 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
  - Jordan, Lebanon, Oman, Pakistan have developed codes

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

- For CG to take root in countries with relatively undeveloped financial markets, banks can play a crucial role to advance good CG practices.
- Establish 'cascading effect' of CG to banks' corporate clients.
- Over 85% 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 Corporate Sector

- Two step process consistent with implementation of Basel II:
  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

# 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 corporate governance 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.

# Islamic Financial Institutions: Draft Guiding Principles for CG

- **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

# Complementary Work Needed to Advance CG

- Engage wide participation from NGO's, Chambers of Commerce & Industry, media, business associations, government
- Develop necessary institutions and build human capacity in major areas (accountants, regulators, bankers, company directors)
- Design an effective regulatory system, but also create the conditions that make such a system credible.
- Corporate governance is about establishing a climate of integrity, trust and confidence.
- Corporate governance is critically about enforcement and will require judicial reform

# 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 CCROs 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

# MENA CG and Regulatory Governance Reform 1

- There is no 'one-size fits all' in CG or Regulatory Governance reform.
- GCC and MENA countries have CG on the policy agenda
- Countries depending on their institutions and history will need to strike a balance between:
  - Laws vs. Regulations and self enforcement and developing SROs
  - Internal vs. External CG regimes and enforcement

# MENA CG and Regulatory Governance Reform 2

- CG reform should encompass:
  - Listed companies and all issuers of securities
  - Banks and non-bank FIs as well SOEs and FOEs
  - Shari'a compliant institutions and finance
- CG and Regulatory Governance reforms and implementation are complementary and reinforce each other

# MENA CG and Regulatory Governance Reform 3

- Regulatory Governance reform requires capacity building
- Reinforcing Institutions: Central Credit Reporting Organizations, Credit Rating Agencies, Companies' Houses
- Enforcement of good CG will require legal and judicial reform



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