A DYNAMIC AND CHANGING ENVIRONMENT: CORPORATE GOVERNANCE IN THE MENA COUNTRIES

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Strong economic growth, driven by investment and high energy and commodity prices, and abundant liquidity have fuelled a spectacular resurgence of the asset and capital markets in the Middle East and North Africa countries. Stock markets grew more rapidly than economies: market capitalization jumped from an average of some 65% of GDP in the MENA countries to over 100% of GDP between 2002 and 2006, with the GCC markets out performing emerging and developed markets. Participation in the markets increased along with strong IPO activity and rising trading volumes on the regional exchanges. Market capitalization grew from less than $200 billion in 2002 to about $1 trillion by early 2006. However, the leading stock markets in the region soon began experiencing important corrections and investor confidence was shaken by the uncertainty and volatility that has characterized the region's equity markets. Now that more than a year has passed since corrections began, P/E ratios and other investment parameters appear more in line with fundamentals, though there are concerns that the process of 'exuberance correction' may still have not fully run its course.

Corporate governance has become an increasingly important factor when assessing the investment climate in the region as a result of the turbulence that has characterized the region's equity markets. The year 2006 represented a watershed year for corporate governance in the region as policy-makers and regulators contemplated introducing measures to improve corporate governance in listed companies. The next two years will see regulators and companies grappling with changing governance structures and board practices to comply with new corporate governance requirements put in place in the previous years. As equity markets in the region mature and become increasingly integrated with the global economy, both domestic and foreign investors are requesting higher transparency and disclosure standards. Moreover, they are demanding that regional companies comply with the global corporate governance standards that are expected from companies in other emerging markets. Change is also being driven by the growing presence of international firms in the region, and larger number of western expatriates in senior management level positions, who themselves are subject to global corporate standards.

A Dynamic and Changing Environment

The increasing openness and integration of the MENA countries with the global economy has created push-and-pull factors that are contributing to changing the corporate governance environment. Policy and regulatory reforms in the MENA countries have been led by international convergence and adoption of prudential and regulatory codes and standards, such as Anti Money Laundering (AML) and Counter Terrorism Financing (CTF) regulations, Basel banking supervision core principles, and international

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obligations and agreements resulting from entry into the WTO, Regional trade Agreements (RTAs) and Free Trade Agreements (FTAs). This has been reinforced by competitive pressure and emulation within MENA countries. Moreover, international institutions, such as the IMF, OECD, World Bank, WTO and the BIS have played a role in providing technical assistance and building knowledge and capacity.

Recent Advances in Corporate Governance Reforms

The region as a whole has been advancing in developing corporate governance frameworks. The first code of corporate governance was launched in Oman as early as 2002. Egypt has published two corporate governance codes: one for listed companies and for State Owned Enterprises. Egypt has sought to strengthen its listing rules and is focusing on implementation by launching the Egyptian Institute of Directors and a series of training programs being conducted by the Egyptian Banking Institute for bank directors. Bahrain, Morocco, Qatar, and Tunisia have facilitated the review of their legal and regulatory framework and are in the process of preparing a corporate governance code. Jordan is developing a model corporate governance code for listed companies.[1] Lebanon has conducted a bank corporate governance survey and conducted a legal review followed by the Central Bank issuing a corporate governance regulation. Additionally the Lebanese Corporate Governance Task Force has spearheaded the development of a code of corporate governance for non listed companies and is working with Lebanese companies for voluntary compliance. In the UAE, the Central Bank has drafted corporate governance guidelines for banks, and the UAE's Securities and Commodities Authority has issued a corporate governance code, setting a national CG standard, for both the Dubai Financial Markets and the Abu Dhabi Securities Market. Similarly, Saudi Arabia's Capital Market Authority launched corporate governance regulations for its listed companies, and the banking sector is seriously looking at improving corporate governance standards. The West Bank/Gaza is also in the process of developing a code of corporate governance, after a series of corporate governance awareness programs organized by business associations and regulatory authorities. The Hawkamah Institute for Corporate Governance, a regional institute, was formed in 2006 to assist MENA countries and companies in designing and implementing corporate governance reform. A membership organisation, with more than 200 members, Hawkamah has created a network of international and regional partners and received institutional support from the region's banks, chambers of commerce & industry, business associations, regulatory authorities, Ministries and Central Banks. Hawkamah has launched task forces for bank, State Owned Enterprises, insurance sector corporate governance reform[2] and is undertaking a survey on insolvency in the region to initiate reform. It is undertaking corporate governance promoting conferences and workshops and director training programmes; it has undertaken a benchmark surveys on the state of CG laws and regulations in the GCC and a survey of CEO corporate governance practices in MENA, (http://www.hawkamah.org/).[3]

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[1] Egypt, Jordan and Morocco have each undertaken a corporate governance Report on the Observance of Standards and Codes, see, http://www.worldbank.org/ifa/rosc_cg.html

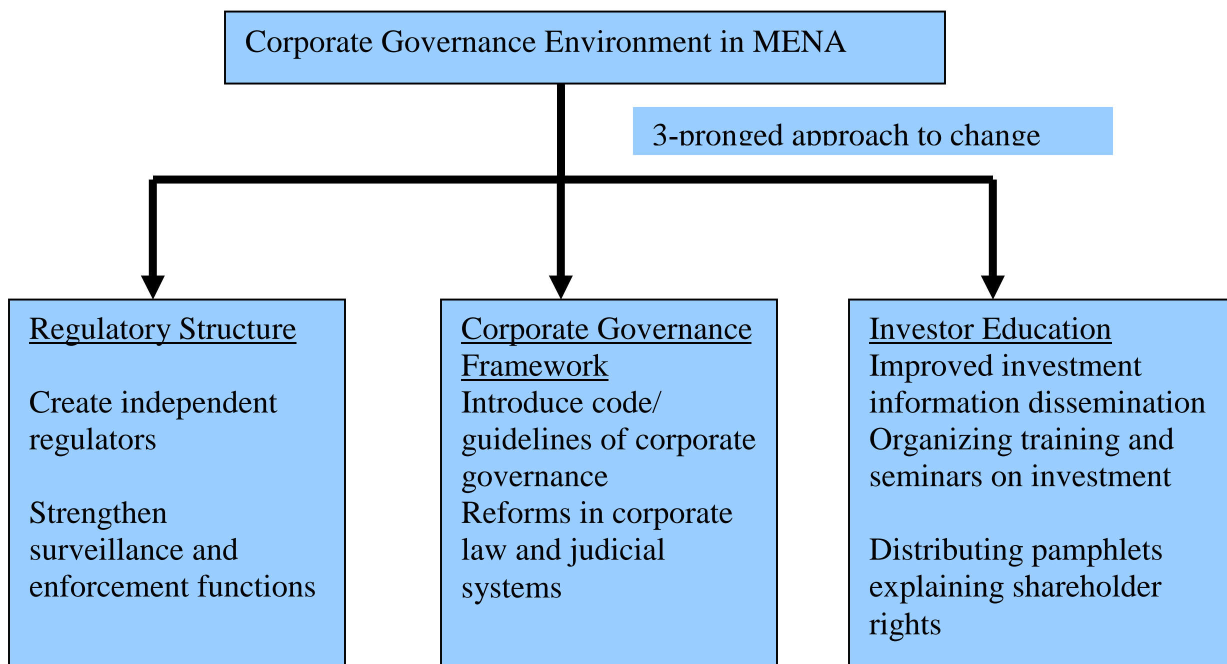
[2] The task forces are in association with various international bodies including the OECD, WB, IFC, INSOL, Arab Forum of Regulatory and Insurance Commissioners and the Union of Arab Banks.

[3] See also the report on the state of corporate governance by the OECD, http://www.oecd.org/dataoecd/37/46/36086926.pdf

Role of Governments & Regulators in the MENA region

Most regulators and governments in the region have adopted a three-pronged approach to strengthening corporate governance in their countries that focuses on (i) Regulatory Structure, (ii) Corporate Governance Framework and (iii) Investor Education. The interplay between factors affecting change in the region's corporate governance environment and methods employed by regional authorities is explained and illustrated in Figure 1.

Figure 1 Three-pronged Approach to Change



Need for targeted reforms in Family-Owned Enterprises (FOEs)

A three-pronged approach, while effective for listed companies, fails to address corporate governance weaknesses in non-listed companies. Family-owned enterprises (FOEs) constitute more than 85% of non-listed companies in the region. In general, compared to global corporate governance standards, these companies have weak corporate governance practices and are reluctant to change the 'old' ways of doing business. Their resistance can be attributed to:

- Fear of loss of control by family
- Fear that increased transparency and disclosure will reduce competitive advantage of business
- Fear of change fuelled by a lack of understanding of 'new' corporate governance practices
- Failure to recognize the benefits of good corporate governance practices, in ensuring successful succession planning, higher equity valuations, access to external sources of capital and finance, improved credit ratings, better terms and conditions of finance

Nevertheless, if equity markets are to deepen in the region, it is important for authorities to introduce incentives and corporate governance reforms aimed at FOEs. Many non-listed FOEs in the region are sizable enough to list on a stock exchange. However, due to inadequate corporate governance standards these companies will not receive valuations that would adequately compensate them for the loss of the family's control and increased compliance costs. Introducing reforms that specifically address weaknesses in the FOE governance structure will help bring corporate governance practices of these companies more in line with current best practices. Moreover, reducing the gap between current practices and corporate governance requirements incorporated in listing rules of stock exchanges will make it easier for non-listed companies to list on stock exchanges in the future. In particular, the introduction of two-tier stock exchanges or 'alternative investment markets' with listing requirements designed to attract FOEs and SMEs can be an important structural change encouraging IPOs.

Targeted reforms for family-owned enterprises include:

- Reforming company boards by increasing overall board independence and reducing the number of family members or requiring FOEs to establish advisory board of directors
- Limiting role of family members in senior management
- Increasing transparency of ownership structures and related-party transactions
- Requiring FOEs to submit audited financial reports to authorities
- Other mechanisms that FOEs should be encouraged to adopt include creating family councils and family charters that deal with family disputes and establishing guidelines for hiring family members into the business

Role of the Banking System in cascading change[4]

The banking sector in the MENA region is well-developed and banks continue to be the primary provider of funds to businesses. Over the past three years, banks and financial institutions in the region have significantly improved internal corporate governance practices. Progress has been achieved in the corporate governance of the banking sector in the MENA countries, by complying with the BIS Core Principles for Effective Banking Supervision and related prudential and regulatory measures. Moreover, instituting effective bank supervision authorities, and acting to ensure market integrity through anti-money laundering and counter terrorist financing legislation and instituting AML/CTF commissions has, as a by-product, also helped strengthen corporate governance in MENA banks.

To comply with risk management guidelines of the Basel Committee, Central Banks across MENA have revised regulatory requirements. MENA banks are now required to put in place a board-level audit committee, appoint independent directors and establish a risk management system. For example, in Kuwait, audit committees exist

[4] For further discussion, see N. Saidi (2006), "Improving Bank Corporate Governance in the Arab Countries", published in Arab Bank Review, http://www.arabbank.com/ABDATA/review/vol7_no2/Review_Oct_05.pdf

only in banks and financial institutions under the supervision of the Central Bank of Kuwait. Banks are also required to obtain prior approval from their central bank before appointing a director. Similarly, banks must provide corporate governance-related information to central banks as part of their annual reporting cycle. Consequently, corporate governance practices in the banking sector are significantly better than those practiced in the non-bank corporate sectors.

Increasingly, along with the strong growth of Shari'a compliant banking (currently representing some 20% of banking assets in Bahrain and the UAE and more than 50% in Saudi Arabia), increased attention is being attention to implementation of the Islamic Financial Services Board (IFSB) CG guidelines for Islamic financial services.[5]

Bank financing continues to be the largest source of external funding for many MENA businesses. Most regional banks are controlled directly by families or governments that have strong ties to the business community in the MENA. Name-based lending is prevalent among banks, although most central banks, to minimize default risk in the region, place a limit on the maximum exposure to individual businesses and prudential limits on related party lending. As a result, companies have had little need to rely on equity markets to meeting funding needs and have limited incentive to change corporate governance practices and strengthen minority shareholder rights, which lies at the heart of good corporate governance principles.

Up to now, banks in the region have played a limited role in scrutinizing governance practices of borrowers. Nevertheless, banks can play a larger role in the short-term until authorities strengthen enforcement and surveillance functions at the regulatory level. In some instances, bank representatives serve as directors on the board of companies and are privy to strategic discussions. The underlying philosophy to allow bank representation on boards is that banks have a fiduciary responsibility to their depositors and therefore a bank's interest is aligned with interest of minority shareholders. However, this may not always be true and risks exist when banks play a larger role in providing corporate governance oversight. Nevertheless, banks are important stakeholders in MENA companies and can play a significant role in improving corporate governance practices in borrowing firms by requiring firms to provide governance related information such as:

- Quarter financial reports and audited annual reports
- Names and biographical information regarding board of directors
- Details regarding meeting frequency of board meetings
- Report on risk assessment by the board of directors
- Report on quality of internal controls from the board of directors and/or external auditor
- Board representation if debt covenants are broken

Way forward for corporate governance in MENA

[5] http://www.ifsb.org/index.php

Interest in corporate governance reform is high in the MENA region and intentions are being put into action. The recent Dubai Declaration[6] calls on the MENA countries building on recent efforts "***to continue improving the legal and regulatory framework underpinning corporate governance".*** Further, it requires that ***"parallel to strengthening these frameworks, the capacity of supervisors and regulators should also be addressed".*** Moreover, it says that ***"self-regulatory measures and corporate governance codes should be developed as a complementary mechanism for improving enforcement in the region."***

The MENA countries have a strong interest in investing to promote higher corporate governance standards because good corporate governance is part of the institutional infrastructure (laws, regulations, institutions and enforcement mechanisms) underlying sound economic performance. Better corporate governance is correlated with better operating performance, 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 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 efficient mechanism for transferring wealth between generations. By setting corporate governance 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 financial sector must develop the capacity to channel a significant proportion of savings into long-term productive investment. Domestic financial systems and in particular, 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 equity culture. Furthermore, greater competition among sources of financing is needed. MENA financial institutions also need to face the competition of a global business and regulatory environment. Implementing the principles of corporate governance will be a major building block for sound financial markets and the banking industry. The stakes are high: better corporate and public governance improves the investment environment and creates better institutions, which enables diversification of economic activity and sustainable economic growth.

[6] See http://www.hawkamah.org/regional_conference/dubai_declaration/