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Working Paper

Strengtheing Corporate Governance in Arab Banks

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Good Governance

What is "good governance"?

- **Narrowly defined, it is the system by which businesses are directed and by which controls are implemented**
- **At the end of the day, it is the 'four eyes" principle in practice**
- **Accountability plays a key role in good governance**
- **Transparency is needed so accountability can be monitored**
- **Governance is often defined to cover ethical standards as defences against corruption and financial abuse**
- **The need to strengthen governance is being acknowledged by parliaments and supervisors following the US corporate scandals.**

What can good governance achieve?

- It protects shareholders, employees, customers, the public
- Conversely, bad governance in banks can undermine economic and financial stability
- Bad governance poses a significant reputation risk for individual firms and even for countries
- If a system fails to provide incentives for good governance and does not punish transgressors, corruption flourishes
- Firms which practice good governance will (a) earn higher ratings, (b) have access to cheaper funding
- But trade-off needed – important not to strangle enterprise.

Governance in practice

- **Weak corporate governance in Asian banks (and their customers) was one of the key factors in the Asian crisis:**

  - many banks were controlled by owner-managers and independent directors played little or no role (so no 'four-eyes" principle)

  - banks were often parts of wider conglomerates, so funded other parts of the group (connected lending) and were reluctant to foreclose

  - banks were subject to political influence in their lending decisions and credit discipline was undermined by the legal and cultural environment

  - management was weak and lacked self-responsibility

  - growth was seen as more important than return on capital.

Lessons from recent corporate scandals

- Conflicts of interest abound as finance becomes more complex and as each firm offers greater variety of services

- The accounting and audit process is undervalued in terms of the skills needed, the responsibility and the risks incurred

- Too much latitude is given to staff whose results appear to be exceptional (that in itself is often suspicious)

- More attention is needed to the damaging incentives provided by badly structured compensation packages

- Sadly, no governance system can be expected on its own to prevent greedy, dishonest people from putting their personal interests ahead of the organization that pays them.

Status of Governance in the Arab Region

Major Features:

- **Concentration in corporate ownership (table 1)**
- **Substantial family corporate holdings (table 2)**

Table No. 1: Ownership Concentration

(outstanding shares)

Concentration Ratio (%) [1]

Country	Largest Shareholder	Top five Shareholders	As of end of the year	Company Coverage
Jordan	20	35	2000	All PLCs
Lebanon	25	55	2001	Non-financial PLCs
Kuwait	60	80	1999	All PLCs
Saudi Arabia	70	80	1998	All non-financial PLCs
UAE	75	85	2000	All PLCs

(1) PLC: Publicly Listed Companies

Table No. 2:

Ownership Composition, 2000

(Average in percent)

	Jordan	Lebanon	Kuwait	Saudi Arabia	UAE
Non-Financial Companies	15	12	20	15	13
Banks	25	40	35	40	45
Financial Companies	8	13	15	11	9
Individuals	16	14	20	17	16
Others (1)	36	21	10	17	16
	100	**100**	**100**	**100**	**100**

(1) Including government, foreigners and others.

Other Features:

- **Boards of directors are often dominated by controlling shareholders that represent the interests of families or family groups and close relatives.**

- **Boards of directors often consist of friends and relatives of controlling shareholders who would not oppose management, which in turn are appointed by large shareholders .**

- **A major shareholder often has a strong or even dominant control over corporate decisions. The separation of boards of directors from management is often only nominal.**

- **Boards of directors lack the representation of non-executive or independent directors.**

- **In many corporations the chairman of the board of directors if often the CEO or a member of the top management team.**

- **The board of directors determines the director's remuneration. This is because independent committees in the boards of directors do no exist, nor any outside directors are accepted as members of the board.**

- **Shareholder participation is passive, and legal protection for shareholders is inadequate.**

- **Investors (i.e. shareholders) in the five countries have never paid adequate attention to corporate governance issues.**

- **Insufficient transparency and inadequate disclosure characterize the financial and corporate sectors.**

- **Creditors, including banks and non-bank financial institutions, in general, have limited involvement with corporations' management and decision making, and their role in corporate governance is weak.**

- **With credit and control analysis not being highly developed, credit decisions tend to rely on collateral and cross-debt guarantees among affiliates, rather than on the basis of projected cash flows or some broader methods of project evaluation.**

- **Insolvency law is not sufficiently suitable for the new international business environment, since it contains a number of loopholes.**

Four Areas of Reform

- **Corporate Ownership Structure**
- **Corporate Internal Control and Shareholder Protection**
- **External Monitoring and Discipline**
- **Capital Market Development and Financing.**

► Rationing Corporate Ownership Structure:

Here there is great need to:

- Continue reform measures in the national economy.

- Increase the minimum percentages of outstanding shares required for public listing in stock exchanges.

- Apply new minimum requirements to companies seeking new listing, with a view to promoting broader corporate ownership and reducing concentration.

- Introduce measures aiming at reducing or prohibiting interlocking shareholdings (cross shareholding and pyramiding).

- Tighten the requirement for prompt disclosure of underlying ownership of shares held by nominees and holding companies and changes in ownership.

► Strengthening Corporate Internal Control and Shareholder Protection:

- Strengthening the Board of Directors System and Accountability.

- Strengthening Minority Shareholder Rights.

- Improving Transparency and Disclosure.

- Developing Institutional Investor Community.

- Promoting Shareholder Activism.

► Strengthening External Monitoring and Discipline:

- Improving Financial System Regulations.

- Promoting Product Market Competition.

- Developing the Market for Corporate Control.

- Reforming Insolvency Procedures.

► Developing Capital Markets and Improving the Efficiency of Corporate Financing:

- Developing Capital Markets.

- Developing Corporate Finance.

► Reform and Action Priorities

► On the Part of Public Authorities:

- Strengthening Corporate Internal Control via improving standards of accounting, auditing, and financial reporting systems and their enforcement.

- Strengthening External Discipline via prudential regulation and supervision of banks and non-bank financial institutions.

- Enforcement of corporate laws and regulations, via effective regulatory bodies with statuary powers and an efficient judicial system.

- Improvements in the state of governance in both public and private sectors.

- Reviewing the relationship between legal enforcement and self-regulations.

- Enforcing the implementation of sound corporate governance principles and good practices in financial and non-financial institutions in line with international standards.

► On the part of Financial Institutions (Mainly Banks):

- Adopting sound corporate governance strategies, standards and practices in line with national and international directives (OECD, IFC, Basel).

- Given their dominance in corporate financing, banks and non-bank financial institutions as creditors should and could play a greater role in monitoring and disciplining non-financial corporations, not only in insolvent, but also in solvent conditions.