

**Union of Arab Banks (UAB)
General Secretariat**

Working Paper

**Good Governance In Banks & its Implications for
Governance in Private Corporates**

By

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**The World Strives to Achieve Economic & Social
Progress
Yet...**

**The Record of Development Has Not Been Fully
Satisfactory:**

**Sound Macroeconomic Fundamentals Are No
Longer Enough to Prevent Crises**

The World Needs A Better System

.... Better Governance

**Banks may be an important part of the corporate
governance framework, even when their role is
limited to debt supply, if their own corporate
governance is good.**

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 corporates the chairman of the board of directors is 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 not exist, nor are any outside directors 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 corporates' 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.**

The Basel Guidelines

- Document issued in 1999
- Sets out the key elements of corporate governance
- Focused on the unique issues related to corporate governance of banks
- Intended as a supplement to OECD guidance
- Document does not promote a particular governance structure (e.g., unitary board)

Objectives:

- To encourage practices which can strengthen corporate governance under diverse structures (e.g. as regards the relative role of the board of directors and management)
- To assist supervisors in promoting the adoption of sound corporate governance practices by banking organizations in their countries

Mechanisms

- **Establishing corporate strategy**
- **Fostering interaction between board and senior management**
- **Setting clear lines of responsibility and authority (with checks and balances)**
- **Monitoring potential conflicts of interest**
- **Developing an incentive structure**
- **Providing an audit structure**
- **Setting corporate values and standards**

Basel Guideline 1:

Strategic objectives and corporate values should be established.

Basel Guideline 2:

Clear lines of responsibility and accountability should be set and enforced.

Basel Guideline 3:

Board members should be qualified, understand clearly their role and not be subject to undue influence from management or outside concerns.

Basel Guideline 4:

There should be appropriate oversight by senior management

Basel Guideline 5:

The work conducted by internal and external auditors should be effectively utilized.

Basel Guideline 6:

Compensation approaches should be consistent with the bank's ethical values, objectives, strategy and control environment.

Basel Guideline 7:

Corporate governance should be conducted in a transparent manner.

What is the role of supervisors?

- **Supervisors should:**
 - **expect banks to implement organizational structures that include appropriate checks and balances**
 - **ensure that boards and senior management of individual banks have in place processes to fulfill their responsibilities**
 - **hold the board accountable for any problems detected and require timely corrective measures**

- be attentive to any signs of deterioration in management
- Set our minimum standards for individuals holding board and management positions
- Give clear guidance on the specific responsibilities of the board (e.g., oversight, policy-setting, audit, setting of limits)
- Establish minimum frequency of board meetings and attendance
- Address possibility of occasional meetings between the board and supervisors

Supervisory review process

Traditional methods for monitoring corporate governance:

- On-site examinations
- Off-site surveillance
- Meetings with bank management
- Review of work of internal and external auditors
- Periodic reporting

The OECD Principles of Corporate Governance

Principle no. 1:

The Rights of Shareholders: Corporate governance framework should protect shareholders' rights.

Principle no. 2:

The equitable treatment of shareholders:

Principle no. 3

The Role of stakeholders in Corporate Governance.

Principle no.4:

Disclosure and Transparency.

Principle no.5:

Responsibilities of the Board.

The Code of Banking Ethics

The Concept:

The code comprises a pool of rules related to good and sound conduct, which rule relationships between banking institutions, and between these institutions and their customers and other counterparts.

Objectives:

- 1- Establishing defined, unified and adequate standards for sound and safe banking practices.**
- 2- Raising the level of transparency and openness in banking practices.**
- 3- Reinforcing mutual trust within the banking sector and between the banking sector and the corresponding counterparts.**
- 4- Enhancing healthy competition between banks, and allowing market forces to operate freely, competently, and efficiently, in order to provide better services and products for customers.**

5- Continuously ensuring the rights and interests of customers, shareholders, and the corresponding banking institution.

6- Ensuring the presence of an ethical professional and good-conduct staff ready to put aside personal interests for the sake of the institutions interests.

7- All time compliance with applicable banking directives and decisions.

Principles:

1. Integrity and Fairness
2. Confidentiality
3. Professionalism
4. Compliance with Directives
5. Monitoring Procedures
6. Sound Implementation
7. Transparency of Transactions
8. Good Customer Services
9. Promotion of Banking Services- Advertising
10. Transactions Giving Rights to Suspicion
11. Collecting and Keeping Information on Customers
12. Handling Customers Complaints
13. Interbank Relations and Rotations with other Parties

How Can Banks Exert Better Governance on Corporations?

- Banks should seek to improve the behavior of their corporate clients, thus improving their own corporate governance.
- Banks should have experience in using their expertise and knowledge to control the behavior of corporates.
- Banks should play a role in improving the efficiency of investment projects and their implementation.

- **Banks must play a much greater role in corporate control. This influence comes from the shares they own in corporates, and also from the external financing they supply corporates in the form of debt. Debt as a controlling device is an active force in corporate governance in corporates.**

- **Banks should enforce sound corporate governance by securing projects to be funded. They should monitor performance and enforce lending clauses. Before granting loans, they should:**

- **Ask for project proposals, statements of financial conditions, and resumes of senior management;**
- **Examine the shareholding structure; and**
- **Review the borrower's records to establish accomplishment.**