Governance
and The Financial Crisis

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Governance and Integrity Panel

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Outline

- Context - Why did the Crisis occur?
- Where did Governance failures occur?
- Do We Know What Corporate Governance (CG) Is?
- Is There a Return on CG?
- A Matter of Survival or Just Sustainability?
- What Do We Do to Avoid Further Crises?
- Is it Only Banks That Need to Shape Up?
- What Do Others Need To Do?
- Conclusions

Context- Why Are We in This Crisis?

- There appears to be general agreement on common causal factors
- Lax Governance amidst an Easy Credit and High Liquidity Environment are arguably the highest amongst these factors
- The Lax Governance cut across governments, regulators, banks, as well as corporations
- Therefore it would not be too far fetched to call this a Public and Corporate Governance caused crisis
- The regulators were too lax with enforcing good CG practice amidst a bubble friendly liquidity/interest rate environment
- Many banks had boards and managements that were complacent and/or sensitive to competitors rather than risk

Context- Why Are We in This Crisis?

- US Financial Crisis Inquiry Commission (FCIC) Conclusions
- The top three conclusions were:

"…*this financial crisis was avoidable*",

"…*widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets*", *and*

"….*dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis*"

Benefits- Any Upside to Crises?

- Many would agree that "learning from crises" can make institutions more resilient, so "it's time to learn!"
- Institutions that navigated well through the crisis were those that were "governed" for the long term and stuck to what they knew best, even if that meant short term "opportunity" costs
- This meant difficult expectations management of stakeholders (Risk Sensitive Chairmen/CEO's were not popular)
- Investment of time, money and effort in robust governance and risk management paid off post crisis
- The "culprits" were not new, e.g. leverage, illiquid, speculative, and/or complex investments, along with cheap money, low risk premiums, and generous short term pay-offs (bonuses)
- I like to call it the..."Bubble Bath Party"…addictive and fleeting

Future Environment for MENA FI's

- Demographics and employment outlook dictate infrastructure investment and expansionary policies to build capacity
- The financial and institutional capacities required go beyond local or even regional resources, which reinforces the trend to open up and attract external investment
- On the other hand, the global drive for enhanced regulation and upgrading governance is intensifying
- This will impose both domestic and international demands for enhanced governance, transparency and risk management
- Other global regions will vie and compete for the limited resource capacity that exists thru their own governance programs
- Regional developments have cross border impact (e.g. Dubai World, Gosaibi/Saad, Gulf Bank, etc.)

Do We Know What CG Is?

- In a recent IFC/Hawkamah survey, almost half the MENA Listed Companies and Banks surveyed responded improperly, as to what CG was, considering it a "legal compliance", "economic development", or "social responsibility" exercise
- Corporate Governance (CG) is the system by which companies are directed and controlled
- In other words it is the process thru which stakeholder objectives are achieved
- Stakeholders include Shareholders, Customers/Depositors, Creditors, Regulators, Employees, and the Community/Public
- When Listed MENA FI's were surveyed as to the business case for CG, most responded that it was to comply with legal and regulatory requirements, while less than a third responded that it was to achieve lower costs of capital and access thereto

Do We Know What CG Is?

- Over 85% of the Chairmen of the top 1000 Listed UK companies cited protecting shareholders and lower cost, or higher access, to external capital as the benefits of improved CG, while only 1% cited compliance as a major benefit
- On average, MENA market Listed Companies scored less than 50% on a check list of 32 CG governance indicators (list available), with only 3% adhering to "Good practice", or a score of 75%
- Using another measure called BASIC based on 43 indicators that cover Trading History, Disclosure, and Corporate Communication called BASIC, Hawkamah's site shows that almost 75% of MENA Listed companies, and/or 42% of listed Banks scored less than 5/10, with the balance of banks scoring between 5 and 7/10 (the average for these banks was 6/10)

Is There a Return on CG Investment?

- A study of S&P 500 companies found that those with strong/improving CG practices outperformed those with weak/deteriorating practices by almost 19% over a 2 year period (IFC/Hwakamah MENA Survey)
- Well governed UK companies posted 18% higher risk adjusted returns than those with poor governance; wost offenders underperformed industry ROA averages by 300-500 bppa (IFC/Hawkamah)
- Well governed firms in Korea have been found to trade at a premium of 160% to poorly governed firms (IFC)
- Institutional investors pay premiums ranging between 22-30% for well governed companies in Eastern Europe and Asia (IFC/Hawakamah)
- Such premiums for some MENA countries are estimated to be around 30% (IFC/Hawkamah)

How About Survival? Downside/Upside

- Many of the FI's that wound down or were reduced to a shadow of their former size, during the Crisis, suffered from major CG lapses
- For example, Lehman Brothers and Bear Stearns did not have a majority of ***risk*** qualified independent members on their Board Audit and Risk Committees
- Other examples abound, even before the crisis, of firms that ceased to exist due to CG weaknesses, such as Barings, et. al.
- In the Gulf we have had situations such as Gosaibi/Saad, and some investment companies, where I believe the long term survival of the institution is now in question, due to poor Governance practices
- These include badly constituted structures, as well as CG processes, such as coordination of business and risk strategies

What MENA Banks Can Do To Benefit from CG?

- Chairmen, Board Secretaries, and CEO's should champion CG programs, in their respective institutions (less than half of MENA listed companies surveyed responded that they assign responsibility for CG to their Boards per IFC MENA Survey)
- CG policies, structures, and codes should be formalized (Less than 38% of MENA Listed Companies and Banks have implemented such a code)
- Regulators, and CG champions at Banks, should mandate a minimum level of CG training for Board members and Senior Executives (less than 20% of MENA Banks provide such training)
- Conduct independent Board Evaluations (less than 20% of MENA Banks conduct such evaluations)

What MENA Banks Can Do To Benefit from CG?

- Nominate at least 2 Risk qualified independent Board members to the Risk and Audit Committees, along with the Main Board (Best practice requires a majority of independent directors on these Board sub committees)
- Constitute Board Nomination/Compensation Committees, as well as Board Risk Committees (less than 30% of MENA Banks have both)
- Chief Auditors and Chief Risk Officers should have independent unfettered access to Board Committees, even if the CRO also has a reporting line to the CEO (less than 50% allow CRO's such unfettered access)
- The Nomination, Compensation and Release of Chief Auditors and CRO's should be determined by a Board Committee

What MENA Banks Can Do To Benefit from CG?

- Variable Remuneration of Senior Executives should be based upon medium term risk adjusted performance metrics, and determined by a Board Compensation Committee with two independent Risk qualified members
- Of MENA banks surveyed the most important qualification criterion for board membership was High Profile, while only about half the respondees cited Competence and Skills as a qualification criterion
- Establish and comply with a Conflict of Interest and Related Party Policy including public disclosure, and voting abstention by conflicted Board members (survey respondees indicated that Board members do not always comply with such policies)
- Establish a process for coordinating Business strategy with Risk strategy, in line with Risk appetite that is approved at Board level
- Encourage Corporate customers to apply good CG practice thru highlighting business case

Is It Only Banks That Need to Shape Up?

- The Crisis has demonstrated that Public Governance is intertwined with CG, as Regulators apparently did not enforce strong Governance practice prior to the Crisis
- Independent bodies need to challenge the Monetary Policy followed by Central Banks, and enforcement by bank regulators of robust Governance, as the interest rate and liquidity policies followed in the USA contributed to asset inflation and distorted risk premiums (e.g. Financial Stability Forum)
- Investment Banks, Investment Companies, and other FI's must be subject to rigorous regulation (especially if systemically critical)
- Capital Market Regulators must enforce good practice CG upon Listed Companies (especially if systemically critical)

Conclusions and Recommendations

- Quality and quantity of resourcing at multiple levels; Regulator, FI Boards and Management levels is a pre-requisite to addressing governance and risk issues
- Empowerment of Governance/Risk Champions across the hierarchy, i.e. at Board and Management levels, whilst requiring escalation
- Strongly recommend appointing at least two independent expert directors on Gulf FI Boards, Risk, and Audit Committees
- Upgrading ERM frameworks at FI firms, to incorporate risk strand correlation, including operational and liquidity risks
- Realignment of compensation structures at FI Boards, as well as Managements, to be based on medium term "risk adjusted" performance metrics, which are independently reviewed

Conclusions and Recommendations

- Require training, certification, & annual appraisal of FI Board members, that covers governance, risk appetite, regulatory compliance, liquidity management, and stress testing
- Improve compensation levels at MENA regulators and FI Boards to address adequate resourcing
- Banks and Regulators should coordinate to encourage improved CG at systemically important family controlled entities whether Listed or Not (please see table re Listed Firms)
- A promotional slogan of a bank in the Gulf…" We Do Banking, You Do Life!"

Market Insight by TNI (May 2008)

COUNTRY	3 FAMILIES WITH MOST BOARD SEATS
Saudi Arabia	Rajhi / Isa / Zamil (Aggregate Seats % = 7.2%)
Kuwait	Sabah / Ghanim / Kharafi (Aggregate Seats%=9%)
Abu Dhabi	Qassimi / Dhaheri / Mazrouei (Aggregate Seats%= 15.3%)
Dubai	Ghurair / Mulla / Futtaim (Aggregate Seats %= 12.4%)
Qatar	Thani / Mana / Attiya (Aggregate Seats % = 33.2%)
Bahrain	Fakhro / Kanoo / Moayyed (Aggregate Seats%=8.4%)
Oman	Shanfari / Rawas / Sultan (Aggregate Seats%=9%)

Thank You