MENA-OECD INVESTMENT PROGRAMME

WORKING GROUP ON CORPORATE GOVERNANCE

POLICY BRIEF ON CORPORATE GOVERNANCE OF BANKS

Building Blocks

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OECD, Hawkamah and the Middle East and North Africa (MENA)

The OECD, comprised of 30 member countries sharing a commitment to democratic government and the market economy, is dedicated to supporting economic development throughout the world, and has active relationships with some 70 other countries, NGOs and the private sector. In 2004, the OECD established its MENA Investment Programme at the request of countries from the region in order to provide advice on implementing investment policy reform as driving force for economic growth and employment throughout the region. Since 2006 the Programme operates under the chairmanship of the Arab Republic of Egypt and the United Kingdom.

As a part of this Programme, the Working Group on Corporate Governance aims to enhance capacity for reform and institution building by creating a regional network for policy dialogue. It is uniquely placed to do so, as it brings together a network of senior policy makers, regulators, market participants and representatives of academia from Bahrain, Egypt, Jordan, Lebanon, Morocco, the Palestinian Authority, Saudi Arabia and the United Arab Emirates, as well as OECD countries. Consistent with its usual policy for avoiding duplication, the OECD MENA Working Group works closely also with longstanding partners from the Global Corporate Governance Forum, the World Bank, the International Finance Corporation and the Centre for International Private Enterprise.

The Working Group ensures local ownership and relevance of its activities by closely co-operating with home-grown regional and country specific initiatives and institutions, such as Hawkamah, the regional Institute for Corporate Governance, the Egypt Institute of Directors, the Union of Arab Banks, National Country Teams, established within the OECD MENA Investment Programme, and others.

Hawkamah, the Institute for Corporate Governance, constitutes a groundbreaking development for institution building, corporate sector reform, good governance, sustainable economic development and growth in the region. Its mission is to assist the countries and companies of the region to develop sound and globally well-integrated corporate governance frameworks. Hawkamah is an independent international association that will efficiently coordinate and sequence the design, planning and implementation of corporate governance reforms and monitoring the outcome of corporate governance at the private sector level.

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Background

The focus on regulation and corporate governance of banks is important for MENA given the prevailing role of banking institutions as a source of finance for the corporate sector. Improved board structures, administrative procedures and disclosure requirements could result in better governed banks, which are more likely to allocate capital efficiently.

The MENA Working Group decided in its first meeting in Amman, that corporate governance of banks should be a priority in its activities. In light of this decision, and the work carried out by Hawkamah and IFC on corporate governance of banks, the Working Group could contribute its guidance on policies to pursue in the future in order to improve existing frameworks and practices of bank governance.

It is proposed to do this by developing a Policy Brief on Corporate Governance of Banks in the MENA Region. The process for the development of this Policy Brief and ensuring a strong constituency behind it will be supported by a **joint secretariat, involving the OECD and Hawkamah, the Institute for Corporate Governance.**

This note aims at launching a discussion on the building blocks of the Policy Brief, which would lead to meaningful recommendations or the definition of policy options for addressing the challenges faced by MENA banks.

Issues for discussion by the Policy Brief

Proposed preliminary issues to be discussed in the Policy Brief would include:

1. The importance of the CG of banks

We have extensively discussed over the last two days why banks have distinct features different from that of other firms (e.g. *inter alia*, banks are more opaque than non-financial companies and information asymmetries are larger; banks are heavily regulated, which may inhibit standard CG arrangements). The importance of ensuring good corporate governance in banking is not a new issue either:

The Basel Committee noted that:

- supervisors "… should consider issuing guidance to banks on sound CG and the pro-active practices that need to be in place. They should also take account of CG in issuing guidance on other topics."[1]
- CG for banking organisations is arguably of greater importance than for other companies, given the crucial financial intermediation role of banks in an economy … and …. is essential to achieving and maintaining public trust and confidence in the banking system."

[1] In 1999, "Enhancing CG of banking institutions" (revised in 2005)

The Basel II Capital Accord and regulators in a number of countries are also increasingly concerned to examine corporate governance. This is the case of some MENA countries as well, which have started surveying their frameworks and practices or have developed regulations or manuals on good corporate governance of banks.

Good corporate governance is also important for the sound development of the banking sector. Banks channel public savings to the corporate sector. If banks are not in a position to assess the viability of debtor companies, they risk accumulating non-performing loans and be forced into direct or indirect re-nationalisation to avoid systemic risk.

2. The characteristics of MENA banks

Financial systems in MENA countries are dominated by banks and in some economies, by state-owned banks. The banking sector in the MENA region is moderately to highly concentrated.

The most important forms of external finance of the corporate sector include bank loans, followed by equity. This can be explained by the dominance of family owners relying on bank financing in order to maintain ownership and control and the still insufficient degree of development of capital markets.

In spite of current prudential regulations, preventing banks from holding "significant" shares in listed companies, commercial banks have become large shareholders in non-financial listed companies, sometimes ranking among the five largest shareholders. This suggests the need for particular attention to good governance of banks with a special focus on related lending and sound risk management policies.

Allocation of credit to productive investment should be a key element of a sound lending strategy. However, government interference in credit allocation is a feature for many MENA countries. Public sector banks play a role in this respect, channelling soft finance to target sectors, often in the framework of industrial development plans aiming to ensure import substitution and export promotion. Implicit and explicit state guarantees and bail-outs of failing corporations lead, in some countries, to a moral hazard problem for corporations and banks alike.

Data collection and feedback sought by WG members on the following:

Banking landscape: *Number of publicly held, closely held, and state owned banks; Outstanding lending (%compared to GDP);Legal forms of banks*

Bank holding companies: *(with primary activity to control other companies, including banks, rather than driving their own business) in your country? If bank holding companies are allowed, please describe the key problems/challenges.*

Information on bank regulatory institutions responsible for: *off-site monitoring (reviewing and assessing disclosed information) and on-site inspection of banks; granting and revoking licenses banks; administrative measures on individual bank; policy making concerning bank regulations (banking law, corporate governance regulation for banks, related regulations/rules); supervising the corporate of governance of banks in your country?*

Information regarding the regulatory convergence*: with international standards; more in particular, with which corporate governance related items of the 25 "Basel Core Principles for Effective Banking Supervision"*

Deposit insurance structure: *(e.g. full versus limited coverage, resources, institution which operates insurance, expected changes in the future, if any). What side effects of deposit insurance schemes ('moral hazard') may affect corporate governance of your country banks?*

General issues: *key corporate governance issues in respect whereof banks need different regulation than other (non-banks) companies; key corporate governance characteristics of banks in your country in which they differ from banks in other MENA countries; necessity (or lack thereof) to draft a separate Code of Corporate Governance for Banks in your country; coverage of the current Code of Corporate Governance* *of Companies of the major aspects of corporate governance of banks; key problems/challenges of corporate governance of banks in your country (as perceived by securities or banking sector regulators)*

3. Family- owned banks (FOBs);

In many MENA economies, banks have ownership structures and other features that lead to conflicts of interest, which are harmful for sound corporate governance. In many cases banks lend to their owners or to companies in the same business group, all controlled by the same controlling shareholder. Similarly, there may be cross-shareholding between a borrowing company and the bank, each owning a stake in the other.

In such settings, lending on favourable terms (so called related lending), is a key problem. Related lending is "tunneling" of resources away from minority shareholders, to the detriment of deposit insurance, and in some cases, the government as a lender of last resort.

Recent research on bank practices in emerging economies reveal that related lending can stretch from 20 to 90 per cent of bank loans. More importantly, evidence suggest that the loans granted on better terms are more likely to default and are harder to recover than loans to non-related parties.

Corporate governance arrangements in MENA FOBs have a long way to go to improve their corporate governance standards. As FOBs in other emerging economies, they are also facing numerous "incentives" for entering into related party transactions. In dealing with these challenges, special attention needs to be paid, *inter alia,* to regulatory frameworks and board practices:

- Strong regulatory frameworks, and credible mechanisms for compliance and enforcement are instrumental in dealing with conflicts of interest, and ensuring that lending policies regarding related borrowers are conducted on an arms'-length basis, on market terms and conditions, and in a manner consistent with sound risk management and prudential practices.
- The OECD Principles stipulate that the review of related party transactions should be undertaken by a sufficient number of non-executive board members capable of exercising "independent" judgement to ensure that such transactions are conducted at arm's length and in the interest of the bank (OECD Principles, principle VI. E. 1.).

Data collection and feedback sought by WG members on the following:

<u>Overall situation of closely held banks</u> *(e.g. numbers, numbers of listed ones among them, their scale in total, average % of shares held by the owner).*

<u>Banking laws / regulations</u> *regarding related party lending (arm's length rule) within closely held banks. Key corporate governance problems / challenges regarding related party lending within closely held banks? (e.g. compliance with law / regulations; areas for improvement).*

<u>Laws / regulations regarding individual persons holding shares in banks</u> *(e.g. upper limit of such holdings, approval of regulatory institutions for such holdings, mandatory reporting standards, mandatory disclosure). Key corporate governance problems / challenges regarding individual persons holding shares in closely held banks (e.g. compliance with law / regulations; areas for improvement)*

<u>Example(s) of a family owned bank</u>, *typical in your country (shareholders, board/management composition, bank's relationship with owner and other companies controlled by the owner, possible problems, if any, in corporate governance, the reference to the name of the bank is optional).*

4. State owned commercial banks[2] (SOCBs);

A significant percentage of MENA banks are owned by the state. State ownership presents its own challenges, one of which is the propensity to extend loans on non-commercial grounds and to roll-over soft credit to borrowers approaching default. Industrial policy concerns could also lead to heavy state guidance, prompting similar behaviour on the part of private banks. These are ways of tunnelling resources from tax payers to borrowing companies and of encouraging corruption and various abuses.

The 2005 OECD Guidelines on Corporate Governance of State-Owned Enterprises represent good practices which should also be applied to SOCBs. In this respect, it is important to establish mechanisms allowing government agencies, exercising the government ownership function, to be active accountable owners, while at the same time avoiding day-to-day interference in the management of the bank. The state as a shareholder should focus on setting the objectives for the SOCBs, while letting SOCBs' boards exercise their role independently.

Sound governance practices of SOCBs are an important prerequisite for their successful privatization. As highlighted in the OECD Policy Brief on Corporate Governance of Banks in Asia[3], good governance of privatized banks may have spill-over effects and exercise market pressure for better corporate governance on other banks.

Data collection and feedback sought by WG members on the following:

Temporary state ownership

Data *(direct or indirect ownership) of all, or a significant proportion, of the shares due to a reconstruction procedure after a crisis (e.g. numbers, numbers of listed ones among them, scale of them in total, type of shares held by the state, average % of shares held by the state, average % of voting rights held by the state).*

Role of the state *regarding the corporate governance of these banks.*

Key corporate governance problems *during the period of state ownership (for example, are these banks' lending practices fully independent from the state)*

How have banks been privatised *and/or how they will be privatised in the future*

Key corporate governance problems of banks which were once owned by the state *tentatively but have now been privatised*

Example *of a banks temporarily owned by the state, typical in your country (shareholders, board/management composition, bank's relationship with other state owned enterprises, and possible problems in corporate governance, the reference to the bank name is optional).*

Long-term state ownership

Data *regarding banks in which the state permanently holds (direct or indirect) all, or a significant proportion, of the shares (i.e. other than those banks mentioned above) (e.g. numbers, numbers of listed ones among them, their scale in total, type of shares held by the state, average % shares held by the state, average % of voting rights held by the state, division of responsibilities among institutions involved).*

Plans for future privatisation

Law *on state owned banks other than a banking law (if available): description and corporate governance related issues.*

Role of the state *regarding the corporate governance of these banks.*

Key corporate governance problems *of banks owned by the state for the long term For example, are these banks' lending practices fully independent from the state?*

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[2] State-owned policy lending banks or development banks will not be tackled by the Policy Brief, as they fulfill specific policy objectives, which are beyond the focus of the Brief.
[3] The Policy Brief an be accessed by Internet, www.oecd.org

Example *of a bank* permanently *owned by the state, typical in your country (shareholders, board/management composition, bank's relationship with other state owned enterprises, and possible problems in corporate governance, the reference to the name of the bank is optional).*

6. Role of the board

Banks lend money that is, in effect, borrowed from depositors. Depositors are, thus, stakeholders specific for the banking sector. Boards of directors and managers need to take into account and protect the interests of depositors. This is a distinct challenge of gank corporate governance and requires special attention in order to maintain the stability and confidence of depositors in the banking system.

Controlling shareholders in the MENA, especially in the case of FOBs, often appoint all directors, which can undermine the independence and objectivity of the board. Director independence is an important issue for SOBs as well in countering political interference and in effectively monitoring management. Independent directors can play a critical role in preventing abusive related party transactions (including lending), which may have more serious consequences in banking than in most other industries. Well defined independence criteria and mechanisms for ensuring compliance by banks are fundamental in this respect.

Banks' boards of directors should ensure the implementation of existing regulation regarding lending exposure to a single client, including related borrowers. Independent directors should play a critical role in this respect. Board members should act in accordance with their duties of care and loyalty. These duties are perceived to be more important in the case of banks, as they accept public money in the form of deposits.

Personal integrity and competence should be key criteria for appointing bank directors, in order to ensure that bank boards function effectively. Boards of directors should approve and oversee the development and implementation of the strategic objectives of the bank. "Fit and proper" tests are particularly important for the banking sector, both upon the appointment of directors, but also on a continuing basis. Banking supervisors are expected to place more emphasis on securing sound corporate governance of banks they supervise rather than to focus only on regulatory compliance.

Specialised board committees play an important role in supporting decision making in boards of banks as well. The establishment of a risk management committee, in particular, should be encouraged, in order to oversee the bank's risk management system and ensure that the risk policy of the bank is properly implemented.

Data collection and feedback sought by WG members on the following:

Brief outline of the general requirements *on the composition of the board and the executives of listed companies (not limited to banks) (e.g. mandatory outside directors, mandatory committees, separation of the chairman and CEO).*

Laws/regulations *which are special to banks on the composition of their board and the executives (e.g. mandatory outside directors or committees, separation of the chairman and CEO, mandatory qualification on directors).*

Existence of a regulatory institution *(provided for by law) with a power to approve and/or to remove a member of the board or the executives of banks. If yes, please describe the conditions on which the institution can exert the power.*

Problems *in the overall composition of the boards of banks as well as their function in terms of corporate governance*

Example *of a board of banks, typical in your country (number of directors, number of outside directors, the degree of independency of the directors, division of responsibility between board and management, the reference to the name of the bank is optional).*

7. Internal Controls

Basle II and regulators in a number of countries are also increasingly concerned to examine the internal controls of a company. There is even a perception that, corporate governance of banks can sometimes be regarded simply as the system of internal controls, without due attention being paid to the remaining elements of a sound governance framework.

During the review of the OECD Principles, there have been suggestions that they also address internal controls and the appropriate role of senior management, especially the CEO and CFO. Both the UK Combined Code and the Sabanes Oxley Act in the US place considerable responsibility on boards and management to maintain good systems of internal control similar to the requirements already in place for banking.

Internal and external auditors, as well as other officers exercising compliance and legal functions play an important role in overseeing banks' risk management and control systems. They need to ensure that the banks' financial statements represent the financial position and performance of the bank fairly in all material respects.

Boards of directors and senior management rely on the work of the internal and external auditors, and of others performing control functions as an independent check on the information received from management. In particular, internal and external audit functions, underpin the long-term soundness of operations and performance of banks.

Data collection and feedback sought by WG members on the following:

Brief outline of the general requirements *on internal controls.*

8. Disclosure

Transparency is essential in enabling shareholders, stakeholders and market participants to effectively monitor and hold accountable the board of directors and senior managers.

Good transparency and disclosure are relevant to banks as well as this is the only way to facilitate market scrutiny, and enhance the ability of supervisors and stakeholders to effectively monitor them. Both listed and closely-held bank need to apply high standards of disclosure. This concerns private banks with a sole owner, because they participate in payment systems and accept retail deposits and thus, their soundness affects financial stability. Disclosure is of particular importance especially to banks with complex interlocking ownership structures.

International accounting standards and practices and the guidance of the Basel Committee need to be reflected by national laws and regulations on banks. Non-listed banks, in so far as they are required to disclose their information to the public, should also adhere to these standards and practices. The OECD Policy Brief on Corporate Governance of Banks in Asia stresses the need for co-operation between banking supervisors, securities regulators and stock exchanges on disclosure by listed banks.

Data collection and feedback sought by WG members on the following:

Key problems / challenges *in corporate governance issues related to disclosure by banks in your country.*

9. Take over of banks

MENA banks play a dominant role in corporate financing and often wield power over borrowing companies. This situation logically poses the issue of the "pros" and "cons" for banks to play a role in the corporate governance arrangements of their corporate clients.

Sound corporate governance through market pressure is not functioning in many MENA economies due to the fact that their capital markets are still developing. The assessment and monitoring function of banks may deserve special attention from banks, policy makers and banking supervisors, as one of the effective policy tools for improving corporate governance practices in a country. Moreover, low corporate governance standards of clients affect their credit worthiness. *Ex-ante* evaluation and *ex-post* monitoring of their corporate governance should have a positive impact on credit risk management of banks.

The input of task force members will be sought with respect to the role of banks in assessing and monitoring corporate governance arrangements of their borrowers, and with respect to the need for banks to be pro-active in promoting corporate governance improvements by their clients.

In launching this discussion, it is assumed that only banks with sound corporate governance will be able to play a role in improving the corporate governance of their borrowers. It should also be noted that banks often allow their employees to act as a director or senior manager of debtor companies even if they do not hold any shares. While bankers with deep knowledge of corporate finance may be able to have a meaningful contribution to the success of these companies, such practices should be subject to a close scrutiny for potential conflicts of interest.

Data collection and feedback sought by WG members on the following:

Laws / regulations *which prohibit / regulate banks from holding shares of the companies which borrow money from them?*

Prevailing lending practice of banks *in your country. Are banks usually able to exert influence on the corporate governance structure of the debtor companies?*

Taking into consideration the advantages and disadvantages of relationship banking, please describe the pros and cons *of promoting bank role in the corporate governance of their clients.*