

POLICY BRIEF ON IMPROVING
CORPORATE GOVERNANCE OF BANKS
IN THE MIDDLE EAST
AND NORTH AFRICA REGION

November 2009

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

The objective of this *Policy Brief on Improving Corporate Governance of Banks in the Middle East and North Africa* is to provide targeted recommendations to policy makers, banking supervisors, banking associations and individual banks in the region. This document is a product of over two years of discussions of the MENA-OECD Task Force, comprising representatives of the public and private sectors from across the region. The policy recommendations provided by this document have been developed with consideration of the *OECD Principles of Corporate Governance* (revised 2004) and the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (issued 2005). The Basel Committee's guidelines on *Enhancing Corporate Governance in Banking Organisations* have also been extensively drawn upon.

The OECD and its regional partners hope that this Policy Brief will serve as a key reference point for improving corporate governance standards and practices in MENA banks for years to come. In particular, it is expected that this Policy Brief will serve as a basis for ongoing dialogue on policy design, implementation, enforcement, and assessment of future progress towards good corporate governance among MENA banks. Insofar as its recommendations are targeted to the ownership and regulatory characteristics of the MENA region, they can be implemented by a variety of institutions in the region - listed or unlisted, private or state-owned, conventional or Shari'a compliant.

The preparation of this Policy Brief was coordinated by the OECD Secretariat, involving contributions from numerous individuals and institutions. Active discussions and co-operation among participants of the Task Force has been fundamental to achieving a consensus on the policy recommendations provided in this document. The Hawkamah Institute for Corporate Governance has played an instrumental role in developing this document. The assistance of the Union of Arab Banks in coordinating the responses of banks has been an important factor in the success of this initiative. The project was implemented with the financial support of the Global Corporate Governance Forum and the Japanese government, for which they are thanked.

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Summary of Recommendations

Board Performance

1. The Task Force considers that regulators should define director duties more concretely and ensure that directors fulfil them in practice. Banking supervisors should also help banks introduce training programmes which would increase the awareness of boards' responsibilities in terms of corporate governance.
2. Bank boards need to carefully consider the frequency of their meetings that would allow them to fulfil their responsibilities with due diligence.
3. Board members, especially non-executive directors, should have access to bank staff and other technical expertise, including opportunities to obtain views from internal and external auditors.
4. The Task Force is of the opinion that board member liability and how board member duties are specified should remain on the policy agenda since it is not clear that effective arrangements are yet in place.
5. It is important that board committees receive adequate resources, information, investigative powers and recognition within the bank.
6. While recognising the value of other committees, the Task Force believes that one of the most important committees for MENA banks is the audit committee.
7. The establishment of a risk monitoring committee, with the primary duty of overseeing that the bank's risk management system is properly implementing the risk policy of the bank, is strongly advisable.
8. Information technology governance is a responsibility of the board of directors and executive management, and the Task Force is of the opinion that it merits the specific attention of a board committee.

9. The Task Force considers that a competent committee of the board should, at minimum, be responsible for the nomination of a bank's Chairman.

10. The Task Force considers that the separation of the CEO and Chairman posts contributes to the achievement of appropriate checks and balances, increased accountability and improvement in the board's capability for independent decision-making.

11. Directors' skills should be enhanced by ongoing training programmes that underscore the professional, ethical and technical demands imposed by the increasingly complex industry practices.

12. The Task Force recommends that the performance of individual board members and the board as a whole should be regularly evaluated.

13. It is recommended that bank boards should have a majority of independent, or non-executive directors, to ensure the necessary checks and balances.

14. The Task Force advocates that MENA countries should continue to refine the definitions and the expected proportion of "independent" directors on bank's boards. A related issue to address is the tenure of board members and how that might affect their objectivity.

15. The Task Force considers that it is preferable to hire well-qualified directors and manage resulting conflicts of interest in an ethical manner than to have boards lacking the necessary collective skills.

16. Supervisors have a role to play in ensuring that board directors satisfy the "fit and proper" test.

17. Bank management and board members should not act to profit personally from inside information, even if this is not an offence in their jurisdiction. They should also abstain from voting or even taking part in decision-making processes on any matter where they have an actual or potential conflict of interest.

18. Banks should take the initiative to develop and enforce codes of conduct (or a code of proper practice) for their employees, management, and for the members of the board themselves.

19. Banks are also encouraged to define a corporate governance structure that governs its policies, standard operating and internal control procedures.

The role of remuneration practices in sound corporate governance

20. Bank supervisors in the MENA region should give consideration to how the supervisory review process can include an assessment of risks emanating from banks' remuneration policies.

21. The Task Force recommends that MENA banks establish a special committee of the board, comprising wholly or a majority of independent directors, preferably with risk management expertise, that reviews the reward structure of the bank and establishes the salary structure for all bank employees and board members themselves.

22. Banking regulators in the region should require that boards develop a remuneration policy statement and monitor compliance with it.

23. It is considered a good governance practice to disclose in the annual report the executive and board member compensation on an individual basis, and also the earnings of other staff in an aggregated fashion.

24. Banks, and indeed other corporations, should be able to explain the main characteristics of their performance-related remuneration programmes, including the total cost of the programme, performance criteria and how the remuneration is adjusted for related risks.

Disclosure and Transparency

25. Improving non-financial disclosure standards for banks remains a priority for MENA supervisors.

26. Supervisors should be specific in establishing the elements of public disclosure for banks, while also working on changing the mentality of bank executives who view disclosure strictly from a compliance point of view, rather than as an effective tool for managing stakeholder relations and adding value to the business.

27. The supervisor should have access to information about beneficial owners even where they are not required to be publicly disclosed.

28. Consolidated financial reporting ensures that disclosure on intra-group relations, transactions and financial terms is made on a transparent basis and should be mandated by regulators.

29. Establishment of the role of a Chief Risk Officer (CRO) with adequate powers and a reporting relationship to the board would be advisable in MENA banks.

30. Good practice requires that senior management reports at least once a year to the board on the scope and performance of the internal control system, providing an opportunity for the board to review the efficiency of the controls.

31. The bank's board of directors should constantly review the appropriateness of, and set suitable limits on, the bank's operations in risky jurisdictions, and should ensure that senior management establishes policies for managing the risks associated with them.

32. In addition, supervisors should compile figures on banks' consolidated exposure to group companies.

33. Supervisors should ensure that auditors are appointed through a process that ensures their independence, and that adequate procedures exist to maintain the independence.

34. It is a good practice for banks to change the auditor periodically, or at least to request a change in the lead partner.

35. The Task Force recommends that MENA supervisors develop contacts with their national audit associations so that they are in a position to address any audit concerns they might have.

36. Each bank should have an internal audit charter that has been approved by senior management and confirmed by the board or a delegated committee of the board.

37. The internal auditors should monitor related party lending to ensure that all such lending is carried out on the terms agreed by the board.

38. The Task Force proposes that a senior officer in each bank be appointed to confidentially receive and investigate any employee or stakeholder complaints, without any prejudice for or against the complainant, even though it recognises that complaints can on occasion be the result of an unjustified grievance.

Conflicts of interest and abusive related party transactions

39. Banks are recommended to establish information barriers (so-called "Chinese walls") between the different departments so that decisions by staff in one department are made in ignorance of confidential information available to staff in other departments, which might affect their decision.

40. The Task Force does not recommend an outright regulatory prohibition of conflicts of interest as this may only drive them underground, but suggests that banks remain alert to the possibility of personal conflicts.

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41. To monitor situations which may involve conflicts of interest for management or staff, all banks should have a competent and independent compliance function that reports to the board audit committee.
 42. Conflicts by board members or senior executives should be disclosed to the banks' compliance officers and if they are material, to the supervisor, while the board should ensure the appropriate public disclosure.
 43. Supervisors should insist on being informed of the policies of banks they oversee, including their approach to managing conflicts of interest.
 44. The legal/regulatory framework should clearly define who is considered as a related party and make clear that any established criteria merely stipulate examples of transactions and are not exhaustive.
 45. All related party transactions should be reviewed and monitored by a sufficient number of directors capable of exercising objective and independent judgment. The review process should require approval of individual transactions, even those which are not flagged by the regulator but which may pose a risk for the bank.
 46. Appropriate disclosure of material related party transactions would prove helpful in reducing the burden for banking supervisors who may have limited human resources.
 47. It is therefore strongly recommended that any lending to group entities be monitored by a board-level committee that contains a majority of directors who are wholly independent of the group to which the bank belongs. Supervisors need to draft specific guidelines for intra-group exposures, require special reporting for the funding of affiliate companies, and monitor such lending carefully.
 48. It is important that the duty of loyalty of bank directors is specified to the bank's shareholders, not its parent company.
 49. The bank should adopt firewalls to prevent abusive transactions within the conglomerate structure to which the bank belongs ("banking group").
 50. Given the prevalence of group structures in MENA countries, regulators should mandate the consolidation of accounts.

Recommendations specific to state-owned, family-owned and Shari'a complaint banks

51. State-owned banks should deal with government organs and other state owned enterprises (SOEs) on arms-length basis.
52. Once the state has set the objectives for state owned banks, it should take advantage of their corporate form and allow boards to exercise their responsibilities with the requisite independence.
53. At the same time, the state should not be a passive owner, and should establish an ownership policy that includes its objectives for ownership.
54. The state should establish the necessary mechanisms to track the performance of state-owned banks and put in place arrangements similar to those in commercial banks in terms of the risk management, compliance and audit functions.
55. Investments by the state or state-owned/controlled bodies in commercial banks should be made in a transparent manner as to allow bank shareholders and stakeholders to understand the nature of state intervention.
56. If MENA governments choose to retain their ownership in financial institutions for a period, while letting them operate in the market, then they should consider changing the banks' corporate governance arrangements to be in accordance with the OECD Guidelines.
57. Banking supervisors should be particularly vigilant in reviewing related party transactions in family-owned and especially unlisted banks. They should ensure that reporting requirements apply to them in an equal measure as they do to listed banks.
58. Supervisors should require family-owned banks (FOBs) to submit a long-term succession plan that provides for a smooth transition of ownership between family generations so as to ensure continuity. In addition, as a matter of good practice, FOBs (listed and non-listed) should consider adopting family constitutions and structures to help them differentiate family interests from those of the company.
59. Members of the Task Force are of the view that the principles in this Policy Brief can, and should, be applied to Shari'a compliant banks.
60. Banks offering Shari'a compliant products should provide an appropriate level of disclosure, including on their investment strategies, and the supervisor should play an active role in prescribing the level of such disclosure.

61. The relationship between the Shari'a board and the main board/other bodies within the bank, needs to be defined.

62. The Task Force supports the IFSB recommendation to establish a corporate governance committee at the board level in Shari'a compliant banks.

63. The evolving experiences of national supervisors in developing regulatory frameworks for Islamic banks should be shared.

Banks' impact on corporate governance of their clients

64. The Task Force is of the opinion that MENA banks should consider that it is in their own best interest to monitor the governance structure and practices of their corporate borrowers.

65. Banks should require their borrowers to provide consolidated financial reporting.

66. Even in circumstances where a bank cannot directly influence the governance practices of their borrowers, it can have an important influence by "leading by example".

The role of supervisors in improving corporate governance of banks

67. Supervisors should provide guidance to banks on corporate governance, making it clear that they will not only evaluate corporate governance policies and procedures, but also evaluate banks' implementation of these policies and procedures. They should publicly announce the criteria for assessing the corporate governance practices of banks and publicly recognise the improvements that have been made.

68. MENA regulators might wish to evaluate the appropriateness and completeness of policy guidance on corporate governance of banks, given the lessons learned from the financial crisis.

69. Supervisors should evaluate the expertise and integrity of existing and proposed directors and management. They should also evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their oversight responsibilities.

70. Supervisors should evaluate the potential dangers of financial or non-financial group structures which comprise a bank(s). Supervisors should be able to obtain up-to-date information regarding the structure of the group to which a bank belongs.

71. Supervisors are called upon to frequently inspect financial institutions' internal risk management systems and compensation policies, and require changes where deficiencies are noted.

72. In addition, supervisory agencies should allocate sufficient staff resources. They are encouraged to either create a separate function with corporate governance expertise or integrate corporate governance expertise in existing organisational frameworks.

73. Harmonisation of regulatory frameworks, coordination of supervisory responsibilities and sharing of information on bank reviews should become a priority for MENA bank supervisors.

74. Further measures to improve the governance of banking regulators are welcomed by the Task Force in order to ensure, in particular, that supervisors have the necessary independence, accountability, transparency and integrity to perform their functions effectively.

Introduction

Background

Improving corporate governance standards in the MENA region is an essential element of corporate sector reform. To maintain financial stability in the region, there is a need to strengthen the banking sector's legal/regulatory standards and to improve its transparency and disclosure. Banks are especially well placed both to benefit from and to lead efforts to improve corporate governance practices in the region. Banks dominate the financial systems in the region and play a key role in the credit and investment process that is vital to economic development. Though the levels of banking intermediation in some MENA countries remain moderate when compared with OECD countries, bank loans constitute the most important form of external finance of the corporate sector. The dominance of bank credit as a means of financing can be explained by the business owners' preference for debt, as opposed to equity financing, which leaves more control in their hands. Given the relatively underdeveloped markets for listed bonds, particularly in the absence of a yield curve for public debt in many countries, bank financing, as opposed to issuance of public debt instruments, remains the preferred option.

In addition, the banking sectors in a number of MENA countries are continuing to experience growth, owing to the development of financial infrastructure in the region and the greater need for financial intermediation associated with higher economic growth. Further accentuating this trend is the fact that a number of MENA economies, not least in the Gulf region, are seeking to position themselves as financial centres. In part related to the continuing growth of banking sectors across the region, banks account for a significant portion of market capitalisation of MENA countries, despite the prevalence of non-listed banks. Across the region, banks are usually the main repository of savings and represent the most important source of corporate borrowing. In this regard, banks fulfil an important function since finance for entrepreneurship is scarce, and yet is urgently needed in order to provide the means for growth and employment creation.

The role of banks as financial intermediaries and the prudential considerations associated with bank oversight dictate slightly different corporate governance priorities as compared with other companies. Banks determine the destination of financial resources, which makes them a powerful engine of economic growth. They are also the fulcrum of the payment system and serve as a tool for the execution of domestic monetary policy. Shortcomings in bank corporate governance can destabilise the financial system and pose systemic risks to the real economy. Given the important socio-economic impact in case of bank failures, particular attention to corporate governance of banks appears warranted. On the other hand, developing governance standards for banks is challenging considering that banks are already subject to significant prudential requirements and that they can pose a systemic risk to the economy.

The consequences of inadequate corporate governance arrangements in banks have come under the spotlight time and again. The 1997 Asian financial crisis and other banking crises vividly demonstrated the damage that can occur when corporate governance standards in banks are weak. Various analyses of causes of the current financial crisis have likewise pointed to insufficient corporate governance arrangements in banks, concluding that corporate governance practices - if not the ultimate cause of the current crisis - could have prevented some of its manifestations. Clearly, insofar as bank failure might involve systemic risks for the broader economy, there are a host of other arguments for improving bank governance, which are closely linked to prudential concerns. Though in recent years MENA countries have avoided major banking crises and appear to have fared relatively well in the current financial turmoil, this is not a sufficient justification to dismiss the lessons learned elsewhere. Going forward, these lessons may help regional banks steer clear of the issues that have recently affected some OECD economies, previously thought to have developed and well-supervised banking sectors.

Recognising the special role played by banks in MENA economies and the potentially disastrous consequences of bank failures witnessed in other countries, corporate governance of banks was established as a priority for OECD's work in the region. *The Dubai Declaration*, adopted in November 2006, called for the establishment of a regional Task Force on Corporate Governance of Banks. Following this call, the MENA-OECD Working Group on Corporate Governance, with the valued support of the Hawkamah Institute for Corporate Governance (hereafter, Hawkamah) and the Union of Arab Banks (UAB), established a Task Force in early 2007 with a mandate to develop a Policy Brief on the corporate governance of banks in the MENA region. Since then, this Task Force has met in Amman in February

2007, in Doha in November 2007; and in Dubai in October 2009¹; two other consultations were held (in Paris in June 2008 and in Beirut in May 2009). The objective of these discussions was to reach a consensus around the key corporate governance challenges facing banks and their supervisors as well as to discuss appropriate policy recommendations relative these challenges, to be covered in a Policy Brief.

Methodology

The drafting of this Policy Brief was supported by a survey issued jointly by the OECD and Hawkamah in 2007 and disseminated, with the assistance of the UAB, to selected experts from the MENA countries in order to collect factual input. The questionnaire was circulated on the understanding that the responses do not necessarily represent the views of the organisations to which the respondents belong, but would be regarded as their personal opinions. In total, 30 responses from 8 countries were received. The central banks of Bahrain, Egypt, Jordan, Lebanon, Oman and Qatar responded on behalf of their constituencies. The questionnaire was also completed by private sector institutions in Egypt (7), Jordan (13), Kuwait (1), Lebanon (2) and the UAE (1). The individual responses remain confidential, although in the case of the six responses from central banks the source of the information will be readily evident.

Part I of the questionnaire was designed to establish how far the actual practices followed in MENA are in line with international standards. Part II, intended to be completed by banking supervisors only, aimed to collect data and additional factual information, in order to understand the context and inform the discussions of the Task Force. A summary of the responses received is attached as Annex I.

The responses reveal that while much of the infrastructure for good governance of banks participating in the Survey is in place, some banks have a long way to go in order to be considered in line with evolving international good practice. Further improvement is clearly needed since, as mentioned earlier, MENA banks play a dominant role in regional finance and can act as leaders in improving corporate governance of other firms by setting benchmarks not only by their own behaviour, but also by monitoring the governance arrangements of their corporate borrowers. An additional reason why further progress is needed is that the responses to the Survey

¹ In particular, the October 2009 Task Force meeting served as platform to discuss the applicability of the lessons learned from the financial crisis to the governance of regional banks.

received represent a limited sample and it is very likely that those who have responded can be characterised as corporate governance leaders in the region. The selection bias of this exercise should be taken into consideration when interpreting the results of the Survey and the observations made in this Policy Brief.

The Policy Brief is designed to provide practical recommendations on corporate governance practices in the banking sector, and is relevant not only to banking organisations, but also banking associations, institutes of directors, banking supervisors and other institutions working on improving corporate governance in MENA countries. It provides practical guidance for a variety of banks, be they listed or privately held, conventional or Shari'a compliant, controlled by a block holder or characterised by widely dispersed ownership, privately or state-owned. The Policy Brief is non-binding and has been prepared on a consensus basis. The Policy Brief does not advocate a standardised approach to corporate governance and does not suggest that identical, best practice governance arrangements should be replicated in all MENA banks. Instead, it raises specific considerations for banking institutions such as family- and state-owned banks, as well as Shari'a compliant banks. These recommendations are not exhaustive, only intending to highlight key issues that have arisen in discussions during Task Force meetings.

The policy recommendations contained in this document are consistent with and based on existing international guidance. Specifically, they are consistent with the *OECD Principles of Corporate Governance* and the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (where applicable) as well as the *Standards on Enhancing Corporate Governance for Banking Organisations* issued by the Basel Committee. Other Basel Committee documents, such as the *Core Principles for Effective Banking Supervision (2006)*; *Internal Audit in Banks and the Supervisor's Relationship with Auditors (2001)*; *Compliance and the compliance function in banks (2005)*; *The relationship between banking supervisors and banks' external auditors (2002)*; *Enhancing Bank Transparency (1998)* have been taken into account. Recommendations issued by the Hawkamah Institute for Corporate Governance, the Union of Arab Banks, and the International Finance Corporation in the course of their work in the region have also been considered.

Implications of the financial crisis

The policy recommendations provided in this document have been modified to incorporate the recent lessons learned from the financial crisis, to the extent that they are relevant to the MENA region. At this juncture, it

is difficult to estimate the exact impact of the financial crisis on MENA banks, since only a limited number of them have quantified and declared their exposure. The banking sectors of MENA countries have performed relatively well throughout the financial crisis, with the exception of some banks domiciled in Gulf Cooperation Council (GCC) countries. In particular, some analyses demonstrate that Islamic financial institutions, while not immune from the crisis, have been less impacted to date than conventional financial institutions.² Overall, the deterioration in the performance of MENA banks is related to the slowdown of economic activity in the region triggered by the deceleration in global demand (including for natural resources), as opposed to the contagion in the financial sector.

Nonetheless, while some observers have predicted that MENA financial institutions will remain unaffected by the crisis, this has been proven false. The financial performance of Gulf banks has declined due to the significant loans they extended in the preceding boom years for real estate and equity purchases, the value of which has declined dramatically. In addition, the relatively greater financial integration of the Gulf countries in international financial markets has exposed them to the toxic financial instruments (collateralised debt obligations and others).³ For Gulf banks, but also for banks in other MENA jurisdictions, performance has been affected primarily through two main channels: the lower lending volumes associated with lower liquidity and a drop in brokerage fees associated with a decline in stock market activity.

While MENA banks have performed relatively well compare to their international competitors, that is not, in most cases, a result of their governance practices. Instead, it is a product of other temporary trends which may or may not prevail in the future. Notably, the resilience of MENA banks is largely attributed to the lower financial integration of MENA economies in global financial markets. As the rest of the region follows the trend set by the Gulf countries and becomes more financially integrated, it will become increasingly exposed to sophisticated financial instruments, and its regulators and bankers will need to be equipped with tools and skills necessary to manage the risk profile of their institutions.

² Standard and Poors (2009). *Rated Gulf Financial Institutions and Takaful Companies Have Shown Resilience To Global Market Dislocation, But They Are Not Risk Immune.*

³ For example, a number of Gulf banks have been exposed to the Lehman Brothers collapse in September 2008 through US bank bonds, investment products Lehman structured and derivative trades where it acted as counterparty.

Furthermore, the significant exposure of a number of MENA banks to the real estate sector potentially underscores a deficiency in risk management processes and structures, which has also been observed to be one of the more glaring shortcomings coming out of the present financial crisis.⁴ The financial crisis has also revealed the significant concentration in MENA banks of loans to specific individuals/businesses whose financial affairs have been negatively impacted by the crisis. This is indeed unsurprising given the prevalence of "name lending" in the region. As demonstrated by the recent scandal surrounding loans extended to the Alghosbi and Saad groups⁵, this practice can be quite dangerous for the sustainability of regional banks.

Clearly, not all of the lessons learned about the role of corporate governance practices in bank performance in North America or Europe are relevant to MENA countries. A number of key differences stand out. First, MENA banks generally have a more conservative lending approach and prudential regulators in a number of countries require local banks to have high capital adequacy ratios.⁶ That being said, the focus on capital adequacy ratios has been noted as one of the problems that led to the current financial crisis. Second, the question of reform of remuneration and incentive schemes for key executives and middle-management, much debated in OECD, does not appear equally relevant in the MENA region, where complex equity compensation strategies have only recently begun developing. Last but not least, the question of shareholders being able to effectively participate in governance requires a different approach in the context of MENA banks, which are characterised by high to moderate ownership concentration, with either majority shareholders or large block holders.

On the other hand, board oversight, in particular of the risk profile of a bank, has also been observed as deficient in a number of for MENA banks, currently overexposed to the real estate sector. Risk management practices are also seen to be lacking. Therefore, for MENA regulators and banks, ignoring lessons learned from the financial crisis and the reform of relevant

⁴ Banks in the UAE and Kuwait are reported to have the highest exposure to the real estate sector, standing at 35% and 31%, respectively, of their loan books in the first half of 2008.

⁵ Standard and Poors estimates the exposure of some Gulf banks' at over 20% of banks' adjusted total equity.

⁶ Data published by IMF in May 2009 demonstrates that the capital adequacy ratio of all MENA countries (for which information was provided) was above 10%. Egypt and Jordan had capital adequacy ratios of above 15%.

standards and principles would have its opportunity cost. While the lessons emerging from the European and North American banking corporate governance debate are not directly transposable to the MENA region, they are not irrelevant either. The underlying conflicts of interest present in MENA banks are not entirely different from their counterparts in OECD countries. Furthermore, as practices such as asset securitisation mature, and as MENA countries' financial sectors become more integrated with global financial markets, the relevance of the lessons learned from the present financial crisis is likely to increase. Already, some parallels between the origins of the crisis in MENA countries and some OECD countries (i.e. Ireland, Spain), provide some food for thought for MENA banking regulators.

The Characteristics of MENA Banks and the Importance of Good Governance

"Given the historically dominant role of banks in the economies of MENA countries, they have an obligation to act as corporate governance leaders in the region." Dr. Fouad Shaker, Secretary-General, Union of Arab Banks, 2009

Key features of MENA banking sectors

The banking sector landscape in the region is characterised by moderate to high level of concentration, due to the presence of family-controlled banks and the presence of company groups which include banks. The vast majority of large companies in the region have come into existence as family businesses or businesses of a number of influential families. Family control by the founders or the descendants remains the norm in most of the countries among the large non-listed, as well as small and medium-sized, enterprises. Despite efforts of the authorities to increase the free float of listed companies, it remains rather low by international standards. Minority investor protection arises as an obvious concern in this context. The risk that bank boards are dominated by controlling shareholders and are not capable of exercising an objective and independent judgement is not negligible and is also addressed in the Policy Brief.

The ownership composition in the region also highlights a substantial role of families, often facilitated by nominee accounts. Individuals among the top five shareholders are mostly family members or close relatives holding high level executive positions within the bank. Family and other controlling shareholders influence corporate decisions also indirectly through their stakes in a number of holding companies and subsidiaries. Family owners often list companies for reasons associated with prestige, but are often reluctant to conduct secondary offering, at least those that would require them to relinquish control. Non-family shareholders often hold comparatively low stakes in publicly listed companies and effectively do not participate in their governance. The prevailing practice of raising equity

through rights issues, allowing existing shareholders to buy shares before they are offered to the public, is one of the reasons why the levels of ownership concentration are maintained.

In most countries of the region, state-owned banks can be found, but they no longer account for a significant proportion of the banking sector, particularly with the entry of foreign competitors. State-owned banks still play an important role in countries such as Syria and Egypt. The relaxation of ownership restrictions and limits on foreign investment, have increased foreign participation in MENA banks, and even some state-owned banks. The privatisation process of state-owned banks is ongoing in a number of MENA countries, but faces some challenges. In the past, banking sector privatisation in the region was fraught with difficulties related to significant non-performing loans of SOE banks. The overall levels of non-performing loans in the MENA region have been historically high, especially in SOE banks. Looking at the recent figures, non-performing loans are estimated at over 16% in Egypt and Tunisia, 7% in Morocco and 5% in Syria (IMF, 2009).

Recognising some common patterns in the structure of banking sectors begs the need to also recognise some relevant differences. First of all, the corporate governance and general legal/regulatory frameworks for banks, as for other companies, are rooted in different legal traditions. The Gulf Cooperation Council Countries, Egypt, Jordan and the Palestinian National Authority converge to the common law system, while the rest of the countries rely on the civil code tradition. The French legal system is of clear influence in North African countries (Egypt, Morocco, Tunisia, Algeria) whereas other countries are more influenced by Anglo-Saxon legal tradition. Interestingly, despite this diversity of legal traditions, single tier boards prevail across the region, with the exception of Morocco where banks have a choice whether to have a dual or a single board structure, as indeed do other companies. In most countries in the region, the legal system is also compatible with the Shari'a law, although this compatibility is assured through different mechanisms.

Corporate governance frameworks

The awareness of the need to improve corporate governance practices of banks in the MENA region has been growing in recent years. According to one recent survey, 76% of MENA banks cite corporate governance as being an important consideration.⁷ This statistic reflects in large part the

⁷ International Finance Corporation, Hawkamah Institute of Corporate Governance (2008). Regional Middle East and North Africa Survey.

significant efforts of supervisory authorities to raise banks' awareness of sound corporate governance practices. In addition, banks, even non-listed, have been subject to tighter governance requirements, which they have had to adopt or risk being penalised by their supervisor. In particular, MENA supervisors have introduced guidelines and regulations concerning a range of corporate governance-related issues, notably the composition of the board, disclosure requirements, risk management practices and related party transactions, in addition to existing prudential regulations. Many of these reforms have been inspired by international standards, notably those of the Basel Committee on Banking Supervision, and have taken the form of regulatory requirements.

At the same time, to the extent that banks are subject to the reforms of the general corporate governance frameworks (i.e. through tightening of the listing requirements for example), they have had to bring their arrangements in line with the requirements of the broader corporate governance framework in their jurisdiction. Over the past decade, a number of MENA countries have revised their listing requirements and general company legislation, bringing them more in line with the *OECD Principles* and other international standards. It is noteworthy that in a number of MENA jurisdictions (i.e. Egypt), the general corporate governance code applies to banks among other enterprises. In other countries, banking sector-specific corporate governance codes have been devised by banking associations and/or Central Banks. The development of governance codes seems to echo the responses to the OECD-Hawkamah Survey which noted that it would be desirable to develop corporate governance standards tailored to banks. The following table summarises the corporate governance codes that apply to regional banks and highlights other closely connected initiatives introduced by the regulators. Some of the codes listed in the Table below apply on a voluntary basis, whereas others have a more binding nature.

Whereas the MENA jurisdictions surveyed have improved their corporate governance frameworks in recent years, significant challenges arise in their implementation and enforcement. A number of MENA jurisdictions do not currently have in place the appropriate institutional infrastructure (e.g. sufficient resources, experience, and focus) necessary for effective enforcement. Policy makers should be aware that sound corporate governance of banks cannot be achieved without tackling the constraints and weaknesses of the supervisors. Likewise, improvements are not likely in the absence of engagement of management and the board. Where bank governance has improved in substance (i.e. beyond "ticking-the-box"), often it has been as a result of the approach adopted by bank management. Examples of banks which are considered to be leaders in governance include Burgan Bank (Kuwait), Arab Bank (Jordan), BMCE Bank (Morocco), Bank

Audi (Lebanon), National Commercial Bank (Saudi Arabia) and others. Without exception, in all of these institutions, improving corporate governance has been a matter of "tone at the top", as opposed to legal/regulatory compliance. While implementation challenges abound, banks in the region have opportunities to seek professional advice from international organisations and other specialists. For instance, the International Finance Corporation over the past year has worked not only with country authorities on devising standards but also with individual banks on implementing them. Likewise, the Union of Arab Banks, as a regional umbrella organisation, has issued *Guidelines for the Corporate Governance of Banks in the Arab Region* and a *Toolkit for Bank Executives* in 2009 and can provide implementation advice to individual banks.

Table 1. Corporate Governance Codes and Regulations That Apply to Banks in MENA Countries

Country Name	Code Name	Other related Initiatives
Bahrain	-----	Guidelines for banks based on Basel Committee's recommendations on Enhancing Corporate Governance for Banking Organisations
Jordan	Corporate governance code for banks	Bank Directors Handbook of Corporate Governance
Egypt	General corporate governance code applies to banks (under revision)	Draft Corporate Governance Guidelines for Egyptian Bank Directors
Lebanon	Corporate governance code for listed companies and banks (forthcoming)	Guidelines for banks based on Basel Committee's recommendations on Enhancing Corporate Governance for Banking Organisations
Morocco	Annex to the general corporate governance code pertaining to credit institutions (forthcoming)	-----
Saudi Arabia	Corporate governance code for banks (forthcoming)	Powers and Responsibilities of the Board of Directors in Commercial Banks in Saudi Arabia Qualifications and Requirements for Appointments to Senior Positions in Banks licensed in Saudi Arabia 1
Syria	Code of governance for financial intermediaries	
Yemen	Corporate governance code, annex specific to banks (forthcoming)	-----

Source: OECD, based on research and responses to questionnaires.

Note: 1. This is not the only example of a requirement bearing on the "fit and proper" standard in the region. In a number of jurisdictions, authorities have chosen to address the issue in other regulations.

Policy Recommendations

"Specific national banking crises in the past have been more severe – for instance, the collapse of the US banking system between 1929 and 1933. But what is unique about this crisis is that severe financial problems have emerged simultaneously in many different countries, and that its economic impact is being felt throughout the world as a result of the increased interconnectedness of the global economy." The Turner Review, 2009.

The policy recommendations provided in this Brief center around a number of key themes, namely: board performance, disclosure and transparency, conflicts of interests and related party transactions, as well as the role of remuneration practices. The selection of these themes was dictated by the ownership landscape of MENA banks, the regulatory frameworks they are subject to, as well as the remaining challenges underscored by the OECD-Hawkamah Survey and other available research. The remuneration practices in banks have also been highlighted as crucial in the wake of the financial crisis. Therefore, guidance provided by this Policy Brief on remuneration has been expanded.

Board performance

Existing research underlines that bank boards in the MENA region are underdeveloped, in part owing to the fact that the role of the board is at times misunderstood. According to the IFC-Hawkamah survey, 93% of banks stated that the board, and not management, was responsible for setting corporate strategy, which is contrary to the good practice that management develops, and the board reviews and guides corporate strategy. Furthermore, banks boards do not meet on a sufficiently regular basis in order to provide the necessary oversight of the bank's operations. In the MENA region only 27% of bank boards met a minimum of 10-12 times a year (IFC-Hawkamah Study, 2008). On the other hand, a study of select best practice European bank boards concluded that most boards met more than 10 times a year; in

addition, board committees meet separately.⁸ MENA bank boards are dominated by representatives of controlling shareholders and may not be capable of exercising independent judgment as recommended by the OECD's Principles of Corporate Governance. This forces the question to what extent there is a difference between "management" and "boards" in MENA countries, characterised by concentrated ownership in the banking sector. The following recommendations are motivated by these general observations regarding the key challenges in the performance of boards in MENA banks.

Functions and duties of the board

The *OECD Principles* provide that the board should fulfil certain key functions, including reviewing and guiding corporate strategy, major plans of action, risk policy; monitoring the effectiveness of the company's governance practices and making changes as needed; selecting, compensating and monitoring key executives and monitoring succession planning, aligning key executive and board remuneration with the longer term interests of the company and its shareholders; ensuring formal and transparent board nomination and election process; monitoring and managing potential conflicts of interest. The Basel Committee's guidance allocates a similar role for bank boards. In MENA banks, and more generally, in listed companies in the region, the role of the board in providing strategic guidance and oversight over management is not always understood. ***The Task Force considers that regulators should define director duties more concretely and ensure that directors fulfil them in practice. Banking supervisors should also help banks introduce training programmes which would increase the awareness of boards' responsibilities in terms of corporate governance.*** Institutes of Directors, recently established in some MENA countries, would also be useful in this regard.

Banking products and banking transactions are becoming increasingly complex, often involving counterparts in other jurisdictions, and are subject to more specific and technical codes, standards and regulations. Bank boards need to take special care that they remain involved in strategic issues rather than becoming immersed in day-to-day management of the banks, in essence, that they focus on the "big picture" and do not attempt to micro-manage. On the other hand, bank boards ought to gather sufficiently

⁸ Stilpon Nestor (2007). *The Turnkey Role of the Board in Strengthening Corporate Governance: A Comparison of CG Practices in 10 Best Practice European Bank Boards.*

frequently in order to remain up-to-date on strategic issues the key risks faced by banks. Bank boards need to carefully consider the frequency of their meetings that would allow them to fulfill their responsibilities with due diligence. As highlighted above, the frequency of board meetings in some MENA banks appears insufficient to ensure that the board fulfils its functions with adequate care.

If the board is to fulfill its functions properly, it needs to ensure that it receives sufficient flows of information, internal and external, as well as adequate administrative support. In this regard, the OECD Principles suggest that board members should have access to accurate, relevant and timely information in order to fulfill their responsibilities. The current financial crisis has highlighted the fact that in a number of instances, information received by boards was not complete or provided in a format that would not enable board members to understand the nature of risks faced by the bank. Boards should have the financial resources to obtain additional advice and analysis from outside experts when appropriate. In terms of administrative resources, a qualified secretary to the board should be appointed to ensure the efficiency of board procedures and also to advise the board and its members of their corporate duties. Board members, especially non-executive directors, should have access to bank staff and other technical expertise, including opportunities to obtain views from internal and external auditors.

Members of the board are accountable to the company and its shareholders and have, inter alia, a duty to act in their best interests. In addition, members of the boards are expected to take due regard of and deal fairly with other stakeholder interests, most notably in the case of banking institutions, the creditors. The fiduciary duties of board members include the duty of care and the duty of loyalty. The fiduciary duties of banks' board members are arguably more onerous than those of other companies – irrespective of the legal traditions of the jurisdiction where the banks are operating – due to the fact that banks accept money in the form of public deposits. Board members of banks need to be conscious, and be regularly reminded by banking supervisors, of their fiduciary duties to depositors, as well as shareholders. Recent discussions regarding the potential breach of fiduciary duties by bank directors in some large financial institutions (i.e. Bank of America's board during the acquisition of Merrill Lynch), highlight the importance of this issue but also the evolving interpretation of how far the fiduciary duty of a bank director extends. Increasingly, the liability for a breach of a fiduciary duty can extend beyond an affirmative wrongful conduct by a director to directors' failure to properly oversee the operations.

An interesting finding of the OECD-Hawkamah Survey is that with the exception of Kuwait, the majority of regional banks do not arrange for

insurance cover for directors in case they are subject to a legal action against them. This finding is not necessarily inconsistent with the practices in other corporates in the MENA region, but it does raise questions about the ability of shareholders and stakeholders to take legal action against directors whom they presume to be in breach of their duties. The Task Force is of the opinion that board member liability and how board member duties are specified should remain on the policy agenda since it is not clear that effective arrangements are yet in place. In particular, the duty of loyalty is extremely important, since many MENA banks are often controlled by a group company. For board members who are working within the structure of a group of companies, the duty of loyalty should be specified to the bank and all of its shareholders, and not exclusively to the controlling company. Given the concentrated ownership landscape of MENA banks, it is also important to ensure that board members treat all shareholders equally, carrying out their duties in an even-handed manner with respect to all shareholders.

The discussion about director duties brings up the question of protection of minority investors in MENA banks, judged by Task Force members to be of significant concern. Ex-post but also ex-ante minority investor protection is a concern not unique to banks in the region. Though the Task Force stopped short of suggesting that cumulative voting or minority investor representatives on boards should be made a part of the legal/regulatory framework, members did express the view that such mechanisms for minority investor participation in board discussions should be fostered. Whereas for listed banks, minority investor protections might be addressed through the broader regulatory framework, this may not be the case for unlisted banks, leaving a vacuum to be filled by banking regulators. A variety of measures, which cannot be exhaustively examined in this document, can be proposed in this regard.

Committees of the board

The Basel Committee's guidance on *Enhancing Corporate Governance for Banking Organisations* notes that bank boards have found it beneficial to establish certain specialised committees. The OECD Principles further recommend that when committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board. Examples of committees most frequently established by MENA banks include the audit committee, the risk management committee, and the compensation committee. All committees should be accountable by having well-defined and transparent mandates, composition and working procedures. It is also worth considering occasional

rotation of their Chairs and members. Committees of the board need support from the board for the decisions they reach, and in order to ensure that their recommendations are carried out in a timely fashion. ***It is important that board committees receive adequate resources, information, investigative powers and recognition within the bank.***

In MENA Banks, the audit committee is the most commonly established committee. The OECD-Hawkamah Survey results show that while audit committees are mandated in five of the countries that responded to the survey, they are not currently mandated in all MENA jurisdictions.⁹ As the Basel Committee's corporate governance guidance stipulates, the audit committee is typically responsible for providing oversight of the bank's internal and external auditors; approving (or recommending to the board of directors or shareholders for their approval) the appointment, compensation and dismissal of both internal and external auditors; reviewing and approving audit scope and frequency; receiving and questioning audit reports; and ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors. ***While recognising the value of other committees, the Task Force believes that one of the most important committees for MENA banks is the audit committee.***

Available statistics indicate that 84% of banks already have an audit committee with a defined charter.¹⁰ Establishment of an audit committee or its equivalent should be a priority for all MENA banks which do not possess one. An audit committee should ideally be composed of a sufficient number of non-executive or independent directors with appropriate banking or financial expertise. An audit committee or an equivalent body should, amongst other duties, ensure that the bank adheres to accounting and auditing standards and practices in the jurisdictions where it operates. It should also oversee the internal audit process and audit reports on matters concerning the effective implementation of policies and controls that are within the competence of the committee; make sure that the banks and its staff comply with all applicable laws and regulations; and be kept informed of major balance-sheet activities. Any differences of view between the external auditor and the management on accounting issues, particularly if the management is inclined to reject the external auditors' opinions, should also be brought to the attention of the audit committee.

⁹ In a notable departure, Lebanon reports that the prevalence of audit committees in the banking industry is far from uniform (approximately in 50% of banks).

¹⁰ Union of Arab Banks (2007). Corporate Governance Survey in the Arab Banking Sector.

The financial crisis has illustrated the importance of a more future-oriented risk committee. Its role should include reviewing the implementation of risk management policies and also obtaining from senior management periodic information on both risk exposures and risk management activities. It should ensure that an adequate process of risk management is developed, that controls are properly enforced, that management conducts stress tests and that their results are shown to the board. The board would then be in a position to decide whether to reduce or hedge risks if the potential losses are intolerable. A board level risk committee should also review and provide guidance about the alignment of corporate strategy with the risk appetite and the internal risk management structure. ***The establishment of a risk monitoring committee, with the primary duty of overseeing that the bank's risk management system is properly implementing the risk policy of the bank, is strongly advisable.***

Information technology (IT) governance provides the structure that links IT processes, resources and information to enterprise strategies and objectives, enhances effective board decision-making and creates greater transparency and accountability. Information technology (IT) governance is integral to the success of a modern bank, ensuring that related risks are properly identified and managed. IT governance is becoming an increasingly important aspect of banks' budgets on the one hand, and operational vulnerabilities on the other. For large banks in particular, the board needs to sign off on significant IT expenditures as well as keep a close track of all aspects of IT governance, including procurement and outsourcing, the efficiency of systems and procedures, back-up and standby arrangements, IT security, customer data protection, and the adequacy of anti-fraud methods. It is noteworthy that nowadays, the incidence of internal and external fraud is often related to a failure to manage IT related risks. ***Information technology governance is a responsibility of the board of directors and executive management, and the Task Force is of the opinion that it merits the specific attention of a board committee.***

In principle, boards should have a committee whose principal task is to nominate senior executives and new board members, including the Chairman of the board (usually called a Nomination Committee). ***The Task Force considers that a competent committee of the board should, at minimum, be responsible for the nomination of a bank's Chairman.*** In many MENA banks, the Chairman tends to be selected by the controlling shareholder; indeed the Chairman may even be the controlling shareholder or one of his close relatives. In 3 of the MENA countries responding to OECD-Hawkamah Survey (Bahrain, Egypt and the UAE), there is mandatory separation between the roles of the Chairman and General Manager. In other countries practices vary significantly. Overall, it is

estimated that approximately 75% of Arab banks have a separation between the roles of the Chairman and the CEO. Although mandatory separation of the positions of chairman of the board and chief executive officer (CEO) is not widespread in MENA, *the Task Force considers that the separation of these two posts contributes to the achievement of appropriate checks and balances, increased accountability and improvement in the board's capability for independent decision-making.*

To avoid the proliferation of board committees, a useful alternative, at least in the case of smaller banks, may be to establish a single committee that combines the responsibilities for nomination, remuneration, succession planning and other concerns including their ongoing training and access to technical support and information. Such a committee (which is sometimes called a governance committee, a consultative committee or an executive committee) should also regularly evaluate the performance of board members and the board as a whole in a fair and constructive manner based on clearly-defined criteria. It is essential that any such committee, ideally made up of independent or non-executive directors, possesses the necessary capacity for objective and independent judgment.

In the case of two-tier board systems, the Chairs of the two boards should be different persons. This is commonly mandated in OECD jurisdictions where two-tier boards exist. In addition, the head of the management board should not become a Chair of the Supervisory Board upon retirement. A former CEO of a bank is likely to be too close to his successor and to the internal processes to be able to take on the appropriate oversight role. While a number of policy options exist to ensure that in the dual board context, the two Chairs are not the same, and that the head of the management board does not become the Chair of the Supervisory board at a later stage, such prohibitions could potentially be incorporated into corporate governance codes.

Composition of the board

Both the OECD Principles and the Basel Committee's guidance on corporate governance suggest that boards should be able to exercise objective, independent judgement on corporate affairs. Although the Principles do not take a stand on what proportion of the board should be capable of such judgement, they do suggest that a sufficient number of non-executive board members be appointed on the board. Ideally, each board should have a sufficient number of board members with the knowledge and experience to challenge the management on any of the activities in which the bank is engaged. The Basel Committee's corporate governance

guidance (2006) specifies that at least 1-2 directors with an understanding of the banking business are required.

The OECD-Hawkamah Survey responses reveal some concerns about the adequacy of bank directors' skills in the MENA region. This is an important observation given the spotlight that the financial crisis has placed on the failure of bank boards, in part attributed to their poor understanding of financial instruments and risk exposures (i.e. Lehman Brothers). The perception that boards of MENA banks lack the necessary skills is somewhat unsurprising given the existing board nomination procedures, which are also addressed in this Policy Brief. ***Directors' skills should be enhanced by ongoing training programmes that underscore the professional, ethical and technical demands imposed by the increasingly complex industry practices.*** In this regard, it is important to note the concept of competencies is not a static one and should be reviewed in the context of relevant developments.

It is estimated that only 35% of MENA banks conduct formal training for board members (UAB, 2007). This may be in part related to the fact that board members believe themselves to be "above training", and in part due to the fact that internal corporate governance know-how is lacking, as are qualified external trainers. In the wake of the crisis, some countries have considered introducing measures whereby annual training for board members will become compulsory. Such training could be provided by, for example, stock exchanges or professional associations such as banking industry associations or institutes of directors. Continuous monitoring of board competencies is necessary to ensure that appropriate skills are represented on bank boards and that they continue to function effectively. Board evaluations, which incorporate an assessment of member competencies, have been made mandatory for banks in some countries (Bahrain, Kuwait), but are optional in most other MENA jurisdictions. As a result, in the region, only 20% of banks are estimated to conduct board evaluations (IFC-Hawkamah, 2008). ***The Task Force recommends that the performance of individual board members and the board as a whole should be regularly evaluated.***

Perhaps surprisingly, the OECD-Hawkamah Survey responses reveal broad satisfaction with MENA banks' procedures for appointing new board members. However in practice, controlling shareholders, often appoint the entire board (particularly in the case of family-owned banks). Thus, the objectivity and independence of the board can be undermined, and the resulting value of nominally "independent" directors can be marginal. In fact, whether there is sufficient independence of mind on boards of MENA banks is questionable. Recent figures demonstrate that 54% of banks do not have a single independent director. Most national guidelines stipulate that at

least half the board should be non-executive directors, which however does not imply that half should be truly independent.¹¹ In Egypt, at least half of bank boards are required to be constituted of qualified independent directors; in Jordan, a quantitative limit has been established (2 minimum). No MENA jurisdiction has adopted a regulatory approach similar to one adopted in Italy which required that board members representing minority shareholders be appointed. This policy option may be of interest to supervisors in the region as it would likely lead to a greater diversity on bank boards, at the same time providing an additional protection to minority shareholders. ***It is recommended that bank board should have a majority of independent, or non-executive directors, to ensure the necessary checks and balances.***

The very definition of what would constitute an "independent director" in a number of MENA jurisdictions is however lacking. A key shortcoming is that a number of governance codes or other relevant regulations in the region simply recommend that boards appoint non-executive or independent directors, without specifying what would constitute "independence". In Bahrain, Kuwait and Oman, the characteristics of an "independent director" are defined, and in 3 MENA countries surveyed by the OECD, names of independent directors are required to be noted in banks' annual reports. ***The Task Force advocates that MENA countries should continue to refine the definitions and the expected proportion of "independent" directors on bank's boards.*** In defining who an "independent director" might be, it is important to underline that such directors should be independent not only of management but also of controlling shareholders. ***A related issue to address is the tenure of board members and how that might affect their objectivity.*** Regulators should consider establishing limits on board tenure.

While establishing necessary conditions, "negative" criteria defining who may not be defined as an independent director can be complemented with "positive" examples of necessary qualities which increase the probability of effective independence. Small jurisdictions often have a problem of very close relationships among banks and related circles and this may require further policy initiatives.¹² That being said, it is recognised that in some MENA jurisdictions the supply of qualified directors may be limited and it may even be very difficult to find directors with the necessary skills who do not also have conflicts of interest. That is precisely the reason

¹¹ A non-executive board member can also lack independence if he/she has ties to the bank or its management.

¹² For example, as a result of the scandal in the Irish banking sector, the regulator has moved to bank cross- directorships.

why this Policy Brief does not rule out the appointment of directors who have conflicts but recommends that such conflicts should be disclosed and prudently managed. *The Task Force considers that it is preferable to hire well-qualified directors and manage resulting conflicts of interest in an ethical manner than to have boards lacking the necessary collective skills.*

Bank supervisors generally insist that board members and executives should fulfil the established “fit and proper” requirements regarding their competence, integrity and qualifications. In a number of MENA countries including Jordan, Kuwait, Oman and others, the board is required to have a quorum of “fit and proper” board members. To the extent that in a few MENA jurisdictions banks are required to obtain the supervisors’ approval for key board appointments (Bahrain, UAE), *supervisors have a role to play in ensuring that board directors satisfy the “fit and proper” test.* In some countries, the supervisor is not only engaged in the assessment of the character of each of the bank’s board members, but also of their expertise. In its recent analysis, the OECD has suggested strengthening the “fit and proper” test to technical and professional competence, including general governance and risk management skills, and potentially to term limits on board membership. In addition, whether board members are “fit and proper” to serve in their position should be re-assessed on a continuous basis.

Ethical standards of the board

It is a fundamental duty of board members to avoid conflicts of interest. Conflicts of interest arise when an individual becomes privy to any information from which they can benefit personally, for which opportunities in the banking industry are significant. Responses to the OECD-Hawkamah Survey highlight that a number of MENA Central Banks have established rules designed to avoid conflicts of interest. For instance, Jordan’s Banking Law 28/2000 obliges all bank administrators to disclose any interests in dealings or contracts to which the bank is a party, and they are not permitted to participate in meetings where the said matter is discussed. Where banking regulations do not bear on conflict of interest situations, they are often addressed in the general companies or securities legislation/regulation. According to the Union of Arab Banks’ 2007 corporate governance survey of the banking sector, 88% of MENA banks oblige board of directors and executive management to disclose material interest in transactions. *Bank management and board members should not act to profit personally from inside information, even if this is not an offence in their jurisdiction. They should also abstain from voting or even taking part in decision-making processes on any matter where they have an actual or potential conflict of interest.*

Banks in the region should not rely entirely on the regulatory frameworks to prescribe acceptable behaviour of bank board members. It is incumbent on board members to observe and promote high ethical standards. ***Banks should take the initiative to develop and enforce codes of conduct (or a code of proper practice) for their employees, management, and for the members of the board themselves.*** In some jurisdictions in the region, bank supervisors already request that the board approves a code of conduct (i.e. Bahrain). The bank codes should emphasise principles and avoid as far as possible box-ticking behaviour. Codes of conduct need to clearly prohibit unacceptable practices such as insider trading. The OECD-Hawkamah Survey responses confirm that most of the MENA banks have codes of conduct in place. Efforts are needed to ensure their implementation is taken seriously and that the responsibility for monitoring their implementation is appropriately located within the organisational structure of the bank.

The board is crucial in developing a sound corporate governance framework for the bank. The board should clearly define areas of responsibility, authority levels and reporting lines within the bank. These relationships and the working practices/procedures of the board of directors should be fully documented and kept current. However, according to the IFC-Hawkamah 2008 survey, only half of the surveyed banks have assigned the responsibility for corporate governance policies to the board. Banks and regulators are encouraged to take note of this deficiency and move towards a system where boards' monitoring of governance includes a continuous review of the internal structure to ensure that there are clear lines of accountability for management throughout the organisation. ***Banks are also encouraged to define a corporate governance structure that governs its policies, standard operating procedures and internal control procedures.*** The supervisor might be interested to observe board meetings of banks, and indeed this is a common practice in some OECD jurisdictions. Boards should be willing to listen to their supervisor's advice or warnings and, when necessary, to reorganise their governance framework and operational procedures.

The role of remuneration practices in sound corporate governance

The role of remuneration practices and in particular, their role in aligning the incentives of banking executives with the objectives of banks, has been highlighted in the course of the present financial crisis. Various analyses of factors leading to the financial crisis have noted the role that compensation practices played in promoting the accumulation of risks. First, the compensation structures of senior and mid-level executives led to

imbalanced risk taking strategies by several financial institutions since their executives faced significant incentives to take on additional risks, while the downside of their doing so was marginal. Second, as the OECD noted in its analysis of the financial crisis, the success or failure of banks' governance systems might well be determined by an incentive system which is well below the level of key executives (i.e. Société Générale January 2008 scandal). Another area of concern uniformly highlighted by all reviews of remuneration systems in financial institutions was the absence of a risk adjustment in measuring performance for the purposes of variable remuneration.

Until recently, regulators did not focus sufficiently on the implications of the compensation system for the risk profile of a bank. Bank boards acted as if compensation systems were unrelated to risk management and risk governance. The performance of financial sector firms in the wake of the crisis has prompted a number of national regulators and international regulatory bodies to put forward guidelines or recommendations on executive pay. The European Commission has been seeking to bring forward legislative proposals to include remuneration schemes within the scope of prudential oversight. The Committee of European Banking Supervisors is publishing principles on remuneration policy addressed to both regulators and regulated institutions. The Financial Stability Board (FSB, formerly FSF) has released its own guidelines on compensation in April 2009, the *FSB Principles for Sound Compensation Practices*, which were endorsed by the G20 leaders and will form part of the Basel Committee's standards.

In OECD member countries, executive compensation has been on the rise in recent years at a much faster pace than average worker pay, and in a number of countries practices such as "golden handshakes" or compensation when a failed executive leaves the company (i.e. "rewards for failure") have been a source of concern. It is understood that in MENA banks, variable pay mechanisms are still a developing practice, as is their complexity. Practices such as "golden handshakes" or "golden parachutes", which have been isolated by various analyses of the role of remuneration in the financial crisis as having played a negative role, are not widely prevalent. Given these differences in the compensation practices between MENA banks and those domiciled in OECD countries, some attempts of OECD national supervisors to re-regulate pay practices may not be entirely relevant to MENA banks.

For instance, it appears that a number of measures adopted by national regulators such as deferrals of bonuses are not necessarily pertinent to MENA banks, whose compensation structures tend to favour fixed

remuneration components.¹³ Likewise, the "say on pay" measures adopted in many OECD countries¹⁴ may not be entirely relevant in the context of MENA banks, many of which are controlled by a majority shareholder or a block holder. Effectively, this points to a potentially larger role for banking supervisors in reviewing compensation structures in local banks. Indeed, the FSB Principles recommend that "supervisory review of compensation practices must be rigorous and sustained and any deficiencies must be addressed promptly with supervisory action." *Bank supervisors in the MENA region should give consideration to how the supervisory review process can include an assessment of risks emanating from banks' remuneration policies.* This appears to be particularly important in the context of the growing number of investment banks operating in the region.

As the Basel Corporate Governance Guidance notes, the remuneration structure for persons in senior positions needs to support the long-term profitability of the bank. In this regard, the executive compensation practices in MENA banks are different than those in their European and North American counterparts, where alignment of compensation with risk outcomes and their time horizon was observed to be lacking in past years. In many MENA banks, rewards often appear to be more closely correlated with individual status and family ties than with being commensurate with responsibilities and performance. It is worth pointing out that a remuneration committee or its equivalent, very common in banks in OECD member countries, remains relatively rare in MENA banks. Results of the UAB survey of MENA banks conducted in 2007 highlighted that only 55% of regional banks had a nomination and remuneration committee. Instead, compensation arrangements are often decided in shareholder assemblies, allowing majority shareholders to have control over remuneration practices.

The FSB Principles note that "the firm's board of directors must actively oversee the compensation system's design and operation". The OECD Principles arguably go further by recommending the boards "align key executive and board remuneration with the longer term interests of the company and its shareholders." In MENA banks, compensation arrangements for both boards and management may not be optimally

¹³ Corresponding with this observation, it is reported that bankers in the MENA region have experienced salary cuts of approximately 10% in 2008-2009. This is likely to reflect several factors including the strength of the impact of the economic slowdown on banks, but perhaps also the more conservative remuneration practices which rely more on fixed, as opposed to variable compensation.

¹⁴ In Italy, for instance, shareholders vote on remuneration of boards and management of banks. Other jurisdictions have adopted a non binding say on pay vote (UK, Australia) or a binding say on pay vote (Denmark, Netherlands, Sweden).

structured as noted above and this may put in peril the ability of the bank to attract qualified staff. Given these risks, *the Task Force recommends that MENA banks establish a special committee of the board, comprising wholly or a majority of independent directors, preferably with risk management expertise, that reviews the reward structure of the bank and establishes the salary structure for all bank employees and board members themselves.* Where committees have already been established, additional capacity might be needed in order to avoid over-reliance on remuneration consultants. Exclusion of the executives that sit on each other's remuneration committees should also be considered as this practice could lead to significant conflict of interest. In principle, it should be considered good practice that remuneration policies be submitted to the annual meeting and be subject to shareholder approval. However, as mentioned above, "say on pay" arrangements may not be ultimately effective given the concentrated ownership structure of MENA banks.

Beyond establishing a governance structure around remuneration, the absence of a coherent remuneration policy generates potential risks for a bank that needs to be contained. The *OECD Principles* recommend that boards "develop and disclose a remuneration policy statement covering board members and key executives". The exact form and the implementation of remuneration policy should take into account the size of the bank and the complexity of its activities. Such policy statement should focus on making compensation sensitive to risk outcomes and the horizons of risks. A remuneration policy statement can be made more useful if it includes measurable standards that emphasise longer term interest. ***Banking regulators in the region should require that boards develop a remuneration policy statement and monitor compliance with it.*** In addition, the compensation system should be also monitored and reviewed at lower levels of the organisation to make sure it operates as intended.

The OECD-Hawkamah Survey results highlight that in MENA countries, board remuneration policy is approved by the annual assemblies but in many cases the process for determining compensation arrangements is not transparent and actual amounts earned by the directors and senior managers are not disclosed. Unfortunately, this is not inconsistent with the practices adopted by corporates in other sectors in MENA countries. Lessons learned from the financial crisis also highlight that disclosure of remuneration policies and structures in banks worldwide, particularly, at their lower levels, has been poor. Based on internet disclosures provided by MENA banks, less than 20% of banks disclose remuneration of key executives (IFC-Hawkamah, 2008). ***It is considered a good governance practice to disclose in the annual report the executive and board member compensation on an individual basis, and also the earnings of other staff***

in an aggregated fashion. In addition to being disclosed externally, the remuneration policy of a bank should be transparent internally. Lessons learned from the financial crisis underscore that transparency in this area needs to be improved beyond disclosure. ***Banks, and indeed other corporations, should be able to explain the main characteristics of their performance-related remuneration programmes, including the total cost of the programme, performance criteria and how the remuneration is adjusted for related risks.***

Disclosure and transparency

Adequate disclosure and reporting to supervisors

Transparency of banks' operations, structure, and financial performance are important for a variety of reasons, ranging from prudential to corporate governance-related. Publicly traded and non-listed banks can pose the same types of risk to the financial system through their various activities, including their participation in payments systems and acceptance of retail deposits. Therefore, non listed banks should be required to provide similar information as are listed ones. In principle, disclosure should be proportionate to the size, complexity, ownership structure, economic significance and risk profile of the bank. Good corporate governance practice calls for the full annual financial statements, with supporting notes and schedules, to be compiled on the basis of internationally recognised accounting standards and practices. They should be available to depositors and other customers through the bank's website, on bank premises and/or in reports to supervisors (where such reports are available to the public). Such disclosure will provide a clear and comprehensive picture of the financial standing of the bank and enable counterparties and the financial community to exercise market discipline.

In the MENA region, a majority of banks comply with financial disclosure requirements mandated by law (typically including the financial statements, the Chairman's report and the auditor's report). On the other hand, non-financial disclosure remains weak, and this situation is indeed not unique to the banking institutions in the region. ***Improving non-financial disclosure standards for banks remains a priority for MENA supervisors.*** Among the types of corporate governance information that should ordinarily be disclosed are the bank's board and senior management structure, basic ownership structure, including information on beneficial owners, incentive structure, code or policy of business conduct and/or ethics, policies related to conflicts of interest, as well as the nature and extent of transactions with

affiliates and related parties (including any bank matters for which members of the board or senior management have material interests either directly, indirectly, or on behalf of third parties).

According to the UAB 2007 survey of the Arab banking sector, only 55% of surveyed banks publish documentation outlining the bank's governance structure, principal organs and relevant reporting relationships. Answers to the OECD-Hawkamah Survey indicated that of the jurisdictions surveyed, only in one country do banks' annual reports have to contain a separate chapter on the corporate governance processes. Interestingly, the two foremost factors found most significant in preventing effective disclosure in banks have been the lack of legal requirement and the absence of market demand for the information (IFC-Hawkamah, 2008). *Supervisors should be specific in establishing the elements of public disclosure for banks, while also working on changing the mentality of bank executives who view disclosure strictly from a compliance point of view, rather than as an effective tool for managing stakeholder relations and adding value to the business.*

Supervisory reporting enhances the ability of regulators to more effectively monitor the safety and soundness of banks and to advise them on possible weaknesses in their franchise. Regular supervisory reporting is essentially quantitative in nature and a number of references have already been made in this Policy Brief to matters that should be disclosed to the supervisor as and when they occur. *One issue that should be adequately addressed in MENA jurisdictions is the supervisory access to information about beneficial owners where they are not required to be publicly disclosed.* Although banking supervisors are the primary authority for ensuring prompt and proper disclosure by banks, securities regulators also exercise oversight and enforce standards related to accounting, audit, and non-financial disclosure for listed banks. Any shortcomings in listed banks' disclosure, that are identified either by banking supervisors, securities regulators or stock exchanges, should be promptly shared among them so that coherent corrective action can be taken or sanctions applied according to relevant laws and regulations.

In parallel to the adoption of Basel rules by MENA Central Banks, the implementation of the International Financial Reporting Standards (IFRS) has been underway in a number of MENA jurisdictions. In others (i.e. Egypt), the authorities have developed local accounting standards which in most respects are consistent with internationally recognised accounting standards. In fact, according to recent figures, banks are ahead of listed companies in the region in adopting the International Financial Reporting Standard, with 77% of banks reporting according to IFRS, as opposed to 58% of listed companies (IFC-Hawkamah, 2008). A particularly important

issue for MENA supervisors is to ensure that financial accounts are consolidated for banks that are part of a group. ***Consolidated financial reporting ensures that disclosure on intra-group relations, transactions and financial terms is made on a transparent basis and should be mandated by regulators.*** It was recently estimated that 84% of MENA banks which are part of a group prepare consolidated financial accounts ((IFC-Hawkamah, 2008). In a number of MENA jurisdictions, regulators do not require such reporting.

Sound risk management and internal controls

Regulators in all countries place considerable stress on the need for banks to maintain sound risk management and robust internal controls. To this end, many of them have adopted the Basel II framework. Basel II reinforces the need for sound risk management practices, recognising that measuring, managing and controlling risk is becoming more challenging as banking becomes increasingly complex and as operational risk in particular takes on new forms. The revisions to the Basel II framework issued in July 2009 contain further guidance in relation to the weaknesses that have been revealed in banks' risk management processes during the course of the latest financial crisis, including firm-wide risk management, capturing off balance sheet exposures, and managing risk concentrations.

In its analysis of the key risk management failures of the crisis, the OECD concluded that in many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Moreover, risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. As the financial crisis amply demonstrated, a key principle that clearly needs to be better implemented in banks all over the world is the board's oversight of the risk profile of the overall bank. The establishment of a risk monitoring committee, with the primary duty of overseeing that the bank's risk management system was already recommended above. Some MENA countries such as Oman and Qatar already require the constitution of a risk management committee in banks, others like Egypt and Jordan do not, with the consequence that risk management committees are present in an estimated 50% of the regional banks.

The OECD has recently recommended introducing the role of a Chief Risk Officer (CRO) responsible for risk management, with direct access to the board. The CRO should lead a risk management function which has the responsibility of identifying, measuring and reporting on risk exposures. The CRO should have a reporting relationship to the board in order to make sure the board receives the necessary information about the risk profile of the

bank. This is an important point given that in the region, there appears to be very few cases where the CRO reports to the board (13%, according to IFC - Hawkamah, 2008). Overall, the role of the CRO is not very prevalent in MENA banks. This is contrary to the practice adopted by large internationally active banks which appoint a senior executive with the responsibility for the risk management function and the institutions' organisation-wide risk management framework. ***Establishment of the role of CRO with adequate powers and a reporting relationship to the board would be advisable in MENA banks.*** CRO removal, on the other hand, should be subject to board discussion and public disclosure.

As opposed to risk strategy, internal controls are embedded in a bank's daily activities and should be designed to ensure that financial statements are accurate and subject to appropriate policies and procedures, legal and regulatory processes. Responses to the OECD-Hawkamah Survey demonstrate a lack of confidence in the reliability of MENA banks' internal controls. This is indeed unsurprising given that only 62% of MENA banks report having either a risk manager or a risk department in place (IFC-Hawkamah, 2008). ***Good practice requires that senior management reports at least once a year to the board on the scope and performance of the internal control system, providing an opportunity for the board to review the efficiency of the controls.*** This is also a recommendation of the Basel Committee's internal audit paper (2001). In ensuring that the board is sufficiently informed, management will have to make a judgment on how to filter information to ensure that only relevant information reaches the board.

Risk policy may be more difficult to establish and monitor in banks which have cross border operations or complex ownership structures. The Basel Committee's corporate governance guidance recommends that the board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (so-called "know-your-structure"). Although banks may choose to operate in a particular jurisdiction or establish complex structures for legitimate business purposes, such operations can pose financial, legal, and reputational risks. In addition, banks may also be exposed to legal and reputational risk indirectly when they perform certain services or establish opaque structures on behalf of customers. ***The bank's board of directors should constantly review the appropriateness of, and set suitable limits on, the bank's operations in risky jurisdictions, and should ensure that senior management establishes policies for managing the risks associated with them.***

A few risk management issues to which particular attention needs to be paid in the MENA region, noted elsewhere in this Policy Brief, are related party transactions in group companies and lending to outside parties on non-

arms' length terms. More recently, the issue of "name lending" has been dominating the regional media. A global downturn has put a strain on the key sectors of MENA economies, which has resulted in several large regional firms being on the brink of bankruptcy proceedings, or actually collapsing. The default of some large family conglomerates (i.e. the Saad, Algosabi, and Al Tuwairqi groups) have demonstrated the downside of a common practice in MENA countries "name lending", where banks lend to family groups on the strength of their name and reputation, as opposed to based on the assessment of relevant financial and non-financial information. In such circumstances, regulators can play a key role by promptly requiring local banks to declare their exposure. ***In addition, supervisors should compile figures on banks' consolidated exposure to group companies*** (as it done, for example, by the German Central Bank, the Bundesbank). This can enable the regulators to have an up-to-date picture of the overall exposure of the banking system to group companies, which can be useful for both prudential and corporate governance reasons.

External and internal audit

The *OECD Principles* recommend that an annual audit is conducted by an independent, competent, qualified auditor. As mentioned, it is increasingly common for external auditors to be recommended by the audit committee and be appointed either by that committee or by the shareholders directly. In view of the relatively high ownership concentration of MENA banks, the appointment of auditors by an independent audit committee would minimise conflicts of interest that auditors appointed directly by a majority shareholder, might have. Insofar as the audit committee is one of the most widely established committees of the board in MENA banks (over 80%), the introduction of mechanisms whereby the audit committee nominates an independent auditor should be straightforward. In fact, recent statistics collected by the UAB demonstrate that less than 10% of MENA banks do not consider that their external audit is conducted by an independent auditor. ***Supervisors should ensure that auditors are appointed through a process that ensures their independence, and that adequate procedures exist to maintain the independence.***

It is a good practice for banks to change the auditor periodically, or at least to request a change in the lead partner. Around 78% of UAB surveyed banks indicate that their internal policies include rotations of external auditors according to specific terms. Other surveys of MENA banks estimate that auditor rotations actually occur in approximately half of MENA banks. However, if the change may be the result of a disagreement, the supervisor should investigate the circumstances that caused the bank not

to reappoint its regular auditor. For instance, in Qatar, the Board cannot dismiss an auditor without the approval of the Central Bank. Some other Central Banks in the region can be commended for having issued specific guidelines regarding auditor independence. Ensuring auditor independence may be challenging in small jurisdictions where there are onerous qualification requirements for auditors, while the number of recognised accounting firms is low.

The responses to the OECD-Hawkamah Survey did not suggest any serious concerns about the external audit process, partly because the largest MENA banks are being audited by one of the major international firms. In some cases, Central Banks have established auditor rosters comprising auditors with specific experience/qualifications relevant to bank audits (i.e. Egypt). Others have established the minimum requirements bearing on the number of auditors who can audit a bank (i.e. Morocco, Egypt). In most cases, both listed and privately held banks are required to be audited by recognised auditors, and regulators should ensure that this is the case. ***The Task Force recommends, as suggested by the Basel Committee, that MENA supervisors develop contacts with their national audit associations so that they are in a position to address any audit concerns they might have.*** Almost all MENA countries now have national accounting associations.

The Basel Committee's 2001 paper on internal audit calls for a permanent, independent and professionally competent internal audit function within each bank, armed with an extensive mandate to oversee the internal control systems. The role of internal audit is to evaluate and assess the effectiveness and adequacy of the bank's risk management, internal control and corporate governance rules and procedures.¹⁵ It is important to point out that internal audit should not be tasked with ensuring that the company adheres to internal and external requirements – this is typically the role of a compliance officer. It is estimated that 88% of MENA banks are reported to have an internal audit function (IFC-Hawkamah, 2008). Some respondents to the OECD-Hawkamah Survey noted that in many banks, the internal audit function is geared towards traditional, "plain vanilla" banking and that in most cases, it lacks the knowledge/capabilities to review complex transactions or operations that span multiple regulatory environments.

¹⁵ The scope of the internal audit function as described in the Basel paper is extensive: it should include ensuring that the internal controls established by the management on the instructions of the Board operate effectively; reviewing all the actual mechanisms of control, such as the IT system, accounting records, internal and external security and regulatory reports and on occasion carrying out special investigations.

Each bank should have an internal audit charter that has been approved by senior management and confirmed by the board or a delegated committee of the board. The charter should demand that internal audit functions impartially, objectively and independently. The Chief Internal Auditor should have access to the independent audit committee. The majority of Central Banks in the region have either mandated the frequency and scope of internal audits and/or issued guidance on the subject. In particular, internal and external audit functions underpin the long-term soundness of banks' operations. It is acceptable for smaller banks to outsource the internal audit function, on condition that the service provider is professionally competent; is wholly independent of the external auditors; has no connections with any members of the board, senior management or their families; and has no other substantial contracts with the bank. Responses to the OECD-Hawkamah Survey indicate that standards of internal audit in the region are adequate; most respondents quoted the standards of the Institute of Internal Auditors.

Minimising the growing incidence of internal and external fraud is the clear responsibility of the internal audit and compliance team. Where fraud is disclosed, it should be reported both to the audit committee and to the board of directors. Internal and external auditors also need to ensure that the banks' financial statements fairly represent its financial position and performance 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. ***The internal auditors should monitor related party lending to ensure that all such lending is carried out on the terms agreed by the board.*** In particular, the respondents to the OECD-Hawkamah Survey noted that lending to the firms within the company group to which the bank belongs and lending to favoured clients are the most problematic types of related party transactions, which auditors should therefore monitor carefully. External auditors should test the material information concerning related party transactions, as is called for international auditor standards.

The Basel Committee paper on internal audit in banks notes that as bank supervisors and internal auditors have common objectives, periodic consultations between them can be of value. That being said, reliance on internal auditors as in-house consultants is a potential risk for the bank. This can be dangerous as the auditors need to take an objective view of the control systems and this is unlikely if they have to review the accuracy of systems that they have in effect put in place. The same applies to external auditors. From the responses to the OECD-Hawkamah Survey, it appears that internal auditors in MENA banks enjoy adequate independence. Less

comforting is the fact that some line managers in MENA banks are apparently not ready to recognise the value of the internal audit process. Some respondents to the OECD-Hawkamah Survey noted that internal auditors have little leverage at the board level to attract the board's attention to their findings. The Institute of Internal Auditors, which has offices in the region, could promote general awareness of the role and importance of internal audit in MENA banks. The supervisor also has an important role to play in this regard.

Handling staff concerns about potential governance failings

The Basel Committee' *Enhancing Corporate Governance in Banking Organisations* recommends that banks develop a policy setting out adequate procedures - consistent with national law - for employees with concerns about the integrity of the bank's operations or its personnel. Employees should be able to communicate their concerns with corporate protection from reprisal from the company or its management. The procedure should facilitate confidential and direct (or indirect through a neutral channel) communication to the board outside the internal "chain of command". The establishment of appropriate communication channels would allow staff members to discuss their concerns in confidence without fear of retaliatory action. The OECD-Hawkamah Survey responses demonstrate that this question has not been properly addressed in MENA countries, with some respondents expressing hope that such arrangements will soon be put in place, while others expressing the concern that staff or third parties communicating concerns could be subject to retaliatory action. A greater recognition of the value of such channel of communication for risk management appears to be necessary. ***The Task Force proposes that a senior officer in each bank be appointed to confidentially receive and investigate any employee or stakeholder complaints, without any prejudice for or against the complainant, even though it recognises that complaints can on occasion be the result of an unjustified grievance.***

Conflicts of interest and abusive related party transactions

Managing conflicts of interest

Conflicts of interest generally arise when a member of management or the board is privy to information from which they can benefit personally. Conflicts of interests in a bank can arise on a number of fronts, particularly when the bank is acting for a single client in a number of capacities. For example, the bank may be providing portfolio management advice and also

managing/marketing financial products. This appears to be a common conflict of interest in a number of regional banks. ***The recommended approach is for banks to establish information barriers (so-called “Chinese walls”) between the different departments so that decisions by staff in one department are made in ignorance of confidential information available to staff in other departments which might affect their decision.*** This approach is widely followed in investment banking where a bank may obtain confidential information in its capacity as adviser to an entity which might affect its banking or trading decisions.

Disclosing and effectively managing conflicts of interest is of fundamental importance to maintaining sound corporate governance, especially in banking organisations when conflict of interest situations may arise in several respects (i.e. between the bank and a client, a bank manager, board member or service provider and a client, two or more clients of the bank, a bank vendor and a client). ***The Task Force does not recommend an outright regulatory prohibition of conflicts of interest as this may only drive them underground, but suggests that banks remain alert to the possibility of personal conflicts.*** Banks should create rules and an environment in which board members and staff declare when they are faced with a conflict; and then seek to manage the conflict in a manner that does not harm the bank’s own interests or those of its customers.

Trading for personal gain on the basis of knowledge obtained in a professional capacity, for example in confidence from a banking client, often involves a breach of law and makes the offender no longer “fit and proper” for a senior banking position. In most jurisdictions, insider trading has indeed been made a criminal offense. No bank officer, especially a board member, should act to profit personally from inside information, even if this is not an offence in their jurisdiction. ***To monitor this and other situations which may involve conflicts of interest for management or staff, all banks should have a competent and independent compliance function that reports to the board audit committee.*** The compliance function is responsible for developing the structure of a sound governance framework by means of documented procedures and reporting lines. Those banks which do not forbid their staff to conduct certain transactions are likely to insist that they trade only through the bank’s own trading desk or require staff members to disclose their financial assets and all transactions undertaken.

When a conflict of interest situation arises for one of the members of the board, only non-conflicted directors should discuss and decide on a related-party transaction. ***Conflicts by board members or senior executives should be disclosed to the banks’ compliance officers and, if they are material, to the supervisor, while the board should ensure the appropriate public disclosure.*** A good corporate governance practice adopted by some banks is

to put in place and disclose a conflicts of interest policy (i.e. Deutsche Bank). Other banks cover their conflicts of interest issues in a code of conduct (i.e. National Bank of Bahrain). In a number of MENA and OECD jurisdictions, supervisors provide guidance on managing and disclosing conflict of interest situations. Where this guidance does not yet address all possible situations which may give rise to a conflict of interest, regulators are encouraged to review it. ***Supervisors should insist on being informed of the policies of banks they oversee, including their approach to managing conflicts of interest.***

Prevention of abusive related party transactions

The starting point for monitoring and curbing abusive related-party transactions is defining what constitutes a "related party." Otherwise, measures such as improving disclosure, shareholders approval process, enhancing the role of auditors/independent directors or the legal/regulatory framework are not likely to have the desired an impact. The *OECD Methodology* suggests that the definition of a related party be sufficiently broad to capture the kinds of transactions in the jurisdiction that present a real risk of potential abuse, are not easily avoided and/or effectively enforced. The Basel Committee's *Core Principles for Effective Banking Supervision* set out a range of recommended supervisory requirements in this respect, including the need to define related parties; a requirement that related party lending does not take place on favourable terms¹⁶; the need for transactions with related parties exceeding certain amounts to be subject to prior approval by the board of directors; and arrangements to obtain and review information on the bank's aggregate exposures to related parties.

In the context of the MENA region, the definition of related parties should be sufficiently broad to take into account features of the ownership landscape in the region: the presence of state-owned enterprises and state-owned banks and the relations between them; the fact that banks are often part of a larger family group and the relationship between the bank and other entities within that group; the high ownership concentration and the risk of controlling owners being able to pursue non-arm's length transactions for their own benefit. ***The legal/regulatory framework should clearly define who is considered as a related party and make clear that any established criteria merely stipulate examples of transactions and are not exhaustive.*** In addition, the legal definition of related parties should be harmonised

¹⁶ An exception can be made for "soft" lending to bank staff as a defined benefit in their remuneration arrangements.

among MENA jurisdictions to avoid excessive regulatory burden and arbitrage, enhancing implementation and enforcement.

While not all related party transactions are abusive, under certain conditions, they may allow controlling shareholders to benefit personally at the expense of non-controlling shareholders.¹⁷ Regardless of the shape of abusive related party transactions, the common element is that they are in many cases accompanied by a misrepresentation of a bank's financial situation. Thus, *all related party transactions should be reviewed and monitored by a sufficient number of directors capable of exercising objective and independent judgment. The review process should require approval of individual transactions, even those which are not flagged by the regulator but which may pose a risk for the bank.* Available data indicates that only 53% of Arab banks have written policies on how to review transactions which involve conflicts of interest and related party transactions (UAB, 2007). While shareholder approvals of related lending transactions exist in some countries (i.e. Lebanon), the approval of such transactions is generally left up to the board and/or shareholders, which may be insufficient in banks with a majority shareholder or controlling block holders. One of the options to rectify this situation may be to establish a committee of the board responsible for reviewing all related party transactions, ideally constituted of, or at least dominated by, independent directors (for example, the audit committee).

It is for the regulators to prohibit listed companies from engaging in certain specific types of related party transactions, such as personal loans to board members, their relatives and friends or to controlling shareholders. Banks and supervisory authorities in the MENA region should consider outright prohibition for selected types of related party transactions. In a number of MENA countries, related lending is strictly regulated (i.e. Bahrain, Lebanon). In Egypt, the Banking Law 88 (2003) prohibits all lending to related parties, and in Oman related lending is capped at 10% of bank capital. In recognition of the damage that can be inflicted on entire economies from abusive related party lending, some jurisdictions have gone further, limiting the voting rights of individual bank share owners for certain types of votes.

The Basel Principles on Effective Banking Supervision also recommended that banks report to national banking supervisors any transactions with related parties that pose special risks to the bank. It is also

¹⁷ Abusive related-party transactions may take various forms including selling an asset to the bank at an inflated price, buying an asset from the bank at a reduced price, shareholders or board securing loans from the bank on privileged conditions, etc.

important for the market and stakeholders, in addition to the banking supervisors, to know whether the bank is being run with due regard to the interests of all its stakeholders, and therefore it is essential for the bank to fully disclose material related party transactions either individually or on an aggregate basis. The OECD-Hawkamah Survey demonstrates that most MENA banks generally disclose related party transactions in accordance with the International Financial Reporting Standards. However, the implementation of the relevant provisions is understood to be lagging in a number of jurisdictions. *Appropriate disclosure of material related party transactions would prove helpful in reducing the burden for banking supervisors who may have limited human resources.*

Related party transactions in group companies and subsidiaries

In addition to the risk of abusive related party transactions, other specific concerns arise in relation to governance of banks which are part of a non-financial group. As mentioned, in the MENA region where banks are often held by a group company, related parties should include the holding company and sister companies that share a common controlling shareholder and associated companies that might have a linkage. Indeed, in the MENA region, lending to firms within the company-group to which the banks belong was cited in the OECD-Hawkamah Survey as of the most problematic types of related party transactions. Therefore, when monitoring related party transactions, it is important to understand what constitutes control, direct and indirect. This was highlighted in the results of the OECD-Hawkamah Survey, where respondents noted that bank lending to partner entities within the same corporate group is a risky practice in MENA banks.

In extreme cases, if there is no independent credit assessment, a commercial partner can cause the failure of a bank. The exact corporate structure is irrelevant as the funds can be drawn down by an affiliate that is upstream, downstream or at the same level as the bank. *It is therefore strongly recommended that any lending to group entities be monitored by a board-level committee that contains a majority of directors who are wholly independent of the group to which the bank belongs. Supervisors need to draft specific guidelines for intra-group exposures, require special reporting for the funding of affiliate companies, and monitor such lending carefully.* It is not only direct lending that should be carefully monitored but intra-group exposures of all kinds, as recommended in the Basel Joint Forum report *Intra-Group Transactions and Exposures Principles* (December 1999).

Bank board members, even if they are appointed by the parent company, should be aware that they have specific duties to depositors in addition to

the fiduciary duties to all shareholders. Furthermore, *it is important that the duty of loyalty of bank directors is specified to the bank's shareholders, not its parent company.* An additional code of conduct for the board members appointed by the parent company can be formalised. The parent company as a single or controlling owner of a bank should appoint a sufficient number of independent directors – independent of both management and the parent company – to the board of the bank and allow the board to fulfil its duties. Moreover, *the bank should adopt firewalls to prevent abusive transactions within the conglomerate structure to which the bank belongs (“banking group”).*

Inssofar as standards in a branch or subsidiary are concerned, being a member of an international financial group can actually strengthen the governance as the parent bank may insist on stricter standards at group level than are applied locally, and support this with inspection visits from the group’s internal auditors, risk managers or compliance officers. However, this does not mean that banks with foreign owners should be exempted from the standards established by the local corporate governance framework. On the contrary, the bank should be capable of risk assessment on both a company and consolidated basis. However, assessments carried out over the past few years have shown that the implementation of consolidation in accordance with Basel Core Principle 24 is often deficient in emerging market economies. *Given the prevalence of group structures in MENA countries, regulators should mandate the consolidation of accounts.*

Policy Considerations Specific to State-Owned, Family-Owned and Shari'a Compliant Banks

"The variety of ownership structures in regional banks warrant a more nuanced examination of the particular corporate governance priorities for these institutions" Nasser Saidi, Founder and Director of the Hawkamah Center of Corporate Governance; Co-Chair, MENA-OECD Working Group on Corporate Governance, 2009

Additional considerations for state-owned banks

Despite privatisation plans introduced in a number of MENA countries in 1990s, state-owned banks play an important role in a number of MENA countries' banking sectors. A fundamental governance issue is how to establish mechanisms that permit governments to act as active, accountable owners, while at the same time avoiding day-to-day interference with the management of the bank. The role of the state as a regulator and supervisor and as an owner should be considered separately, in accordance with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. Furthermore, the state should be aware that day-to-day or otherwise undue intervention may result in undesirable and potentially harmful consequences in the development of professional management. In effect, ***state-owned banks should deal with government organs and SOEs on arms-length basis***. Accordingly, officials should not interfere in any specific lending decisions of state-owned banks, even if the latter are specifically dedicated to implementing certain state-designed lending policies (e.g. agricultural finance). Instead, the state should properly utilise and respect the legal corporate structure of state-owned banks, which is most often that of a joint stock company. ***Once the state has set the objectives for state-owned banks, it should take advantage of their corporate form and allow boards to exercise their responsibilities with the requisite independence.***

At the same time, the state should not be a passive owner, and should establish an ownership policy that includes its objectives for ownership. The

Basel Committee's corporate governance principles note that where the bank is state-owned, an ownership policy should define the overall objectives of state ownership, the state's role in corporate governance of the bank and how it will implement its ownership policy. The state should establish the necessary mechanisms to track the performance of state-owned banks and put in place arrangements similar to those in commercial banks in terms of the risk management, compliance and audit functions. This is important for a number of reasons. First, insofar as MENA governments intend to continue privatising some banks, it is imperative that they address the situation of non-performing loans which are weighing quite heavily on the balance sheets of a number of large regional state-owned banks. Secondly, in some countries, rigorous requirements for external audit have been introduced later for state-owned entities than for privately owned companies (i.e. Egypt) and further follow up is required to ensure that they are complied with. Last but not least, insofar as the financial statements of state-owned banks are generally subject to audit by supreme audit institutions that usually have quite an important status and reporting relationship in several MENA countries, the perception of the importance of proper external audit has sometimes suffered.

Recent trends justify additional recommendations in this area. The governance arrangements of state-owned banks have come under the spotlight following the acquisition of significant stakes in local banks by a number of OECD governments. The temporary government control of financial sector entities in many of the OECD countries has raised a number of difficult policy questions. In particular, governments which end up being shareholders in banks, have to face a number of important policy decisions: how the separation of ownership and regulatory functions can be best achieved in circumstances when the recapitalisation effort has a largely regulatory element, how should the existing ownership entities be involved, to what extent should the temporary shareholding be integrated into a government's overarching ownership framework and what are the implications for the relationship with stakeholders in circumstances where governments want to limit the risks of moral hazard.

While the details of the support provided by MENA governments to domestic banks in difficulty are not entirely clear, it is known that this support has taken form of, for example, direct investment by Sovereign Wealth Funds. At the time of release of the Policy Brief, it was not clear to what extent these investments have been made at the behest of the governments and to what extent they may have been motivated by financial interests of SWFs. Although the fact that SWFs invested in local banks is not controversial per se from the perspective of the OECD Principles, investments by the state or state-owned/controlled bodies in commercial

banks should be made in a transparent manner as to allow bank shareholders and stakeholders to understand the nature of state intervention.

Generally speaking, the experiences of OECD countries with temporarily government ownership of banks in the wake of the financial crisis may be instructive for governments and bank regulators in the region. A key recommendation in this regard is that if MENA governments choose to retain their ownership in financial institutions for a period, while letting them operate in the market, then they should consider changing the banks' corporate governance arrangements to be in accordance with the OECD Guidelines. This is particularly relevant for governments which have an intention to divest of their ownership in the future since good corporate governance arrangements in banks, reflective of the state's role as a shareholder in the bank, would re-assure prospective investors.

Corporate governance considerations in family-owned banks

In comparison with OECD countries, MENA countries are somewhat exceptional in the number of non-listed banks, a significant number of which have controlling shareholders, in many cases families. For instance, in Lebanon, families are estimated to own over half of the local banking sector.¹⁸ Some of the most known banks in the region are family-owned or controlled (i.e. Bank Audi, Arab Bank). A number of factors can be used to explain the dominant role of family-owned, unlisted banks, notably the generally weak equity culture in the region and the desire of families to provide less public disclosure. As the responses to the OECD-Hawkamah Survey highlighted, in several MENA economies banks have ownership structures and other features that lead to conflicts of interest that can prove harmful for bank shareholders and stockholders (see above). In many cases banks lend to their owners, their associates or companies in the same business group. Similarly, there may be cross-shareholdings between a borrowing company and the bank, each owning a stake in the other.

More importantly, evidence suggests that the loans granted on favourable terms are more likely to default and are harder to recover than loans to non-related parties. The OECD-Hawkamah Survey reveals a perception of a high degree of risk in situations where family banks provide lending to other group affiliates. It is crucial that related lending, especially in non-listed banks, is dealt with as recommended above. In particular, approval of related-party transactions should in principle be undertaken by a

¹⁸ Chahine and Safeiddine (2008). Corporate Governance and the External Monitoring of Banks in Lebanon.

sufficient number of members of the board capable of exercising “independent” judgment, as already noted above. This may be a challenge in the case of FOBs given their board structure. ***Banking supervisors should be particularly vigilant in reviewing related party transactions in family-owned and especially unlisted banks. They should ensure that reporting requirements apply to them in an equal measure as they do to listed banks.***

Succession planning is a particularly important issue for governance of FOBs, given that it might impact on the continuity of the bank's operations. Available information demonstrates that on average, only about a third of FOB boards in regional banks are composed of individuals other than family members. Therefore, in case of inability of one or more of them to continue fulfilling their functions, the operations of the board could be significantly impacted. The other question this statistic raises is the availability and diversity of relevant expertise on the boards of family-owned banks. In this regard, the recommendation that the qualifications of board members be included in the "fit and proper" test appears to be relevant. On the other hand, the fact that in almost 70% of MENA FOBs the position of a CEO is occupied mostly not by a family member, but an outsider who is presumably deemed by the controlling owners to possess the necessary qualifications, is encouraging. ***Supervisors should require FOBs to submit a long-term succession plan that provides for a smooth transition of ownership between family generations so as to ensure continuity. In addition, as a matter of good practice, FOBs (listed and non-listed) should consider adopting family constitutions and structures to help them differentiate family interests from those of the company.*** A family constitution should define the relationship among the governance bodies and how family members can participate in the governance of their business. It is valuable to identify family members who are subject to the family constitution (shareholders or all family members) and address the rights, roles and obligations of all family members. Family constitutions are important to define the governance structure of FOBs but also for governing conflicts of interests and clarifying employment policies and procedures. Available information demonstrates that banks are behind other family-owned enterprises region in this regard.

Particularities of corporate governance in Shari'a compliant banks

Shari'a compliant financial services, including banking services, are increasingly prevalent in the MENA region. While in a few countries of the region (eg. Morocco), Islamic banking institutions are not common, in others (i.e. Bahrain), they account for approximately 25% of the total number of institutions operating in the country. Some banks offer only

Shari'a compliant services, whereas others have separate activities and product lines for each of the conventional and Shari'a compliant services. Given the differences between MENA jurisdictions in terms of degree of presence of Shari'a compliant banks and approved financial instruments, the view of the respondents to the OECD-Hawkamah Survey on this matter are limited. Nevertheless, ***members of the Task Force are of the view that the principles in this Policy Brief can, and should, be applied to Shari'a compliant banks.*** They consider that the different business models adopted by Institutions offering Islamic financial services (IIFS) in no way absolves them of the need for engaged, independent and qualified directors, the prudent treatment of related party transactions, and other issues covered by this Policy Brief.

Indeed, the *Guiding Principles on Corporate Governance for Institutions*¹⁹ issued by the Islamic Financial Services Board (IFSB) in 2006 note that "in order to avoid reinventing the wheel in developing a set of corporate governance best practices for IIFS, the OECD Principles and the BCBS paper are among the leading references that can provide useful guidelines." The IFSB also notes that it shares the governance philosophies subscribed to by the OECD and by the Basel Committee, as they can accommodate the needs and requirements of different national environments. Since its inception, the IFSB has issued seven industry standards in areas including capital adequacy and market transparency. In the area of corporate governance, many of its Guiding Principles are indeed close to the *OECD Principles*. In some areas, relevant differences can be noted, mostly related to the integration of considerations of Shari'a law such as obtaining rulings from Shari'a scholars.

However, like the recommendations of the Accounting and Auditing Organisation for Islamic Financial Institutions, there are no sanctions for non-compliance with these principles. National supervisors could also interpret these principles differently, leading to uneven application. Partly as a result of this, there are many irregularities in terms of what Islamic banks consider as acceptable practices, and often their activity is not as closely regulated as that of conventional banks. On the other hand, the *Basel Committee's Principles on Corporate Governance* may not adequately address the special features of Islamic banking which may leave a gap in setting and monitoring the application of Shari'a compliant banks or banks offering Shari'a compliant services. That being said, available research demonstrates that corporate governance recommendations of the Basel Committee and the OECD are adopted by some Islamic banking

¹⁹ These Principles are applicable only to institutions offering exclusively Islamic financial services, excluding Islamic insurance and Islamic mutual funds.

organisations, and over half of Islamic banks surveyed have either developed or are planning to develop their own principles of corporate governance.²⁰

The Task Force also recognises that the distinctive features of Shari'a compliant banks raise additional governance-related issues. The two key issues relate to the conduct of the bank's business in compliance with Shari'a and the offering by Shari'a compliant banks of risk bearing investment accounts deposits, sometimes called profit-and-loss sharing (PLS) deposits. The return on those deposits is defined *ex post* to reflect the performance of the assets in which those deposits have been invested. The risk-bearing nature of these deposits renders them akin to investment products such as mutual funds. Deposits where the depositor does not restrict the bank to specific asset allocations are on the bank's balance sheet. They are generally used to conduct the general bank intermediation business. It is widely acknowledged that financial institutions should make greater disclosure on products such as mutual funds where the return is reflective of investment strategy and market conditions, than they do with conventional deposits where, barring bank failure, returns are predictable. ***Banks offering Shari'a compliant products should provide an appropriate level of disclosure, including on their investment strategies, and the supervisor should play an active role in prescribing the level of such disclosure.***

Islamic banks incorporate in their governance structure a Shari'a Supervisory Board whose role is to assess the compliance with Shari'a of the bank's products and processes and express its opinion on the matter. Members of the Shari'a board themselves should be subject to rules of governance. In addition, ***the relationship between the Shari'a board and the main board/other bodies within the bank, needs to be defined.*** The Task Force recognises that much work in this area has been done by the IFSB in its *Guiding Principles on Corporate Governance*. The IFSB notably proposes the establishment of a corporate governance board committee that would be empowered to oversee the implementation of a governance framework. The composition and procedures of that committee should be in line with accepted practices. The IFSB recommends that it is composed of a member of the audit committee, a non-executive director and a Shari'a scholar, and additional independent non-executive directors if necessary. ***The Task Force supports the IFSB recommendation to establish a corporate governance committee at the board level in Shari'a compliant***

²⁰ Safeiddine, Assem (2009). Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory. *Corporate Governance: An International Review*, 17(2).

banks. In selecting members for board level Shari'a committees, care needs to be exercised in ensuring that Shari'a scholars do not hold too many posts on such boards, which would preclude them from discharging their duties effectively. The Task Force also noted that some jurisdiction such as Algeria and Malaysia have established national level Shari'a boards, but raised concerns about the selection of scholars on such boards.

Islamic banks face a number of the same risks as do their conventional counterparts, but also a number of unique risks that ought to be recognised and adequately overseen. For instance, Islamic banks face a substantial liquidity risk because they do not have the tools to manage asset-liability mismatches, and potentially greater operational and legal risk because of the lack of product standardisation and financing methods. Likewise, the reputational risks of Islamic banks are also slightly different than those of conventional banks. If a bank which positions itself as Islamic or offering Islamic financial instruments and is found not to comply with Shari'a law, this might potentially carry significant reputational risk. On the other hand, some of the important risks that Shari'a banks face are exactly the same as those facing conventional banks in the region. For instance, the decline in the value of the construction and the real estate sectors, which are also heavily represented on the balance sheets of Islamic banks, has the same impact on Shari'a compliant banks as it does on conventional banks. Regulators in MENA countries have adopted different approaches in supervising Islamic banks, in some cases adopting a separate law/regulations/rules for Islamic banks (i.e. Kuwait, Bahrain, UAE) and in other cases making the regular banking law applicable to Islamic banks as well (Saudi Arabia, Qatar). ***The evolving experiences of national supervisors in developing regulatory frameworks for Islamic banks should be shared.***

Banks' Impact on Corporate Governance of their Clients

"...it is important for banks that their clients apply the principles of good governance" Chahine and Safieddine, 2008

Good corporate governance of borrowers reduces the risk for banks. The role and incentives of banks in monitoring the corporate governance practices of their borrowers has been much debated in the literature. A number of analyses point to the fact that banks can perform important monitoring functions, in large part in order to reduce their own credit risk. Banks are arguably in a better position than dispersed shareholders to monitor the performance and possibly the governance of their borrowers due to the informational advantages they enjoy. Some analysts note that banks' monitoring is effective in constraining the opportunistic behaviours of managers, implying that banks can play an important role in the corporate governance system.²¹ Available research of the role of banks in corporate governance in other jurisdictions (i.e. Germany) is less optimistic about the role that banks can play in terms of impacting the corporate governance arrangements of their borrowers. It concludes that at the maximum, banks may be in position to monitor some corporate governance elements that are critical to the lending decisions such as, for example, the succession plans in family-owned banks.

In some respects, banks in the MENA region are in an especially strong position to monitor the governance arrangements of their borrowers. Despite efforts to develop capital markets in the region, bank credit remains a predominant financing mechanism for enterprises, and therefore banks wield power over a range of borrowers. In addition, banks own significant stakes in listed companies. This suggests that banks may play an important role in the corporate governance of companies in which they have invested. In light of this, the Task Force has decided to consider not only the governance frameworks and practices of banks, but also to explore to what extent banks

²¹ Ahn, Sungyoon and Wooseok Choi (2009). The Role of Bank Monitoring in Corporate Governance: Evidence from Borrower's Earnings Management Behaviour.

in the region could play a role in monitoring the corporate governance practices of their clients.

Given the important role of banks in the region, it would intuitive if they played an active role in monitoring the corporate governance arrangements of their borrowers. Nonetheless, responses to the OECD-Hawkamah Survey revealed a relatively low level of interest by banks to do so. Available evidence corroborates that the role of MENA banks as monitors of their borrowers' corporate governance arrangements is in early stages, something also observed in other jurisdictions. The UAB 2007 survey indicates that only 42% of surveyed banks indicated that their systems of risk assessment include an evaluation of clients' corporate governance practices. Consistent with this figure, 50% of the surveyed banks indicated that they are well informed about the corporate governance practices of their clients. Key constraints to bank monitoring of the corporate governance practices of their clients appear to be the cost of the bank's active involvement and the lack of necessary competencies. Nonetheless, ***the Task Force is of the opinion that MENA banks should consider that it is in their own best interest to monitor the governance structure and practices of their corporate borrowers.***

For banks to play a more active role in the governance of their clients, an important obstacle is the latter's transparency, particularly when their activities are structured in complex groups. Likewise, in case of borrowers which are not listed and controlled by a majority shareholder, the ability of banks to pressure the owners to improve governance arrangements might be limited. In such instances, banks might be able to assess the creditworthiness of borrowers, but find it difficult to go beyond this to examine corporate governance practices of their borrowers such as their risk management practices. The ability of banks to request disclosure beyond the financial statements depends on a number of parameters, such as the size of the loan. However, should MENA banks be able to only improve the financial disclosure, that would be already a very positive development, especially in the case of private companies, which may be subject to less onerous disclosure standards. An important recommendation in this regard is that ***banks should require their borrowers to provide consolidated financial reporting.***

Whether, additionally, banks should be more proactive in attempting to influence the corporate governance practices of their corporate borrowers is a more sensitive matter. In principle, the benefits of banks' involvement in governance of their borrowers appear intuitive. In practice, and as confirmed by the OECD-Hawkamah Survey, banks might find it too resource intensive and ambitious to monitor the corporate governance frameworks of their borrowers. In order for banks to have an interest to engage in such

monitoring, they must perceive a clear benefit from it. *Even in circumstances where a bank cannot directly influence the governance practices of their borrowers, it can have an important influence by "leading by example"*. Insofar as the corporate governance practices of MENA banks are often more advanced than those found even among domestic best governed, listed firms, they could attempt to influence the governance of their borrowers (and even corporate clients more generally) by ensuring their own governance policies are in line with international good practice.

The Role of Supervisors in Improving Corporate Governance of Banks

"The future approach to banking regulation and supervision needs to be rooted in the fact that the risks involved in performing bank or bank-like functions are different not only from those involved in non-financial activities, but also from those which arise in performing non-bank financial activities, such as life insurance"
The Turner Review, 2009

Although the principal responsibility for ensuring the bank has sound governance arrangements lies with the bank's board members and management, supervisors can play a key role by reviewing and evaluating a bank's implementation of sound governance and providing incentives for banks to improve their governance. Though good governance is not a substitute for proper supervisory oversight, the supervisor's confidence in the governance arrangements of banks can go a long way to giving the supervisor a level of comfort regarding the reporting provided by the reporting bank. To this end, and as noted in earlier sections of this Policy Brief, bank regulators in the region have introduced corporate governance codes and recommendations on corporate governance of banks. Some of these recommendations apply on a voluntary basis, while for others, compliance is mandatory. In the wake of the current financial crisis, bank supervisors all over the world have been reviewing supervision frameworks for domestic banks, which in most cases include corporate governance requirements.

In the MENA region, banking supervisors have also reacted with some emergency regulatory measures, mostly bearing on prudential requirements of banks. However, in order to be effective, these changes will have to be accompanied by a governance shift, enabling key corporate governance actors – board members, shareholders, and managers to adequately understand the activities, structure and risk profile of banks. ***Supervisors should provide guidance to banks on corporate governance, making it clear that they will not only evaluate corporate governance policies and procedures, but also evaluate banks' implementation of these policies and***

procedures. They should publicly announce the criteria for assessing the corporate governance practices of banks and publicly recognise the improvements that have been made. However, supervisors need to be cautious about appearing to endorse a bank's governance regime as excellent or even adequate as this can undermine the supervisor's authority if an adverse event were to occur in the future. In some jurisdictions, supervisors conduct a specific corporate governance review of banks, which are followed by on-site inspections at full cost-recovery if the findings of the first review are not satisfactory.

In developing corporate governance guidelines or recommendations, standard setters should recognise that banks will need to adopt different approaches to corporate governance that are proportional to the size, complexity, structure and risk profile of the bank. In addition, supervisors should, on a periodic basis, review the substance of their requirements, codes or directives to ensure that they remain pertinent. In particular, *MENA regulators might wish to evaluate the appropriateness and completeness of policy guidance on corporate governance of banks, given the lessons learned from the financial crisis.* From its analysis of the roots and consequences of the financial crisis, OECD has recently concluded in its work that corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation. The discussion above on improving risk management practices has already provided several recommendations in this regard. Furthermore, the emerging consensus points to the need for banks to provide better disclosure on complex financial instruments, including off-balance sheet instruments.

It may be helpful for supervisors to meet with both directors and senior management as part of an ongoing supervisory process. *Supervisors should evaluate the expertise and integrity of existing and proposed directors and management. They should also evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their oversight responsibilities.* Supervisors should ensure that the internal audit function conducts independent, comprehensive and effective reviews of bank risk management and internal controls. This could include meetings with internal and external auditors as well as senior risk managers, compliance officers, and other key personnel in control functions. In the MENA region, it is understood that the consent of senior management may be necessary for such meetings to take place, which is not in line with internationally accepted good practice. *More generally, supervisors should have a framework in place which allows them to make an assessment of a bank's governance policies/practices and tools to have redress of any deficiencies they identify.* To this end, corporate governance assessment

may be included as part of the work of the Central Bank's compliance examinations.

All supervisory guidance should place appropriate stress on the transparency of banks' governance processes. Banks should be expected to structure their business in a manner that enhances a transparent disclosure culture. *In particular, supervisors should evaluate the potential dangers of financial or non-financial group structures and should be able to obtain up-to-date information regarding the structure of the group to which a bank belongs.* Information about group structure should allow for an assessment of the fitness and propriety of the major shareholders and directors of the parent company and the adequacy of the oversight processes within the group. The latter is a particularly important issue in the context groups other than bank holding companies. On the other hand, financial group structures and universal banks, also present in the region, give rise to other conflicts of interest that supervisors should closely monitor. Chief among them is the conflict of interest between the bank's role in executing trades and its activity as a financial adviser.

Supervisors are called upon to frequently inspect financial institutions' internal risk management systems and compensation policies, and require changes where deficiencies are noted. Since corporate governance represents an evolving culture both for national banking systems and for individual banks, each supervisory agency should determine what "success" in its market from a corporate governance perspective should look like and publish benchmarks, against which banks should be encouraged to conduct their own assessments. If supervisors believe that the bank has taken risks that it is unable to fully measure or control, they should hold the board of directors and senior management accountable and require that corrective measures be taken in a timely manner. Supervisors can consider whether it is practical to apply penalties such as higher deposit insurance premiums for banks that do not make a requisite effort to adopt the corporate governance norms. **In addition, supervisory agencies should allocate sufficient staff resources. They are encouraged to either create a separate function with corporate governance expertise or integrate corporate governance expertise in existing organisational frameworks.** More generally, the financial crisis has highlighted the difficulty for supervisors to recruit staff able to keep up with the pace of development of financial instruments and practices in the industry.

Last but not least, lack of coordination among supervisory bodies is a point underscored by the financial crisis. A key lesson learned from the crisis is that regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the

macro systemic risks of a contagion. It also highlighted the complexity of supervising cross-border banks. The G20 has agreed that supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions. In addition, it decided that major global banks should meet regularly with their supervisory college for a comprehensive discussion of the firm's activities and the risks it faces. These recommendations may not be entirely relevant to the MENA region, where the presence of large, systemically important, cross-border activity of banks is still relatively limited. Nonetheless, **harmonisation of regulatory frameworks, coordination of supervisory responsibilities and sharing of information on bank reviews should become a priority for MENA bank supervisors.** This may be particularly relevant in the case of financial groups with cross-border operations or when the bank has subsidiaries in jurisdictions where the supervisory review is not as stringent. It might be also of particular importance in jurisdictions where oversight of banks is shared between several institutions.

The last consultation on this document conducted in October 2009 highlighted that the Task Force participants deem the ability of the supervisor to promote good governance in banks as closely related to the good governance of the supervisor itself. The Task Force participants expressed the view that regulatory governance should ensure the accountability of regulators. While it is beyond the scope of this document to provide detailed recommendations on this complex matter, it would be useful to point out that Chapter I of the OECD Principles addresses this area indirectly, focusing on ensuring the basis for an effective corporate governance framework. In particular, Principle I.D notes that "supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained." In the wake of the crisis, further measures on improving the governance of banking regulators might be forthcoming. ***Such measures are welcomed by the Task Force in order to ensure, in particular, that supervisors have the necessary independence, accountability, transparency and integrity to perform their functions effectively.***

Next Steps

An important finding of the OECD-Hawkamah Survey is the impression of a lack of awareness by many MENA banks and their boards of the importance of good corporate governance practices that should be adopted by banks. To this end, the Task Force recommends a focused educational effort for senior members of the management and boards of MENA banks. Such training can be conducted by the supervisor itself and/or by banking institutes or associations. In promoting good corporate governance, it would also be useful to quantify and publicise the potential benefits of improvements. The Task Force therefore welcomes the efforts to conduct empirical research into the tangible benefits that have accrued to the banks that have become corporate governance leaders in the MENA region. Comparative research on governance practices of leading banks from within and outside of the region would help regulators establish more relevant benchmarks and help banks better understand how good governance practices can be implemented in a practical context.

Effective corporate governance of banks in the MENA region will only be achieved in substance rather than form if bank's boards and management are convinced of its value. Without private sector buy-in, corporate governance of banks is not likely to continue improving. Therefore, awareness raising efforts targeted at local banks will be needed at the national level. To this end, a final draft of the Policy Brief will be circulated (in English and Arabic) to all the MENA Central Banks and banking associations inviting their official endorsement. They are encouraged to circulate the Policy Brief to the local banks. The Union of Arab Banks, as an important body regrouping the majority of regional banks, is also invited to circulate this Policy Brief to its members. Individual banks could, with the help of this document, conduct self-assessments in order to benchmark their corporate governance practices against regional and international good practices. Indeed, given that some regulators in the region (i.e. DFSA) have already asked banks to conduct corporate governance self-assessments, the guidelines provided in this document might be useful in this regard. The OECD and its regional partners stand ready to accompany banking

regulators and banking associations in raising the level of awareness around good corporate governance practices in MENA banks.

In order to implement the recommendations of the Policy Brief, more detailed codes and initiatives are needed at the national level. As mentioned above, a number of MENA regulators have already developed general corporate governance codes that apply to banks or banking specific codes or recommendations. These regulations or recommendations might require revision in light of lessons learned from the financial crisis, in particular on remuneration or risk management. First, the Task Force recommends each bank regulator develops its own corporate governance expertise and issues specific guidance against which banks could be assessed during self- or regulator examination processes. Second, private sector banking associations are encouraged to set up working parties of national experts to provide additional guidance as a benchmark for good governance in their banking sector. In order to implement this recommendation, it is suggested that Task Force members or national banking supervisors discuss with their banking associations, institutes of directors, stock exchanges, securities regulators and any other involved parties the practicality of establishing a working party of national experts to develop more detailed national guidance on such contentious concepts as the independence of directors, related party transactions and conflicts of interest. These would need to take into account the conditions within each jurisdiction and any existing corporate governance codes already developed at national level. The MENA-OECD Working Group on Corporate Governance, the Hawkamah Institute of Corporate Governance and the Union of Arab Banks commends the Policy Brief to the attention of policy makers in the region and is encouraging awareness raising and follow-up to support its implementation. A review of progress made in the implementation of policy recommendations contained in this document is proposed in two year's time (2011-2012).

Annex I.

Summary of Responses to the OECD-Hawkamah Survey

Part I

A. General principles

What are the most serious problems/challenges, in your view, involving corporate governance of banks in your country?

A significant number of problems/challenges were cited, with some respondents mentioning half a dozen or more. The most common concerns were:

The lack of awareness/understanding by banks and boards of the need for strong corporate governance and its potential benefits. This was partly ascribed to the absence of firm direction by the authorities, whether through inadequate laws and regulations or inadequate publicity. However, the preponderance of family-owned banks or banks with concentrated ownership was also mentioned as a cause, because these shareholders would likely be closely involved in the day to day running of the bank and thus not appreciate the need for stakeholder protection.

One Central Bank mentioned “cultural reasons” as an impediment to the implementation of strong corporate governance and another the frequency of the same person serving as a Chairman and a CEO. Others cited the concentration of ownership as a reason for concern as this created inadequate checks and balances. The result was often inadequate questioning of management decision-making, failure to hold officers accountable for their actions and the creation of conflicts of interest, especially over lending judgements.

Many cited the weakness of audit processes, the absence or lack of effectiveness of a board level audit committee or of an independent compliance function. There were related concerns about the refusal of the board of directors (BOD) to accept auditors’ recommendations and weaknesses in risk management processes generally.

Several responses mentioned the absence of skills, independence and diversification among bank BODs. This was variously ascribed to the lack of experienced directors, lack of understanding of Directors’ roles and responsibilities, inadequate training facilities for directors and concentration among bank ownership.

Concern was raised by a few banks about the accuracy of financial statements, with some confusion being caused by IFRS and IAS39. Weak disclosure and transparency was another common concern, with reference both to financial statements and to the structure of the bank.

Remuneration was cited by some respondents, not only the fact that remuneration policy might not fit with the long term strategy of the bank but also the legal basis and structure of Directors' remuneration. One response mentioned that the key factor influencing good corporate governance is support and sponsorship by senior management.

Please provide examples (on anonymous basis, if appropriate) of:

a) *Recent failures*

This question appears to have been misunderstood by most respondents. The few who cited causes of failures mentioned the absence of an audit committee, politically motivated lending policies and inadequate governance that allowed greed to flourish.

b) *Regulatory initiatives*

Initiatives cited included: a recent circular by the CB and the Investment Ministry (Egypt), issuance of a Directors Handbook (Jordan), corporate governance seminars in several countries under the aegis of Central Banks or banking institutes and implementation of Basel II were also cited.

Respondents also cited central bank initiatives/guidelines regarding risk management, the compliance function, banks' relationships with auditors, disclosure, international accounting practices, connected lending and limits on individual shareholdings and the creation of board committees.

Measures taken by individual banks

Measures cited include: separation of the posts of the Chairman and the CEO, the recent establishment of corporate governance, audit and other board level committees; the appointment of a Corporate Governance Manager at senior level; improvements in disclosure and transparency; development of codes of conduct.

Do you think corporate governance of banks needs special attention in comparison with other listed companies? If yes, do you also think that corporate governance of banks is more important than of other large listed non-financial companies? Please briefly explain your views.

Nearly all the responses agreed that corporate governance is more critical for banks, although a couple of respondents argued that it is important for all listed companies and see no reason why banks should be expected to observe higher standards. The reasons mentioned by the majority include the key role banks play in the financial system; “banks are different”; the need for strong accounting and disclosure of activities that are often hard for stakeholders to understand; and the importance of additional checks and balances over complex financial operations via the “four-eyes” principle in order to reduce the risk of fraud.

Is there a corporate governance code in your country that exclusively (or mainly) focuses on the banking industry? Is there a corporate governance code that applies generally, including banks? Which entity, if any, monitors compliance with the code(s)?

Bahrain: No, but the Central Bank has issued guidelines in line with the Basel paper of February 2006 and a Steering Committee has been formed to develop corporate governance standards for all companies.

Egypt: Not for banks alone but the Institute of Directors issued a voluntary code. The Capital Markets Authority applies some aspects of it to listed companies and the Central Bank monitors banks’ risk management standards.

Jordan: The Central Bank has issued a manual for bank directors in 2004 and is currently drawing up more specific guidelines based on BCBS documents. It will monitor banks’ compliance after this has been issued. The Securities Commission is in the process of issuing a code for all listed companies. The Association of banks has issued a voluntary corporate governance code.

Kuwait: Yes (no more details)

Lebanon: There is a voluntary corporate governance code for all companies but compliance is not monitored. The CB issues a circular in July 2006 based on BCBS guidance but there are no specific standards for banks alone.

Oman: No specific standards, but the CMA monitors the Code it issued for all listed companies.

Qatar: corporate governance is monitored as an element of prudential norms. The QCB is currently elaborating more specific corporate governance guidance.

UAE: None specifically.

Do you think it is desirable for your country to develop a corporate governance code that exclusively (or mainly) focuses on banks? Please explain your standpoint.

Virtually all the responses agree that it would be desirable to develop standards for banks alone, arguing on the same lines as for question 3. Other points made were the need to keep up with international standards for competitive reasons and the fact that banks have special characteristics so need standards tailored to their special circumstances. One response mentioned that although many laws and regulations covered aspects of corporate governance, they were scattered and could benefit from being brought together in a coherent manner.

What is the actual/potential role of the bank supervisor in issuing guidance to banks about corporate governance? Is there a danger that instructions or regulations regarding corporate governance will result in “ticking the box” or pro-forma compliance?

Nearly all the respondents (both Central Banks and banks) accepted the role of the regulator in advising on and enforcing corporate governance standards, although a few thought this would be better done by the national banking federation. Some thought there should be minimum requirements and “tangible deliverables” (such as changes in the composition of the board) but several saw the risk that regulation could become a box-ticking exercise. Others noted that the size and nature of banks differed widely and opposed a “cookie-cutter” approach. To avoid these downsides some stressed the need for a flexible case by case approach supported by a regular dialogue with the regulator and onsite inspection. Several mentioned that banks’ management should be held responsible for their corporate governance and stressed the need that it would only be really effective if industry “buy-in” were obtained. To that end they argued in favour of high level seminars and conferences, where the importance of strong corporate governance could be explained by the CB and other experts.

What is the organisational chart of the governing bodies and departments ensuring good corporate governance with their underlying responsibilities, lines of reporting and authority? (Please choose between outlining the organisational chart typical for your country’s banks or the one of your bank).

The answers to this question do not lend themselves to a succinct summary.

To the best of your knowledge, are there any measures taken by banks in your country in order to implement sound corporate governance practices? Does your bank have specific written procedures and policies as regards corporate governance? If yes, please briefly give a description thereof. If not, are there any planned steps to be taken in this regard?

In Bahrain, Kuwait, Lebanon, Oman and Qatar the authorities have issued specific guidance that the Central Bank monitors. The answers of the Egyptian and Jordan banks are fairly consistent, generally stating that they assume other local banks are applying specific corporate governance standards but their own bank is not doing so yet, although many say they are still assessing the situation (one answer from a failed bank blames the failure on the absence of corporate governance). In one country, banks’ annual reports have to contain a separate chapter on their corporate governance processes.

B. Board (and management) issues

1. Please summarise the key points of the mandatory requirements on the composition of the board and the executives of banks in your country (e.g. mandatory outside directors, mandatory committees, mandatory separation of the chairman and CEO, one-tier/two-tier system, fit-and-proper person requirements), as well as the functions of board members?

The common points made were as follows:

In a number of countries, respondents pointed to mandatory separation between Chairman and CEO (Bahrain, Egypt, UAE). In Lebanon the Chairman is by law also the General Manager, who can choose to appoint a CEO but who remains responsible to the shareholders for the day to day running of the bank.

At least half the board should be qualified independent directors (Egypt), at least two (Jordan) or “a sufficient number” (Bahrain).

The requirement for the board to be accountable for the objectives and strategies, especially risk strategies and complying with laws (virtually all responses).

The board must develop a code of conduct for itself, its management and employees (Bahrain).

The board must clearly define, document and enforce the responsibilities of all the senior parties, including itself and its Chairman (Bahrain, Jordan).

The board should have a quorum of qualified (“fit and proper”) directors (Egypt, Jordan, Kuwait, Oman, and Qatar). The Central Bank has to approve key appointments in Bahrain and UAE. The board should periodically assess its composition and size (Bahrain).

The Company Law or equivalent has established many detailed regulations about the composition of boards in several of the countries under review.

Please list all mandatory committees (if any) of banks required by laws/regulations in your country. If they are requested by voluntary codes/rules, please list them, too. What are the board committees of your bank? What are the most frequent board committees typical for the banks in your country?

The board committee that is mandated the most is the audit committee (Bahrain, Egypt, Jordan, Oman, and UAE). A Credit Committee is mandatory in Jordan and the Lebanon, which also mandates several other Committees. Oman and Qatar mandate a risk management Committee. Many other Committees that are not mandatory are mentioned in the various responses, most notably Compensation, Executive, Nomination, HR and ALCO, but it is often not clear whether these are board or management committees.

What is the usual size of bank boards of directors in your country? What is the typical composition of bank boards of directors, in terms of profile (qualifications), number of independent directors, relations to the bank shareholders, etc.? Please specify the requirements in these respects and their source (legislation, specific regulations or by-laws)?

The size of bank boards is in some countries constrained by legislation (Jordan 3-13, Lebanon 3-12) but the numbers quoted are mostly in high single figures with two independent members. The profile is basically for financial or legal skills, with local businessmen a common feature. Some countries require a majority of nationals and several a minimum shareholding.

Is there a definition of independent director in your country legal framework of corporate governance, in a national Code or in the statutory documents of your bank? If yes, please

describe. How are independent directors appointed? Are the independent directors identified as such in the annual report of the bank?

Only in Bahrain, Kuwait and Oman is there an official definition, although Jordan is considering the issue. Independent directors are appointed by the board of directors or nominated by the shareholders and approved by the general assembly or the Central Bank, as required. In Bahrain, Egypt, Jordan and Oman independent directors are recorded in the bank's annual report.

What is the procedure for appointing new directors in your bank? Is this a formal and transparent procedure? Is it functioning properly? Do nomination committees exist in the majority of banks? On what grounds are board members removed? What is the overall practice in your country?

Some banks require minimum shareholdings. Nearly all the respondents seem to think the system is fair and transparent and functions properly, although a couple of the Egyptian banks were more sceptical in light of perceived shortcuts by dominant chairmen. Most banks said they had no Nomination Committee. Removal was only rarely addressed and then mostly in legal terms.

Do bank boards of directors in your country function properly, in your view? How often do they meet? Do directors dedicate enough time to their duties? Do directors perform well their function of overseeing management or do they get involved in the day-to-day management of the business?

With the exception of some of the responses from Egyptian banks, the responses to this question were encouraging, with all the respondents apparently believing that boards were functioning effectively, perhaps surprisingly in light of the responses to some earlier questions. Among the Egyptian respondents, concerns were the lack of transparent processes, personal conflicts and the tendency of directors, especially in public sector banks to interfere in the day to day business at the expense of strategic focus. The UAE response also notes a tendency for boards to become over-involved. Most boards appear to meet quarterly or bi-monthly. Several countries have established a minimum meeting frequency.

Are the opinions of board members accurately reflected in the minutes of board meetings? Do directors have access to the information necessary for fulfilling their duties?

All the responses to this question were positive. The UAE Central Bank observed that individuals' comments would normally only be recorded if so requested.

Do banks arrange insurance cover in respect of legal action against directors, in your country? What are the practices in your bank?

Insurance cover is rarely arranged except in Kuwait where it is generally the case. In Bahrain, Egypt, Jordan and Lebanon a few banks do so.

Do bank boards undertake formal annual evaluation of their own performance, and that of their committees and individual directors? What are the practices in your bank?

Generally no, but in Bahrain (where the CBB monitors the results) and in Kuwait it is the norm. In Egypt, a formal report is presented to the Annual General Meeting. Other countries where some banks follow the practice are Jordan, Lebanon and the UAE.

C. High standards of professional conduct and appropriate management of conflicts of interest

Do most banks in your country have a written set of documents clearly stipulating strategic objectives, corporate values and standards of conduct?

This is the case for all the banks in Bahrain, Kuwait, Oman and Qatar, and for some the banks in the other four reporting countries.

What kind of regulations prohibits a bank from lending money to its related parties on unduly favourable terms and conditions? Please summarize the key points of the law/regulations that may prohibit certain type of related-party lending or may ensure that related-party lending is based on market terms and conditions (i.e., arm's length rule). (E.g., mandatory disclosure / reporting, mandatory approval by the board, etc.)

The answers to this question are extensive and worth recording in some detail. A common feature of the requirements for related lending, if permitted, is that the terms and conditions should be market based and not on favourable terms and that they become subject to formal approval and disclosure processes. Moreover:

In Bahrain several criteria are laid down in the CBB Rulebook Module, including restrictions on related party exposures and the need to establish a clear commercial advantage for the bank. Shareholders owning 10% of the bank's capital and directors with significant ownership are prohibited from any borrowing. Exposure to all connected counterparties cannot exceed 40% of the capital base.

In Egypt Banking Law 88/2003 prohibits all lending to a related party. But one response notes that the key is not the law but whether it is applied in spirit.

In Jordan the Central Bank sets and carefully monitors limits on related party lending.

In Kuwait, Oman, Qatar and UAE related lending is permitted, subject to market terms and disclosure.

In Lebanon the Code of Money and Credit prohibits related lending in the absence of express conditions including prior shareholders' and board approval, submission of a mortgage or bank guarantee and a positive assessment by the Central Bank.

Generally speaking, which type of related-party lending below can (potentially) be most problematic in your country?

A. lending to shareholders;

B. lending to board members/management;

C. lending to employees;

D. lending to the firms within the company-group to which a bank belongs;

E. lending to favoured clients, such as relatives of the management / board.

The most common issues cited as potential problems were D and E, often both. A and B were also mentioned in a number of responses.

Please summarise the key points of the laws/regulations regarding individual persons and corporate entities holding shares of banks (e.g. upper limit of such holdings, approval of banking supervisor for such holdings, fit-and-proper test, mandatory reporting, mandatory disclosure, disclosure of beneficial owners).

In Bahrain, there are clear limits, for example a "controller" (defined as someone who exercises voting power of 10% or more or who exercises significant influence over the management) is subject to a "fit and proper" test.

In Egypt, no family or individual can own more than 50% of bank capital and more than 10% requires approval from the Central Bank of Egypt.

In Jordan, shareholdings of 5% and all related party shareholdings have to be disclosed. Foreign shareholders are limited to 10%.

In Kuwait the upper limit for individuals including family members is 5%.

Lebanon law requires prior CBB authorisation for any holding exceeding 5% and for any purchase or sale by a board member. However, no limits are prescribed.

In Oman, holdings above 10% require prior approval and banks must report quarterly any changes on those holding 5% or more. Limits apply to individuals (15%), an incorporated body (25%) and a joint stock or holding company (35%).

Qatar defines any entity and its related parties holding 5% as a "major shareholder" which cannot transfer any of its shares without prior the Central Bank's approval.

Other than the related-party lending, please explain major problematic activities (if any) of banks involving conflicts of interest (e.g., bank's insider trading of the shares of its corporate borrowers, operating investment funds).

Not many of the answers address this matter specifically. The principal activity mentioned is insider trading, which seems to be of a particular concern in Jordan and Egypt, where "Chinese walls" are not mandatory and where there rules regarding employee trading are not considered rigorous. Bahrain mentions "name" lending to prominent family businesses that do not provide financial information to enable the bank to assess its risks accurately. One Jordan bank is concerned about the risk that a Chairman and CEO are sometimes from the same family. Lebanon cites investment abroad as a potential conflict.

Is a bank employee in your country usually able to communicate his/her legitimate concerns about illegal/questionable practices of the bank to the board (or to an independent body within the bank) without fear of retaliatory action?

Many of the responses said that this might occur but it was not very common in the countries concerned. Bahrain and Kuwait were more positive, but two of the responses by Egyptian banks said that whistleblowers would expect retaliatory action.

D. Clear lines of responsibility and accountability (in the case of group structure)

Are there any parent companies that hold domestic banks as their subsidiaries in your country? If yes, do you see major problems involving corporate governance of the parent companies and/or banking subsidiaries? Please explain briefly.

Most of the answers address subsidiaries or branches owned by foreign banks. In this regard, no problems of corporate governance were identified save for the Egyptian banks, which saw conflicts between international and local regulations.

Is the parent company expected to support the bank beyond its commitment as a shareholder?

A large majority of responses were positive although a few noted that it depended on individual circumstances.

Is the oversight of bank subsidiaries an issue?

Where this question was answered, it was largely in the negative, although three Egyptian and two Jordan banks acknowledged that oversight of bank subsidiaries was an issue. The Qatar Central Bank identified a need for intra-group exposure limits in the context of consolidated supervision.

E. Appropriate oversight by senior management consistent with board policy

Do you think most (if not all) senior management²² of banks in your country have the necessary skills to manage the business under their supervision and have appropriate control over the key individuals in these areas? If not, please briefly explain.

Nearly all the answers are were in the positive. Some respondents have cited the “fit and proper” rules established and monitored by the regulators. However, responses received from Egypt were far less optimistic, with one doubting whether there is a sufficient understanding of IT issues, compliance needs and operational risk, while another questions the overall competence of the senior management of public sector and smaller banks.

Please provide a brief description of the role and responsibilities of senior management of banks in your country? Are there any rules to avoid conflicts of interest?

Some of the answers to the first part of this question are extensive and cannot be briefly summarised. The common themes are that senior management is responsible for implementing the business strategies, policies and procedures as established by the board; determining and continuously supervising financial activities; providing strategic direction and leadership to the bank staff; and implementing sound audit processes. One response makes the point that management must believe in the value of sound corporate governance so as to set the appropriate tone from the top.

Several of the responses note that the CBs have established rules designed to avoid conflicts of interest and these can be vetted during onsite examinations. Jordan’s Banking Law 28/2000 obliges all bank administrators, subject to heavy penalties for non-compliance, to disclose in writing any interests in deals or contracts to which the bank is a party. They are then not permitted to participate in meetings where the deal or contract is discussed.

Bahrain’s answer suggests that a board member or senior manager should: not enter into competition with the bank; not accept gifts from the bank for himself or his associates; not misuse the bank’s assets; not use privileged information for financial gain; report any potential conflicts of interest in their activities with or commitments to other organisations, and declare their interests in other activities or enterprises; absent themselves from any decision-making that involves a transaction where a conflict of interest exists.

F. Internal audit, external audit and internal controls

Is there an accepted standard for internal audit? What are the practices and requirements in terms of auditor’s qualifications, remuneration and training? How are auditors appointed and by whom?

²² “Senior management” means those such as CFO and division heads who are responsible for overseeing the day-to-day management of the bank.

There are extensive responses to this question and most of these imply that there are good standards of Internal Audit (IA) in the MENA region. The standards that are quoted are either those of the Institute of Internal Auditors (IIA) or of the Basel Committee, which in the case of some countries have been adapted by the local regulator or the banking association. For foreign banks, more stringent practices are usually laid down by the head office. The appointment of IAs can vary from bank to bank. More specifically:

In Bahrain, internal audit is mandatory. Banks have some freedom to determine the detailed practices but are encouraged to benchmark against international standards. Outsourcing to qualified outsiders except to the external audit firm is permitted, but the prior approval of the CB is required.

In Jordanian practice, this issue is addressed by in the Banking Law 61 and the Company Law. The appointment of IAs differ, they can be appointed by and report to the audit committee, the board or general manager in collaboration with the Chairman of the board, or even human resources. Lower level IA staff is usually appointed by the Head of internal audit with the approval of the board of directors. One response noted that some banks might have weak IA owing to lack of independence.

In Kuwait the CBK has issued circulars on internal audit and the scope of internal audit is reviewed regularly. In accordance with the CBK's instructions, all banks are required to carry out an internal control review every year by an external audit firm and report to the CBK on their soundness, including the IA function. The appointment of a chief of IA has to obtain the prior approval of the CBK.

In Lebanon, internal auditors must hold no executive responsibilities. As in Bahrain, the internal audit function can be outsourced. The internal controls must comply with Basel Committee standards.

In Oman and Qatar, internal audit must be independent and qualified. The board of directors appoints the head of IA, who reports directly to the board.

In Oman, the head of IA must report directly to the Board and if he is removed, the CBO normally tries to arrange a one-on-one meeting with him.

The UAE response indicates that the audit committee selects the head of IA.

Are audit committees common and well-functioning governing bodies of your country's banks? What is their mandate? Are members of audit committees generally well qualified to perform their duties?

Audit committees are mandatory in Bahrain, Egypt, Jordan, Kuwait, Qatar and UAE. They are common in UAE but less than half of the Lebanese banks have an audit committee and few of them are staffed by independent Directors.

Audit Committee statutory duties differ quite widely, but common features are to review the integrity of financial reporting, especially for reports going to the BOD; oversee the IA and EA processes; monitor the control systems; review the accounting policies and financial statements; supervise the enforcement of codes of conduct; and check that recommendations from the regulator and the EA are acted upon.

Most respondents noted that audit committees function well, although respondents from some of the Egyptian and Jordan banks were not so convinced of their effectiveness.

Is a matrix system of management oversight of banking operations common? Please briefly explain major problems (if any) regarding the internal audit function of banks in your country.

Little matrix management is apparent in the MENA although in a couple of countries it is beginning to appear.

In Jordan, the problem appears to be a lack of qualified staff and the lack of appreciation and recognition of the importance of internal audit by some senior managers. Indeed, a few senior managers complained about the internal audit processes and follow-up methods. One response mentions that internal auditors often do not have access to all the material they need to do a proper job. A concern of the Central Bank of Oman is that internal audit processes are often insufficiently risk-focussed and that there can be undue delays in the implementation of their recommendations.

Are there any provisions or well established practices regarding the external auditors of the bank? Please briefly explain major problems (if any) regarding the external audit function of banks in your country. Is there effective implementation of high quality audit?

There are provisions in all the countries and these seem to be satisfactory. In Egypt, there is a register of approved auditors and each auditor can audit a maximum of two banks. Oman and Qatar both require the Central Bank's prior approval for the appointment of the external auditor. In addition, in Oman an external auditor can only audit the same bank for a maximum of four years and in Qatar for five years.

In most cases, the external auditors of banks are affiliated with one of the four major audit firms and if there are problems, few were raised. One Jordan bank noted that fruitful collaboration between the external and internal auditors can reduce duplication. A foreign branch of another bank mentioned that there can be inconsistencies between domestic audit standards and those to which the parent company belongs, arguing in favour of the same firm auditing all members of a banking group.

Few mention the practice of holding trilateral meetings between the regulator, the bank and its external auditor.

What steps have been taken to ensure the independence of auditors?

Many precautions are noted under this heading, which mostly refer to the external auditors. The most common features are that the bank cannot lend to its external auditor, an audit partner cannot be a shareholder (or a substantial shareholder) or director of the bank, that the external auditors cannot provide any non-audit services such as tax advice. In addition, respondents noted that the external auditor should have the right to inform the Central Bank of any problems it discovers that it feels should be brought to official attention.

As noted earlier, external auditors are usually nominated by the audit committee or the board of directors for approval by the general assembly. For foreign branches and subsidiaries, the head office usually decides. In Lebanon, where external auditors are mostly used for tax and advisory services, a decree has been issued in 1983 that expressly excludes a range of defined related parties from acting as the bank's external auditor. In Qatar, the board of directors cannot change or dismiss its external auditor without prior QCB approval.

What are the risk management systems in your country's banks? How are risk management systems overseen?

Although the answers imply that there is a standard approach taken to measuring, monitoring and managing credit and market risks, reading between the lines reveals some uncertainty. Only one response specifically refers to the assessment of risk tolerance/risk appetite. A common qualification is that risk management systems (RMS) are currently being upgraded, but it is too soon to judge whether they have yet reached a satisfactory level. The implementation of Basel II in the more advanced MENA countries is providing a strong stimulus to RMS, which have been largely focussed on credit and market risks but are now beginning to encompass operational, legal and reputation risks. However, it is also noted that Basel II requires a substantial upgrading of RMS and although banks are expected to be Basel I-compliant quite soon, the reality (especially in Jordan) may be rather different.

RMS are generally overseen by the internal audit function and the audit committee, but as Basel II is more widely accepted and applied, they are also coming to the attention of senior management and the board. In Qatar, there is now a complete separation between the RM function and the business lines, but no other responses appear to refer specifically to the separation of front, middle and back offices. However, one Jordanian bank has appointed a head of risk and another has an independent RM department that reports to the CEO. In Kuwait, the RM functions are reviewed by external auditors and Central Bank examiners. In Lebanon, there are extensive regulations under which each of the BOD, the CEO, the risk manager and IA unit have specific tasks, in accordance with Basel Committee recommendations.

Are risk management committees common? If yes, do they provide effective oversight of senior management's activities in managing credit, market, liquidity, operational, legal, compliance, reputational and other risks of the bank?

Risk management committees appear to be relatively common, apart from a few Egyptian and Jordan banks. Most respondents believe they address the issues mentioned and are functioning effectively, but in a few banks they have been established too recently to be able to judge.

Please briefly explain major problems (if any) regarding internal control functions (including the compliance and legal functions) of banks in your country.

Several of the answers reveal uncertainty on this matter. Bahrain is concerned about the inadequate segregation of duties in some banks and one UAE respondent believes that control functions (compliance and legal) in all emerging markets have fallen behind the increasing sophistication in the banking industry. Several Egyptian answers mention the difficulty of managing IT risk and note the huge investment needed to build adequate control systems. Another problem identified by several is AML, which is being undertaken in relatively inexperienced units, and the difficulty of updating customer data. Resources are another issue and one Oman respondent mentioned that the spirit of controls was not always being followed. The overall impression is that there is still some work in this area to be done by many banks.

G. Compensation policies

Do you see major problems in terms of compensation (including stock options and retirement payment) of board members and/or senior management of banks in your country? If yes, please explain briefly.

No response raises concerns about stock options and board retirement packages (“golden handshakes”), as these are not yet common in the MENA region. However, a couple of the responses raise concerns that the incentive structure is not satisfactory and others note that measuring performance is not a precise science.

H. Transparency (disclosure and reporting)

What are the reporting standards for banks in your country? Is there full compliance with International Financial Reporting Standards (IFRS)? Are there specific difficulties encountered by banks in this respect (please provide examples)?

All responses maintain that IFRS or very similar national standards are applied. In Jordan, if there is any difference, the more conservative accounting standard prevails and one Jordan bank notes that the external auditors can always qualify the accounts. Some respondents also note the relevance of Basel II and especially its Pillar 3 disclosure requirements. The only difficulty, mentioned by Oman, is occasional conflicts with local provisioning requirements for bad debts.

Does the banking supervisor have access to information about beneficial owners²³ of banks even though it is not known to the banks or not publicly disclosed?

²³ Beneficial owner is the person who benefits from the ownership of a security or other property, the *de facto* owner. The beneficial owner may not always be the same as the nominal owner (who is registered as the owner or who holds the title to the property).

Perhaps surprisingly, few respondents see any problems on this issue. The main reason seems to be that the Central Banks in Jordan, Lebanon and Oman for example, have the powers to obtain the information they deem relevant, at least for sizeable shareholders.

In addition, in Kuwait all holdings exceeding 1% of share capital and in Qatar all those exceeding 5% have to be reported. The only exceptions to this positive view are UAE, where the respondent was not aware of the answer to the question.

Two respondents on behalf of individual banks have pointed out the fiduciary character of some beneficial ownerships.

Is it mandatory for banks in your country to disclose (or report to the supervisor) information about some kind of related-party transactions? If yes, please summarise the key points of the disclosure (or reporting) requirements.

Several respondents say that such disclosures are required under IFRS and as a result, no problems arise. But a few respondents have added additional comments. In particular, in Jordan, Central Bank approval is required for related party lending. Lebanon's response stated that disclosure is not mandatory, but will become so from 2008 under Pillar 3 of Basel II. In Oman, such lending is capped at 10% of capital on an individual basis and 35% collectively. In Qatar, related party transactions are subject to prudential safeguards and only have to be reported in the case of violations. In the UAE, disclosures are only required in the annual reports.

Is important information (e.g., annual financial statements) of banks available to depositors of non-listed banks in your country? If yes, how do the depositors of the non-listed banks receive such information (e.g., the annual report published by the bank, or the supervisor making such information public)?

In Egypt, Jordan and Kuwait all banks except for foreign branches have to be listed. Elsewhere the financial statements of both listed and non-listed banks are published in the banks' annual reports and on their websites, and usually in the press as well.

What are the requirements for public disclosure of information by banks in your country? What are the most frequent problems with public disclosure of information by banks in your country?

Some of the answers to this question were quite extensive in listing the requirements, others simply stated that they are in line with IFRS, BCBS, IOSCO, AAOIFI, etc. There are also in many cases capital market disclosure requirements. Most answers cite the annual accounts, the quarterly statements and occasional press releases of material information as required by the respective capital market regulators. Others note that under Pillar 3 of Basel II many more details will be required than at present. Additional issues raised include:

Egyptian banks have to publish their financial statements in at least two national newspapers. But two banks note that there can be difficulties in obtaining the correct information about NPLs and credit facilities to borrowers, while another questions whether operating results are always correctly disclosed.

Jordan's rules require a list of disclosures, including forecasts and financial analysis.

In Qatar, the annual balance sheet, income statement and profit distribution has to be approved by the Central Bank before it goes forward to the AGM.

Do investment advisors and business media in your country weigh information provided by banks and probe for additional information?

The answers here are uniformly affirmative except in the case of Egypt ("sometimes") and Lebanon (only the rating agencies).

Is the board remuneration policy disclosed? What are the requirements regarding disclosure of the remuneration of members of the board and key executives?

Most responses mention that the BOD's remuneration policy is decided in the annual assemblies, although one response mentions that this is not the same as public disclosure.

The answers to the second question are split, with disclosure not required in Bahrain, Egypt, Lebanon and UAE; although in the UAE the aggregate amounts have to be disclosed in banks' annual reports. Full disclosure in the annual accounts appears to take place only in Jordan, where the rules are established by its SEC. One response notes that although disclosure is required, it may not be wholly reliable in the case of key executives.

I. Monitoring of the corporate governance of corporate borrowers by banks

Generally speaking, do banks in your country usually occupy a dominant position vis-à-vis corporate borrowers? More specifically, are they potentially able to exert de facto influence on the corporate governance structure/practices of their corporate borrowers if they want to do so?

Answers to the first part of this question are very mixed, even from the same country, and there is some doubt whether it would be possible in a competitive market to influence borrowers significantly unless they are distressed and thus unable to finance their activities elsewhere. However, one response envisages the possibility of a bank enforcement of corporate governance requirements by making them a precondition for borrowing. Two responses make the point that an assessment of the corporate governance of borrowers should already be a regular part of the credit assessment process.

Does the board (or senior management) of corporate borrowers in your country often include bankers (or ex-bankers) of the bank who lends money to the company? If yes, what are the pros and cons of such practice in your view?

In most cases the answer to this question was negative. An exception to this was in instances when a bank has a very large interest or appoints an executive to assist a distressed borrower, in which cases the person would side with the bank and not the borrower. The pros identified for having bankers or ex-bankers in senior corporate positions include the provision of financial intelligence, such as advising the corporate on loan negotiations, or managing the use of a credit productively; providing awareness of banks' expectations of their corporate clients and what services they can provide; and helping to prevent the borrower from adopting unethical practices. The main con identified is the likelihood of a conflict of interest.

Please describe the pros and cons of encouraging banks in your country to play a more active role in improving corporate governance structure/practice of their corporate borrowers.

There is not a great deal of enthusiasm for making banks responsible for assessing the corporate governance of their borrowers, if only because of the potential costs involved and doubts as to whether the bank would be able to exert effective influence. Some pros were identified, apart from the obvious value of good corporate governance to society, such as helping to raise awareness of the benefits of corporate governance, improving the credit's transparency and strengthening the banks' knowledge of its customers and their businesses. However, apart from the question of cost, some questioned why banks and not the authorities should be responsible for raising corporate governance standards and argued that banks were not qualified to judge their customers' governance.

Following on this, some respondents noted that doing so would pose a reputation risk for the bank. Moreover, respondents speculated that those banks that made an effort in good faith would probably suffer competitive disadvantages in the absence of strictly enforced legislation.

J. Other

Please feel free to comment any views on corporate governance of banks other than above.

Only seven comments were made under this heading, all but one from Jordan respondents:

There is a need for an enforced corporate governance code for every company, not only the banks.

It is strongly recommended that the CBJ and the Jordan Stock Commission should work together to drive corporate governance initiatives and come up with one code/practice for implementation.

Every bank should apply the Basel Committee's corporate governance principles.

Lack of awareness around corporate governance practices from board members can impair the bank.

For corporate governance practices to be effective, the CBJ should make their guidelines mandatory for banks.

The qualities that banks should look for in a director are leadership, accountability, a strong work ethic, interpersonal skills and, most important of all, integrity.

SYNOPSIS OF ANSWERS TO PART 2 OF THE MENA QUESTIONNAIRE
(QUESTIONS ADDRESSED TO CENTRAL BANKS ONLY)

Part II: general statistics about the banking sector	Bahrain	Egypt	Jordan	Lebanon1	Oman	Qatar
1. Total lending outstanding by all banks as % of GDP	52%	58%	94%	74%	34%	N/A
2. Total assets of the banking sector as % of GDP	1050%	145%	236%	343%	46%	N/A
2 (a) Numbers of banks – total number, of which	114	39, all domestic	23	61/63	16	16
- Commercial	26		13	31/40	7	5
- Investment	37			7/9		
- State-owned	2					1
- Islamic	242		2	2/4		3
- Local branches of foreign banks	47			10/10	9	7
- Foreign subsidiaries, locally incorporated	18		8	11/0		
- Listed domestic banks with no controlling shareholders	7			5/1	6	6
- Listed domestic banks with controlling shareholders	8		18	0/5		
- Unlisted domestic banks with no controlling	25			11/2		3

**SYNOPSIS OF ANSWERS TO PART 2 OF THE MENA QUESTIONNAIRE
(QUESTIONS ADDRESSED TO CENTRAL BANKS ONLY)**

Part II: general statistics about the banking sector	Bahrain	Egypt	Jordan	Lebanon1	Oman	Qatar
shareholders						
- Unlisted domestic banks with controlling shareholders	17			24/42	1	
3. Market share of the largest five banks	69%	72%	65%	48%	84%	84%

1. The two sets of numbers in this column represent the numbers submitted in two different responses.
2. Either commercial or investment.

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
4. What are the key characteristics of your banks, in which they might differ from banks in OECD countries?	Bahrain banks are well capitalised with NPLs around 2%	The cities are over-banked and the system is not yet fully automated		There is a high level of foreign currency trading, sovereign risk and dollarization but low derivatives activity		
(a) What is your overall assessment of state-owned banks' role in the financial sector?	The two state-owned banks do not play a major role, specialising in development and SME project finance	In the past they have been key to development but their role is declining	Not permitted, all banks must be joint stock or a foreign owned branch or subsidiary	There are none - banks can only be incorporated as joint-stock companies	They play a significant role in housing and SME project development	One bank is 50% state-owned and this is the most active bank in project finance
(b) Is there a need for consolidation of the banking sector? If so, please explain.	Consolidation would allocate scarce resources more efficiently, reduce the	Yes, to boost the capital base and improve banks' competitiveness	Yes, the CBJ is in favour of consolidation as it would increase the competitive	No, as consolidation started 10 years ago. But there is room for further	Yes, it could improve financial stability and add economies of scale, but	More consolidation would improve efficiency but the present situation is

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
	costs of intermediation and enhance financial stability		power of Jordan banks at home and internationally	consolidation.	with 88% in the hands of 5 banks concentration is sufficient	adequate
(c) What is your overall assessment of the role of family-owned banks in the financial sector?	The two family banks focus on investment banking. Their corporate governance is weak but competition and regulatory pressure is having positive effects	None now survive	Family ownership is 7% of total assets	Some large banks are partially family-owned but their market share is decreasing as the other banks increase their capital base	There are none but some banks have significant business shareholders	We believe family banks play a role in efficient financial intermediation
5. Do laws in your country allow banks to engage in what is called "universal banking"	Yes	Yes	Yes	Yes	Yes	Yes

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
6. Information regarding banking regulations						
(a) Which institution implements the off-site monitoring and on-site inspection of banks? How many persons are employed for off-site and on-site supervision?	Central Bank of Bahrain (CBB) 65 for both	Central Bank of Egypt (CBE)	Central Bank of Jordan (CBJ) 60 for both	Banking Control Commission (BCC) 45 onsite, 55 offsite	Central Bank of Oman (CBO) 26 onsite, 8 offsite	Central Bank of Qatar (QCB) 50 for both
(b) Which institution is responsible for “fit and proper” tests for:						
- members of boards of directors and management	CBB	CBE	CBJ	Central Bank (BDL) and CBB	CBO and Capital Markets Authority (CMA)	QCB
- major shareholders	CBB	CBE	Ministry of Trade and Industry	BDL and BCC	CBO	QCB

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
(c) Which institution licenses banks and revokes them? How many licences were revoked in the last five years?	CBB 16 including Offshore Banking Units	CBE	CBJ None	BDL and Higher Banking Council (HBC) None	CBO None	QCB None
(d) Which institution is in charge of the administrative measures on individual banks, such as forcing banks to do (or not to do) something in order to comply with the banking law, and of sanctioning (i.e. prompt corrective action)?	CBB	CBE	CBJ	HBC is in charge of imposing penalties on banks that violate administrative provisions or submit false information.	CBO A PCA framework has been in operation since 2005 with triggers based on Basel capital ratios and NPLs.	QCB

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
7. Does a deposit insurance or guarantee scheme already exist in your country? What are its main features (e.g. insurance caps on accounts covered or insurance caps on individuals covered)?	Yes, for all deposits of full commercial banks. Compensation is 75% of a person's total eligible deposits subject to a ceiling of BD 15,000 and a BD 25 million annual limit for all banks in total	No, but all bank deposits are guaranteed by CBE	Yes, Jordan Deposit Insurance Corporation established in 2001. 10,000 JD was established as deposit insurance ceiling per depositor and per bank.	Yes, National Institution for Guarantee of Deposits, jointly owned by the State and the banks. Guarantee covers amounts up to 5 million Lebanese Lira for a single person's total deposits with the bank	Yes, all licensed banks must be members. CBO subscribed part of the initial funds and contributes an annual premium equal to 50% of the total paid by the banks. The guarantee covers 75% of amounts deposited subject to a maximum 20,000 Rials	No, but on Qatar's future agenda.
8. Do banks pay premiums for deposit insurance based on criteria, such as assessed risk, or is it a flat payment, related only to the level of	No premiums paid	No	Flat rate	Flat rate	Flat rate, currently 0.03% of average annual total deposits	N/A

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
deposits?						
9. At this point in time, are there any banks whose shares are (partially) owned by the public sector as a result of a rescue operation?	No	Yes, Bank United	No	No	No	No
10. a) Does your country's framework comply with international standards on anti-money laundering and terrorism financing? Please cite the related legal acts and their date of enactment.	Yes, guidance following FATF and similar international standards first issued in 1997 and updated in 2001. Recommendations on terrorist financing	Yes, AML law 50/2002, FATF standards and KYC principles.	Yes, Banking Law Article 93	a) Yes, Law 318 (2001) and the Penal Code. Law 318 established an independent AML unit empowered to circumvent secrecy barriers and a Special	a) Yes, Oman is committed to adopt international standards; AML law was enacted in 2002, executive regulations issued 2004, based on	AML is extensive. Detailed regulations have been issued by QCB and a national Committee was set up in 2002. A FIU has been established to

Questions	Bahrain	Egypt	Jordan	Lebanon	Oman	Qatar
b) How are extraterritorial issues addressed with respect to money laundering and terrorism financing occurring across borders?	issued in 2005 as per UN resolution			Investigations Committee (SIC) with its own judicial powers. b) MOUs and international protocols. SIC is an Egmont member for info exchange	FATF/ IMF. b) Addressed by regulators, with input from Foreign Ministry, FIU and FATF	investigate suspicious transactions

Annex II.

Task Force Participants

Note: While all members of the Task Force occupy senior positions in their respective organisations, the findings and opinions expressed in this policy brief are personal and do not necessarily reflect the views of the organisations they serve or their countries of origin. The OECD and its partner organisations are very grateful to the Task Force members and other experts that contributed to this work on an ad-hoc basis, for their time, insights and comments.

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Organisations	
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<p>Union of Arab Banks <i>Dr. Fouad Shaker</i>, Secretary General</p>	
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Annex III

Descriptions of Participating Organisations

Organisation for Economic Co-Operation and Development

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-OECD Investment Programme at the request of governments from the Middle East and North Africa region in order to provide advice on implementing investment policy reform as a driving force for economic growth and employment throughout the region.

As a part of this Programme, the Working Group on Improving Corporate Governance was established 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 senior policy makers, regulators, market participants and representatives of academia from across 18 MENA countries and territories participating in the Programme, as well as OECD countries. The MENA-OECD Working Group works closely with its longstanding partners including the Hawkamah Institute of Corporate governance, the Global Corporate governance Forum, the World Bank, the International Finance Corporation, the Union of Arab Banks, and the Centre for International Private Enterprise.

The Hawkamah Institute for Corporate Governance (www.hawkamah.org)

The Hawkamah Institute for Corporate Governance (Hawkamah) is an international association of corporate governance practitioners, regulators, and institutions advancing home grown but globally integrated corporate governance best practices in the region.

Hawkamah's mission is to promote corporate sector reform and good governance, assist the countries of the region in developing and implementing sustainable corporate governance strategies adapted to national requirements and objectives. Regional cooperation will facilitate exchange and allow countries to learn from successful experiences, combine efforts, move towards harmonization of corporate governance frameworks, and build on synergies resulting from national actions and initiatives.

Hawkamah is currently shaping the development of corporate governance in the Middle East, North Africa, and Central Asia. By promoting its core values of transparency, accountability, fairness, disclosure, and responsibility, Hawkamah works on policy and practical aspects of corporate governance reform in the region.

The Union of Arab Banks (UAB)

The Union of Arab Banks (UAB) currently comprises of more than 330 Arab financial and banking institutions. This makes the UAB the foremost banking and financial consortium in the region, and the truest representative of the Arab banking community. The UAB is committed to serving the Arab banking sector, ensuring its complete compliance to international financial standards, and strengthening its international cooperation with the world marketplace and thus participation in international initiatives.

Over the last three decades, UAB has developed its role as a pivotal referral entity for the Arab banking community through its professional training, information, research and advisory services in the fields of finance and banking. The UAB is a leader in providing training seminars, forums and conferences for banks in Arab and non-Arab countries. UAB is also renowned for its banking and communication capabilities within its member base, with other financial and banking institutions in the Arab region, and with key international financial markets. Last but certainly not least, the UAB has championed several initiatives whose purpose is to promote and raise awareness of best international practices in the Arab banking sector.

The Global Corporate Governance Forum

The Global Corporate Governance Forum is an International Finance Corporation (IFC) multi-donor trust fund facility located within IFC Advisory Services. The Forum was co-founded by the World Bank and the Organization for Economic Co-operation and Development (OECD) in 1999. Through its activities the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crisis, and provide incentives for corporations to invest and perform efficiently in a socially responsible manner. The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs. The Forum has an extensive [work program](#) to support corporate governance reform in developing countries. The Forum is currently funded by IFC and the governments of Austria, Canada, France, Luxembourg, the Netherlands, Norway and Switzerland. In addition, the Forum receives bilateral funding from the government of Japan and Flanders.

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