

## First Sustainability Index for MENA region

Hawkamah Institute for Corporate Governance in partnership with Standard & Poor's and with the support of the International Finance Corporation has launched an exchange tradeable Environmental, Social and Corporate Governance (ESG) Index for the MENA region. **The S&P/Hawkamah ESG Pan Arab Index** is the first Pan Arab Index of its kind. It ranks and tracks the performance, transparency and disclosure of regional companies on ESG issues.

Following the global financial crisis, investors and business leaders have been forced to rethink the fundamentals of mainstream asset pricing and business models. It is now generally recognized that ESG factors can have long-term consequences on a company's financial performance, either for better or for worse. Specifically, potential shareholders expect any company in which they invest to meet certain minimum standards in terms of governance and disclosure.

The S&P-Hawkamah pan-Arab ESG Index includes the top 50 MENA companies ranked according to their performance on nearly 200 ESG metrics, when compared to their regional peers. The Index constituents are derived from the top 150 pan-Arab companies, measured by total market capitalization, listed on the national exchanges of Bahrain, Egypt, Jordan, Lebanon, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia and the United Arab Emirates, and subject to a liquidity screen, which requires a minimum average daily value traded of USD 100,000, to ensure tradability.

The 200 ESG metrics include carbon emissions, water and energy consumption, employee health and safety, community investment,



*Panellists from the ESG launch*

charitable giving, financial reporting and auditing, board independence and executive remuneration. The environment and social screens are based on output obtained from the mapping of the Global Reporting Initiative (GRI), Global Compact (GC) and the Millennium Development Goal (MDG). The weighting of environmental and social disclosure items varies across sectors, based on their impact in each sector. The corporate governance screen is an adaptation of Standard & Poor's existing corporate governance methodology to suit the MENA region.

It is now generally accepted that ESG issues can have medium- and long-term consequences for a company's financial performance. The 2010 BP Gulf of Mexico oil spill, which halved the company's share price in a couple of weeks, is a prime illustration of the risks of neglecting ESG performance.

Increasingly, socially responsible investment (SRI) is becoming part of the mainstream in the global investment community. Between 2006 and 2010, 800 institutions across the world signed up to the United Nations Principles for Responsible Investment. These signatories represent around USD 22 trillion of assets, which is more than 10% of total global capital markets. This trend is set to continue. The Responsible Investment market is forecast to grow to account for 15 – 20% of the total global market by 2015.

This ground-breaking Index is not only a tool for investors, but also for

### In this Issue

- The Hawkamah / S & P ESG Index – pg1
- Industry Roundtable on CG in Qatar and Beyond – pg2,3
- Calculated Risks? The view from the Boardroom –pg2
- Cutting “Clutter” and improving transparency – pg3
- Mudara IOD Power breakfast in partnership with SCCO International “Aligning Risks and Rewards – Designing an effective incentive scheme” – pg4
- Setting up a mortgage guarantee insurance framework in the UAE – pg5,6
- Upcoming Events –pg6
- Contact Us –pg6

companies. Hawkamah aims to provide incentives for performance. Inclusion in the Index provides public recognition for a local company of its ESG practices. But the Index is more than just a badge of honor. As the SRI movement spreads among the investment community, capital will start flowing towards companies with better ESG reporting, thereby improving their access to external capital. It also sets the benchmark for companies for the type of ESG or sustainability reporting expected by long-term investors. It may be useful for the region's stock exchanges and regulators to add ESG reporting as part of the required listing criteria. ➤

For more information, please contact [info@hawkamah.org](mailto:info@hawkamah.org) or visit <http://www.hawkamah.org/sectors/esg>

## Industry Roundtable on CG in Qatar and Beyond

An industry round-table was organised in Qatar by the Qatar Financial Centre Regulatory Authority (QFCRA) and Thomson Reuters Governance, Risk and Compliance on corporate governance.

Moderating the discussion was Michael Ryan, the QFC Regulatory Authority's deputy chief executive officer. In his opening remarks, Ryan noted that while corporate governance had always been a concern, it had become especially crucial in the aftermath of the global financial crisis. He launched the discussion by stressing that regulators, boards of directors and investors were increasingly focused on the role of corporate governance in protecting not only specific institutions, but also the financial system in which they operate.

Dr. Nasser Saidi, Executive Director, Hawkamah said we need to discuss governance at both the company level as well as at the level of the regulators and hence we need to start discussing the governance of regulators as well.

Michael Lesser, managing director of authorisation and supervision at the QFCRA said that "Knowledge is Power- in terms of governance, if the board does not have a full understanding, if the board doesn't have the expertise and, most importantly, if the board doesn't have unfettered and free access to the information they need to make decisions, then they can't do their job." From a regulators perspective, Lesser said he had to ensure that boards had access to the right information, without relying on the CEO as gatekeeper. "The key control functions must have direct communication with the board and with the committees of the board, so that the board can be armed with the information that it needs to make decisions." he said. Lesser also cited skill-sets as another key issue: "Independent outside expert board members are few and far between, especially in this region, and that is something really necessary in terms of proper governance.... Being able to make decisions requires having people that have that knowledge and expertise."

There was a general lack of understanding in the GCC about board member roles and responsibilities.: "For example, you see in this part of region that the chairman has a far higher authority than the CEO, which shouldn't be the case; it should be the actual CEO who plays this role, while the chairman has a secondary role, where he gives guidance and vision." Mr. Abdul Hakeem Mostafawi, CEO HSBC Qatar

Mohammad Al Thani, Risk Management Director, Qatar Central Bank said that the regional banks should clarify the supervisory role of their board of directors and improve the level of education, knowledge and skill among board members.

Lesser said that the authority to challenge board members

*Continued on Page 3...*

## Calculated Risks? The view from the boardroom

*Based on the report by The Korn Ferry Institute*

As part of an ongoing research, the Korn/Ferry Institute undertook a study to understand how risk oversight in the boardroom is evolving in the post-crisis economy. Twenty-six chairmen, chief executives, and board directors from companies in the United States, Europe, and the United Kingdom were interviewed to gauge their opinion and approach to risk.

The findings suggest that because of the increasing complexity of risk, the threat and reality of new regulation, heightened public interest, and the Internet-enabled speed at which issues can turn into crises, boards are fundamentally reassessing this aspect of their work. They are demanding additional resources, improved data, and sharpening boundaries around oversight. They are looking more critically at themselves, asking how they can best support the business, in part, by challenging it on risk issues. They are seeking to exploit their knowledge and understanding of risk to enhance strategic debate and decision-making and gain commercial advantage.

Seven key tenets were identified:


- **A board's risk purview needs to suit the company's scale, strategy, and regulatory situation.** Precise boundaries between oversight and decision-making should be explicitly agreed upon and articulated.
- **Final accountability for risk oversight rests with the whole board, even for those with risk committees.** Some will require committees because of the complexity of the business's risk profile; it is up to the board to determine and create the appropriate structure.
- **Risk reports need reassessment.** Board members require more granular information, including less refined data. They also want more leading indicators, as well as opportunities for far-ranging discussions with relevant executives.
- **Organisational risk culture is a pressing issue.** Leading boards are considering ways to measure, and influence, how thoroughly their risk appetite is saturating the company.
- **Chairmen lead the charge against group-think on risk issues.** Risk oversight is dangerously hampered by stifled opinions, so an open, trusting environment is mandatory.
- **Board renewal is an asset to risk oversight.** Bringing on new directors weeds out habitual assumptions and renews imagination on risk issues.
- **New directors should be recruited with risk in mind.** Boards, on balance, should have industry experience, strong risk instincts, strategic minds, and diversity in all its manifestations. ↗

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*“One of the other things we don’t have in this region are independent directors who come in from outside the business and give feedback on different elements of the business model-that’s very important.” – Mr. Abdul Hakeem Mostafawi, CEO HSBC Qatar*

was lacking in the region, especially if the chairman is also a prominent government minister. Dr. Saidi noted that he was a non-executive board member for two companies, a bank and an industrial company, and that the crisis had prompted important board-level reforms.” At the bank, two things happened: First, we made sure that the board audit committee was majority independent and we increased the frequency of meetings with external auditors and intensified internal audits across the whole processes within the bank. Second, we raised the profile of risk management within the bank itself. Previously the chief risk officer was there, but nobody would care, nobody was listening when things were going well”, he said.

*Non-executive directors had an extremely important role to play. ‘You need to pick them to be competent, but the biggest quality that they need to have is the ability to say ‘NO’ to the chairman.’ – Dr. Nasser Saidi, Executive Director, Hawkamah*

The roundtable also debated the regulatory reforms required in the area of corporate governance, the board recruitment process, duties of stakeholders, linking formal education and corporate governance 

## Cutting “Clutter” and Improving Transparency

Transparency issues in financial reports remain a challenge on the global scale, and are more so in our region. There is no doubt that more transparency in financial reporting adds value to companies. The more companies say about where they are making money and how they are spending their resources, the more confident shareholders and investors can be about their fundamentals.

It is even better when financial reports provide a line-of-sight view into the company's growth drivers. Transparency makes analysis easier and thus lowers an investor's risk when investing in stocks. That way shareholders and investors are less likely to face unpleasant surprises.

The annual report's primary purpose is to provide investors with information that is useful for making their resource allocation decisions and assessing management's stewardship. It can also help stakeholders assess the company's governance, and whether it enables the board and management to deliver on the long-term success of the company.


Transparency in reporting is not limited to the amount of information included in the reports, but also includes the quality of that information. Information in financial reports that might be unnecessary out-dated or misleading is referred to as “clutter”. Cluttering comprises of two problem areas which are:

- Immaterial disclosures that inhibit the ability to identify and understand relevant information; and
- Explanatory information that remains unchanged from year to year.

Immaterial disclosures are remarkably common, for example detailed notes supporting line items that are small – often the case for share-based payments. However, reports also contain explanatory narrative information that is either wholly or largely unchanged from year to year. It is the changes that can often be illuminating but, without comparing the precise text, it is often difficult to identify them.

Clutter in annual reports is a problem, obscuring relevant information and making it harder for users to find the salient points about the performance of the business and its prospects for long-term success. Hawkamah believes that removing clutter from financial reporting is an essential step towards increasing transparency in the region, and achieving better and more efficient corporate governance, which will lead to increasing the value of the companies in the region, and in-turn give regional and global investors a clearer picture about the business of these companies.

The latest report by the Accounting Standards Board of the Financial Reporting Council (FRC) on cutting “clutter” provides preparers of annual reports with practical aids for reducing clutter, giving ideas for how disclosures might look without the clutter, and factors to consider when planning the annual report process and identifies the following steps to make that immediate change possible:

- Set out three calls for action which are essential to start combating a number of barriers to cutting clutter and provide better reporting.
- Follow a behavioral aid developed by the FRC that preparers can use at suitable times during the annual report process to help overcome some of the barriers.
- Follow the three disclosure aids developed by the FRC to demonstrate what some key areas of the annual report could look like without the clutter. 

These steps are explained in detail in the link to the FRC paper provided below:

<http://www.frc.org.uk/images/uploaded/documents/Cutting%20clutter%20report%20April%2020112.pdf>

## Mudara IOD held Power Breakfast session on “Aligning Risks and Rewards – Designing an effective incentive scheme” in partnership with SCCO International

### Entrepreneurial Incentive Schemes as Key in State-of-the-Art Management Systems

There have been very few topics lately that have stirred up as many emotions as management compensation. Unclear basis for measuring success and high bonuses for financial results that turned out to be a bonfire are main accusations in the discussion. There is no doubt that many “traditional compensation models” have malfunctions and do not meet the requirements of upcoming regulatory restrictions – not only in banking. From our experience truly entrepreneurial incentive schemes need to address four key challenges:

#### 1. How to incentivize decision making in accordance with owner’s interest?

The majority of companies are using financial performance metrics like EBITDA, EBIT or Net Income as basis for their compensation. However, these metrics fail to represent the full picture, because capital costs remain totally or at least partly unaccounted for.

But entrepreneurial endeavours require capital – partly for investments and partly as a risk buffer for possible losses. Thus, only absolute value creation figures such as Economic Profit where costs of debt and equity as well as underlying risks are taken into account are suitable for measuring success.

#### 2. How to set ambitious financial targets detached from “budget rounds”?

In order to evaluate a given performance, it is typically compared with a target based on the annual budget. In those cases, target bonus is paid if budget is met. The obvious problem: the various budget rounds become a political negotiation process – the original focus of planning is lost completely and scarce resources are wasted.

Targets for compensation systems need to be derived from the long-term strategy and should not be re-negotiated annually. The target level should be set by

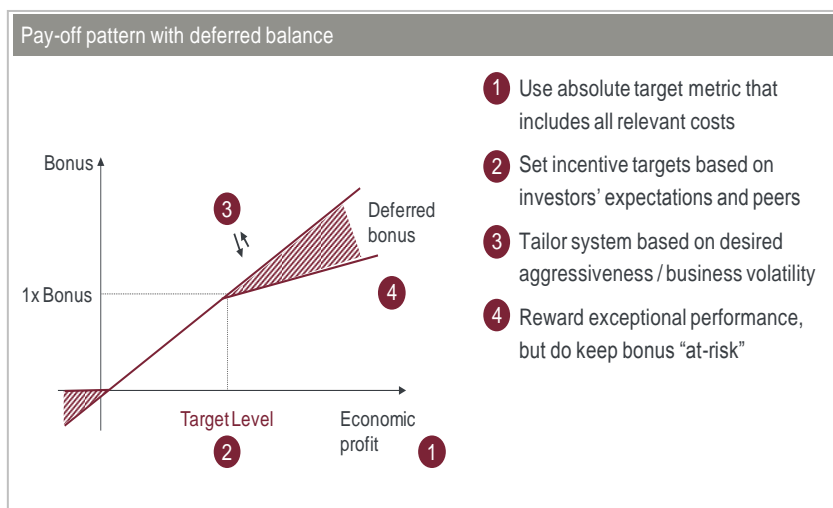
comparing the internal view to competitor’s performance and investors’ expectations to create ambitious, yet realistic targets.

#### 3. How to reflect underlying business characteristics?

A high number of companies put a lot of efforts in the calibration of the fixed pay and target bonus components of their employees. But what happens, if 50% or 150% of the target performance is achieved? What is the adequate “slope” of the bonus line within a specific business? A common approach is very often a linear relation applied to all business units: “Same aggressiveness for all”.

Entrepreneurial incentive schemes address this topic in a more differentiated way. The scheme is calibrated based on the volatility of the underlying business. High variations in performance, e.g. in cyclical or seasonal businesses are buffered with a rather flat bonus line

#### Summary of key recommendations to turn executives into “entrepreneurs”



(e.g. steel or property business). Low performance volatility in relatively stable businesses such as retail or utilities needs to be calibrated with a rather steep bonus line.

#### 4. How to ensure

##### sustainability of results and performance?

A compensation system should avoid paying out high bonuses to management who cannot be made accountable for a decline in performance in subsequent years. Implementing too narrow caps in the annual bonus system is obviously not the right answer.

The solution for this challenge lies in the structure of bonus pay-outs. High bonuses awarded for performance in a specific year should not be paid out immediately; rather a part is credited into the employee’s individual deferred balance. A fixed percentage of the deferred bonus is then paid out in each subsequent year while the remainder is carried over to the following year. With this system, a significant part of the bonus is subjected to future business risk, which is a form of active capital participation by employees. Applying this framework only sustainable value creation is rewarded. ↗

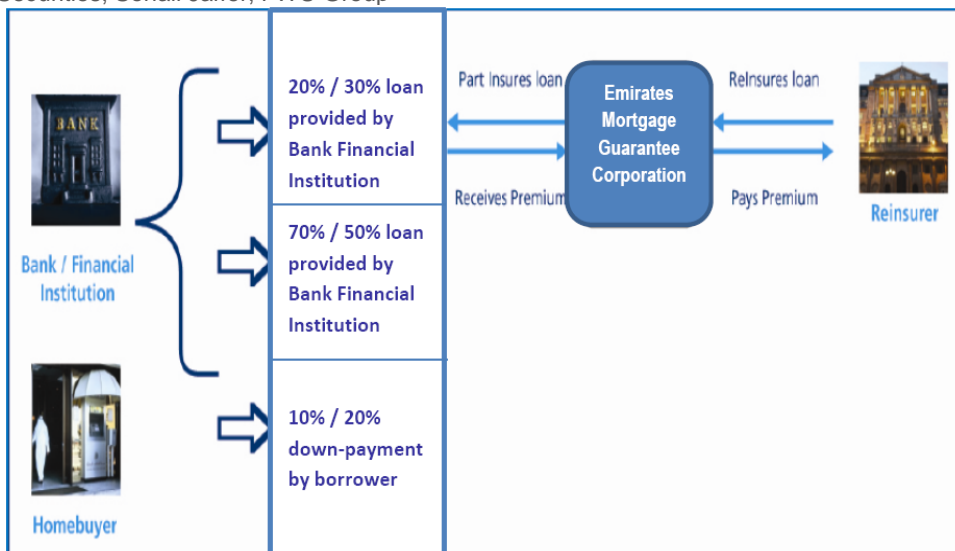
## Setting up a Mortgage Guarantee Insurance Framework in the UAE

Hawkamah partnered with the Dubai International Financial Centre (DIFC), Real Estate Regulatory Agency (RERA) and Arthur D Little / Altran Financial Services at the 3rd Arab Real Estate and Urban Development Conference.

Dr. Nasser Saidi, Chief Economist DIFCA, Head External Relations and Executive Director Hawkamah gave the opening address, providing an overview of the real estate sector and the mortgage market in the GCC. The conference was attended by over 250 people.

Key speakers included Waseem Saifi, Global Head Islamic Banking, Standard Chartered Bank, Wagn Erik Nørgaard Vice President, VP Securities, Sohail Jaffer, FWU Group and Simon Gray, Director Supervision, Dubai Financial Services Authority.

The topics discussed were financing the real estate sector in the GCC (through Islamic and Conventional finance), setting up a mortgage



individuals experiencing economic hardship or adverse events. This kind of institution is increasingly common across the world and therefore the time has come for the UAE to establish an **Emirates Mortgage Guarantee**

The crunch in international credit markets is making it increasingly difficult for banks to ensure a steady source of medium and long term funding in addition to clients' deposits.

Without adequate financing, real estate will continue to be a drag on economic recovery, leading to lower growth than in other emerging market economies. Widespread uncertainty at a global level has exacerbated risk aversion by local lenders, leading to a tightening of credit for housing finance and stricter requirements for mortgage approvals.

These credit problems are compounded by the lack of the typical tools and institutions available in many developed countries and even emerging markets, which allow risk mitigation and risk pooling, thereby reducing individual bank exposure to adverse events. In particular the UAE lacks an institution providing insurance against mortgage defaults by

**Corporation (EMGC).**

What would EMGC do? Mortgage lending banks and financial institutions are exposed to a series of risks: (a) If a borrower defaults, there is a loss on the individual home market value; (b) local or regional recession causes a generalized decline in real estate prices; (c) a major economic downturn spurs deterioration in all asset prices and in credit quality. The first risk is a reasonably manageable risk, as it involves repossessing the dwelling and reselling it to cover the outstanding debt. In normal times this process might be costly and time consuming for the bank, but it does not jeopardize its solvency. The other two risks are potentially disruptive because repossessions in generally deteriorating markets will reduce recovery of the loan value.

The EMGC would provide insurance coverage of eligible housing loans to approved institutions (i.e. designated banks and financial institutions in full compliance of regulatory requirements, and in particular capital adequacy requirements) for an amount of up to 30% of the value at origination (subject to the insurance eligibility criteria of

market in the GCC and Challenges & Blueprint for Danish mortgage model adapted to the GCC.

It was stressed that mortgage contracts should be standardized both in conventional and Shari'a-compliant finance to allow efficient packaging of risk and more effective risk management.

One of the lessons learnt from the UAE mortgage systems was that there is a dire need to establish a credit bureau, overcome the limited re-financing opportunities for banks and mortgage companies, there is lack of depth in secondary property market, there are no circuit breakers to cool over heating property market – vulnerability for mortgage lenders and while foreclosure law exists their enforcement still remains untested.

Dr. Nasser Saidi also emphasised that the need of the hour is to set up a Mortgage Guarantee Corporation for the UAE. A summary of the concept is as follows<sup>1</sup>:

<sup>1</sup> The analysis, views and opinions expressed are those of the author and should not be interpreted or construed to represent any official policies or views or endorsement.

Continued on Page 6...

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different mortgage guarantee products), enabling the banks to advance mortgage loans of up to 80% to 90% the property value, with the home buyer putting down 10% to 20% of the value (as shown in the accompanying chart). With the additional protection of mortgage guarantee, the down payment required for potential homebuyers can be reduced without additional risk to the banks.

The EMGC would hedge the exposure of the mortgage guarantee by taking out reinsurance with approved Reinsurers. Part of the risk could then be offloaded to international reinsurers. In this way the bank prudential limits on mortgage lending (typically 60% to 70%) can be overcome without exposing individual banks to undue risk. In other words, banks would be exposed for 60% to 70% of the mortgage but they could earn interest on the full amount of the loan.

In order to make effective this provision, mortgage contracts should be standardized both in conventional and Shari'a compliant finance to allow efficient packaging of risk and more effective risk management. Specific provision for Shari'a compliance can be easily devised as the mortgage is backed by a real asset generating a stable cash flow. Underwriting rules should also be standardized in a more rigorous legal framework. The mortgages, both conventional and Shari'a compliant, could also be repackaged into Mortgage Backed Securities which then could be used to increase the liquidity of banks via repo operations with the central bank. In this way a secondary market for MBS could gradually emerge with positive effects on the overall depth and liquidity of domestic securities markets, both conventional and Shari'a compliant. Stated differently, mortgage guarantee would crucially facilitate the transformation of illiquid assets into high quality negotiable securities for all types of investors and financial institutions.

The EMGC could be founded as a private-public partnership with half

of the capital provided initially by public entities and the rest by private investors and non-banking financial institutions. At a later stage and once the scheme is firmly established, the share of public capital could gradually decrease.

EMGC should be established by a law that would define the level of coverage (we suggest 30%, but this could vary), devise the regulatory and supervisory structure (e.g., capital requirements, accounting rules, and prudential requirements) and set the details of the procedure to be followed in case of default with predefined deadlines for payments. It would be desirable also (a) to specify catastrophic loss reserve requirements to be used in exceptional circumstances; (b) to prevent conflict of interest by establishing independence from the banks and other entities; (c) to prohibit premium rebates to banks (or their brokers) or any other significant involvement by third parties.

It is also worth mentioning that mortgage guarantee is more effective when the broader legal framework hinges on stable principles and follows established practices.

In conclusion, a mortgage guarantee scheme is a special form of credit insurance that protects lenders against loss from borrowers' default on mortgage loans caused by economic adversity. It would produce five main beneficial effects for the UAE economy, the public at large and the financial sector:

- Revitalize the real estate market and the construction sector as engines of growth for the UAE economy;
- Facilitate broader home ownership;
- Support the growth of the mortgage market and integration of capital markets;
- Allow banks to offload some risk from their balance sheet spurring the resumption to normal lending levels;
- Promote product innovation and standardization while fostering the development of a liquid secondary MBS market. 

## Forthcoming Events

Hawkamah launched the [Policy Brief on Islamic Financial Institutions and Banks in the MENA region](#) on 08 June 2011

19 June 2011

[Company Secretary Workshop](#)  
Dubai, UAE

20 – 21 June 2011

[Director Development Programme Introduction to Corporate Governance](#)  
Dubai, UAE

22- 23 June 2011

[Director Development Programme The Board](#)  
Dubai, UAE

26 June 2011

[Mudara IOD Power Breakfast Board Effectiveness and Assessments](#)  
Dubai, UAE

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