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ECONOMIC AND CORPORATE GOVERNANCE CENTER

FLAGSHIP REPORT ON THE BANKING SECTOR IN THE MIDDLE EAST AND NORTH AFRICA: GOVERNANCE IN SUPPORT OF STABILITY AND TRUST

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Foreword

In the aftermath of the second largest financial crisis in the world's history, good corporate governance, especially in the financial services sector has emerged a key consideration for regulators worldwide. Though the Middle East was not directly affected by the crisis, Central banks, securities and other regulators in the region have been observing closely the unravelling of the global financial system and the implications that this may have on financial institutions in the region.

We are fortunate that through a combination of a strong regulatory framework and constant dialogue between the regulator and the organisations we oversee, the impact of the crisis on the Lebanese banking sector and on Arab banks more generally, has been contained. However, this shall not be taken to imply that regulators in the region can afford to be complacent in the coming years, which will be in a number of ways be a test to the resilience of Arab economies and banking institutions.

The banking sector remains a fundamental pillar of the Lebanese economy and indeed is the single most important source of corporate financing in the wider Middle East and North Africa region, where capital markets remain relatively less developed. While Arab banks have been able to withstand the global financial crisis, the instability in the region over the past 5 years has had an impact on local banks, requiring them to be attune to a wider range of economic and political risks.

In Lebanon, the Central Bank (Banque du Liban, BDL) has been a key actor actively promoting the importance of corporate governance in the banking sector and beyond. It for this reason that we have supported the establishment of a dedicated corporate governance center, the Institute of Finance and Governance at the ESA Business School in 2015. Since its launch, the Institute has been a pivotal force in leading the conversation and research on corporate governance in the banking and in the corporate sector more generally.

As we accumulate valuable experience on the implementation of better governance to support the resilience of the Lebanese banking sector, we are keen to share this experience with our peer regulators in the region and also to learn from the regional and global experience. While the challenges that Arab banks face are in some ways unique, I believe that we stand to gain from being active participants in the global dialogue aimed as safeguarding the stability of the international financial system.

I would like to express my gratitude to the Institute for Finance and Governance as well as the Union of Arab Banks for their contributions to the success of this project. I would like to also thank GOVERN for authoring this comprehensive, authoritative report on the state of corporate governance in the Middle East and North Africa, based on such a breadth of primary and secondary research.

I believe that the recommendations put forth by this report are equally relevant to Central Banks as policymakers, but also to bank boards and executives. At the BDL, we look forward to hosting policy conversations around this report and to working with our peers in the region and internationally to create an international supervisory architecture that can address the growing complexity of the banking sector.

Riad Salamé
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Introduction

Bank competitiveness and stability is underpinned by good governance at the level of the executive, the board and by the quality of relationships with shareholders, stakeholders and regulators. Following the last global financial crisis, bank boards and executives now face a much more complex set of compliance and risk management prerogatives. Banks identified as systemically important face more rigorous oversight domestically and cross-border supervision by international and supra-national regulators.

These developments and lessons learned from the global financial crisis have been reflected in the global corporate governance standards, notably the *G20 OECD Principles of Corporate Governance* as well as in the *Corporate Governance Principles* issued by the Basel Committee, both revised in 2015. In recent years, central banks in the Middle and North Africa region have taken these guidelines into account as they have revised and continue to revisit national banking governance standards.

Considering the speed of these developments and the growing complexity of the political and economic environment facing Arab banks, it is now urgent to take stock of the governance reforms implemented in the region to date and consider how they have supported the resilience of the banking sector and what regulators can learn from the consolidated policy experience accumulated thus far in the region.

This urgency is accentuated by a number of macro-economic trends, notably the decline in the price of oil and political instability, which have resulted in further complexity affecting the business environment in which banks operate. At the same time, the sector is being impacted by major industry disruptive trends and technological challenges such as block chain technology which threaten the traditional business of banking.

With this in mind, this *Flagship Report on the Banking Sector in the Middle East and North Africa* focuses on how corporate governance can foster banking stability and trust in the broader communities. As such, the report seeks to present and compare corporate governance regulatory frameworks and approaches adopted by central banks across the Arab world in order to highlight regional best practices, and additionally suggest areas where they can be further strengthened.

In doing so, the report builds on the previous *Policy Brief on Corporate Governance of Banks in the Middle East and North Africa*, issued by the OECD[1] in collaboration with the International Finance Corporation (IFC) and the Union of Arab Banks (UAB) in 2009. Leveraging this work, the report presents an extensive legal benchmarking of laws and regulations bearing on corporate governance of banks, including central bank laws and regulations, as well as company law and capital market requirements that apply to banks.

The report also builds on a survey of a sample of Arab banks conducted by GOVERN in 2017. This 50-question survey was disseminated by the UAB to a sample of its members at the level of boards and senior executives in order to obtain their feedback on corporate governance regulations, their implementation and obtain views of board members and senior executives on challenges going forward. Respondents represented a variety of Arab jurisdictions with the exception of Algerian, Bahraini, and Moroccan banks.

The largest category of respondents, corresponding to 31 percent of the banks, had assets between $1-4.9 billion USD, while 23 percent have assets exceeding $20 billion USD, with the assets of a further 23 percent totalled less than $1 billion USD. The ownership models of the surveyed banks were diverse, including both controlled and widely-held. More than half of the banks had listed equity, less than 10 percent has listed debt, while 35 percent recorded no listed debt or equity.

Countries examined for the purpose of this report include 11 jurisdictions in the Middle East and North Africa with the largest financial and banking sectors including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Egypt, Jordan, Lebanon, Morocco and Tunisia.[2] These jurisdictions were reviewed in terms of their regulatory practices and responses were subsequently compared to the results of the aforementioned 50 question survey. Secondary research and interviews were conducted for the purposes of the report and their findings are presented herein.

[1] The Policy Brief was authored by Alissa Amico, Managing Director of GOVERN prior to her departure from the OECD.
[2] Algeria, Djibouti, Iraq, Mauritania, Palestine, Syria and Yemen have not been examined due the smaller size of the banking sector and lack of comparable data sources.

Based on this benchmarking and analysis, this report provides a number of practical recommendations to banking as well as to securities regulators for listed banks, to ensure they can continue to have a positive impact on the governance and ultimately on the stability and performance of local banks. To that aim, the report's recommendations are also addressed to the boards of directors and C-suits of Arab banks, as well as the company organs responsible for the oversight of legal, compliance and governance functions.

This flagship report is the first of a kind to comprehensively address the state of banking corporate governance in the region and provide an outlook for reform for the next decade. As such, it is hoped that this report will guide further policy dialogue among central banks in the region as well as further collaboration between banking, securities and other regulators in the individual countries.

The report was developed by Alissa Amico, Managing Director, GOVERN with research assistance by Shahira Wassef, Lars Hodel and Patrick Brindle, for which they are kindly thanked. The authors would like to thank the Banque du Liban and the Institute of Finance and Governance for sponsoring this important study. The Institute of Finance and Governance is looking forward to hosting further policy dialogue around this study in the coming year in order to further advance the bank governance agenda in the region.

Summary of Policy Recommendations

The Regulatory Framework

- Regulators are encouraged to review the consistency of domestic regulatory standards with the revised *OECD Principles of Corporate Governance* and the *Basel Committee Principles on Corporate Governance*.

- Some regulators have already included corporate governance in the broader prudential assessments of banks and this practice should be encouraged.

- Regulators should consider the benefits and costs of introducing mandatory versus "comply-or-explain" approaches. A mixture of requirements may also be advisable in jurisdictions where the size and sophistication of banks may be variable.

- At the same time, central bank regulations bearing on governance of banks should be consolidated in a single code/recommendation with additional guidance if necessary in order to make them accessible and easy to follow.

- The regulations developed by central banks and securities regulators should be consistent as to ensure that listed banks can follow a framework that is not contradictory. Where banks have listed equity, regulators may wish to consider subjecting them to the same standards as other listed companies.

- Regulators may wish to consider addressing particular Shari'a governance concerns and prerogatives, either as part of the main corporate governance code or as a separate regulation.

- State-owned banks should be subject to the same regulatory framework as all other banks to ensure a level playing friend.

- The particular dynamics of family-owned banks merit to be considered from the perspective of ensuring there are the right separation of powers between ownership and management.

- Central Banks and other regulators are encouraged to consider introducing proportionality and flexibility and regulatory approaches to banks of different size, sector and complexity.

- The regulatory treatment of systemically-important banks as proposed by Basel Committee, including surveillance of corporate governance of such institutions, should be implemented in the region.

- Central Banks may wish to establish specialised units or expertise to monitor the implementation of good corporate governance in supervised entities. The efforts of the banking institutes established by a number of central banks can be complementary in providing training to boards and executives on corporate governance.

- Industry associations should be provided a formal role in the development of self-regulatory standards, including on corporate governance.

Board Nomination and Appointment

- The "fit and proper" criteria for board members merit to be further detailed to ensure that board members of banks are suited to fulfil their responsibilities.

- Central Banks should review the profile of board members individually and the board as a whole. Likewise, the resignation of board members as well as senior executives should be notified to the regulator.

- In addition to the corporate governance code, guidelines on board duties and responsibilities may be useful to outline the scope of fiduciary duties of board members.

- Board members serving on particular committees, notably the Audit Committee, should be subject to specific financial literacy criteria. Risk Management and Governance committees should also have individuals with specific skills and qualifications.

- Boards should be comprised of a sufficient number of independent directors and best practice would suggest that this means that at least 30-50% of board members be independent.

- It is critical that key committees of the board especially Audit, Nomination and Remuneration and Governance Committees are majority independent and led by an independent director.

- Regulators may wish to review existing board independence regulations and ensure that the appointment of directors in banks is consistent with the established requirements.

- Independence requirements should be set with reference to negative criteria which should address any conflicts of interest situations which could compromise a director's objectivity.

- Independent directors should be limited in the number of mandates they can cumulate. They may be allowed to continue serving on the board after but shall not be considered as independent.

- Boards of banks should facilitate discussions among the independent directors separately from the main board and consider appointing a lead independent director to lead this discussion.

- Board members, especially those appointed as independent directors, should be free of conflicts of interest and should report to the board and the regulator immediately if there are any material changes to their situation.

- Regulators should consider measures to foster female participation on bank boards. This could include a range of measures including quotas and guidelines. Banks should be required to report to the regulator and the public measures they have adopted to foster diversity.

Board Effectiveness and Responsibilities

- Boards should adopt a board charter, outlining the role, responsibilities and composition of the board and its committees. The charter should address not only the regulatory requirements but also the specificities of the bank's ownership structure and other relevant parameters.

- Members of bank boards should take their duties seriously and hence should avoid sitting on more than 5 boards in order to dedicate sufficient time to their responsibilities. Conflicts of interest that might arise from their executive or board appointment in other organisations should be considered.

- Boards should conduct assessments annually and no less than every three years. Regulators might consider requiring boards to provide them the results of these assessments, which should include any actions that the board is taking as a consequence.

- Succession planning is a gap which is not addressed by all regulators in the region. The Nomination Committee should be charged with elaborating a succession plan for senior executives and the board.

- The requirement existing in most jurisdictions for board members to hold shares in order to qualify for board membership creates legal obstacles and should be abolished.

- Regulators should pay particular attention to regulations dealing with addressing conflicts of interest in the banking sector, taking into account the ownership structure of banks.

- Notably, regulators in best practice jurisdictions in the region have expressly forbid lending to board members and members of senior management.

- Boards should be supported by a qualified Corporate Secretary who should not be a member of the executive nor be a member of the board. The Corporate Secretary shall support the organisation of board meetings, board evaluations and training.

- Board members should receive training when they assume their responsibilities and periodically as it relates to the challenges faced by the board and/or the specific committee on which they serve. At the same time, boards should have the resources to engage external expertise if/when required.

The Risk Management Framework

- Bank executives and management should evaluate and seek to address particular risks stemming from concentrated lending and consider how domestic institutions may be impacted by economic and political shocks.

- They may consider reviewing limits established on exposures to a single organisation/high net worth individual by a particular bank. Likewise, regulators should consider exposures to such entities faced by the domestic banking system as a whole.

- Banks should establish specific procedures for approving related party transactions, including establishing specific thresholds for transactions that need to be approved by the board (or its Audit Committee) or the shareholders.

- Regulators may wish to retain the right to unwind abusive RPTs at the expense of the party at fault.

- The risks stemming from cross-border operations of domestic banks should be reviewed and coordinated with peer regulators in the region and internationally.

- Information technology, notably cyber risks, should be considered by the Risk Management Committees and strategies to address these in the short- and medium terms shall be devised.

- In fully and partially state-owned banks, the risks related to non-performing loans stemming from non-arm's length lending practices to the government or other SOEs need to be addressed.

- Certain practices such as lending to board members, especially when it is not done on market terms, should be forbidden. Other situations which may create conflicts of interest should be addressed in the board charter.

- The board of the bank should be aware of and have process to monitor the risk profile of the organisation as a whole and at the level of individual subsidiaries.

- Banks should appoint a Chief Risk Officer with the mandate to implement an enterprise risk management framework across the organisation. The CRO should also report to the board and the dismissal/resignation of a CRO should be notified to the regulator.

- The internal audit function should be endowed with the necessary resources and independence to carry out its activities. The Head of Internal Audit should report to senior management and to the board, at least annually.

- Governance of bank subsidiaries should be consistent with group-level practices. At the same time, care should be exercised so that these practices are consistent with the regulatory requirements in the jurisdiction where the subsidiary operates.

- Macro-prudential review of banks should take their risk management practices into account with the possibility that the regulator may levy an additional surcharge if the practices are insufficient.

- The board shall set up channels to receive complaints from the company's employees, partners or the broader stakeholder community. There should be a process established to review these complaints and the identity of whistle-blowers acting in good faith should be protected.

Shareholder Rights

- Shareholders should be informed of AGMs with sufficient notice to facilitate their participation. Shareholders, especially foreign shareholders, should be enabled to participate and vote in AGMs virtually via modern technology.

- It is increasingly considered a good practice for board members to participate in AGMs and to answer questions shareholders may have, in addition to the participation of executive management.

- In order to elect board members, shareholders should be provided with sufficient information about their profile, including their CV and how they fit the skill gaps of the board.

- Cumulative voting on board members is an increasingly recognised practice in the region and should be used to elect board members in banks.

- The annual report should include a corporate governance report outlining how the bank complies with domestic and international corporate governance guidelines and what actions the board is planning to adopt to further improve corporate governance.

- Disclosure should be provided through several modern and accessible channels of information including in particular the corporate website. To the extent possible, banks should provide reporting in English and Arabic.

- Listed banks should establish an investor relations function to liaise with shareholders. The head of this department should be of sufficient seniority to be able to address shareholder inquiries.

- Banks should review the quality of their non-financial disclosure to ensure that, in particular, governance, environmental and social disclosure are not provided as segregated information but in the form of integrated reporting.

- It is increasingly considered a good practice for bank boards and management to disclose the remuneration of top executives and board members, including a discussion on how it fosters long-term objectives of the organisation.

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