

Governance in the Gulf: in search of best practice and a common view Abu Dhabi, November 28th 2010

At the second INSEAD Governance Meeting, held on INSEAD's Abu Dhabi campus, board members, investors, including heads of private equity funds, and institutional leaders in the governance arena met to discuss the evolving governance scene in the Gulf.

There was widespread recognition that corporate governance is taking a greater role in the region. *"Everyone understands the benefit of good corporate governance,"* said Fatima Al Jaber, Chief Operating Officer of the Al Jaber Group, who was named by Forbes Arabia as the seventh most influential woman in the Arab world in 2008, *"the challenge is to balance the need for better governance with both established best practices worldwide and the realities of the region."* She insisted that, *"Greater transparency, and demonstrating on a daily basis that the organization and its management and employees operate with integrity, have never been more crucial to the Gulf's corporate reputation and its success."*

A changed outlook worldwide

Led by Ludo Van der Heyden, the Mubadala Chaired Professor in Corporate Governance and Strategy at INSEAD, the forum began with an assessment of the global context, looking at corporate governance trends and changes in individual regions. He observed that a positive point to come out of the recent global crisis was that business people had a much greater appreciation for what corporate governance consists of and what benefits it can bring to companies, especially in terms of sustainability and risk management. One area where good governance is often lacking – with substantial value destruction as an outcome – is that of M&A, and the related field of partnerships and joint ventures. Not-for-profit associations also are known to face complex governance issues, often leading to crises at the top.

He said the US was not setting an example, despite its recent soul-searching in the wake of the banking meltdown. Best practice in the governance area could be found in countries such as Canada, which appears to be surprisingly unaffected by the crisis of its southern neighbour, and Australia, a country that reformed its governance regime years ago after a series of business scandals.



In Europe, one of the biggest shake-ups has occurred in the UK, where a large part of the banking sector has been nationalized - Barclays being a notable exception.

Governance practices worldwide are converging, as shown by trends such as the separation of executive



and supervisory powers, greater transparency in financial statements and decision making. Corporate governance reforms have been particularly noticeable for improving accounting standards and practices. Risk management practices and skills of board members of financial institutions have been considerably strengthened.

Professor Van der Heyden's comment was backed up by Ziad Makhzoumi, Chief Financial Officer of Arabtec, a construction company publicly listed on the Dubai Financial Market since 2004, who added that, although there is substantial room for improvement, Saudi Arabia is one of the most regulated countries in the Middle East for listed companies. *"Since the recent market bubble, the main regulatory body for the capital market has imposed further requirements to introduce credible financial statements based on International Accounting Standards and audited by an independent auditor,"* he noted.

Regional and governance practices

"We have more and more boards and people with expertise on those boards, but there is also a widely held perception that in recent years, boards have not complied with or managed the risks associated with their businesses, stressed Khalid Deeb, Director General, Abu Dhabi Center for Corporate Governance (ADCCG), and we are striving to bring in risk management systems and frameworks into companies' cultures."

Yet, Arab financial markets, and more broadly speaking, the markets of the Middle East and North Africa (MENA), still suffer from a lack of business transparency, which leaves *two or three sets of accounts – the question is, which one is the right one?*” asked a Saudi-based expert, who continued: lenders in a quandary, restrains foreign investors, and keeps capital markets relatively closed. *“It is not rare to have “There are governance scorecards compiled by shareholder advocacy groups, but the state of governance is inherently very difficult to measure.”* International investors, who take corporate governance very seriously, are often absent from Gulf Cooperation Council (GCC) markets because of the lack of sound corporate governance frameworks, participants agreed.

To separate ownership from management remains a huge hurdle. *“Around 90% of GCC companies are family businesses,”* noted HE Rashed A. Al Baloushi, Deputy CEO of the Abu Dhabi Securities Exchange (ADX). *“Arab firms still tend to have concentrated ownership, so generational ties and family involvement often impact governance relations and agreements”.*

Much depends on how the family business has been run

In Saudi Arabia, for example, one-third of listed firms have more than two directors from the same family, and the company is often dominated by the original founder’s traditional methods and attitudes. Many Saudi leaders of privately held companies are reluctant to scrap a model that has historically worked well enough to be taught to new members. Participants also expressed concern about over-reliance on personal family relationships. Amongst the points raised was the fact that owners who double up as managers or main shareholders often find it hard to trust “outsiders ” (including on the board) and, as a result, deny them any real decision-making powers. *“These goals will not be accomplished by another layer of legal procedures; what is required is the implantation of a new culture of business governance in the region,”* noted Fatima Al Jaber.

The crisis reveals the benefits of greater openness

“We see more and more corporate entities, government or family-owned, looking to raise capital through private placements and/or public offerings, ready to increase disclosure and governance” said Alex Carre de Malberg, who led investment banking practices in the UAE at Rothschild and at Invest AD before joining The National Investor, a 17-year-old privately owned regional investment company, counting prominent Abu Dhabi based families as shareholders.

Another positive side of the slowdown in credit growth is that lenders are taking a much closer look at the small print on corporate balance sheets, noted one senior investor. *“An increasing number of enterprises need to open up their books for the first time as they seek credit ratings and as market flotations from family-held enterprises increase,”* he stressed.

No single ideal – yet a need to transcend current compliance practice

For the past ten years, those running the region’s stock markets have sought to persuade these companies to move from private to public. As the old corporate patriarchs are replaced by a younger generation of executives, often educated at leading business universities, the business culture is also changing.

And as power is split in the family, younger members are setting up their own companies and running them in a less autocratic and closed way.

Given the conclusions reached, the question remained whether a greater openness towards international corporate governance standards implies that such standards can easily be applied to the MENA region?

Amongst participants there was considerable cynicism about the Western experience, which has failed to prevent multiple large-scale corporate scandals – even after far-reaching reforms such as Sarbanes-Oxley (SOX).

Further scepticism was fuelled by examples of banks that performed well during the crisis, despite having a family culture and powerful executive chairmanship. Conversely, other firms seen as paragons of good governance, including powerful outside directors, did much worse. Pinning down an ‘optimal and context-free’ corporate governance model is far from easy, if indeed such a model exists.

Participants emphasized the need for the Middle East to spend more time thinking about intangible things such as firms’ values and cultures, adding that there was now room to develop shared values on which to build consensus, including the pursuit of prosperity. These remarks echoed those of Ludo Van der Heyden, who in his introduction had quoted the French philosopher Montaigne – saying that the spirit is more important than the form and that corporate governance could not be reduced to a procedural exercise.

To separate the chairman and CEO roles, or not?

The general feeling was that the role of the chairman is vital in realizing the board’s potential – or blocking it. If the right chairman cannot be found, the board’s value will be largely diminished. It was accepted that dual structure leadership might have a positive effect on firm value. As a result and as an example, the emphasis on separating the CEO and chairman roles typically used by firms in the United Kingdom was seen as desirable in itself. Participants pushed this point by noting that, *“in family-run firms a separation of roles would almost have to be mandated by regulators requiring a split leadership structure before you’d see a big shift.”*

Good chair is key to an effective board

Conversely, it was noted that the image of a strong executive chair might hamper the contribution of independent board members. Almost everyone shared the view that focusing on the quality of the board – one tier/dual or two tier/independent – does impact the exercise of power at the top, and hence impacts performance and sustainability. It also counters the managerial domination of Gulf owners who often act as board members and executives, with insufficient clarity in roles.

Without independent board members, owners are de facto on the board. *“Bringing independent, non-executive directors – individuals with international exposure at corporate, industry, or investor levels – who are long-term investors or have this mindset and can guide and secure access to new markets and technology, is extremely valuable, particularly to navigate in a complex market and technology context,”* said Sultan Al Hajji.

On balance it was felt that attendance of CFOs and CEOs was required for efficiency and effectiveness of meetings, but that they should understand that boards might meet without them to discuss a particular point – without implying that this time is devoted to criticism of the latter, for example - to allow non-executives to clarify their positions (e.g. on whether to dispose of certain assets – always a sensitive and typically demotivating issue for executives) or simply to exchange feedback in a way that is best done without executives.

Defining the roles of the board and management

Another view was that management's role is to come up with proposals for business growth and to answer questions, but not to excessively debate or dominate the exchanges, unless expressly asked to.

"Director-friendly" access to information held by executives is key here, because only then can an outsider provide an independent and less biased perspective on executive proposals. Each new director should receive a formal and "customized" induction to the business leadership, the strategy (including financial) and the operations. This takes time and should be seen as an investment so that the board member can add value to the executive team. It includes meetings with senior management, visits to company facilities, presentations regarding strategic plans, significant financial, accounting and risk management issues, and how compliance programs are executed.

Inverting the famous family entrepreneurship paradigm - according to which the first generation creates, the second maintains, and the third destroys - one participant stated that the first generation will likely ignore the value of a good board (and destroy value as a result), the second generation might look into it (starting a practice of value preservation), and the third will enforce it (aiming for value improvement and creation through engaged board/executive debate and challenge).

There is a clear evolution towards better corporate governance, financial reporting, and management teams becoming more professional in building proper investor relations and reporting functions. *"Even the finance function is now very much something that advises, provides decision-support and is focused on rigorous and honest risk assessment,"* said one participant.

Experienced non-execs can make a big difference

The challenge, however, appeared to lie elsewhere. It consists in learning to recruit and benefit from intelligent and competent people with deep industry experience, and getting them to commit the time needed to truly understand and effectively supervise complex business activities.

A final warning was issued: there is a lack of board education in most countries, although Canada and the UK are notable exceptions, and particularly in the Middle East, where countries struggle to better prepare board members to cope with the pressures of globalization (though often from a better position). The number of experienced non-executive board members severely limits the possibility of a board being equally good at supporting and questioning – via frank discussion back and forth – providing peer discipline over one another, and feedback on each other's contributions. And the practice of governance is only now emerging as a subject for broader academic and professional inquiry.

One conclusion was clear: the governance scene is changing in a region that acts as a bridge between vibrant Asian economies, European-Mediterranean partnership opportunities, and Africa's significant economic and human potential. All these factors highlight the need for the Gulf region to position itself on the global economic map – and good governance is a vital part of it, not just in terms of linking executives with their investors, but of linking the region to the rest of the world.
Sylvie Bergeron, January 2011

Save the Dates:

Next INSEAD Governance Meeting:

Paris, 15 June 2011
Abu Dhabi, 27 October 2011

Next INSEAD Directors Programmes:

Europe campus

2011:

- 7-9 July 2011
- 15-17 Sept 2011
- 24-26 Nov. 2011

2012:

- 19-21 Jan 2012
- 12-14 April 2012
- 14-16 June 2012

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