GOVERNANCE

In the eye of the beholder

Companies in the Gulf are beginning to realise that good corporate governance can pay dividends

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UNTIL recently, the idea of corporate governance was virtually unknown in the Gulf. The surge in banking and finance in the region has led to demands for increased awareness as well as improved standards of conduct. As capital markets grow, sound governance is seen as essential if companies active in the region are to enhance their businesses and sustain them for the long term.

That is one reason why Saudi Arabia's bourse recently made it mandatory for all firms whose shares were listed on it to disclose directors' reports. Behind the decision are efforts by the Saudi Capital Markets Agency to introduce a minimum standard of corporate governance by 2009.

There are other precedents, too, notably the establishment in 2006 of Hawkamah based in Dubai – from the three Arabic root words for government, judgment and wisdom – an organisation dedicated to advancing governance in the Gulf. Executive director Nasser Saidi saw the need for a home-grown, yet integrated approach to the promotion of disclosure, transparency and accountability.

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Good governance helps economies, says Saidi, not just because it encourages the development of markets and improves a country's ability to mobilise, allocate and monitor investment. But also because good governance makes it easier to tap external capital as well as lowering the cost of debt and equity.

"For companies wanting to access capital markets, improving governance should be at the top of their to-do lists," says Saidi. "Institutional investors and private equity firms and others all look for evidence of it as part of their due diligence processes."

If so, Hawkamah has its work cut out. Companies in the Gulf have a long way to go before they meet international stan-

dards. According to a study of corporate governance in the Middle East and North Africa by Hawkamah and the International Finance Corporation, an arm of the World Bank, a majority of the 1,044 participating banks and listed companies could not even define the concept of corporate governance.

Most confuse it with corporate social responsibility or even with corporate management. The difference is that corporate governance is the framework under which a company is managed and administered. This includes a firm's links with stakeholders, including shareholders, and the way it articulates its goals. Corporate social responsibility, by contrast, is the way corporations accept responsibility for the effect that their activities have on customers, employees, suppliers and the environment.

In western markets, much of the discussion turns on whether firms should go beyond compliance by adopting stricter standards on, say, carbon dioxide emissions or refraining from doing business in countries that violate human rights. In the Gulf, by contrast, most companies struggle even to comply with the basic standards. Nor are regulations enforced as strenuously as they are in developed economies. For most firms in the region, the leap to becoming a good corporate citizen is still a big one.

A dismal 3 per cent of firms surveyed follow good practice, and none follow what is regarded as best practice, the study found. Some 56 per cent of boards have no more than one independent director, making oversight difficult. And 42.3 per cent of companies still combine the roles of chairman and chief executive when, ideally, such positions should be separated. A paltry 12 per cent of those surveyed provide information on executives' compensation.

It is accepted among international businesses that it pays to be seen as playing by the rules, or better still, surpassing them. Yet most companies surveyed view governance – particularly disclosure – as a matter of compliance rather than as a tool for managing their relations with stakeholders or of adding value to their business.

Many argue that good governance can, and should, be viewed as a source of value for shareholders. Indeed, an increasing number of investors in the region make it clear that they expect standards on par with those in the west. "If you want to be in the global market, you need to be up there on a level with the global players," says Carolyn Hanson, director of the Dubai office of the International Compliance Association, an organisation that provides training in compliance.

A drawback is that boards of directors are often ornamental, providing negligible oversight. "In my experience, many directors take directorships without fully understanding their fiduciary responsibility," says Hanson. "When they find out what it actually is, they get really scared." Although it is flattering to be asked to join a board, many fail to recognise the responsibility that a directorship entails – particularly the stewardship of shareholders' money. "I'd very strongly urge someone to consider carefully whether to take a board seat," she says.

Firms in the Gulf are discovering what their western counterparts already know: that there is competitive advantage in being seen to meet the gold standard of governance. And there are tangible benefits for those who do it well. Companies that have taken corporate governance to an extra level have seen increases in their share prices.

This is not hard to understand. "You want to deal with good people," Hanson says. "Corporate governance is really just about doing things the right way: behaving ethically, transparently, disclosing conflicts of interest. It is just doing the things any upstanding person would do."

The problem, she says, is that – as with Enron, an American energy company that went bust in 2001 – nobody wants to be the one who points the finger. To overcome such reluctance, companies, especially family-run ones, should increase the number of independent directors who sit on their boards. Banks should also strengthen their compliance.

Yet governance should not be viewed as a salve for all wounds. "No board can control all the transactions, even sizeable ones, of a big financial institution. They need to give their people some room to manoeuvre," says Holger Spamann, executive director of corporate governance at Harvard Law School. "Boards do, of course, have to make sure that they have adequate monitoring systems in place. But they cannot, and should not, intervene in every transaction or re-do every analysis done by the firm's employees. That would simply be impossible."

The financial crisis is likely to result in a slew of new regulations for banks and other such institutions, particularly as far as remuneration is concerned. The culture of bonuses undoubtedly played a part in causing the international credit crisis by encouraging risk-taking to boost the short-term performance of financial institutions.

"Generally speaking, investors welcome performance pay as long as the remuneration schemes are sufficiently stretching, with appropriate targets spread over a longer term," Saidi says. "It is the pay for non-performance that sparks investors' ire." The extent to which the crisis reveals shortcomings in governance in western financial institutions remains to be determined, says Spamann. "The fact that almost all firms made the same basic mistake of betting on mortgage-related securities suggests that the problems were the risk models rather than the oversight," he says. "The jury is still out." ■

Virtuous circle

Corporate governance is the system under which companies are directed and controlled. In its narrowest sense, what is regarded as good governance is a source of value for shareholders because it leads to better performance, more efficiency and so to greater profitability. In its widest sense, the idea takes into account such things as a company's responsibilities to its shareholders and its approach to corporate social responsibility, that is the result of its action on customers, employees and the planet at large. Good governance often translates into greater efficiency and so into a higher value being placed on a company's shares. A high standard of corporate governance stimulates the performance of a company and therefore leads to greater productivity. This, in turn, results in greater profits and so higher returns for shareholders.

Companies that monitor the performance of managers, making them accountable for their actions, help to protect the interests of investors. As a result, countries which encourage such action tend to receive more investment – both directly and from portfolios – than those which do not. Moral: do as you would be done by.