Supporting Environment for Sound Corporate Governance

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Good morning Excellencies, ladies and gentlemen, it is my pleasure to participate in this dialogue on corporate governance organised by Kuwait's CMA. I see many familiar faces in the audience and it comforting to be in the company of old friends. The OECD has been working with partners in Kuwait for about 6 years now in the framework of a project on improving corporate governance in the MENA region, launched by the OECD with MENA policymakers in 2005. This project includes in its scope of work corporate governance issues and challenges specific to listed, state-owned companies and companies operating in specific sectors such as banks.

In Kuwait, we have over the past several years worked with a number of institutions and organisations, including of course the CMA since its establishment, but also the Kuwait Stock Exchange, the Privatisation Council, the Ministry of Commerce and the Kuwait Investment Authority. In fact the Ministry of Commerce hosted one of our regional roundtables last year on corporate governance of state owned enterprises. All these institutions, from different vantage points, have an important role to play in promoting good corporate governance practices, as of course does the corporate sector itself and the investment community.

Indeed, this statement goes to the core of the topic that I was asked to address in my speech, that is the supporting environment for good corporate governance. The development of the institutional frameworks for corporate governance started about a decade ago and has been quite rapid in the region. Almost all countries in this region now have a corporate governance code and an entity, normally the securities regulator, to oversee its implementation. As we all know, the establishment of the securities regulator in Kuwait dates back about two years, and it has been developing rapidly. In the region, only Yemen does not yet have the infrastructure to facilitate the public offering process through a stock exchange and consequently does not have a securities regulator. Lebanon was the last country in the region to have introduced such an entity.

In almost all jurisdictions, the establishment of capital market authorities actually followed the introduction of central banks, which have traditionally been the pioneers in promoting corporate governance in the region. A number of capital market authorities now have dedicated corporate governance departments (Saudi, Oman, etc.) and most certainly all have some competencies in corporate governance. The debate in the last 3 years or so has rightfully has focused on the issue of enforcement. The question that we at the OECD often hear from the regional regulators is along the lines of: we have the rules, how do we ensure they are applied? Should codes be made voluntary or mandatory? Should listing rules include corporate governance requirements?

The common concern is that if the requirements remain voluntary, compliance rates will be low and if the codes are introduced on a comply-or- explain or if corporate governance rules become mandatory by virtue of laws, listing requirements or regulations, that that would put a downward pressure on the market, forcing companies to delist or not to come to public markets in the first place.

In fact, the focus in the region now, at least if we look at listed companies, can be well summarized in the term "corporate governance compliance". But what is corporate governance compliance, an expression we hear so often in the region? And what do companies need to do to get there? I think these questions go back to the issue of supporting environment for corporate governance, the issue I was asked to address. If I were to take the analogy of the famous children's game Lego, I would say that it has several building blocks and enforcement is only one of them. First, we need to look at the environment/development of capital markets (what kinds of companies are listed in public markets, what is the level of development of public markets, level of dynamism in IPOs and secondary offerings), the nature of shareholders and their behavior (are companies controlled? Are shareholders active? Are they long term? What does it mean to be long term?).

The regulatory and institutional environment of course matters too, and here the efficiency and the good relations between regulatory bodies such as the securities regulator, the central bank and the stock exchange are primordial. These are all pieces of the puzzle called "good corporate governance". However, without shareholder engagement, enforcement can be only as effective as any stick without a carrot. On the other hand, without effective enforcement, minority shareholders may be abused and the level of local or foreign investment or interest in a particular market may dry up.

In my presentation today, I thought it might be useful to address each one of these "building blocks" separately. First, let us consider the companies themselves because we are, after all, talking about corporate governance. In developed markets, in Europe and North America, the interest of companies in raising funds in capital markets has been declining in recent years. Compared to the 1990s, initial public offerings in the US have fallen by about 75 percent, from an annual average of 515 to 117. And the UK has lost half of its listings in the last decade. Few markets with some exceptions such as China have had good IPO year in 2012.

Some of these changes may indeed be of cyclical nature but it cannot be excluded that there are also structural forces at work that we need to identify in order to facilitate the supply of risk capital to tomorrow’s companies. The governments of both UK and US have commissioned studies to look at the historical drop in companies coming to their markets and to explore the structural and regulatory factors that might be linked to this (i.e. Kay report in UK).

This phenomenon is of course not unique to markets such as UK and US, which are characterised by dispersed ownership. It is indeed the case in other markets with more concentrated ownership structures, the likes of which exist in this region. Indeed if we look beyond these markets, globally, the average volume of IPOs in the period of 1993-2000 was USD 132.7 bn, whereas the average volume in the following ten years was 69.6 bn. These are by the way estimates from our new work on corporate governance, value creation and growth and clearly they give a reason for reflection.

A key question is how does the MENA region fit in this picture. These worrisome trends certainly find an echo in this part of the world as well. It is undeniable that MENA stock exchanges, much like their counterparts in Europe and North America, have been affected by the global financial crisis but also by the events in the region. Following the revolutions in Egypt and Tunisia, stock markets have tumbled all over the region in 2011, but IPO performance has been somewhat better in 2012. An estimated $2bn dollars was raised by companies from the Arab world in 2012 in 14 deals, and this year has already seen an IPO by Asiacell in Iraq which aims to raise 1.3 billion dollars.

We can characterize the current environment as one of cautious optimism. Companies are going public, but basically the capital raised is impressive only because of a few large deals that mask in a way the fact that overall, activity has been tepid. The other issue is that the IPOs we've seen in recent years in the region also show that large, successful companies from the region are now going to London or other markets outside the region (i.e. DP world IPO in London in 2011, NMC Health in London in 2012, and Amira Nature Foods in 2012 on NYSE). This is perhaps a secondary but still an important question: why are local companies choosing foreign markets as the venue of their primary listing?

From our work with heads of stock exchanges who participate in OECD's regional Taskforce of Stock Exchanges for Corporate Governance, it is clear that stock exchanges are doing a lot to retain and attract listings. The structure and activity of MENA stock exchanges in recent years has been subject to many changes as exchanges have sought to adapt to emerging challenges. A number of markets, not only here in Kuwait, but also in Morocco, Egypt and elsewhere have been looking to demutualise or privatise and this is an area of ongoing interest. In fact, the OECD plans to publish a few regional case studies on interests and lessons on exchange privatisation in 2013.

More specifically in terms of listings, markets in the region have made considerable efforts to attract listings by introducing SME listing tiers (launched in Qatar and Dubai this year), following the launch of an SME exchange in Egypt in 2008 which has almost 20 companies listed now. Cross listing has also been actively considered and a number of markets have signed agreements to facilitate this. As of this year, foreign listings on Tadawul are permitted.

Stock exchanges have been revising listing rules to bring them in line with international standards. Initiatives such as launches of indices of good governed companies (S&P) or the inclusion of some markets in MSCI emerging markets category seem to have brought only limited results in terms of attracting large institutional investors to the region. Indeed, the question looming on the heads of MENA exchanges, to me, seems to be not so much how to stabilize markets in the current environment. What heads of MENA stock exchanges want to know about is how to make their individual markets competitive and, at the same time, how to make the region as a whole an attractive investment destination in order to get a share of the investment pie destined for emerging market equities.

It is also important to address the role of capital market regulators in creating a sound environment for corporate governance. In most countries of this region, including Kuwait, UAE and Saudi Arabia in particular, capital market regulators are today the engines of corporate governance rules and enforcement. Enforcement, as I mentioned, as been a key topic for discussion lately because of the complaints in some countries that it is selective or inefficient.

A number of high profile enforcement cases in the Gulf are worth mentioning. In Saudi Arabia, the legal battle of Algosaibi Group against the Saad Group has been ongoing for a number of years. In the Emirates, the Damas case was perhaps the single most prolific enforcement example, where the regulator ordered the Abdullah brothers - the controlling shareholders of the famous jewelry and watch retailer - to repay the sums embezzled from the company. While the $700,000 USD penalty imposed on the brothers in March 2010 was a first tough stance taken by the DFSA, it is relatively "soft" by international standards.

Nonetheless, these cases demonstrate that at least some regulators and stock exchanges in the region are "growing teeth". The Saudi CMA is perhaps the most rigorous in the region in publishing their enforcement actions against listed companies, which in 2011 exceeded 300 cases, most of them related to corporate governance breaches, particularly the failure to disclose market-sensitive information. Other regulators, some of which recently established, are starting to experiment with their enforcement powers as well.

But is this "regulatory compliance" approach to corporate governance enough? With regulatory forbearance being the only threat, and in the absence of other real incentives for corporates, what can we realistically expect of them? I think this important question begs us to address the role of investors as "demandeurs" of corporate governance. Much debate has surrounded the behavior of investors in Europe and North America during the financial crisis and there is considerable disappointment with the perceived passiveness of investors, especially institutional ones.

Shareholders and potential investors are a last piece of the puzzle that I wish to address today and that I believe their role not much discussed as a motor for corporate governance in the region. Who are the investors in MENA companies and what are their expectations vis-à-vis the governance of listed companies? Globally, pension funds, mutual funds and insurance companies hold nearly half of the total market capitalisation in the world - USD 26 trillion. Intermediation is obviously an important part of any market; and the equity market is no exception. However, it is also a potential source of misalignment of interests between the ultimate saver and the intermediaries responsible for managing their money.

We all know that the level of institutional investment is low in the region and that attracting this type of capital is a challenge for most MENA markets which are retail driven. Investment by households is higher than by institutional investors by about 5 fold in the region while sovereign funds and other government entities play an active role in the regional markets. This is often seen somewhat negatively, but there is an upside to this as well insofar as MENA households are estimated to have 2.7 trillion USD of assets of which 65% is parked in cash and deposits, 14% in fixed income and only 18% in equities. This is low compared to US and Europe (47% and 34% respectively).

The potential role of large private and institutional investors is significant. The voice of investors needs to be amplified so that companies realize that the demand for corporate governance is not just coming from pressures related to regulatory compliance but also from market expectations. Only when management and boards of MENA companies know that they can get awarded for good governance practices by the market, as opposed to punished for certain omissions by the regulator, would there be an environment conducive for companies to adopt good governance practices.

The OECD is in the process of launching a MENA Investor Council which would regroup the largest portfolio investors in MENA markets to give them a more powerful voice in addressing investment challenges. The objective of this Council would be to gather large private and institutional investors to discuss and align their expectations on corporate governance and to present their expectations to policymakers (securities regulators, stock exchanges, etc).

I would like to invite you to participate in this and our other projects dealing with governance of listed companies and state-owned enterprises. Please do not hesitate if you have any questions.

Thank you for your attention.