Corporate Governance & Board Composition

A Comparison of GCC Boards with UK, European and US Boards
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recent Developments in Corporate Governance</td>
<td>1</td>
</tr>
<tr>
<td>Corporate Governance and the Board of Directors</td>
<td></td>
</tr>
<tr>
<td>Board Composition and Independence</td>
<td>2</td>
</tr>
<tr>
<td>Executive Management on the Board – International Context</td>
<td>3</td>
</tr>
<tr>
<td>Executive Management on the Board - Trends in the GCC Region</td>
<td>4</td>
</tr>
<tr>
<td>Board Independence – International Context</td>
<td>5</td>
</tr>
<tr>
<td>Board Independence - Trends in the GCC Region</td>
<td>6</td>
</tr>
<tr>
<td>Our Perspectives</td>
<td>7</td>
</tr>
<tr>
<td>Authors Profile &amp; Contact Details</td>
<td>8</td>
</tr>
</tbody>
</table>
Recent Developments in Corporate Governance

Corporate governance is the system by which companies are directed and controlled. The recent financial crisis highlighted a number of shortcomings in corporate governance mechanisms, and regulators worldwide have been making necessary amendments in their respective codes and guidelines to enhance the robustness of corporate governance within the markets they supervise.

For instance, in October 2010 the Basel Committee on Banking Supervision issued an updated set of Principles for Enhancing Corporate Governance in the banking sector. These Principles are applicable to all banking organisations, irrespective of whether they are owned by the private sector or by governments, and whether they are listed on a stock exchange or not. In the UK, Sir David Walker was asked by the UK Prime Minister’s Office to conduct a review of the governance of banks and other financial institutions, and the Financial Reporting Council (FRC) conducted its review of corporate governance in all listed companies in the UK. Based on the findings of the Walker Review and the FRC Review, a revised UK Corporate Governance Code was issued in June 2010.

Consistent with the developments taking place worldwide, most capital market regulators in the GCC region have relatively recently announced corporate governance codes and guidelines that are applicable to the listed companies in their jurisdiction and, in some cases, GCC central banks have made the implementation of corporate governance codes and guidelines mandatory for all financial services sector firms incorporated and operating under their regulatory umbrella, regardless of whether they are listed or not. For instance, corporate governance codes were announced in Bahrain in 2010, approved in Qatar in 2009, reconfirmed through a Ministerial Decision in the UAE in 2009 and amended by the Capital Market Authority in Saudi Arabia in 2009.

Corporate Governance and the Board of Directors

The board of directors plays a central role in the corporate governance mechanism. The board is responsible for ensuring that the corporation has well-defined and protected shareholder rights, a solid control environment, high levels of transparency and disclosure, and keeps the interests of the company and those of all shareholders aligned. The board is responsible for directing and controlling the business of its company and is accountable to shareholders for its performance.

Given the central role of the board, the corporate governance codes issued by regulators worldwide focus on the board and its workings. With a view to achieving a robust governance environment, these codes provide guidelines on:

- The composition and independence of the board
- A board’s structure (main board vs. board committees)
- The issues a board should address during its meetings
- The process a board should follow to address important governance issues

1 A Corporate Governance Survey of Listed Companies and Banks across the MENA region commissioned by Hawkamah and DIFC
The first step towards establishing a robust corporate governance mechanism is to establish a board that has “the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively”\(^2\). While most reasonable people would agree with this objective, its interpretation in terms of board composition differs substantially in various parts of the world.

In this paper, we summarise the results of our research on board composition and its resulting impact on its independence based on the relative influence of three main constituents on the board (i.e. members of the executive management; independent directors; and, shareholder directors) in various parts of the world.

**Three Key Constituents of a Board**

We have compared the board composition prevalent in the GCC region with what we see in the USA, the UK and Europe and, in light of corporate governance codes recently issued by regulators in the GCC countries, we highlight the likely changes in the GCC board composition in the coming months and years. At the same time, we also point out the challenges facing the GCC boards in making these changes that are being expected by regulators to bring the GCC board composition in line with internationally accepted best practice.

**Scope of Research Conducted by The Directors Counsel Consultants**

**Primary Research**
- Evaluated board composition of the top banks in the GCC, the UK, Europe and the USA
- Top 10 GCC banks (at least one from each GCC state)
- Top 20 banks worldwide (5 top banks each from the UK, the USA, European countries with unitary board structure, and European countries with two-tier board structure)

Survey banks include: HSBC, RBS, Barclays, Lloyds and Standard Chartered from the UK; JPMorgan, Citi, Bank of America, Wells Fargo and Goldman Sachs from the USA; Deutsche, UBS, Credit Suisse, ABN AMRO and Danske representing two-tier boards in European countries; and, Santander, Credit Agricole, BNP Paribas, Dexia and UniCredit representing unitary board structure in European countries.

**Secondary Research**
- Top listed companies worldwide (e.g. FTSE 100, S&P 500)
- Review of research conducted by international advisory firms and regulatory reports issued after the financial crisis
- Review of board composition related information in the financial press
Executive Management on the Board – International Context

Our analysis suggests that representation of management executives on the board is almost universal but the strength of this representation varies significantly.

Looking first at the results of our primary research on the Top 20 international banks, it is worth noting that every board has representatives from the management team, except where local legislation dictates to the contrary. On a global basis, the banks with low (1 executive), medium (2 or 3 executives) and high (4+ executives) representation from the management team were in equal proportion. The exceptions are banks in certain European countries (Germany, Switzerland, Denmark and Holland) where a two-tier board structure (i.e. a Supervisory Board separated from the Board of Executive Directors) is required by law, and management executives are not allowed to be represented on the Supervisory Board.

However, there were significantly divergent regional trends. In the USA, 80% of the banks in our sample had ‘low’ executive management representation, with only the CEO being represented on the board. On the other end of the spectrum, 100% of the UK banks in our survey had ‘high’ or ‘medium’ management representation. Similar to that in the UK, 80% of the European banks in our sample that operated in countries with unitary boards (France, Italy, Belgium and Spain) had ‘medium’ or ‘high’ executive management representation.
While the above observations are based on the review of a fairly small sample from one sector of the economy, the general conclusions are broadly representative of what is happening throughout the world. Similar to the observation in the UK banking sector, our analysis identifies that 100% of the FTSE 150 companies in the UK have either ‘medium’ or ‘high’ representation from the management team on their board. In the USA, the extent of management team representation in general is noticeably less than we see in the UK.

According to the Spencer Stuart 2010 US Board Index, 53% of the companies in the S&P 500 had boards where the CEO was the only representative from the management team. Compared to 7% of companies with ‘high’ management representation in the S&P 500, 24% of the FTSE 150 companies had ‘high’ management representation on their boards. On average, the number of management representatives on the boards of the S&P 500 in the USA was 1.7 compared to 2.9 on the boards of the FTSE 150 companies in the UK.

In conclusion, there is clear evidence to suggest that companies worldwide believe that representation of the management team members on the board enables a more substantive discussion to take place during board meetings, and is in the best interest of the company and its shareholders. The only exceptions are countries where by law there is a separation between the ‘Supervisory Board of Directors’ and ‘Board of Executive Directors’ and where executive members are barred from being included in the Supervisory Board of Directors. However, in these countries, the substantive powers to direct and control the companies lie with the Board of Executive Directors, and the role of the Supervisory Board is substantially more constrained than is common among unitary boards operating in most other parts of the world.

Executive Management on the Board - Trends in the GCC Region

In the above international context, the corporate governance codes issued by regulatory authorities in Bahrain, Qatar and the UAE expect to see at least one executive director on the board. However, these corporate governance codes have left it open for individual companies to choose if they wish to have ‘low’, ‘medium’ or ‘high’ representation of executive directors on the board.

Contrary to the international norms, our sample of the Top 10 banks in the GCC region highlighted that in an overwhelming majority of the cases these banks did not have executive directors on their boards. Anecdotal evidence suggests that the situation is no different in the GCC companies operating in other economic sectors.

Source: The Directors Counsel consultants analysis of Comparative Board Data published in 2010 Spencer Stuart US Board Index and Board Composition data published in 2010 Spencer Stuart UK Board Index.
Our analysis suggests that the presence of independent directors on company boards is universal in all developed countries. The proportion of the independent directors compared to executive board members, directors elected by employees, shareholder directors and other non-executive directors varies significantly throughout the world. However, in an overwhelming majority of the cases, independent non-executive directors represent the majority of the board.

Looking at the results of our primary research on the Top 20 international banks, the significance of independent directors is evident. On a global basis, independent directors represented 70% of the boards of these Top 20 banks, compared to only 16% representation from the executive management team. It is noteworthy that shareholder-linked board members in these Top 20 listed international banks represented a mere 1% of the total number of board members.

There is, nevertheless, noticeably regional variation in terms of the proportion of the board seats held by independent directors. At one end of the spectrum, independent directors represented 91% of the board seats among the US banks in our sample. At the other end of the spectrum, the European banks operating under a unitary board structure had only 54% of the board made up of independent directors. However, in both cases, independent directors represented a majority of the company boards.

The influence of independent directors is no less pronounced when one looks at the wider market. Very similar to what we observed in our analysis of the US and UK banks, across all industries independent directors held 84% and 67% of the board seats on the S&P 500 companies and FTSE 150 companies respectively. The influence of independent directors is marginally less in Europe where they represent 45% of total board members on the largest European companies.

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4 Source: The Directors Counsel consultants analysis of Comparative Board Data published in 2010 Spencer Stuart US Board Index and Board Composition data published in 2010 Spencer Stuart UK Board Index.

5 Source: Heidrick & Struggles Corporate Governance Report 2009 titled: Boards in turbulent times
The concept of an ‘independent director’ is relatively new in the Middle East region. Unlike common practice internationally, many companies in the GCC region do not disclose which of their directors are independent. A few companies have made advances in this area. Ahli United Bank in Bahrain is a good example where the company clearly identifies executive, non-executive and independent directors. However, this level of disclosure is relatively limited in the Middle East region. Hence, it is almost impossible to compare the independence of the boards in the Middle East with that of their international counterparts.

Additionally, there is widespread debate among board directors in the Middle East on the definition of an independent director. There also seem to be differences in the definition of an independent director in the various corporate governance codes and guidelines issued by regulatory authorities in the GCC region.
Our Perspectives

Our review of the limited publicly available information on board composition in the GCC region suggests that with almost no executive directors and very few directors that could be classified as ‘independent’ and sourced from a pool of business professionals, the current board composition resembles the Supervisory Board in a two-tier European board structure. The primary difference being that the GCC boards have the authorities and responsibilities of a unitary board, while at the same time not having the optimal capacity to carry out these responsibilities because of their composition. While there was a theoretical option available to regulatory authorities to consider formalising a two-tier board structure to a Board of Executive Directors, they have universally chosen to opt for a unitary board model in the GCC region. Most regulators have recommended the creation of a balanced board that should include executive directors and independent directors. Given that the region is in early stages of introducing independent directors on its boards, the regulators have generally recommended that at least 1/3rd of the board should be made up of independent directors. While this proportion is less than the international best practice of having “a majority of independent members”, it is arguably a pragmatic approach that would take the region a long way towards international best practice.

The real challenge lies in implementation of the recommendations relating to board composition. There is anecdotal evidence of a feeling of ‘us’ and ‘them’ between the current, mainly shareholder-linked, non-executive board members in GCC companies and the senior management team of these companies. It may take some time before executive directors become fully integrated in the board.

Additionally, there are challenges associated with the recruitment of suitable independent directors on the boards of companies in the Middle East. Given that the concept is relatively new in the region, the boards are unclear about the role independent directors are expected to play. This makes it difficult for them to agree upon a suitable profile for independent directors. The risk is that the boards might aggravate the challenge by making the targeted profile too restrictive and by making the nationality of the independent director an important consideration. This would go against international best practice where most international companies opt to include foreign nationals on their boards to enhance the richness and diversity in board discussions.

Whilst the implementation of the guidance contained in codes for the composition of a board is likely to require a cultural shift for many boards, we believe that the results will prove energising for board capability and performance.

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6 BIS Principles for enhancing corporate governance (Oct 2010). Also, highlighted within OECD Principles of Corporate Governance and explicit within The UK Corporate Governance Code (June 2010).

7 Source: The Directors Counsel consultants analysis of Board Composition data published in 2010 Spencer Stuart UK Board Index.
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