

Hamad Al-Sayari: Corporate governance for banks in the Kingdom of Saudi Arabia

Speech by His Excellency Hamad Al-Sayari, Governor of the Saudi Arabian Monetary Agency, at the High-Level Roundtable Discussion for Bank Executives on Corporate Governance for Banks in Saudi Arabia, Institute of Banking, Riyadh, 22-23 May 2007.

* * *

Dear Distinguished Audience

It is a great pleasure for me to welcome you, and I am delighted by your participation at this important conference on **"Corporate Governance"** organized jointly by the Institute of Banking and the IFC.

Corporate Governance is popularly defined as a structural organization and executive procedures used to direct and manage business to achieve the objectives of the company and ensure its financial stability. In the past decade, this subject has taken increasing worldwide prominence because of its importance and relevance for the enhancement of macro-economic development and growth and the stability of the national financial systems in particular.

In spite of the scarcity of books issued in Arabic on this subject, it is worth referring to two books; the first entitled **"Corporate Governance"** issued by Mr. Abdulmajeed Al-Bastati in 2004 and the second entitled **"The Way towards a Governing System for Corporations"** issued by Dr. Ibraheem AL-Muneef in 2006. The latter refers to a third book, which I have not read, issued by Mr. Saleh Ali Husein in 2003 under the title **"Practicing and Managing the Authority in Business Organizations"**.

Dear Distinguished Audience,

Effective Board and management leadership in any financial institution is the key pillar that would enable the institution to achieve its objectives and guarantee its development and growth for the service of all parties including shareholders and staff. Effective leadership stems from sound corporate governance practiced by competent and highly experienced officials and directors at the various levels, setting a comprehensive strategy and elaborate business plans with appropriate mechanisms of responsibility, transparency and accountability in the financial institution.

In this regard, the board of directors plays a prominent role in overseeing the development of a comprehensive strategy of the financial institution and in monitoring the decisions made by senior management for achieving these objectives. This requires having necessary skills and competencies for realizing the objectives set by the Board. In addition, the board should establish clear guidelines regarding the independence of all departments and businesses in the organization and should ensure their compliance with established policies and approved procedures. Therefore, special committees of the Board such as the Audit, Compliance, Compensation and other special committees, can play extremely important roles in this respect.

The senior management should set a comprehensive business strategy; oversee day-to-day decisions that support the long-term objectives and policies determined by the board. To ensure financial stability, the execution of the overall objectives of the firm must be supported by rigorous internal supervisory controls and effective risk management. An effective internal control system is critical for providing reasonable assurance and producing appropriate timely information by the organization that would help in discovering and correcting errors promptly. Such a system will also promote the organization's operational efficiency and ensure compliance with managerial policies, laws, regulations, and other prescribed mechanisms.

Effective risk management is based on a foundation of good corporate governance and rigorous internal controls. Risk identification in all activities is a core function of any financial institution. At the same time, the institution must have in place the technical systems and management processes necessary to effectively measure, monitor, and control risks.

An effective risk management and control structure must be supported by an institutional culture that ensures that written policies and procedures are actually translated into practice. The institution's culture is determined by the philosophy and the behaviour of its board of directors and the senior management. In particular, the actions of senior management and consistency of their decisions and behavior with the values and principles they articulate are critical in shaping the institution's culture. It is vital that senior managers should emphasize their commitment to ethical behaviour, effective risk management and rigorous controls and that these principles should be continuously applied to all levels of the organization.

The other important factor that supports financial stability is effective market discipline, which also contributes significantly to good corporate governance. When market participants obtain timely, accurate, realistic and latest information about the institution's performance, their investment and credit decisions can be a means of pressure and incentives for managers and boards of directors for managing their risks soundly. Equally important, the same market participants can penalize firms that fail to manage their risks soundly.

Therefore, market discipline must be supported by adequate public disclosure and compliance with sound accounting standards. Knowing a company's risk appetite and its approach and methodologies for managing risk is essential to assessing the institution's future.

Progress in the disclosure area, however, requires that accounting standards are enhanced to ensure proper valuation and to reflect innovations, in terms of both new products and modern risk management techniques. Accounting systems serve a variety of purposes, the most prominent of which is helping creditors and investors make rigorous and informed decisions as to which enterprises meet the market needs in terms of efficiency, competitiveness, and profitability. Sound accounting systems also enable investors in assessing the real financial value of enterprises. The systems also assist in attracting capital, both foreign and domestic.

Looking ahead, I believe that a major challenge for directors and executive management is to find directors who are sufficiently independent but still knowledgeable about the business of the financial institution. Independence reflects qualities of objectivity, experience, insight, and force of character. The need for directors to possess this blend of technical knowledge plus independence is critical, given the increased complexity of most banking activities and the rapid pace of change in financial markets and practices. Getting the right balance of expertise and independence so that the board does not rubber-stamp the decisions of top management is a major challenge.

Now, turning to Saudi Arabia, as the Central Bank and the Banking Supervisory Authority, SAMA has played a leadership role in strengthening corporate governance in the banking industry in Saudi Arabia since its establishment. You may be surprised to learn that as early as 1981, SAMA issued a document entitled "***Powers and Responsibilities of the Board of Directors of Commercial Banks in Saudi Arabia***". This document, in a comprehensive manner, guided the Board members on compliance to Banking Control and Company Laws, required the implementation of a system of accounting and internal controls and assigned the Board the responsibility for monitoring the assets and liabilities, investments and profitability of the bank. This was followed by a guidance document in 1996 on the role of the Audit Committee of the Board. This document in substantial detail provided guidance to the Banks on the composition, mandate, role and responsibilities of their Audit Committees.

In 2004, SAMA issued another important circular affecting the Bank Directors and Senior Managers entitled: "Qualifications and Requirements for Appointments to Senior Positions in

Banks licensed in Saudi Arabia". The circular is aimed at ensuring that directors and senior managers have sound reputation and are persons of integrity and honesty.

Furthermore, over the past two decades, SAMA has issued additional governance related regulations and guidance to banks operating in Saudi Arabia. These include circulars on Internal Controls; Know Your Customers rules, Anti-Money Laundering and Combating Terrorism Financing and Prevention of Fraud. Also, there are specific regulations on the Role of the External Auditors and on the Internal Audit function. SAMA also requires the Board of Directors to establish a specialized Compliance Function that monitors the compliance of the organization with regulations and standards, and has a reporting line to the Board or one of its committees. Moreover, SAMA requires all banks to apply the International Financial Reporting Standards, and that two firms of external auditors are to conduct an annual audit.

Furthermore, SAMA has required banks in Saudi Arabia to meet the corporate governance guidance emanating from the Basle Committee on Banking Supervision and more recently from the Islamic Financial Services Board. In this regard, I should mention that SAMA is participating in the IFSB Technical Committee and in various working groups that are developing standards of corporate governance for Shari'ah compliant financial institutions.

The leadership role played by SAMA, over the past decades, in promulgating corporate governance standards and in promoting a governance culture has been reflected in the emergence of strong financial institutions and a credible banking system. Thanks to these efforts, the institutions and the system have remained stable and steady, despite global economic crises and oil price volatilities.

Dear Audience,

We should not rest on these past successes. We must remain vigilant and continue to monitor changes in regional and global markets. We must continuously ensure adopting and implementing best international standards and principles. In this context, I wish to draw to your attention that SAMA is currently directing the banks in the Kingdom towards the adoption of Basle II Capital Adequacy standard by 1st January 2008. I expect all banks to easily meet the required capital requirements; and this will be positively reflected on fostering the risk management and corporate governance culture that is deemed essential for meeting the challenges of the forthcoming stage.

In conclusion, I wish you a good stay in the Kingdom, and wish all success to your conference. Thank you for your attention.