The New ERA of Corporate Governance in Kuwait

by

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Objectives

- Highlight the new emerging trends in Corporate Governance
- Identify the linkage between good Corporate Governance and investors' trusts
- Define the linkage between stock liquidity and Corporate Governance
Corporate Governance is an emerging concept which becomes a focus for economies.

“Corporate Governance is the system by which companies are directed and controlled.”

The recent global financial crisis of 2007-2008 has only added fuel to the fire, and Corporate Governance becomes in the wake of the challenge which leads to igniting the regulator’s response to the governance issues faced by various stakeholders across the world.
After the financial crisis, regulators have issued a wave of regulatory rules on Corporate Governance.

After the financial crisis the regulators were globally alerted.

Response

Identifying the gap of current regulations to protect the market and avoid having the same crisis in the future.

Enhanced Regulations
The global recommendations and standards adopted a robust approach which focus on protecting stakeholders.

The Regulators Globally have adopted the international recommendations relating to the enhancement of governance.

- Walker Report
- (OECD)
- BASEL Recommendations

Response
Kuwait was not far from global trends and the wave of new rules and regulations, a set of substantive changes were introduced in the last four years.

Ministry of Commerce and Industry latest companies law

Central Bank of Kuwait issued instructions on 2012

Capital Market Authority issued instructions on 2013, and then changed to become part of the CMA executive bylaw in November 2015
The Kuwaiti companies vary in their response to the new wave of rules and regulations.

- **Reactive Approach !!!**
  - Some companies interpreted it as “Tick the box approach”

- **Proactive approach**
  - Others moved forward to enhance and build a SOLID BASE!!
The proactive companies approach focus on the three major pillars of good Corporate Governance that aims to increase stakeholders trust:

- Transparency
- Risk Management
- Accountability
What did the international researchers say about Governance, Companies Disclosure and Market Liquidity

*The effect on stock returns and prices requires link between governance provisions, disclosure requirements and information to investors.*

*Observed that in case of better governed companies the relationship between fundamental signals and stock returns is strong.*

*“Investors want three things from the markets: Liquidity, liquidity and liquidity”*
Companies are facing key challenges in implementing a good Corporate Governance considering the business culture and style of management.

- Identify the disclosure parameters (wait and see)
- Structure and effective Board with adequate independency
- Drawing a line between Executive Management and Board
- Identifying level of authority between Executive Management and Board
- Avoiding overlapping between Executive Management and board
- Clear and measurable KPI’s with comprehensive packs
So, how can we link between quality of disclosure and investors trust? 

- Attract capital and maintain confidence.
- More accurate values of the companies.
- Improves public understanding of the structure of the company.
- Influencing behavior of companies and protecting investors.
- Increase market liquidity.
Effective Corporate Governance will improve financial and operational transparency which decreases information asymmetries.
Transparency improves CG quality, there are five pillars of Transparency & Disclosure quality as a leading practice:

- **Truthfulness**: Accurate description of circumstances.
- **Timeliness**: To timely enable investors to react as quickly as possible.
- **Materiality of information**: Material to influence investment decisions.
- **Completeness**: Sufficient to enable investors to make informed decisions and include both financial and non-financial matters.
- **Accessibility**: Easily accessible and available to investors at low cost.
The effective governance will improve financial transparency by:

- Mitigating management’s ability and incentive to distort information disclosures;
- Improving the quality of the financial statement through a solid Board Committees;
- Issuing accurate earning forecast;
- Improving the ability of shareholders to discern the quality of management and the true value of the firm;
- Strengthening the disciplinary threat of removing management.
Companies with higher level of corporate governance will experience reduction in information asymmetry and improved stock market liquidity.
What about the key components of a good risk governance that could protect the shareholders and maximize the value of the company?

- Setting risk appetite and limits
- Building up a mature culture

Risk Management
Drawing the line between Board of Directors and Executive Management will improve the accountability and guarantee “Board/ Management Handshake Model”

<table>
<thead>
<tr>
<th>Board of Directors (Supervisory Role)</th>
<th>Senior Management (Executive Role)</th>
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<tbody>
<tr>
<td>➔ Approve the corporate strategy and Business Plans</td>
<td>➔ Execute the strategy and business plan</td>
</tr>
<tr>
<td>➔ Setting Corporate KPIs and monitor them</td>
<td>➔ Work to achieve KPIs and report the progress on timely basis to the Board</td>
</tr>
<tr>
<td>➔ Approve the Risk Appetite, risk policies and monitoring it</td>
<td>➔ Manage the risk of the entity and comply with the approved risk limits and risk policies</td>
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<tr>
<td>➔ Setting the overall CG framework including all corporate policies</td>
<td>➔ Develop and implement procedures to comply with approved policies</td>
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<tr>
<td>➔ Monitor the overall business performance</td>
<td>➔ Micromanaging day to day business activities</td>
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<tr>
<td>➔ Requires details and information on certain subject (through Board Secretary)</td>
<td>➔ Provides clear communication channel through the central focal point (The CEO)</td>
</tr>
<tr>
<td>➔ Approves delegation of authority matrix</td>
<td>➔ Complies with the authority matrix in all day to day transactions</td>
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Corporate Governance studies have focused on creating quantitative measures to link CG quality with stock liquidity:

- **Trading Cost**: Time-weighted quoted spread and zero return measure
- **Price Impact of Trade**: Illiquidity estimate and liquidity ratio
- **Immediacy**: Stock turnover and turnover adjusted zero volume days
Control variables related on Corporate Governance and liquidity varies and depends on the nature of the company

- Share price
- Trading volume
- Return volatility
- Firm size
- Company age
- Research and development (R&D) expenditure
- Asset tangibility
- Insider trading
- Institutional ownership
- Analyst following
A leading practice example of using Corporate Governance in calculating market value

Corporate valuation

Market value =

\[ \sum \left( \frac{\text{Cash Inflow}_t - \text{Cash Outflow}_t}{(1 + r)^t} \right) \]

Corporate governance
In reducing information asymmetries between management and traders decreases the incentive to acquire private information, leading to less differences among trader beliefs and smaller speculative positions among informed traders.

Liquidity providers may therefore post wider spreads and smaller depths for stocks of poorly governed companies.
Conclusion: The key stakeholder (Investors, Listed Companies, Regulators and Rating agencies) should give close attention to the below factors in order to have good CG quality:
Closing points

Companies with good Corporate Governance are likely to have liquid secondary markets for their shares because good governance improves financial and operational transparency, which ultimately reduces information asymmetries between the insiders and outside owners/liquidity providers.

Governance affects firm value through the cost of equity capital: poor Corporate Governance leads to lower stock market liquidity which increases the expected (required) return of shareholders, resulting in higher cost of equity capital.

Governance structure affects both the numerator (i.e., cash flows) and denominator (the cost of capital) of the standard discounted cash flow model of firm valuation.
Open Discussion & Questions