CORPORATE GOVERNANCE IN SAUDI BANKS:
THE ROLE OF BOARDS OF DIRECTORS

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LIST OF ABBREVIATIONS

AC	Audit Committee
AGM	Annual General Assembly
BoD	Board of Directors
CMA	Capital Market Authority
CMA CGR	Capital Market Authority Corporate Governance Regulations
CML	Capital Market Law
RC	CMA Regulatory Representative
CG	Corporate Governance
GB	Government Bank
GACC	Government Bank Audit Committee Chair
GAC	Government Bank Audit Committee Member
GB	Government Bank Board Member
IB	International Bank
IAC	International Bank Audit Committee Member
IB	International Bank Board Member
ICEO	International Bank CEO
IFRS	International Financial Reporting Standards
NIS	New Institutional Sociology
SB	Islamic Bank
SACC	Islamic Bank Audit Committee Chair
SAC	Islamic Bank Audit Committee Member
SBC	Islamic Bank Board Chair
SB	Islamic Bank Board Member
MOCI	Ministry of Commerce and Industry
MOF	Ministry of Finance
RS	SAMA Regulatory Representative
SAMA	Saudi Arabian Monetary Agency
SAMA CGR	Saudi Arabian Monetary Agency Corporate Governance Regulations
SOCPA	Saudi Organisation for Certified Public Accountants

ABSTRACT

The University of Manchester

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Doctor of Philosophy (PhD)

Corporate Governance in Saudi Banks: The Role of Boards of Directors

25 April 2014

This thesis sets out to investigate the roles played by boards of directors in the governance of Saudi banks. It explores the factors influencing the selection of board members and the subsequent effects. It also attempts to provide indications of how the selection process influences directors' interactions both inside and outside the boardroom. Furthermore, it presents indications of how the external contextual environment of banks influences the process of director selection and interactions. To achieve the aims of this study, a qualitative case study approach was adopted, involving directors of both listed and non-listed Saudi banks as well as financial regulatory authorities' representatives. This has provided rich insights into the complex web of factors which shape the effectiveness of Saudi banking boards.

There are several micro-level (controlling shareholders) and macro-level (political, legal, social and cultural) factors affecting the Saudi business environment which are more related to the practice of corporate governance. The environment of the Saudi business practice possesses some characteristics of the free market found in developed countries, but differs in certain critical aspects. The early stage of the development of these factors in the country makes the Saudi business practices significantly different from that of developed countries. Thus, the country's attempt to balance free market capitalism with the protection of highly valued social and cultural traditions has led to a unique set of governance mechanisms.

The findings indicate that boards' seats are dominated by controlling shareholders' representatives. Boards that are dominated by directors who come through personal relationships are more likely to follow the interests of those who appointed them and be accountable only to them, ignoring other stakeholders. Personal ties and relationships have greater significance in the selection and appointment of directors to banks' boards than experience, qualifications or financial expertise. The selection and appointment of incompetent directors have substantial effects on the group dynamics and interactions both inside and outside the boardroom.

The limitations of the regulatory and supervisory authorities in implementing and enforcing laws and regulations have an overall implication for a poor corporate governance framework. The controlling shareholders and influential actors (e.g., CEO or chairman) seem to be able to capitalise on social and cultural values (such as respect and seniority) in order to maintain control over other directors. Subsequently, those directors are more likely to engage in unacceptable ethical and moral behaviours.

This study contributes to the growing stream of literature examining corporate boards and corporate governance, particularly in emerging markets. Overall, this study provides theoretical validity by suggesting that new institutional sociology (NIS) theory is more appropriate than agency theory in describing the practices of boards of directors and corporate governance in developing countries such as Saudi Arabia.

DECLARATION

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PRAISE BY TO ALLAH BY WHOSE BLESSING GOOD THINGS HAPPEN

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CHAPTER 1: INTRODUCTION

1.1 Preamble

This thesis sets out to investigate the roles played by boards in the governance of Saudi banks. It explores the factors influencing the selection of board members and the subsequent effects. It also attempts to provide indications of how the selection process influences directors' interactions both inside and outside the boardroom. Furthermore, it presents indications of how the external contextual environment of banks influences directors' selection and interactions.

This research is motivated by a number of observations. The Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA) have issued a number of laws and regulations that organise the framework of corporate governance policy. This study would be of value in informing SAMA and CMA about the extent to which banks comply with the corporate governance laws and regulations and the potential factors that explain differences in banks' compliance.

The research on corporate governance in the business environment of emerging countries in general, and in that of Saudi Arabia in particular, is limited. Most of the available research tends to describe the state of corporate governance from an official regulation perspective or from a perspective of what should be the practical applications of the principles of corporate governance.

There are several political, legal, social and cultural factors affecting the Saudi business environment which are more related to the practice of corporate governance. The environment of the Saudi business practice possesses some characteristics of the free market found in developed countries, but differs in certain critical aspects. The early stage of the development of these factors in the country makes the Saudi business practices significantly different from that of developed countries. Thus, the country's attempt to balance free market capitalism with the protection of highly valued social and cultural traditions has led to a unique set of governance mechanisms.

The Saudi business environment represents a unique structure of ownership. The ownership structure in Saudi is highly concentrated as most of the publicly listed companies are family or state-owned companies. The country's twelve (12) banks are primarily owned and controlled by the government and a few prominent families. This study attempts to assess the extent of those controlling shareholders' power and

influence over the selection of the board members and on the overall corporate governance of Saudi banks.

This research focuses primarily on banks, mainly due to the particularly intricate problems of corporate governance that arise within the banking industry (Macey and O'Hara, 2003; Mehran and Mollineaux, 2012). Two key differences distinguish the governance of financial from that of non-financial firms (Caprio and Levine, 2002; Levine, 2004). The first is that banks have many more stakeholders than non-financial firms. The second is that the business of banks is opaque and complex and can shift rather quickly. Although the opacity and interconnectedness of many financial firms pose similar corporate governance problems, banks face further distortions as a result of regulation and the existence of a "too big to fail" attitude (Ciancanelli and Reyes, 2001; Levine, 2004; Mehran and Mollineaux, 2012).

The Basel Committee on Banking Supervision (2006) has called attention to the need to study, understand, and improve the corporate governance of financial institutions. The Committee believes that corporate governance is necessary to guarantee a sound financial system and, consequently, a country's economic development. The core of the Committee message is the conviction that good corporate governance increases monitoring efficiency.

Financial crises are not random events but, rather, they are set in motion by the decisions of individuals and institutions operating within a given framework of laws and regulations (Mehran and Mollineaux, 2012). In this context, the role of boards as an internal governance mechanism of banks takes on special relevance in a framework of limited competition, intense regulation, and higher informational asymmetries due to the complexity of banking. The board, therefore, becomes a key mechanism by which to monitor the behaviour of managers and to advise them on strategy identification and implementation, and thus have influence over the decision-making process within the organisation (Aguilera and Jackson, 2010).

According to agency theory, the board of directors acts as a delegated party of the shareholders to monitor and control management. In this context, the basic assumption of a governance problem is that management might pursue objectives that are not in the interests of the shareholders. Therefore, the board's main role is generally believed to be that of protecting shareholders' interests by providing effective monitoring and controlling of management actions.

Therefore, one of the most important roles of the board of directors is to ensure that decisions made by managers and executives are in the best interests of the shareholders (Hillman and Dalziel, 2003). Consistent with resource dependence theory, the board members provide linkage to a firm's environment in order to secure resources that may be vital to the firm's success, as well as providing advice and counsel to management (Hillman et al., 2002). Moreover, the institutional theory considers board members as a legitimacy-seeking mechanism, stressing the role of the firm's external and institutional pressures (Parker, 2007).

In order for board members to provide these roles, they have to have human and social capital to enable them to carry out their duties. Human capital relates to the director's skills, experience, knowledge and expertise; while social capital is concerned with the director's network of relationships and the embedded or derived resources emanating from these relationships (Hillman et al., 2000; Certo, 2003; Hillman, 2005). Research recognises the interdependence and interrelatedness of social and human capital and thus it is often difficult empirically to isolate the effect of one from the other.

The overall findings suggest that the roles of boards in the corporate governance of banks are influenced by a number of factors. SAMA has total control over directors' selection and appointments. Although SAMA's intervention procedure in directors' selection is not formally documented and available to the public, this 'political' intervention implies that the government is inclined to remain in control over the banking sector. Besides, the findings show that government ownership in banks is an obstacle to having an effective monitoring system. The government representatives on banks' boards lack the proper qualifications to be able to provide a sound monitoring role. Alternatively, they are significantly important for linking banks to the external environment and providing legitimacy and access to critical resources.

The findings indicate that boards' seats are dominated by controlling shareholders' representatives. Boards that are dominated by directors who come through personal relationships are more likely to follow the interests of those who appointed them and be accountable only to them, ignoring other stakeholders. Personal ties and relationships have greater significance in the selection and appointment of directors to banks' boards than experience, qualifications or financial expertise. The selection and appointment of incompetent directors have substantial effects on the group dynamics and interactions both inside and outside the boardroom.

The limitations of the regulatory and supervisory authorities in implementing and enforcing laws and regulations have an overall implication for a poor corporate governance framework. The controlling shareholders and influential actors (e.g., CEO or chairman) seem to be able to capitalise on social and cultural values (such as respect and seniority) in order to maintain control over other directors. Subsequently, those directors are more likely to engage in unacceptable ethical and moral behaviours.

1.2 Research Aim

The aim of this thesis is to attempt to understand the role of boards in the governance of Saudi banks. The board of directors is the first line of defence against incompetent management and thus, is an important internal governance mechanism in the protection of both firm and shareholders' interests.

Consequently, this thesis seeks to provide insight and evidence into the effects of both national and institutional governance constraints on the selection process of directors, as well as their dynamics and interactions both in and around boardrooms. More specifically, it explores directors' actions and behaviours and their respective consequences, at both individual and bank levels, with specific regard to Saudi institutional contexts.

1.3 Research Questions

From the defined aims, the main research questions this study sets out to answer are, namely:

- How is a board member selected and appointed in Saudi banks?
- What are the factors that influence Saudi bank directors' interactions in and around boardrooms?
- What are the subsequent effects of the selection process on directors' interactions?
- What are the dominant external contextual factors affecting the governance of Saudi banks?
- How do these contextual factors influence the selection of board members and the role of boards in Saudi banks?

The questions are interrelated and can provide evidence on how the external context of the bank influences the directors' selection process. This may in turn enhance our understanding of the role of boards in Saudi banks.

1.4 Research Methodology

To achieve the aims of this study, a qualitative case study approach has been used to generate data relying on interviews with board members of three Saudi banks and representatives of the regulatory authorities.

The data collection for this study involved two primary sources, namely: interviews and archives. The primary data collection was through semi-structured interviews conducted with board members and regulatory representatives. Archival information was obtained from publicly-filed reports, business press coverage and internal reports made available by banks and regulators.

There are twelve (12) Saudi banks which can be categorised based on different variables. All of the Saudi banks, including two of the case banks, are listed on the Saudi Stock Exchange (Tadawul), except one case bank which is unlisted and primarily controlled by the government. They may be divided into three groups in terms of the capital and assets of the bank, namely: large, medium and small. The banks, moreover, have two different banking systems comprising either conventional or Islamic systems or both. The last variable is the ownership structure; namely, whether it is government, local or a joint venture with foreign partners.

1.5 Will Saudi Arabia Ever Change?

This research has been conducted in the backdrop of momentous regime changes across the Middle East which has potential impact on Saudi Arabia. Saudi Arabia, which is generally perceived as a traditional society, will potentially be influenced and is not immune to changes, but the extent of their influence depends on a number of factors that are uniquely and exclusively characterise the Saudi society. The majority of Saudi citizens are disinclined to imitate other infuriated Arab nations elsewhere in the region. This unwillingness to change stems from an implicit, exceptional, and ambiguous “Saudi Code”, which contributed directly into the survival of the regime from the tumult of the “Arab Spring” with the least political damage. The fear of government reprisal in Saudi Arabia, evidently, has no role in the equation unlike elsewhere in the region where suppressed masses were fearful of their regimes’ retribution.

Saudis realise how different they are and they ought to be given the kingdom’s global importance as one of the world’s top 20 economies, the largest oil producer, and most importantly its fundamental and imperative role in the Muslim world. It is largely

acknowledged by Saudi elites that the fall of the regime, an unlikely scenario, would send shockwaves across the world economy due to the fact that the Saudi oil production literally greases the wheels of the rest of the world. They realise that the economy is too big and too important to fall and any volatility and instability of the regime would devastate the already plagued world economy. Accordingly, Saudis recognise that they are privileged and are fully aware of the country's worth, which make them vigilant and ultra-cautious from slipping the country into what they have witnessed in the "Arab Spring" countries.

The exceptional mechanism that governs the internal dynamics of the Saudi society, the implicit Saudi Code and structure of the society set the parameters of how Saudis interrelate with their monarch and consequently the state making it less vulnerable. Such internal dynamics leaves little space for Saudis to perceive their state as inherently unjust, so the disruption of the internal social dynamics, the violation of the Saudi Code, constitutes a grave breach and borders on heterodoxy in a religious sense. A social contract between the government and the conservative religious leaders is symbiotic in nature and largely contributes to the sense of solidarity that the state enjoys. It is remarkable that the elites in both the regime and religious clergy camps invoke the enforcement of the implicit social contract that sums up internal social dynamics rules, at times of instability. Subjectively referenced observers tend to underestimate the serious and tremendous changes that the Saudi society gone through since the discovery of crude oil in the mid of 1940s and consequently fail to realise how the implicit "Saudi Code" came to develop an exceptional national sense of patriotism among Saudi citizens preventing them from being dragged into the Arab Spring inferno regardless of a number of persisting social problems.

In the last three years or so, the government of Saudi Arabia has instrumentally used the accumulated national wealth to provide social stability concerning a number of pressing national issues such as housing and nationalisation (or Saudization) of the job market. Contrary to other Arab regimes, countries that suffer terminal financial and economic stagnation, Saudi Arabia has had an unprecedented budget surplus bulge since 2003. Such surplus has been used in modernising the country's infrastructure, radical labour laws reformation, aggressive job market Saudization initiatives, and direct national investment to resolve the pressing and almost chronic real-estate inflation and housing crisis. With three quarters of its own citizens now under the age of thirty, the unique demographic profile transformation within the country population

has raised new social challenges that are being aggressively accounted for by introducing a complete reformation of legislations and laws concerning the demand on housing and job market. The wise and proactive reallocation of wealth and its consequential social stability and relative prosperity have increased the resiliency of the regime causing higher prospects of endurance for the foreseeable future. It is clear that Saudi Citizens are not satisfied with the status quo, but it is also obvious that the regime would wisely use the staggering accumulated national wealth to defuse any potential threats to the stability, prosperity and the civility of the state.

The interview evidence in this research work suggests that the elite class is critical of the current corporate governance regime, but still abide with the implicit social contract of the Saudi Code to preserve stability in these turbulent times. Certainly, liberalising effect on Saudi society by young Saudis graduates of American and European universities has increased the contribution and involvement of Saudi highly educated financiers and bankers into the fiscal and monetary policy decision-making process and accordingly the demand for more transparent corporate governance in the banking system has been raised. The new generation of decision makers in the banking industry are making changes, demanding more amends and introducing reformation but with the Saudi Code and its social contract that minds the internal social dynamics of the Saudi society in their mind. To an outsider observer, it seems like that change and the potential to change is marginal and unaccounted for, but given the insight into such implicit social contract, this study can claim steady change within context of the internal social dynamics is considered unequivocal.

Surrounded by countries experiencing unrest for economic, political and religious reasons, the Kingdom announced a series of extra-budgetary moves designed to improve the living conditions of most Saudi citizens. In 2011, the government announced a package of benefits totalling SR135bn that have been distributed in the form of salary raises, bonuses, and housing subsidies. Few months later, the King expanded the original package, and announced a new package estimated to cost an additional SR250bn, which involved increases in welfare benefits, bonuses for the army and other public-sector workers, and more funds to build additional housing. The Kingdom, however, has built up well over $500bn in foreign-exchange reserves, a stock of cash that allows the central bank, SAMA, to inject some of those funds into the economy, should conditions warrant it (Gulf Business, 2013).

Many Saudi banks are capitalising on increased wealth in the Kingdom as well as opportunities created by large infrastructure projects, both in progress and planned. The economic stimulus has had a positive effect on the Kingdom's banks. Loan growth has boosted the size of the banking system's balance sheet. At the same time, banks have also been affected by the salary raises, which were part of the stimulus package, and most banks operating expenses have increased noticeably.

The global turmoil as well as the Arab Spring weighed negatively on the local market, but with a gradual return to a semblance of normalcy in the US, euro zone, and China, Tadawul is expected to run at full throttle in 2013 (Arab News, 2013). Saudi Arabia's stock exchange, the Arab world's biggest, has advanced 7.2% in 2012 after declining 3.1% in 2011. Market activity recorded a growth of 73.8% as average daily traded values rose to SR 7.7bn ($2.1bn) compared to SR 4.4bn ($1.1bn) during 2011 and the depth of the market has expanded by seven initial public offerings (IPO) in 2012 worth SR 5.3bn ($1.4bn), up from SR 1.7bn ($454m) (Arab News, 2013). In spite of the problems of the 2008 global financial crisis, SAMA showed incredible growth in all banking indicators with the aggregate net income of the banking system up 14% to SR35bn ($9.4bn) in 2012, compared to SR31bn ($8.3bn) net income in 2011.

1.6 Research Structure

This thesis consists of nine chapters. The current chapter has presented an overview of the study as well as summarising the other chapters. Chapter Two highlights the literature in relation to corporate governance and board of directors. It also provides a background of the development of corporate governance in Saudi Arabia.

Chapter Three sets out the theoretical framework. It draws on new institutionalism perspectives, in particular the new institutional sociology (NIS). This study provides theoretical validity by suggesting that NIS perspective is more appropriate than agency theory in describing the practices of boards of directors and corporate governance changes in developing countries such as Saudi Arabia

Chapter Four details and justifies the research methodology conducted, employing a qualitative case study approach. Data collection methods and the process of data analysis are discussed. The chapter concludes by highlighting issues related to the process of conducting interviews and the translation process.

Chapter Five provides empirical evidence on the director selection process. It offers details of the significance of informal director selection processes and the intervention of regulatory authorities by which to influence the selection process. It also highlights the importance of rational and social determinants of director selection.

Chapter Six provides empirical evidence concerning the interaction of directors both inside and outside the boardroom and the subsequent effects of these interactions upon the bank's governance. It highlights the significance of power and influence of the governance actors, such as controlling shareholders' representatives and board chairmen.

Chapter Seven provides empirical evidence of the banks' external contextual restraints on governance. The external context of the banks includes the political, regulatory and supervisory frameworks, as well as the cultural, social and ethical environments. It provides empirical evidence that political intervention, ownership structure and legal systems are key issues that challenge the effectiveness of corporate governance. Further, it provides evidence that some social and cultural factors may promote negative attitudes and behaviours that may undermine firms' efforts to have a better governance system.

Chapter Eight provides key findings of the case study interviews and the secondary analysis of data. It presents the findings concerned primarily with answering the question of how the external context of the bank influences the directors' selection process. This may subsequently enhance our understanding of the role of boards in Saudi banks.

Chapter Nine reveals a summary of the key findings of the case studies, together with contributions, limitations, and identification of areas for future research.

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

Corporate governance literature is dominated by the agency theory, which has yielded ambiguous and confusing results. Thus, governance researchers are calling for a new theoretical framework that extends beyond the under-socialised concept of agency theory. Moreover, recent research has indicated that the corporate governance structure influenced by the Anglo-American model has problematic implications in emerging markets. Researchers are highlighting the need to consider institutional and macro-level factors affecting corporate governance in the emerging markets. However, the recent financial crisis has prompted attention to advance the research of corporate governance in banks. In general, the research recognises the importance of the internal governance role of the board of directors and extends the functions of the board to include more important roles other than monitoring. Finally, in the context of this thesis, a detailed review on the concept of corporate governance in Saudi Arabia is provided. The review highlights the development of the country's corporate governance and macro and micro issues that affect the effectiveness of the corporate governance system.

The chapter is structured as follows. Section 2.2 is an introduction by which to define corporate governance, while Section 2.3 provides an illustration of the importance of corporate governance in emerging markets. Section 2.4 provides a discussion of the operation of corporate governance in banks and the differences in agency problem in the banking sector. Section 2.5 provides insights into the literature of the board of directors, including the board's conceptual grounds and roles. It also highlights the importance of directors' selection and related directors' social and human capital. Section 2.6 provides a review of the corporate governance arena in Saudi Arabia while Section 2.7 provides a summary and concludes the chapter.

2.2 Defining Corporate Governance

Definitions of corporate governance are varied. According to Aguilera (2005: 41), corporate governance refers to "the distribution of rights and responsibilities among the different actors involved in the organisation" while Johnson et al., (2000: 142) refer to corporate governance as 'the effectiveness of mechanisms that minimise agency conflicts involving managers.'

Much of the research in the field of governance is based on a universal model outlined by agency theory (Fama and Jensen 1983; Jensen 1986) that has dominated corporate governance literature (Dalton et al., 2003). The central premise of this framework is that shareholders (principal) and managers (agents) have different preferences and that their interests are likely to diverge. For example, managers can engage in self-interested behaviour that may be detrimental to shareholders' wealth maximisation. Therefore, researchers have focused primarily on the control of executive self-interest and the protection of shareholder interests in settings where organisational ownership and control are separated (Dalton et al., 2007).

The popularity of agency theory in governance research is primarily due to two factors. Firstly, it is an extremely simple theory, in which large corporations are reduced to two participants (managers and shareholders) and the interests of each are assumed to be both clear and consistent. Secondly, the notion of humans as being self-interested and generally unwilling to sacrifice personal interests for the interests of others is widespread (Daily et al., 2003).

Agency theorists (Eisenhardt, 1989a; Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976) suggest that internal control mechanisms play an important role in aligning the interests of managers and shareholders. The internal governance mechanisms are the first line of protection for shareholders. The more effective these internal control mechanisms, the more likely managers are to pursue the interests of shareholders. The most common internal governance mechanisms pertain to the board of directors, compensation or ownership holdings (Denis, 2001; Daily et al., 2003); while the external governance mechanisms include the legal and regulatory systems, external auditors or the market for corporate control (Daily et al., 2003; Denis and McConnell, 2003).

The related empirical studies using agency theory have yielded ambiguous and confusing results, which have inspired calls for new alternatives to existing board and corporate governance research (Daily et al, 2003; Gabrielsson and Huse, 2004; Davis, 2005; Hambrick et al, 2008; van Ees et al, 2009). These appeals have generated numerous articles expressing the necessity for studies that define behavioural processes and dynamics both inside and outside the boardroom to determine a clearer understanding of what is effective governance (e.g., Huse, 1998; Zajac and Westphal, 1998; Forbes and Milliken, 1999; McNulty and Pettigrew, 1999; Westphal 1999; Westphal, Seidel and Stewart, 2001; Huse, 2005; Leblanc and Schwartz, 2007).

Claessens (2003) summarizes the channels through which corporate governance affects growth and development. These are, namely: increased access to external financing by firms, lower cost of capital and associated higher firm valuation, better operational performance through improved allocation of resources and better management practices, a reduced risk of financial crises as well as better relationships with all stakeholders.

It has been argued that corporate governance research is often more concerned with micro-level governance while ignoring the effects of institutional, legal and cultural aspects on organisations (Dedman and Filatotchev, 2008; Aguilera and Jackson, 2010). The major consequence of ignoring the effects of an external environment is that researchers consider corporate governance in the context of the Anglo-American model. This is primarily characterised by different merits such as little direct state involvement or minimal legal rights for stakeholders (Aguilera and Jackson, 2010).

According to institutional theory, the basic purpose of corporate governance is to assert that an organisation is linked to an environment by clarifying and defining its goals, which should accord with the expectations of the environment (Judge and Zeithaml, 2004). Thus, according to this theory, corporate governance should be involved in defining the organisational goals of the corporation in the context of an existing value system within the firm. In the context of institutional theory, the changes over time of organisational processes and governance structures "fulfil ritualistic roles that help legitimise the interactions among the various actors within the corporate governance mosaic" (Cohen et al. 2007: 11). Thus, complying with guidelines or codes of corporate governance is expected to lend legitimacy to the organisation (Roberts et al., 2005).

2.3 Corporate Governance in Emerging Markets

Corporate governance in emerging markets has not been studied as intensively as in developed markets. As Shleifer and Vishny (1997) point out in their survey, there has been only a little research done on corporate governance outside the UK or the US, apart from a few developed countries such as Japan and Germany. In emerging markets, the institutional context tends to play a significant role in shaping the corporate governance structure and mechanisms (Shleifer and Vishny, 1997; La Porta et al., 2000; Peng, 2003).

The majority of corporate governance literature advocates moving away from the focus on principals and agents as a universal phenomenon, and looking instead at the

patterned variation of corporate governance in different settings (Aguilera and Jackson, 2003; Aguilera et al., 2008; Filatotchev et al., 2012).

Given the "under-contextualised" nature of corporate governance research, a challenge remains to better understand and compare how the effectiveness of different corporate governance mechanisms varies across different organisational environments and institutional contexts (Aguilera and Jackson, 2003; Aguilera et al., 2008; Filatotchev et al., 2012). Effectiveness may involve not only the protection of investors' wealth, as in agency theory, but can also foster creation of new wealth and the fair distribution of wealth among stakeholders (Jensen, 2002).

In most emerging markets, ownership is substantially more concentrated. Legal institutions differ widely, as do managerial career patterns and the salience of social norms around shareholder values. As Globerman, Peng, and Shapiro (2011: 1) indicated: "One needs to understand the institutional framework in which organisations operate in order to understand the rationale for and consequences of specific corporate governance models, as well as the likelihood that specific governance reforms will be adopted and prove effective."

Researchers have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets (e.g., La Porta et al., 1999; Claessens et al., 2000; Young et al., 2008). In their study of 27 countries, La Porta et al., (1999) conclude that "the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders." Similarly, Claessens et al., (2000) identify that the concentrated ownership structure of firms in nine East Asian countries is the main corporate governance problem in these countries that has led to the expropriation of minority shareholders by controlling shareholders. Furthermore, Young et al. (2008) suggest that, although each emerging market has a corporate governance system and creates informal mechanisms to deal with the specific 'weak governance' environment, all of them are characterised by conflicts between the controlling and minority shareholders in the firm.

From a theoretical perspective, institutional theory has been one of the primary pillars that have supported international governance research (Young et al., 2008). Most scholars of developed country corporate governance have focused on the principal-agent conflict. In emerging markets, a new paradigm and more appropriate theoretical challenge tends to present itself, namely: the principal-principal model (Dharwadkar et

al., 2000, Morck et al., 2005, Young et al., 2008). In this context, researchers increasingly realise that there is not a single agency model that adequately depicts corporate governance in all national contexts (La Porta et al., 1997, 1998; Lubatkin et al., 2005).

In developed markets, since ownership and control are often separated and legal mechanisms protect owners' interests, the governance conflicts that receive the lion's share of attention are the principal–agent conflicts between owners (principals) and managers (agents) (Jensen and Meckling, 1976). However, in emerging markets, the institutional context makes the enforcement of agency contracts more costly and problematic (North, 1990; Wright et al., 2005) due to the prevalence of concentrated ownership (Dharwadkar et al., 2000). Concentrated ownership, combined with an absence of effective external governance mechanisms, results in more frequent conflicts between controlling shareholders and minority shareholders (Morck et al., 2005). This has led to the development of a new perspective on corporate governance, which focuses on the conflicts between different sets of principals in the firm. This has come to be known as the *principal–principal* model of corporate governance, which centres on conflicts between the controlling and minority shareholders in a firm (Dharwadkar et al., 2000).

The corporate governance structures in emerging markets often resemble those of developed markets in form but not in substance (Backman, 1999; Peng, 2004). As a result, concentrated ownership and other informal mechanisms emerge to fill the corporate governance vacuum. Each emerging market has a corporate governance system that reflects its institutional conditions. For example, in the case of corporate governance, emerging markets typically do not have an effective and predictable rule of law which, in turn, creates a ‘weak governance’ environment (Dharwadkar et al., 2000; Mitton, 2002). This is not to say that emerging markets have no laws dealing with corporate governance. In most cases, emerging markets have attempted to adopt legal frameworks of developed markets, in particular those of the Anglo-American system, either as a result of internally driven reforms or as a response to international demands. However, formal institutions such as laws, regulations and their enforcement are either absent, inefficient or do not operate as intended. Therefore, standard corporate governance mechanisms have relatively little institutional support in emerging markets (Peng et al., 2003; Peng, 2004). This results in informal institutions, such as personal relationship ties, business elite groups, family connections, and

government contacts, all playing a greater role in shaping corporate governance (Young et al., 2008).

The comparative institutional perspective suggests that whether or not concentrated ownership promotes effective corporate governance may depend on the presence or absence of various types of national institutions. For example, Zhou and Peng (2010) theorised that whether the impact of family ownership and control on firm value is good, bad or irrelevant depends on the level of shareholder protection embodied in the legal and regulatory institutions and these vary across different countries. In countries with less developed institutions, more control through a family CEO or pyramid structure may afford controlling families more opportunities to expropriate funds from minority shareholders (Young et al., 2008; Zhou and Peng, 2010). In addition, institutional environments characterised by informal networks based on trust and reputation considerations may be a powerful factor that restrains family owners' opportunism (Filatotchev et al., 2011). Thus, interdependence among institutions may lead to substitution among functionally equivalent corporate governance mechanisms.

When the formal external governance mechanisms are weak, informal mechanisms may provide proper substitutions. For instance, in emerging markets, external governance often takes place within complex and informal networks based on reputation and trust (Bachmann, 2001). Globerman et al. (2011) argue that, in Asia, informal institutions are often more important than formal institutions. Research by Wong and Tjosvold (2010) focuses on the effects of informal links, or "guanxi" (Chinese word for interpersonal connections) between different organisations in China in the context of conflict management. Their results show the importance of the governance roles of informal social networks that link an organisation with its external partners.

Similarly, the recent Hutchings and Weir (2006) research on understanding networking practices in Arab world finds that "wasta" (Arabic word for personal connections) remains traditional in its significant influence on business and social life decisions in the Arab way of life. Thus, Hutchings and Weir (2006: 278) assert that wasta "involves a social network of interpersonal connections rooted in family and kinship ties … involving the exercise of power, influence and information-sharing through social and politico-business networks." Sawalha (2002:13) suggests that the use of wasta for personal gains created an environment of "nepotism, cronyism, and corruption" that is "a deeply rooted practice among all segments of society and in all sectors."

2.4 Corporate Governance of Banks

The governance of the banking industry has caught the attention of corporate governance scholars and financial regulators (e.g. Adams and Mehran, 2003, 2005; Macey and O'Hara, 2003; Levine, 2004; Caprio et al., 2007; Hagendorff et al., 2007). Corporate governance has become one of the key factors in determining the health of the financial system and the system's ability to survive economic shocks. Formal econometric studies show that banks exert a strong impact on economic development (e.g., Levine 2004, 2005). Banks stimulate productivity growth by efficiently mobilising and allocating funds that lower the cost of capital to firms and thus boost capital formation (Levine 2004). Thus, banks play a key role in the financial system and are a critical component of any economy. Their failures can result in potentially widespread economic distress.

Internationally, the issue of corporate governance for banks has been recognized as one of the most important issues of the corporate sector. The OECD has produced a set of corporate governance principles that have become the core template for assessing a country's corporate governance arrangements. Similarly, the Basel Committee on Banking Supervision has made recommendations for the corporate governance of banks. Following the recommendations of the Basel Committee, OECD and the IMF, many developed countries have designed policies to implement best practice bank management[1]. Developing countries, especially emerging economies in the South Asian region followed the same recommendations and introduced certain guidelines for corporate governance.

There have been many studies on corporate governance, yet only a few of them focus on corporate governance in the banking sector (e.g., Macey and O'Hara, 2003; Levine, 2004; Adams and Mehran, 2005; Caprio et al., 2007; Andres and Vallelado, 2008), even though the key aspects of corporate governance can be applied to banks. The problems of collective action faced by stakeholders who wish to ensure efficient allocation of resources and the distribution of quasi rents, as well as resolving problems derived from different types of ownership and control, are clearly relevant to financial institutions.

However, the relevance of banks in the economic system and the nature of banking characteristics make the problems involved in their corporate governance highly

[1] Examples are the Combined Code in the United Kingdom, German Governance Code and Sarbanes-Oxley legislation in the United States.

specific. The complexity of banking increases the asymmetry of information and diminishes stakeholders' capacity to monitor bank managers' decisions (Morgan, 2002; Levine, 2004; Andres and Vallelado, 2008).

The first line of literature looks at the issue of corporate governance applicable to banks as opposed to other firms and emphasizes the importance of corporate governance for banks. Macey and Hara (2003), argue that commercial banks pose specific corporate governance problems for managers, regulators, and claimants on banks' cash flows. They argue that bank managers and directors should be held to a broader, if not higher, set of standards than their counterparts at unregulated, non-financial firms. Moreover, they recommend that the scope of fiduciary duties and obligations of bank officers and directors can be broadened to address the interests of fixed and equity claimants. They suggest that top bank executives take solvency risks explicitly and systematically into account when making decisions.

Adams and Mehran (2003) also argue that the governance of banks may be different from that of unregulated, non-financial firms for several reasons. They argue that investors, depositors and regulators have a direct interest in bank performance. Given the dependence of the whole economy on banking performance, regulators are more concerned about the safety of the financial system. Adams and Mehran (2003) think that a significant difference between banking firms and manufacturing firms relate to, namely: board size, board makeup, CEO ownership and compensation structure, and block ownership. These differences support the theory that corporate governance structures should be industry-specific.

Levine (2003) argues that banks have two related characteristics that inspire a separate analysis of corporate governance for banks. First, banks are generally more opaque than non-financial firms. Second, banks usually operate in a highly regulated environment. Due to the importance of banks in the economy, the opacity of bank assets and activities, as well as banks being a ready source of fiscal revenue, governments have imposed an elaborate array of regulations on banks.

A growing amount of research is investigating the impact of financial sector development on economic growth. It is important to note that corporate governance is implicit to financial sector development. This is especially so in the role of legal institutions and internationally accepted regulatory structures such as Basel I or II that govern depository institutions (La Porta et al., 2000; Beck and Levine, 2004). Levine (2004) presents a framework whereby a well-developed financial sector facilitates the

allocation of resources and helps to mobilize savings, facilitate risk management, identify investment opportunities, monitor and discipline managers, and facilitate the exchange of goods and services.

It is widely argued that the contract structure of organisations separating ownership from control gives rise to agency problems resulting from the fact that the agents or managers do not bear the risks or the "wealth effects of their decisions" (Berle and Means 1932; Fama and Jensen, 1983). However, Hagendorff, Collins and Keasey (2007) concentrate their research on the banking sector backed by the argument that it requires a separate agency analysis. The opaque nature of many of the banks' main activities (Caprio and Levine, 2002; Morgan, 2002) and the role of regulation in the industry (Basel, 2006) further complicate the agency structures.

The nature of corporate governance problems in the banking sector is not similar to that in non-banking firms. According to a number of studies (Ciancanelli and Gonzalez, 2000; Caprio and Levine, 2002; Adams and Mehran, 2003), the application of a standard agency theory of corporate governance, which focuses on the separation of ownership and control, to the banking sector is difficult since the assumptions of "agency theory" and the "bank's characteristics" are not compatible. Two major factors mainly lead to this incompatibility. First, the multiplicity of stakeholders in the banking sector renders as more complex the asymmetric information problem between stakeholders (Ciancanelli and Gonzalez, 2000; Adams and Mehran, 2003). Second, financial institutions are subject to heavier regulation when compared to their counterparts in unregulated industries, such as manufacturing firms (Adams and Mehran, 2003).

Corporate governance of banks has been identified as being different from that of corporations[2], given the special nature of banks (Adams and Mehran, 2003; Macey and O'Hara, 2003; Levine, 2004; Hagendorff et al., 2007). Yet, clarifying how banks differ from corporations will be the key to solving banks' governance problems, especially during times of financial distress. Further, government regulations and frequent interventions reduce the incentive for effective monitoring and, at the same time, make supervision (or supervisors) less effective.

Information asymmetries can be found in all sectors, yet the problems arising for financial intermediaries may be aggravated by the complexity of banks (Morgan, 2002;

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[2] There is another stream of research that does not distinguish between banks and corporations (Demb and Neubauer, 1992; Krayenbuehl, 1993).

Levine, 2004). Andres and Vallelado (2008) argue that bank opacity and complexity reflect the characteristic nature of banks, and the difficulties faced by outside stakeholders when monitoring bank transactions. Further, they suggest that the issues concerning complexity are common in banking, thus making it difficult for stakeholders to monitor their respective banks.

Regulations play a special role for banks in maintaining a healthy financial system. In the banking industry, regulators are one of the main stakeholders, yet their objectives may clash with those of other stakeholders (Andres and Vallelado, 2008). Supervision of regulators provides additional monitoring and controlling mechanisms for banks, but their role can complicate the governance problem as they could discourage competition and discipline among banks by imposing restrictions on ownership structures (Prowse, 1997; Macey and O'Hara, 2003). Moreover, regulatory authorities might limit the power of markets to discipline the banks (Ciancanelli and Reyes, 2001). They may even pursue their own interests as a regulator when they intervene in the shareholdings of banks (Santomero, 1997; La Porta et al., 2002). In this context, the role of regulatory authorities in the governance of banks casts doubts on the efficacy of supervision and modifies stakeholder incentive to control managers (La Porta et al., 2002). This form of political intervention constrains managerial independence; the agent is faced with a powerful stakeholder having a political or social agenda that may hamper the agent's ability to satisfy other stakeholders, including the principal (Finkelstein and Boyd, 1998; Wiseman et al., 2011). These constraints could come not only by government regulation, but also by government involvement in the corporate governance of individual firms through ownership and board ties (Wiseman et al., 2011).

Andres and Vallelado (2008) suggest that regulation distinguishes the banking industry from other industries where the driving forces in corporate governance are private monitoring and competition. A study by Caprio et al., (2007) shows that legal and institutional factors are more important than the regulatory setting in banking governance. Moreover, empowering private monitoring of banks yields the greatest benefits in developed countries that have in place sound legal and institutional systems (Beck et al., 2006).

Ciancanelli and Reyes (2001) claim that regulation might also be considered as additional external governance forces acting at a macro level (e.g., banking industry level) and at a micro level (e.g., individual bank level). As part of their efforts to

supervise banks, regulators monitor the functioning of bank boards. However, regulators are constrained by the laws of their home countries, while large banks have diversified geographically, setting up branches around the world in countries with many different regulatory systems. In this changing scenario, it is expected that bank boards will emphasise the implementation of strategic decisions to cope with a highly competitive environment, while at the same time ensuring that their bank complies with regulatory requirements in each of the countries in which the bank operates.

A number of studies, however, have argued that boards are the shareholders' first line of defence in governance, focusing on factors that influence board effectiveness (Adams and Mehran, 2003; Hermalin and Weisbach, 2003; Adams, 2010; Adams et al., 2010; Mehran et al., 2011).

Thus, it might be expected that boards of directors would be larger, since a larger board facilitates manager supervision and brings more human and social capital to play in an advisory role to management. However, boards with too many members can experience problems of coordination, control, and flexibility in making decisions (Andres and Vallelado, 2008).

2.5 Researching Board of Directors

Hermalin and Weisbach (2001) point out that there has been relatively little theorising about boards of directors, notwithstanding that they have been subject to a great deal of empirical research. No single theory to date fully explains corporate governance mechanisms, and multiple theories are necessary to take account of the many mechanisms and structures relevant to effective governance systems. Daily et al., (2003) suggest that a multi-theoretic approach is necessary in order to understand the many mechanisms and structures that may enhance the way in which organisations are structured and function.

According to agency theory, board members are expected to oversee and control a firm's management (Fama and Jensen, 1983; Johnson et al., 1996; Dalton et al., 2007). Consequently, the agency perspective has dominated corporate governance studies (Daily et al., 2003). According to Agency theory, Zahra and Pearce (1989) suggest that the presence of outside directors may affect the quality of directors' decisions that eventually would enhance a firm's performance. Overall, a large number of studies (Klein, 2002; Xie et al., 2003; Bedard et al., 2004; Peasnell et al., 2005) have documented negative support for agency theory assumption.

The basic assumption of the agency problem does not hold for certain types of banks. For example, Safieddine (2009) argues that the agency problems in Islamic banks deserve separate and particular examination, as their operations distinguish them from conventional corporations and widens the issue of separation of ownership and control underlying the agency theory. He suggests that the key sources of distinction arise from the observation that managers of Islamic banks are not only entrusted by shareholders to maximize the value of their investments, but have a more compelling duty to achieve these objectives in an Islamic manner (called Shariah-compliant). Thus, while agency problems in conventional banks arise when managers deviate from their duty to maximize shareholders' wealth, any divergence by managers of Islamic banks from placing all supplied funds in Shariah-compliant investments creates an additional source of agency problems.

While in theory a board of directors may mitigate the principal-agent problem, individual directors may face incentives that make them imperfect monitors of management (Mace, 1971). Legally, directors may be found liable for failing to fulfil their fiduciary duty but proving this negligence is incredibly difficult, if not impossible. Successful prosecutions and lawsuits against directors are rare (Valukas, 2010).

Resource dependence theory provides a theoretical foundation for resource provision function of directors. It considers a role for directors beyond the traditional control responsibilities envisaged by agency theorists. Proponents of this theory address board members' contributions as being boundary spanners of the organisation and its environment (Johnson et al., 1996; Dalton et al., 1999; Hillman et al., 2000).

Resource dependence theory (Pfeffer and Salancik, 1978) highlights the interdependence between organisations and their environment, thus suggesting that firms are not self-sufficient and rely on the external environment for survival (Hillman et al, 2007). To acquire needed resources, firms employ board members as linkages or boundary spanners to the external environment (Johnson et al., 1996; Hillman and Dalziel, 2003). Directors can bring to the firm specific expertise or a connection to a resource such as capital or product supply (Westphal, 1999; McDonald and Westphal, 2003). Thus, the resource dependence role of directors suggests board composition will impact in external linkages to the firm's environment (Hillman et al., 2002).

A recent review of Hillman et al., (2009) identifies multiple research streams on the resource dependence theory, one of these pertaining to boards of directors. Resource

dependence studies of boards can be organised around three broad themes. First, some studies demonstrate how board characteristics, such as size and composition, represent organisational responses to the external environment, whereby large boards have the ability to gain access to more resources. A second group of studies has analysed how changes in environmental conditions lead to changes in board composition. Third, further studies have explored the types of firms most likely to benefit from the board resource provision.

From an institutional theory perspective, boards may take on certain characteristics due to societal or business norms and pressures. Firms may follow such norms in an effort to create legitimacy with stakeholders (Pfeffer and Salancik, 1978). For example, factors such as societal and institutional pressure in order to increase diversity in boards (Singh, 2005). Young et al., (2000) assert that, according to institutional theory, the board of directors has two primary roles, namely: linkage and administration. In the linkage role, the board of directors is interested in establishing a relationship between the company and its external environment; whereas in the administrative role, the board of directors is concerned with overseeing the performance of the management team, in particular the CEO.

Resource dependence and institutional theories are similar in that both contend that organisations must adapt to a constantly changing and uncertain environment. As opposed to agency theory however, institutional theory rejects the model of a rational actor, instead advocating that rules and norms over time become authoritative guidelines that govern social behaviours. While acting in accordance with the institutional measures, social norms may appear rational to the actor himself without his realising that the institution is governing his behaviour.

In summary, the extent of a firm's need for resources may influence the mix of inside and outside directors. Outside directors can provide access to critical resources and might be useful when firms need to enhance partnerships and legitimacy. In a crisis, greater outside representation on boards may help firms to obtain valuable resources and information. Increasing the size and diversity of boards assists firms in the linkage to their environment in order to secure critical resources including prestige and legitimacy.

Recent reviews of corporate governance in economic and management literature studies conclude that, despite considerable empirical work, there remains very limited

understanding of the working processes and effects of boards of directors (Daily et al., 2003; Hermalin and Weisbach, 2003).

As a target of blame, agency theory assumptions suggest the dangers of too close a relationship between executive and non-executive directors and the subsequent capture and collusion that this might imply. As a target of reform, these concerns have led to the splitting of the roles of chairman and chief executive (Roberts et al., 2005).

Several recent reviews of a growing amount of literature concerning boards and directors cast doubts on the efficacy of agency theory and its associated prescriptions (Daily et al., 2003; Hermalin and Weisbach, 2003; Roberts et al., 2005). In their review of the economic literature on boards, Hermalin and Weisbach (2003) conclude that there are few definitive and striking findings to link structural characteristics of boards to board outcomes, evolution and firm performance. Similarly, Daily et al., (2003) observe the absence of clear empirical support for a monitoring and oversight approach to governance from a shareholder-value perspective.

Despite the importance of understanding the board process, corporate governance research is more focused on board structure rather than board process, which has an important relationship with board effectiveness and corporate performance (Finkelstein and Mooney, 2003; Leblanc, 2003).

Similarly, governance researchers are calling for more development of theories based on the culture, process and behaviour around corporate governance (Daily et al., 2003). There are a number of studies which have addressed the lack of research in this area and have proposed possible approaches by which to communicate the message that studies are needed to advance the knowledge of the "black box" of corporate governance (Daily et al., 2003; Leblanc and Gillies, 2003; Huse, 2005; Erakovic and Overall, 2010; Lockhart, 2010; Huse et al., 2011). Daily et al., (2003) called for new models of corporate governance employing new theoretical perspectives to steer researchers into beneficial areas of study.

Accessibility to the board directors and executive management is extremely difficult, if not impossible in some cases due to the need for cooperation from these key actors who are not comfortable with being openly on the record for fear of legal liability (Daily et al., 2003; Leblanc and Schwartz, 2007). Leblanc and Schwartz (2007) provided insights as to methods of gaining access to the boardroom to study the black box of board process. Leblanc and Schwatz (2007: 843) expand on this theme and note that "gaining access to corporate boardrooms is extremely difficult if not virtually

impossible for most researchers". They add that the study of corporate governance has been limited by an inability to actually watch boards in action. Daily et al., (2003) emphasised this idea by noting that researchers in corporate governance have a unique opportunity to influence the practice of boardroom governance through literature published integrating theory with empirical studies.

Accountability of directors is not a straightforward issue. In legal terms, directors are accountable for their individual actions, yet they operate and make decisions collectively as a board (Pye, 2002). Individuals may behave differently in a group. Thus, tension exists between the analysis of individual and collective board actions. Directors (like other groups of people) may do things acting together that they would never do alone (Myers, 1994). A board may be greater (or lesser) than the sum of its parts. Boards shape their organisations through all aspects of directors' communications, both inside and outside the organisation, implicitly and explicitly (Pye, 2002).

2.5.1 Director Selection Review

Understanding the determinants of board composition has long been a central focus of corporate governance research (Hermalin and Weisbach, 1988; Finkelstein et al., 2009). This central focus on director selection derives from the critical functions that boards carry out for organisations (Zahra and Pearce, 1989; Johnson et al., 1996; Hillman and Dalziel, 2003). While a number of board functions are discussed, Hillman and Dalziel (2003) integrate and consolidate these into two distinct functions. First, building upon an agency theory perspective, boards of directors serve a monitoring function that helps ensure the alignment of management and shareholder interests (Fama, 1980; Fama and Jensen, 1983). Second, following the resource dependence perspective, boards of directors also provide a resource provision function (Pfeffer and Salancik, 1978). Those directors that are more capable of carrying out these distinctive functions should be able to better affect board and overall organisational performance.

These critical board functions have led to a vast amount of research considering how and why certain individuals are appointed to boards of directors. For example, research considers a variety of organisational and external changes that in part determine the types of directors that are selected to compose the board (Zahra and Pearce, 1989; Finkelstein et al., 2009). These include such organisational considerations as firm performance, strategy, and life cycle stage (Zahra and Pearce, 1989; Pearce and Zahra, 1992). Similarly, research also considers a variety of external factors, such as

environmental uncertainty and changes in the external environment (e.g., industry regulation) that may affect director selection and board composition. This research offers a number of key insights into both the organisational- and environmental-level determinants of director selection and board composition.

While this extant research offers a number of key insights into understanding board composition, it has done so often by neglecting the individual-level characteristics of the potential director. Research is only beginning to consider a variety of individual-level determinants that affect director selection. These studies consider a variety of factors, such as director stigmatization (Gilson, 1990; Wiesenfeld et al., 2008), impression management skills (Westphal and Stern, 2006, 2007), and the ability to provide resources to the organisation (Hillman et al., 2007).

However, even this individual-level research often fails to directly consider the role that human and social capital plays in determining director selection (for an exception see Lester et al., 2008). A director's human and social capital directly relates to the individual's ability to carry out the board functions of monitoring and resource provisions (Hillman and Dalziel, 2003). In turn, this should determine whether an individual is initially appointed to a board of directors and, of interest here, perhaps invited to join subsequent boards[3]. Those directors with higher levels of human and social capital should be better able to provide monitoring and resources to the board and firm. Thus, those directors with higher levels of human and social capital should be more valuable in the market for corporate directors and should receive more board appointments. However, research is yet to formally articulate or empirically examine the underpinning of this critical relationship and the subsequent appointment consequences of director human and social capital.

Research in board literature recognises the value of directors' respective skills, expertise, and experiences that they bring to the board (Bacon and Brown, 1975; Vance, 1983; Lorsch and MacIver, 1989). In particular, Fama and Jensen (1983: 315) posit that "[the] value of their [directors'] human capital depends primarily on their performance as internal decision managers in other organisations. They use their directorships to signal to internal and external markets for decision agents that: (1) they are decision-making experts, (2) they understand the importance of diffuse and separate decision control, and (3) they can work with such decision control systems."

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[3] Because of my focus on current corporate directors, I will examine appointments that follow the director's current board appointments. Therefore, in discussing the board appointment process, I will refer to the appointments as subsequent board appointments.

Much of the current social capital research at the director level focuses on the density or cohesion of an individual's network and its impact on the individual's ability to increase his or her status in the network of corporate elites (Davis, 1993; Useem, 2003). In turn, research utilizes director human and social capital to examine a variety of important firm and board outcomes.

Kim and Cannella (2008) conceptually examine the role of social capital in new director selection and subsequent board performance. In developing their social capital perspective relating to director selection, they distinguish between internal social capital (ties within the focal organisation and in particular within the board) and external social capital (ties external to the focal organisation). They posit that both forms of social capital are positively related to director selection on a specific board; although, each represents different causal logics for the new director appointment. The authors suggest a number of contextual variables that may strengthen the relationship between director internal and external social capital and director selection.

Utilizing a resource dependence lens, Singh (2007) investigates the ethnic diversity on corporate boards in the FTSE 100. Ethnic minority directors were likely to have high levels of human and social capital that allow them to provide a number of critical resources to the board and firm. Singh finds that companies with ethnic minority directors were significantly different from the FTSE 100 companies without any ethnic diversity on a variety of dimensions, including namely: board size, proportion of outsiders, gender diversity, market capitalization, and transparency of new director appointments.

Similarly, Lester et al., (2008) examine the indistinguishable role that human and social capital plays in determining the appointment of former government officials as outside directors. They suggest that the breadth and depth of human and social capital directly affects the likelihood that a government official will be appointed as an outside director of a firm.

Research recognizes the interdependence and interrelatedness of social and human capital (Coleman, 1988). Social relationships are sources of information that individuals can accumulate in order to increase their own human capital. However, because of the interrelated nature of human and social capital, it is often difficult empirically to isolate the effect of one from the other (Coleman, 1988, 1990). In the board literature, the empirical ambiguity led Hillman and Dalziel (2003) to introduce the theoretical construct board capital to capture the combination of a board's

collective human and social capital. The board capital conceptualization offers "a helpful way to conceive of the primary antecedent of the board's provision of resources to the firm" (Hillman and Dalziel, 2003: 387).

In order to perform the monitoring and resource provisioning functions, boards must be composed of individual directors who possess the necessary mix of human and social capital (Hillman and Dalziel, 2003; Nicholson and Kiel, 2004). Therefore, understanding the determinants of board composition and director selection has been a central area for board researchers (Finkelstein et al., 2009; Zahra and Pearce, 1989).

While the selection process is a key determinant of board composition, most board research focuses on organisational and external changes that provide the impetus for board composition changes (Finkelstein et al., 2009). Board composition is traditionally measured along the dimensions of board size and director type (Zahra and Pearce, 1989).

Westphal and Stern (2006; 2007) find that ingratiatory behaviour may be another way that both top managers and directors receive additional appointments. Those top managers that use impression management tactics, in this case ingratiation, toward their CEO are more likely to receive subsequent board appointments at other firms where their CEO serves, as well as at boards connected to the CEO through his or her directorate network. These ingratiatory tactics may substitute to some degree for an individual's elite background or demographic majority status (Westphal and Stern, 2006). Similarly, Westphal and Stern (2007) examine the ingratiatory behaviour that leads directors to receive future board appointments. These authors again find that these impression management tactics along with offering advice and counselling lead to future appointments for directors. Westphal and Stern find that those directors that engage in lower levels of monitoring and control also were more likely to receive future appointments. In both cases, minorities required higher levels of ingratiatory behaviour to receive future appointments and were punished more for engaging in monitoring and control.

2.6 State of Corporate Governance in Saudi Arabia

The Saudi joint stock companies had their beginnings in the mid 1930's, when the "Arab Automobile" company was established as the first joint stock company. By 1975 there were about 14 public companies. The rapid economic expansion, besides the nationalisation (Saudization) of foreign banks in the late 1970's led to the establishment of a number of large corporations and joint stock banks. The market

remained informal, until the early 1980's when the government embarked on forming a regulated market for trading together with the required systems. In 1984, a Ministerial Committee composed of the Ministry of Finance (MOF), Ministry of Commerce and Industry (MOCI) and Saudi Arabian Monetary Agency (SAMA) was formed to develop and regulate the market.

There was no physical bourse in Saudi Arabia and the market conducted business through an Electronic Securities Information System (ESIS) monitored by SAMA, wherein brokerage transactions were handled by the 12 commercial banks. SAMA remained the government body entrusted with regulating and monitoring market activities until the Capital Market Authority (CMA) was established in 2003 under the Capital Market Law (CML). The CMA became the sole regulator and supervisor of the capital market, it issues the required rules and regulations to protect investors and ensure fairness and efficiency in the market. Consequently, The Saudi Stock Exchange (Tadawul) was formed in accordance with Article 20 of the CML. However, the listed companies have to comply with the Company Law (CL) which is the principal body of legislation governing Saudi companies.

The CL (1965) is considered to be the most important regulation and the first organised attempt to regulate Saudi companies. It was derived from the British Companies Law. Although the law has been modified in order to keep up with the rapid development in Saudi companies, many consider it to be outdated and believe it does not fulfil modern corporate requirements (Al-ghamdi and Alangri, 2005).

The importance of adopting a proper corporate governance model is a priority for Saudi Arabian policy-makers involved with capital market development. It is believed that the adoption of corporate governance is a necessity for macroeconomic development and growth stability of the country (Al-Sayari, 2007).

Corporate governance is not a new subject in Saudi Arabia, particularly in the banking sector. SAMA recognised the need to encourage banks to take strong steps to improve their risk management and control procedures. Consequently it took major initiatives in the area of corporate governance. Firstly, it required all banks to develop and strengthen their internal audit departments, and secondly it issued minimum internal control guidelines. Also SAMA issued accounting standards for Commercial Banks in Saudi Arabia which were in line with International Accounting Standards (IAS). In order to create strong culture of corporate governance, SAMA has issued, in 1992, guidelines for the members of the Board of Directors of Saudi banks on their

responsibilities. This was followed by issuance of guidance and rules on a variety of topics including the internal controls, the internal audit function, the internal audit committees, etc. Furthermore, Saudi banks were required to appoint two external auditors from the leading international audit firms. Also SAMA insisted that banks follow both the Saudi Arabian and the IAS to present their financial statements. In recent years SAMA has required all Saudi banks to implement IAS #39 which is a major step towards fair value accounting. SAMA has also encouraged Saudi banks to participate in the annual Basel Committee Survey of Transparency of International Banks. Currently, SAMA claims that Saudi banks' financial statements reflect the highest level of transparency amongst the banks of the emerging market countries (SAMA, 2012).

The Saudi stock exchange (Tadawul) is the largest in the region, with market capitalisation of more than US$373 billion (or 52% of 2012 GDP) and a total value of US$ 514.49 billion shares traded in 2012. The Saudi stock market has evolved dramatically over the past few years and was at its peak at US$646billion in 2005 (CMA, 2009). This bright picture of the market evaporated in 2006 when the market declined sharply to US$327billion, losing 65% of its value. Millions of Saudis lost considerable sums in the stock market crash that wiped out roughly $500 billion in value (Alriyadh, 2006 and 2008; Aleqt, 2007).

The 2006 crash in the kingdom's stock market led the CMA to issue a comprehensive CGRs mandate to enforce the use of best governance practices among Saudi publicly held corporations (Al-Abbas, 2009). As of the end of 2012, the Saudi stock market has a market value of more than US$373 billion with total value of shares at US$514.49 billion and more than 158 listed companies.

The 2006 market crash was a significant factor in the evolution of the Saudi corporate governance framework but there has been a serious need to modernise and develop the statute of the Saudi economy and capital market; as well as improving accountability of Saudi listed corporation board members and executives. Since 2000, Saudi policy-makers have enacted many essential legal economic and capital market presentations, which were expected to enhance Saudi Arabia's economic reputation so that the country would be able to maintain its economic position throughout the world[4].

[4] The accession of Saudi Arabia to the World Trade Organization (WTO) in 2005 has been a significant factor in the kingdom's market reform (Arab News, 2005).

However, the most significant legal development in the area of corporate governance was the issuance of the CGR issued in 2006 where listed companies are required to disclose their adherence to the CGR on a ‘comply or explain’ basis, with a number of articles that are mandatory. The Saudi Arabian model of corporate governance has been influenced by the Anglo-American model, generally referred to as a “market model” or “shareholder model,” which focuses on maximising owners’ wealth. It is a one-tier system where a shareholder-elected board of directors is the highest governing body. In such a system, individual shareholders do not directly affect the direction of the firm (Keasey and Wright, 1993), therefore the role of independent outside directors, ownership structure, and the distinction between the chief executive officer and the chairman of the board among other things, are important elements in monitoring management activities.

The CMA CGRs rules and standards are organised in four parts. The first part consists of two introductory articles, providing definitions of expressions and terms. For example, this part provided definitions of different types of directors (i.e., independent, non-executive), accumulative voting process while it failed to provide a definition for the ‘Corporate Governance’ term.

The second part consists of five articles concerning the rights of shareholders and the annual general assembly (AGM). Articles 3, 4, 5, 6 and 7 include general rights of shareholders in regard to access to information, the general meeting, and voting and dividend rights.

The third part relates to disclosure and transparency including two articles of policies and procedures of the disclosure in board of directors’ report and financial reporting. Articles 8 and 9 highlight the policies and procedures related to disclosure and transparency as well as disclosure in the board of directors’ report.

The fourth part consists of set of rules related to the board of directors. Articles 10, 11, 12, 13, 14, 15, 16, 17 and 18 provide the main functions, responsibilities, formation, meetings and committees of the board, the audit committee, the nomination and remuneration committee, remuneration and indemnification of board members and conflict of interest within the board. A copy of the CMA CGRs can be found in Appendix 1.

On the other hand, SAMA has recently issued Principles of Corporate Governance for banks operating in Saudi Arabia[5]. The local banks must apply these Principles in addition to understanding the related risks, and ensuring that capital adequacy ratios and provisions are commensurate with the size of risks and levels of liquidity and lending, thereby, ensuring the protection of depositors rights as well as the rights of shareholders and stakeholders.

The Principles complement the regulations, rules and circulars issued by SAMA and the CMA regarding the core principles of corporate governance, and highlight the roles of the board of directors and senior management in risk management, setting strategies and defining responsibilities. In fact the SAMA CG Principles are very similar to the CMA CGRs in which it represents a smaller version of the CMA CGRs. Mainly, the Principles consists of two parts; an introductory part and the second part is about the core principles of corporate governance including board members qualifications, composition and appointment, responsibilities, board's committees, the rights of shareholders and disclosure and transparency.

SAMA claims that the Principles are intended to assist banks in enhancing their corporate governance frameworks, and to help board members and senior managers to oversee their banks' activities.

SAMA has already issued a clarifying memo on "Powers and Responsibilities of the Board of Directors of Commercial Banks in Saudi Arabia" to assist members to comply with the Banking Control Law (BCL) and CL that require the application of accounting systems and internal control systems in addition to determining the responsibility of board members in monitoring the assets and liabilities, investments and profitability of the bank. SAMA also issued compensation and Incentive Rules and guidance Manual on "Audit Committees", clarifying the composition of the audit committee, its work mechanism and the role and responsibilities of its members.

SAMA issued a circular to the banks regarding: "Requirements for Appointment in Senior Positions in Banks Operating in Saudi Arabia" aimed to ensure that board directors and senior management enjoy integrity, honesty, and good reputation.

It is, however, becoming increasingly difficult to ignore the debate about the duplication of the application of the legal clauses between the CGR and the CL. There

[5] The SAMA has issued the CG Principles in late 2012 but has not been fully operational due to supervision conflicts with CMA which can be resolved when both agencies sign the MOU.

are, however, numerous similarities and some differences between the provisions of the CGR and the CL in terms of encouraging good corporate governance practices.

It is clear that the subject of disclosure and transparency in the corporation board annual report as well as subject of challenging the board sub-committees, namely the nomination, remuneration and audit committees, have been strongly emphasised by the CGR instead of the CL[6]. In particular, the CL has more or less grasped an understanding of the features of the corporation board's annual report, the encouragement to form the boar d audit committee and the external auditors' obligations, although several significant areas that are connected to these subjects remain unclear.

Both laws deliver shareholders' general rights such as those relating to voting, general meeting attendance, dividends and the right to litigate against any board member. Further examples are those pertaining to board actions including the board meeting, board members' indemnifications and conflict of interest within the board[7]. However, the conflict of interest lawful articles under the CGR are similar to those found under the CL. Three articles regulating the conflict of interests are identical. In this context, a classic example which can be quoted here is Article 18B of the CGR, which is similar to Article 69 of the CL concerning board members' conflict of interests:

> *"A board member shall not, without prior authorisation of the general meeting, to be renewed annually, participate in any activity which may likely compete with the activities of the company, or trade in any branch of the activities carried out by the company."* (CGR 2010, Article 18B).

The CGRs (Article 12D) prevent directors to jointly hold the chairman board and any executive's position while it is endorsed under Article 78 of the CL[8]. The separation of the board's chairman and other executive positions is one of the advanced corporate governance provisions that has been enacted in accordance with the suggestions of the Cadbury report. Therefore, the CL clause should be amended to reflect this necessary change.

Article 12A of the CGR maintains that the minimum number of board members should be three and the maximum number eleven. However, in Article 64 of the CL, the

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[6] CMA CGRs 2010, Articles 8 to 15.

[7] Articles 3, 5-7, 12, and 16-18 of the CMA CGRs corresponding to Articles 66, 69-71, 73-80, 82-84, 87-88, 93-95, 107 and 108 of the CL.

[8] CMA CGRs 2010, Article 12D and CL 1965, Article 78.

minimum number is three but there is no maximum number[9]. It would seem that good practice has been followed by the CGR rather than the CL and therefore, the CL should be amended to follow such standard.

Saudi corporate governance framework can be improved by the role of the listed corporations' self-regulatory corporate governance policies. It is however encouraged by the CMA that the company board should form its own self-regulatory corporate governance policy. This policy should not create any conflict with the provisions of the CGRs[10].

However, the CGR for listed companies takes a bifurcated approach. There is some overlapping regarding the obligations imposed by the CMA and MOCI. There is a grey area of overlapping between the CMA and MOCI when it comes to corporate governance matters. It is unclear how they would be enforced in the event of a major case of a listed company's failure to comply with the corporate governance obligations, which involve serious breaches of directors' duties. Listed companies have to comply with the CL and the mandatory articles of the CGRs[11]. In addition, there is a lack of clarity as to how these interdependent provisions (described above) are interpreted and operate in practice, particularly as some are comply and explain, some are, mandatory and the language of the CL and the CMA requirements appears not to be identical.

In the banking sector, the regulatory framework is more complicated. The regulatory responsibility over listed banks has been divided between CMA and SAMA – creating an area of supervisory overlap. In addition in 2012, SAMA has issued a separate corporate governance code for banks that is creating confusion among banks of which CGRs to comply with or how they would be enforced. The problem of overlapping regulatory authorities is producing inconsistent regulations which banks find themselves having to comply with duplicative regulations from different regulators. Table 2.1 shows the main Saudi market regulatory authorities while Table 2.2 shows the major laws and regulations that stipulate corporate governance requirements.

There has been cooperation domestically. The CMA has memorandums of understanding (MOU) with MOCI, and other government agencies. The CMA has not yet finalised an MOU with SAMA which has been on hold for years. There are few

[9] CMA CGRs 2010, Article 12A and CL 1965, Article 64.
[10] CMA CGRs 2010, Article 10C.
[11] None of the mandatory Articles in the CGRs are imposed by the CL. The non-compliance of a non-mandatory requirement of the CGRs constitutes a violation of the CL which is handled by MOCI.

challenging issues that both agencies have to 'jointly' overcome in order to cooperate. The main issues are concerned with the CMA overtaking SAMA's role of regulating the stock market and deriving some senior staff from SAMA to work for CMA. Although there is an on-going relationship between the two agencies, "cooperation" seems to mean that every agency simply retains the right to regulate and bring enforcement actions and does not appear to contemplate any reduction in the overlapping regulations or regulatory authority.

Table 2.1: The Saudi Market Regulatory Authorities

Regulator	Role
The Ministry of Commerce and Industry (MOCI)	The main regulator of corporate entities and affairs.
The Saudi Arabian Monetary Agency (SAMA)	The main regulator for banks and insurance companies.
The Capital Market Authority (CMA)	The main regulator of the Saudi capital market.
The Saudi Stock Exchange (Tadawul)	The local market for stock exchange

Unsurprisingly, CMA has reported very low compliance with the CGR in its first year of adoption (CMA, 2009). Consequently, CMA is gradually amending the CGRs to increase the number of mandatory articles and has undertaken a number of initiatives and awareness workshops in the area of CG. Currently, compliance with the mandatory and guidance articles of the CGR increased (CMA, 2012). In addition, the listed companies are becoming more involved in the development process of the CGR, as CMA is building relations and cooperation with the companies to reach ideal levels that realise its ambitions about governance applications and practices (CMA, 2012).

Table 2.2: Major Corporate Governance Laws and Regulations

Law/ Regulation	Regulator
Companies Law	MOCI
The Capital Market Law	CMA
The Listing Rules	CMA
Corporate Governance Regulations in Saudi Arabia	CMA
Principles of Corporate Governance for Banks Operating in Saudi Arabia	SAMA
Guidelines for Banks in Saudi Arabia for Organising Audit Committees	SAMA
Powers and Responsibilities of Members of The Board of Directors of Saudi Commercial Banks	SAMA
Compliance Manuel for Banks Working in Saudi Arabia	SAMA
Banking Control Law	SAMA

According to the 2009 ROSC[12] Report, the Saudi corporate governance laws, regulations, and institutions that have been put in place "generally reflect international good practice." The ROSC Report, however, observes that implementation of corporate governance best practices by Saudi companies are still in the early stages. It makes a number of recommendations which would enable Saudi Arabia to bring their

[12] The World Bank's Report on the Observance of Standards and Codes (ROSC) on Corporate Governance in Saudi Arabia, 2009.

framework closer in line with international standards. These recommendations include adjustments to the CGR, better enforcement, and measures to turn the "law on the books" into practice.

According to ROSC Report (2009), regulatory authorities are lagging behind their counterparts in terms of their enforcement capacity. Therefore, CMA and SAMA have announced their intention to hire more staff in their enforcement departments and provide tailored corporate governance courses to new and existing staff, in particular those tasked with monitoring compliance with the CGR.

The IMF Report (2006) recommended that clear and transparent coordination arrangements be established between the CMA, the SAMA, and the MOCI. According to Saidi, the lack of a single securities regulator responsible for monitoring and overseeing disclosure has created regulatory loopholes. It is recommended that reforms be introduced to address this issue.

Saudi's equity culture is still developing. The lack of focus on an equity culture, the high government returns and easy access to bank loans all discouraged an equity culture in Saudi. Debt financing is still prevalent, which hinders further development of an equity culture. However, lack of equity culture and ignorance of investors' rights (characteristics that all regional markets share), are the main cause of weak participation of shareholders to preserve their rights. The consequences of this situation are a very weak qualitative and quantitative participation of shareholders at general shareholders' meetings, thus providing an attractive environment for abuse.

While progress is taking place, a key concern is the weak equity culture in the GCC and the tendency for companies to resist change, especially regarding the role and responsibility of the board of directors (IIF and Hawkamah, 2006). Furthermore, companies that have little need to rely on equity markets have no incentive to provide protection for minority shareholders because of easy access to capital that exists in the Gulf.

In general, Saudi Arabian firms provide a unique context in international corporate governance research. In contrast to the Anglo-American model of corporate governance, many Saudi firms are run by family members and there is extensive state shareholding in private and public firms. In these firms, agency costs are mitigated simply because controlling shareholders often assume management positions and have the incentives and the power to closely monitor and influence managerial decisions (Anderson and Reeb, 2003; Schulze et al., 2001, 2003).

2.6.1 Related Saudi CG Research

Due to the nature of the financial industry, Saudi banks have been the local leaders in adopting best practices that provide better governance structure. However, SAMA has suffered some governance problems and challenges with local banks. The first banking problem faced by SAMA took place in 1960. Riyad Bank and Al-Watany Bank, which had commenced operations in 1957 and 1958 respectively, faced serious liquidity problems arising from mismanagement and improper loans by board members in both banks. By 1960 Bank Al-Watany was technically insolvent and accordingly unable to settle the claims of local depositors. SAMA liquidated the Bank and merged its operations with Riyad Bank. By 1961, SAMA required Riyad Bank to reorganise. Subsequently, with Government approval, SAMA, on behalf of the Government, acquired 38% of the shares of the Bank.

These events tested the Government's resolve to defend the stability of the nascent banking system. The Government not only took action requiring a merger, but also came in strongly as a shareholder to prevent the bank's failure. This sent a clear signal that the Saudi authorities wanted to maintain and fully support a strong, stable and credible banking system. Notwithstanding the government ownership stake, Riyad Bank continued to operate as a private sector institution with no major interference from the authorities.

In 1982, SAMA faced another major supervisory challenge when irregularities appeared in Saudi Cairo Bank's operations. Two senior managers were involved in unauthorized trading in bullion during the period 1979-81 and had concealed accumulated losses that exceeded the Bank's share capital. SAMA required the Bank to issue new shares and double its capital in 1986. SAMA arranged this increase to be taken up entirely by the Public Investment Fund (PIF). The Bank also benefited from "low-cost" deposits from the Public Investment Fund. These measures helped the Bank with liquidity and rescued it to a healthy position.

The corporate governance research on Saudi Arabia is limited. Prior to the introduction of CGR, an Alharkan (2005) study on Saudi corporate governance investigated the perceptions of stakeholder groups regarding corporate governance. He defines stakeholders as falling into four groups, namely; financial managers and internal auditors; academics; external auditors and government officials. The findings indicate that the banking, communications and industrial sectors have corporate governance systems in place. These companies show that they adopt some of the Cadbury Report's

recommendations in relation to the proportion of independent directors and the separation of the roles of chairman and CEO. However, Saudi companies show a lack of disclosure and transparency of their reports to the public.

Similarly, a study by Falgi (2009) on the Saudi stakeholders' perceptions to improve corporate governance indicates that the market is characterised by a lack of accountability, a weak legal system and poor protection of minority shareholders. Moreover, he asserts that the corporate governance structure is influenced by the local social and cultural factors, while boards of directors are dominated by controlling shareholders. The results show that while management is accountable to the board, the board shows accountability to the major shareholders, ignoring other stakeholders.

A study by Alturki (2006) suggests that the CEO or controlling shareholders are more likely to be the ones who select directors, rather than the general assembly. The study findings suggest that boards generally lack effective monitoring of management and exhibit weakness in replacing underperforming executives, especially the CEO. Furthermore, the board of directors lacks the ability to perform management performance evaluation and to provide support for outside directors to access information. The boards fail to show support for enhancement and ensuring compliance with applicable laws, while they disregard the interests of other stakeholders.

Al-Ajlan (2005) examined the roles and responsibilities of the boards of directors in Saudi banks. The findings suggest that boards in Saudi banks have significant roles in strategic planning and advising management. On the contrary, the results provide different views in relation to whether boards of directors are active in monitoring and controlling the management in their banks. However, the findings suggest that banks' major shareholders play a key role in monitoring and controlling these banks, as most of them are board members or have their representatives on boards.

There is a culture of secrecy regarding business practices and a company's financial statements, with owners being reluctant to reveal information necessary to the public. Users of corporate information in Saudi Arabia are financial institutions, major investors, and governmental agencies, all of whom have access to company records and can demand whatever information they need, while public financial disclosure is kept at a minimum (Naser and Nuseibeh, 2003). As a result, voluntary disclosure is rarely done while companies seek to comply with mandatory reporting requirements (Saidi, 2004). The relatively low level of voluntary disclosure can be explained on the

grounds that a significant proportion of companies in Saudi Arabia are owned by either families or government who have little incentive to disclose voluntary information. The disclosure requirements are reasonable and have been recently enforced by CMA, however the main area of weakness is the timeliness of disclosure of material events (Al-Abbas, 2009).

2.6.2 Ownership structure

Ownership structure is an important determinant of corporate governance practices. Shleifer and Vishny (1997) have stated that ownership structure plays a key role in reducing agency costs by aligning the interests of managers with those of shareholders. Controlling shareholders, however, generate another unique set of problems among various types of owners (La Porta et al., 2000). In Saudi Arabia, traditional principal-agent problems between shareholders and managers may be supplanted by principal-principal problems between family members and outside shareholders.

A study by Al-Tonsi (2003) revealed that the Saudi market is dominated by family ownership of approximately 75%, while government and individuals own shares in the remaining 25%. Furthermore, the government controls 45% of the top twenty (20) listed companies with an estimated value of $116 billion in banks, petrochemicals, communications and public utilities companies (Alriyadh, 2012).

A study of Saudi banks found that 72 out of the 108 board seats in the country's banks are held by local families, which accounts for 66% of the total seats (Aleqtisadiah, 2013). The study also indicated that the most prominent of these are twelve (12) families who control 33% of the total banks' seats. The government, however, has shares in all local banks that range from 5% to 80% (SAMA, 2011).

In recent years, issues of corruption and lack of accountability are becoming national concerns in Saudi Arabia. There is huge debate in the country concerning the issue of combating corruption in the public and private sectors, in addition to releasing vital information which is currently unavailable to the public. A study by Al-Owaishig (2005) indicates that current Saudi law does not mandate that government regulations be publicly announced and therefore, only a few of them were ever announced in the media. The study points out that many government bodies rely on unwritten regulations and directives and that the public could not possibly know what the regulations were or how to follow them.

In 2010 local newspapers (Aleqtisadiah; Alriyadh; Okaz) reported that the General Auditing Bureau (GAB) had complained to the King about the increase in corruption. They reported that some Government officials are involved in the illegal spending of public funds, whilst others are awarding projects to firms that are either not delivering or complying with budgetary allocations.

In response to this, a National Anti-Corruption Commission was established in 2011 to combat corruption. It placed all government bodies under its jurisdiction, focusing on upholding transparency and combating financial and administrative fraud in the government.

In a recent report on corruption, Shalabi (2012) predicted a rise in per-capita income in Saudi Arabia from $20,000 to $83,000 should the concerned parties put an end to the financial and administrative corruption in the Kingdom. He also revealed that the Saudi private sector currently spends $20 to $30 billion per year on bribes, while global corruption costs $2 trillion, according to World Bank recent reports.

In addition, compared to developed economies, emerging economies such as Saudi Arabia suffer from the following problems, namely: limited disclosure of firm information, few mechanisms to protect the minority shareholder, and irregular enforcement of corporate governance laws (La Porta et al., 2000). Such differences in broad national governance contexts would affect incentives, investment horizons, as well as capabilities of different types of shareholders to monitor and influence firm management.

In the Saudi market, as in many emerging markets, most of the controlling shareholders are individuals, influential institutions or families. In other words, the insider system is the dominant characteristic of the companies in the region. A single family may have controlling stakes in a number of companies whether directly or indirectly. Controlling shareholders have strong incentives by which to closely monitor the company and its management and can have a positive impact on the governance of the company. However, their interests might also conflict with the interests of minority shareholders. The conflict is evident when the controlling shareholders abuse the company's resources by extracting private benefits at the expense of other shareholders.

Saudi firms believe that corporate governance will be a distraction that will slow down the decision-making process and therefore hinder their growth and development (Euromoney, 2007). Nevertheless, bankers also recognise that there are a number of

good reasons why corporate governance standards in the Middle East in general – and in the GCC in particular – are not as high as they are in the US or western Europe. Foremost among these is the structure of many of the largest companies in the region, which have historically been built up as family-owned organisations operating in a relatively small regional market. These have since expanded into large-scale conglomerates, some of which are now global players.

However, for companies with publicly issued securities, a basic framework for corporate governance should be complemented with other provisions that afford an appropriate level of protection to minority shareholders. This additional framework is almost absent in the Kingdom. Most companies lack adequate public disclosure of insider and/or substantial holdings. The Kingdom has developed codes of corporate governance, but these codes require further strengthening in issues such as independent directors, qualifications of directors and use of supporting committees by the board.

In general, market supervision and enforcement have been inadequate due in part to weaknesses in the legal and supervisory framework. Thus, the public perception in the country is that there is a considerable amount of insider trading and market manipulation, with insufficient action being taken by regulators (ROSC, 2009).

The Saudi Arabian capital market is relatively at development stage compared to advanced markets in developed countries. The development of the capital market has been slow, as most Saudi companies are either government or family owned. However, Saudi Arabia has embraced some structural and regulatory changes in the last two decades, which have accelerated development of and changes in the country's capital market. Further, the Saudi government has made great strides in the implementation of a strong legal framework that provides an underlying governance structure that supports the human resource management function throughout the Kingdom (Mellahi, 2007).

According to the Financial Standards Foundation Report on Saudi Arabia published in 2010, the report shows that the compliance of Saudi firms with the CGRs on the board's key functions is still in its early stages. Further, the ROSC Report (2009) notes that, based on observations, the effective enforcement of penalties related to violations of fiduciary duties are still in the early developmental phase. Shareholders possess the right to file liability lawsuits against directors via the redress mechanisms described in the Companies Law. However there are no laws or regulations at present specifically

pertaining to minority shareholders. To date, there have been no lawsuits filed pertaining to directors' liabilities in Saudi Arabia (ROSC, 2009).

Given the existence of several authorities in charge of overseeing compliance with financial reporting requirements, the Nadal and Saidi report in 2004 concludes that reforms are needed to "avoid the regulatory loopholes created by the presence of several authorities" (p. 54)

In general, Saudi Arabian firms provide a unique context in international corporate governance research. In contrast to the Anglo-American model of corporate governance, many Saudi firms are run by family members and there is extensive state shareholding in private and public firms. In these firms, agency costs are mitigated simply because controlling shareholders often assume management positions and have the incentives and the power to closely monitor and influence managerial decisions (Anderson and Reeb, 2003; Demsetz and Lehn, 1985; Schulze et al., 2001, 2003).

Controlling shareholders, however, generate another unique set of problems among various types of owners (La Porta et al., 2000). In Saudi Arabia, traditional principal-agent problems between shareholders and managers may be supplanted by principal-principal problems between family members and outside shareholders. Furthermore, Saudi Arabian firms represent an interesting hybrid of ownership structures, especially with the dramatic changes that have occurred since the 1997 Asian financial crisis (See Alajlan, 2004).

In addition, compared to developed economies, emerging economies such as Saudi Arabia suffer from limited disclosure of firm information, few mechanisms to protect the minority shareholder, and irregular enforcement of corporate governance laws (La Porta et al., 2000). Such differences in broad national governance contexts would affect incentives, investment horizons, and capabilities of different types of shareholders to monitor and influence firm management. Thus, the Saudi Arabian context offers an opportunity to enhance our understanding of corporate governance within the context of an emerging economy.

In the Saudi market, as in many emerging markets, most of the controlling shareholders are individuals, influential institutions or families. In other words, the insider system is the dominant characteristic of the companies in the region. A single family may have controlling stakes in a number of companies, whether directly or indirectly. Controlling shareholders have strong incentives to closely monitor the company and its management, which can have a positive impact on the governance of

the company. However, their interests might also conflict with the interests of minority shareholders. The conflict is evident when the controlling shareholders abuse the company's resources by extracting private benefits at the expense of other shareholders.

The IIF-Hawkamah survey of Gulf Cooperation Council[13] (GCC) countries has found that corporate governance in GCC countries lags significantly behind international corporate governance best practices among emerging markets. The survey showed that 64% of the institutional investors still consider corporate governance practices in the GCC region as a “significant barrier” to stock market performance, identifying Saudi Arabia as the worst among the GCC countries in terms of corporate governance standards. These results are generally consistent with those of other studies (Alajlan, 2004; Saidi, 2004; Euromoney, 2007).

Companies believe that corporate governance will be a distraction that will slow down the decision-making process and therefore hinder their growth and development (Euromoney, 2007). Nevertheless, bankers also recognise that there are a number of good reasons why corporate governance standards in the Middle East in general – and in the GCC in particular – are not as high as they are in the US or western Europe. Foremost among these is the structure of many of the largest companies in the region, which have historically been built up as family-owned organisations operating in a relatively small regional market that have since expanded into large-scale conglomerates, some of which are now global players.

On the other hand, out of 175 countries assessed in the World Bank's report “Doing Business 2008,” Saudi Arabia is ranked at 50 and 136 for protecting investors and enforcing contracts respectively. Enforcing contracts is one major concern for investors, as well as for local companies. Without a proper legal infrastructure that protects the investors’ money, it is difficult, if not impossible, for them to have faith in the economy.

Moreover, this shows the capability of the legal system to deal with commercial disputes. According to the report, it requires 44 steps and 635 days to enforce contracts in Saudi at a cost equal to 27 per cent of the original debt. This is discouraging for local companies since small and medium-sized enterprises cannot bear the costs and the time necessary for them to enforce a commercial contract.

[13] Gulf Cooperation Council (GCC) is a political and economic alliance of six Middle Eastern countries that include Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman.

2.6.3 Saudi Arabian Culture

Saudi Arabia is unique in the region because it has never been colonised and the Saudis have made a conscious effort to shelter the indigenous population's national and religious identity (Rice, 1999). The influx of foreign labour has no doubt played a role in Saudi Arabia and leaders have made significant efforts to preserve the Saudi culture (Salih, 2010). The Saudis have worked hard to introduce a process of "Saudization" in which foreign workers are replaced with local nationals (Al-Dosary and Rahman, 2005). The impact of Bedouin tribal codes of loyalty and honour, combined with a strong patriarchal family structure, has had a powerful effect on the Middle Eastern culture (Hickson and Pugh, 1995; Robertson et al, 2001). The top-down authoritative structure, sometimes referred to as a "Bedoaucracy" or "Sheikocracy", is highly traditional and pervasive (Habib and Kassem, 1989).

In the Arab world, corporate boards and management are influenced by traditional values and norms (e.g., personal relations, preference for individuals from influential tribes, etc.) that might affect their orientations and behaviour (Ali, 1990). They are caught between the pressure for change and their own tradition where individuals are not prepared to work outside the tribe or the family circle.

Within this system of strong political ties and weak regulatory framework, an influential director, who might be a board chairman or CEO, is likely to misuse his position and hire closely-related directors. Prevost et al., (2002) argue that Arab CEOs who also serve as chairmen of the board are therefore likely to appoint related board members who will be less involved in monitoring and in the overall issues concerning corporate governance. This implies that directors who are in control might be inclined to practice the same behaviour as in CEO duality. This reduces the effectiveness of the monitoring role played by the elected board of directors, and results in a waste of organisational resources (Fan et al., 2007).

The Hofstede (1980) cultural dimensions view the Arab culture as being high in "power distance" between the different parties involved in the society (e.g., rulers and ruled, employers and employees, etc.). In such a context of high power distance, accountability tends to be lower, which results in significant corporate governance implications, especially when the CEO dominates both the boardroom and the management.

Arabs are an extremely collectivistic people (Hofstede, 1980) and there is great ease in social interactions and the formation of groups. This collectivism can thus result in

strong group loyalty and cohesiveness (Ali, 1993), and might be a potential source of beneficial "social capital" (Rice, 2003). This social dynamic does, however, serve to increase the potential for political or group ties that may introduce a degree of inertia to the organisation and diminish the impact of corporate governance mechanisms. Arab organisational culture, however, may be characterised by a "shame culture," as opposed to "guilt culture," which intensifies agency problems when the CEO also acts as chairman of the board. Velayutham and Perera (2004) suggest that in cultures where the emotional state of shame is common, accountability is likely to be weak and people are likely to be negatively inclined towards information disclosure.

2.7 Overview of Saudi Banking Industry

Saudi Arabia has a long banking tradition and as in many developing economies, local banks started out as joint stock companies, partnering with established banks in Europe and the USA. Over time the structure devolved, with many of the local principals buying up the shares of their foreign partners. Some of the banks however continued to have significant foreign ownership. The Ministry of Finance, operating through the Saudi Arabian Monetary Agency ("SAMA"), which was established in 1952 and acts as the central bank of the Kingdom, regulates the banking sector.

Foreign banks' presence in Saudi Arabia can be traced back to 1926, when the Netherlands Trading Company, later to become Algemene Bank Nederland (ABN) began operations. It enjoyed a virtual monopoly until the late 1940s. In 1947, Banque Indo Chine opened a branch, followed by the Arab Bank Limited (1949), the British Bank of the Middle East (1950) and the National Bank of Pakistan (1950). In October 1952, the Saudi Arabian Monetary Agency (SAMA) was established by the Saudi government with primary responsibility for monetary stability. Following SAMA's creation, the government followed an open and liberal policy and permitted the opening of new foreign bank branches, including Banque de Caire, Banque du Liban et d'Outremer and First National City Bank of New York. This first wave of foreign banks linked Saudi Arabia firmly with the global financial markets and encouraged a competitive domestic environment.

During this period, domestic banks were also licensed. The first local bank to be established in the Kingdom was the National Commercial Bank in 1950. The bank operated as a partnership until 1997 when it was converted to a joint stock company. The first bank to be established as a joint stock company was Riyad Bank in 1957. The other Saudi banks were branches of major international banks that were incorporated

in late 1970s as local banks with majority Saudi shareholdings. In recent years, two new local banks were granted licences; Albilad Bank established in 2004 and Alinma Bank that was established in 2006.

By 1975, 10 international banks with 29 branches were present in the Kingdom. These institutions operated as branches of their parent companies but, in 1976, a decision was taken by the Saudi government that these should become incorporated as local banks with majority Saudi shareholdings. The major reason for this important policy decision was that with the boom in oil revenues in the mid-1970s, the Saudi economy expanded and grew very rapidly. This led to sharp rise in demand for banking products and services which the existing banks found difficult to manage.

Consequently, in 1976 the Council of Ministers (the legislative authority) offered foreign banks operating in the Kingdom a chance to form joint venture banks with Saudi shareholders. This decision required foreign banks to convert their branch operations to Saudi joint stock companies in which they could retain up to a 40% shareholding.

Following these changes, no new foreign or domestic banks were granted a license, as the government believed that the country was adequately served by the existing branch network. During this period, the banking system made large investments in the payment systems infrastructure and in technology-based customer products and services. Consequently, while the banking system expanded greatly in size and scope of its activities, there was only limited expansion in the banks' branch network. In early 2000, SAMA opened up the sector, granting licenses to GCC and major international banks to operate branches in the Kingdom.

Over the last 10 years, the banking sector went through a tremendous period of growth, with most banks doubling their asset base. Consumer lending growth was a significant driver, with the availability of funding significantly facilitated by the significant reduction in net claims by banks on the government. In addition, Saudi banks have witnessed a rapid growth in banks' branch network while enjoying supportive macroeconomic environment and outstanding capital market performance.

2.7.1 Banking Growing Pains

No bank in Saudi Arabia has ever failed, and episodes of banking uncertainties are scarce in the Kingdom's history, although the sector is cyclically affected by the ups and downs in the oil prices. SAMA has not stated explicitly that it will support every

bank, but it has admitted to being behind the scenes in some difficult situations to support a troubled bank in the system if the need arose. The failure of one bank in a system that has only 12 local commercial banks would have material consequences for the entire banking system and the economy as a whole.

The first banking problems faced by Saudi Arabia took place in 1960. Launched in the late fifties, Al-Watany Bank and Riyad Bank suffered liquidity issues shortly afterwards due to mismanagement. SAMA decided to step in, liquidating the technically insolvent Al-Watany, and organising its merger with Riyad Bank. In addition, SAMA held a 38% stake in the new entity, on account of the government, which injected new liquidity. The government not only took action, requiring a merger, but also came in strongly as a shareholder to prevent a bank failure. This sent a clear signal that Saudi authorities wanted to maintain and fully support a strong, stable and credible banking system. This episode led to the enactment Banking Control Law in 1966, which provided SAMA with supervisory and regulatory powers, setting stringent requirements for the banking sector.

Early in 1980, two senior managers at the now defunct Saudi Cairo Bank concealed unauthorized trading in bullion, while accumulating losses soon exceeding the bank's capital. SAMA required the bank to issue new shares and double its capital by 1986, arranging this increase to be taken up entirely by the Public Investment Fund (PIF), while the bank benefited from low-costs deposits from PIF.

In 1999, SAMA was faced with the most testing problem in the NCB case. The bank’s capital was virtually wiped out by bad loans during the 1980s, and failed to produce financial statements for 1990 and 1991. In 1999, the Saudi Ministry of Finance, through the government-owned PIF, acquired 80% of the bank's shares from its previous private shareholders, to become the largest state-owned bank in the Kingdom. The bank was consequently able to increase its provisions to cover a portion of the NPLs.

The concentration of shares in fewer hands has raised concerns about the influence of these controlling shareholders on day-to-day operations and bank management through board representation. The shareholder concentration had implications for transparency and created a form of partnerships among joint stock companies. The issue became a concern to the regulators in 2009 following the default of two prominent Saudi family

groups – Al Gosaibi Group and Saad Group[14], which had large exposure to Saudi and international banks, some of loans were seemingly extended on a "name lending" basis from banks where both groups held significant share holdings. SAMA moved quickly to reinforce existing regulations that requested more transparent bank corporate governance and disclosure in cases of direct and indirect shareholder loans.

The 1980s were a tumultuous and testing period for Saudi banks and the banking system. In line with the tremendous increase in government revenues in 1979-1981 and subsequent slow-down in 1982-1986, the Kingdom's commercial banks saw rapid expansion followed by a difficult period of adjustment, deterioration in asset quality and retrenchment.

As oil prices tumbled from an all-time high in 1981 and continued to decline during the next five years, there was significant pressure on the quality of bank assets, which deteriorated with the economic slowdown. Credit to the private sector, which had increased over 500% during the period 1976-1981, only grew at a rate of less than 4% per year over the next five years. The banks suffered from non-performing loans, which increased to over 20% of all loans by 1986. Banks' profits suffered significantly, and loan loss provisions for doubtful accounts for the banking system had risen to over 12% of total loans.

The causes of the problems faced by Saudi banks arose mainly from the macroeconomic imbalances which were created by a steep rise in government revenues in 1979-1981, followed by a precipitous decline in oil revenues. Government revenues, which had risen to SR333bn by 1981, started a rapid decline and dropped to just over SR74bn by 1987. The rapid growth in bank assets and liquidity in late 1970s and early 1980s had given rise to a sharp increase in demand for private sector credit. Some banks expanded too rapidly, and did not have adequate credit assessment and monitoring procedures. They also lacked required technical expertise, faced a shortage of qualified human resources and had inadequate technology. Consequently, when the steep decline in the economy occurred, many companies and businesses suffered from a lack of liquidity and faced a credit crunch. The construction and contracting sectors that had boomed earlier faced the biggest setback, and many projects were affected.

[14] Algosaibi and Saad Groups defaulted on US$22 billion of loans in 2009, borrowed from more than 100 regional and international banks to finance expansion into real estate and investments in the kingdom and elsewhere. One-third of the liabilities are owed to Saudi Arabian banks (Asharq Al-Awsat, 2011).

Banks had difficulties recovering their loans, and the collateral in many cases proved to be difficult to realize.

During this period, SAMA took a number of steps to ensure the stability of the financial system and to help the banks to overcome the prolonged economic downturn. These steps include the following;

1. Banks were required by SAMA to seek its approval prior to announcing their dividends. The Banking Control Law requires all banks to build their statutory reserves equal to their share capital. SAMA further encouraged Saudi banks to build additional reserves to strengthen their capital base.

2. Most foreign shareholders in Saudi banks enjoyed a tax holiday for the first five years of their ownership. To encourage retention of profits, the tax holiday was extended in most cases by another five years, after which a deferred tax scheme was permitted.

3. In 1986, SAMA obtained a ruling from the Tax Department that permitted the tax deduction of loan loss provisions on an accrual basis. This encouraged banks to increase their loan loss provisions for doubtful accounts.

4. To encourage Saudi banks to increase their interbank dealings and to support the development of a riyal interbank market, a tax ruling was obtained which exempted foreign banks from withholding taxes when carrying out interbank transactions with Saudi Banks.

5. SAMA recognised the need to encourage banks to take strong steps to improve their risk management and control procedures. Consequently, it took major initiatives in the area of corporate governance, requiring banks to develop internal audit departments and implement internal controls.

Following the difficulties of the 1980s, in the next decade SAMA embarked on a policy of modernising its supervisory system. The first objective of these policies was to create a suitable infrastructure that required sound corporate governance of banks; a second objective was to introduce international supervisory standards and best practices. In this regard, SAMA issued a range of supervisory requirements, including internal control guidelines for banks, SAMA accounting standards (these were subsequently replaced by IFRS in 1992), fraud prevention guidelines, anti-money laundering guidelines, operational risk guidelines, establishment of the role of audit committees, and external auditors, etc. All of these guidelines were aimed at

inculcating a culture of sound corporate management and enhancement of internal controls. In tandem, SAMA introduced a number of supervisory standards emanating from the Basel Committee. These included the 1988 Basel Capital Adequacy Accord (1992), the large exposure standard (1994) and a number of other Basel circulars dealing with liquidity, interest rate risk, credit risk, market risk, etc.

It is noteworthy that in 1990s, the quality of management in the banking sector had improved significantly due to the bad experiences of the 1980s. Consequently, despite the Russian crisis, the bond market crisis, and the Southeast Asian banking crisis in the 1990s, there was no major impact on the performance of Saudi banks. Also, the banking system coped well with the volatilities of the prices in the oil market; no bank was threatened in this period and no government support was required.

In the decade starting in 2001, the trend towards further enhancement of the supervisory system has continued. SAMA has developed and implemented a range of financial policies and supervisory standards to ensure that the banking system maintains its reputation, safety and soundness. Some of the major supervisory policies introduced since 2001 include the following.

- A new anti-money laundering law.
- New regulations for prevention of money laundering and for combating terrorist financing.
- Implementation of a risk-based supervisory system to support on- and off-site supervision.
- Implementation of Market Risk Amendments to the 1988 Basel Capital Accord (now part of the Basel II Capital Accord).
- Implementation of supervisory rules for consumer loans and margin trading.
- A host of other Basel circulars, including those on credit and operational risks.
- Promoting compliance and governance culture in banking industry through the issuance of compliance manual and corporate governance principals for banks operating in Saudi Arabia.

The main source of current concerns for Saudi banks remains credit risk and high concentration, and possible exposure of some banks to the private corporate sector and family-owned businesses, highlighted by the debt repayment difficulties of some prominent Saudi family conglomerates. However, SAMA has acted prudently and

quickly to ensure adequate liquidity is available and guaranteed local depositors but the emphasis going forward is strengthened corporate governance and transparency at bank board level to avoid lax lending standards and “name lending” from rising up again. Other challenges faced by the Saudi banking sector include the mismatch in their maturity profile of assets and liabilities, and both domestic and foreign banks will have to come up with some innovative new capital instruments to reduce the imbalance in asset-liability maturities.

Early this year, Saudi Arabia issued final regulations on real estate financing, leasing and the supervision of financial companies as the kingdom tries to ease a housing shortage by opening up its mortgage market and enacting the first home-loans law (Arab News, 2013).

Home lending in Saudi Arabia grew at the fastest pace in at least four years, evidence that banks in the largest Arab economy are more willing to take risks. In 2012, real estate financing jumped 83% to record SR48bn from a year earlier, according to data compiled by SAMA. Progress in the country has been slow, however, and mortgage loans as a percentage of gross domestic only represent 2%, compared to 17% in the neighbouring country United Arab Emirates.

Another important development in Saudi banking is the growth in female employees across the sector. The proportion of women in banking workforce is increasing over the last five years to meet the demands of banks expansion of ladies’ branches and as more Saudi female graduates emerge and women’s banking gains greater traction.

2.7.2 Saudi Banks Today

Today, there are 12 banks operating in Saudi Arabia, 11 of which are publicly listed. The National Commercial Bank ("NCB”) is the only privately owned bank. Saudi nationals own 100% of the shares of six banks, whereas strategic foreign partners hold shares in the remaining six banks. Foreign shareholdings in Saudi banks range from a low of 5.8% to a high of 40%.

All banks in Saudi Arabia offer both conventional as well as Islamic products and services, with the exception of Al Rajhi Bank, Bank Al-Bilad and Bank Al Jazira that are fully Shariah compliant, offering only Islamic products. Meanwhile, NCB and Saudi Investment Bank have announced on more than one occasion their intention to become fully Shariah compliant over the next two to three years. With the exception of NCB, all Saudi banks have their shares listed on the Saudi Stock Exchange (Tadawul).

Unlike many banks around the world, Saudi Arabian banks remain in a healthy financial condition, with strong economic fundamentals, robust growth in most areas.

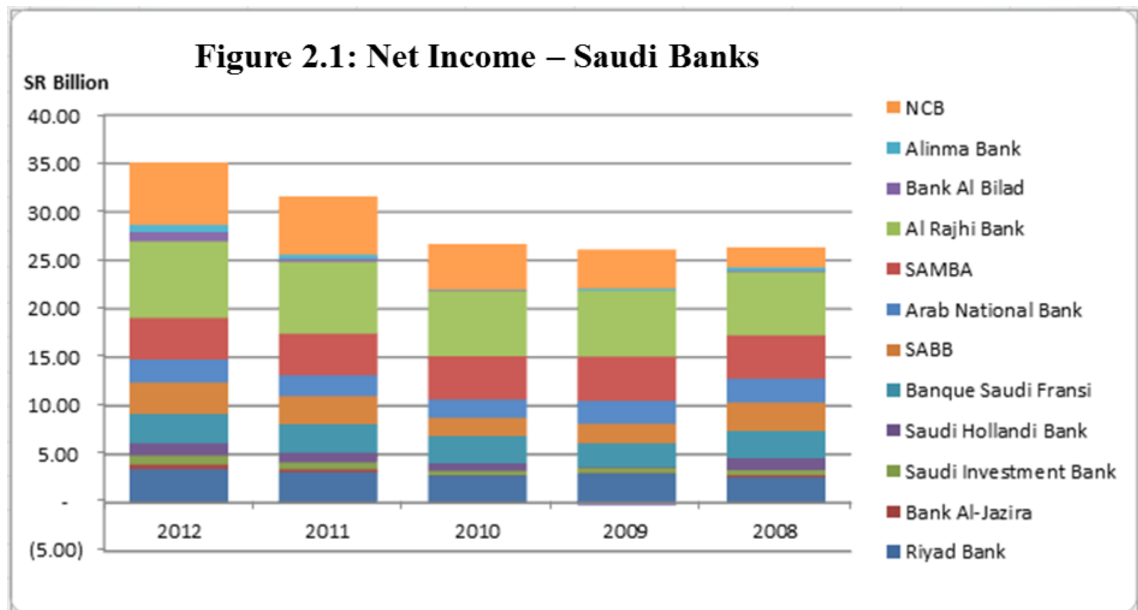
Saudi Arabia's SR690bn stimulus package in 2012 had a significant impact on the banking sector, bringing not only a major increase in customer deposits but also strong growth in lending. With provisions significantly lower in 2012 compared with the previous two years, banks produced strong profit growth in 2012 and very healthy performances. Furthermore, for the first time since 2008, the Kingdom has budgeted for a surplus. With total revenue budgeted at SR702bn, the surplus amounts to SR12bn.

Saudi Arabia ranks among the lowest-risk banking systems in the world, according to new global assessment recently published by Standard & Poor's. The ratings agency upgraded the kingdom's banking system rating, assigning it a Banking Industry Country Risk Assessment (BICRA) rating of 2. With this rating Saudi's banking sector is the most low-risk in the Middle East. Saudi Arabia has 11 banks featured in the Top 1000 World Banks 2012 of which five banks are among the top 200 world banks.

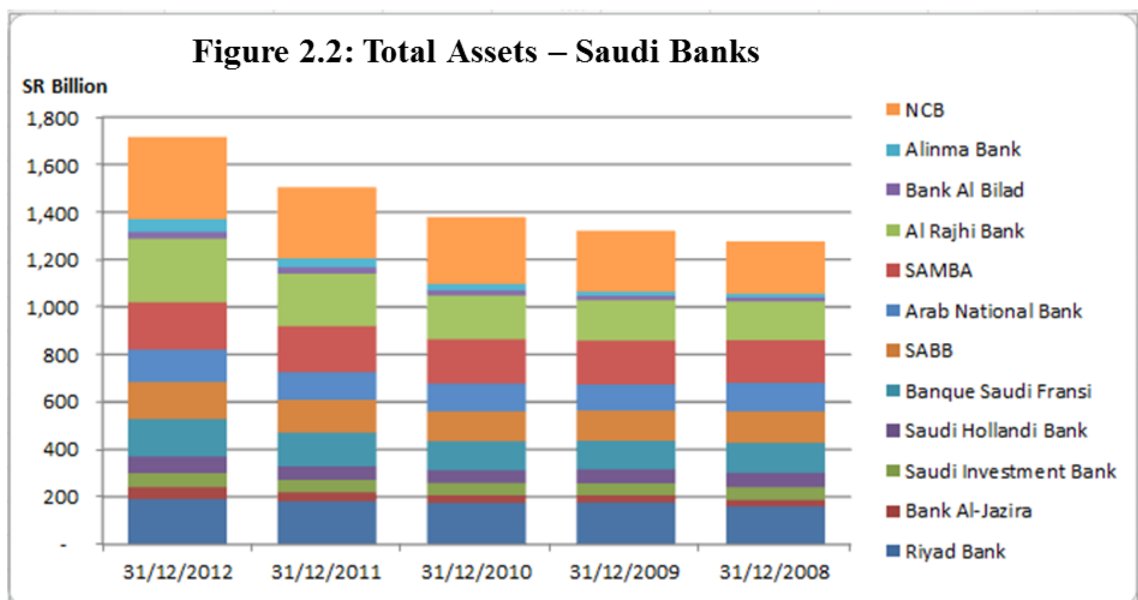
The banking sector is one of the most solid and profitable industries in Saudi Arabia. It represented almost 33% of the total listed companies' profits in 2012. Approximately, 32% of banking profits came from retail banking, 31% from corporate banking, 28% from the treasury and 8% from investment banking. The SAMA showed incredible growth in all banking indicators with the aggregate net income of SR35bn in 2012, compared to SR30bn in 2011, reflecting a year-on-year (YoY) growth of 16.7%.

The results in 2012 showed that the Saudi banks had not only overcome the problems of the 2008 global financial crisis but also the massive defaults relating to the family dispute between Algosaibi and Saad Groups, with banks expanding their businesses in many new areas. Remarkably, the Islamic Bank posted an exceptional growth of 65% (SR501) while other case banks maintained positive returns, representing nearly 27% of the consolidated net income.

The Kingdom's twelve major banks generated a total profit of SR35.1bn in 2012, reflecting a YoY growth of 11.02%. Al Rajhi Bank and National Commercial Bank represented nearly 41% of the consolidated net income. Both banks' profitability rose nearly 7% (see figure 2.1).

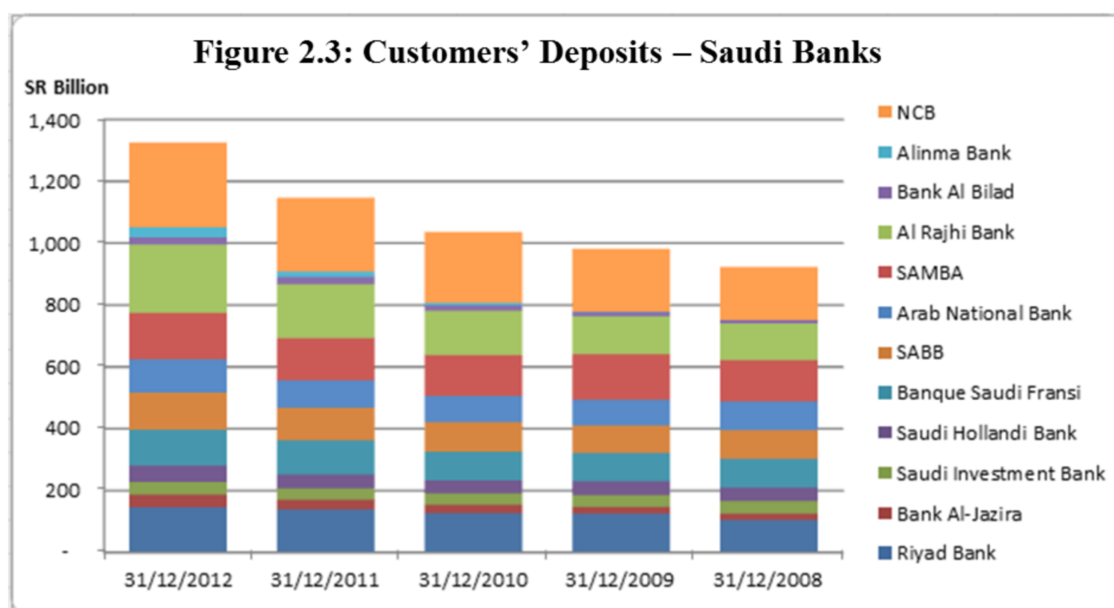


As per twelve commercial banks' consolidated balance sheet at the end of 2012, total assets grew exceptionally to SR1.71trillion, recording a growth of 14% over the preceding year's figure of SR1.5trillion. This is highest growth on YoY basis during past 5 years. All Saudi banks reflected a positive growth in total assets, with the Government Bank representing the largest share of SR345bn (+14.64%), approximately one-fifth of the sector's aggregate value (see figure 2.2).



Deposits of the 12 commercial banks reached SR1.32trillion by the end December 2012, showing an increase of 15.52% over the SR1.15trillion of previous year, mainly due to deposit mobilisation and the banks expansion of branch networks. Major contribution in terms of deposits was made by the Government Bank, representing

SR274bn or nearly one-fifth of the aggregate value of all commercial banks (see figure 2.3).



Saudi banks continued to expand their lending activities. The sector recognised a 17.85% increase in loans and advances. The aggregate value reached nearly one trillion by end of December 2012 versus SR855 billion in 2011.

However, the banking system as a whole remains well capitalised, highly liquid and seems to be withstanding severe temporary shocks, but it could be vulnerable to a large and prolonged oil price decline.

2.7.3 Banks Ownership

The eleven banks that are currently operating in Saudi Arabia can be categorized either as Domestic banks or as Joint Venture banks (JVs). Domestic banks were originally established as Saudi banks with ownership and management resting with Saudi nationals, while Joint Venture banks were originally established as foreign institutions and at a later stage, in accordance with Saudi regulations, foreign partners (parent companies) were obliged to reduce their stakes to a maximum of 40%, while the remaining stake was transferred to Saudi nationals. Despite the transfer of majority stakes to Saudi shareholders, most foreign partners have maintained management control. The number of Joint Venture banks has declined to six after Citigroup pulled out of the Saudi market in 2004, selling its stake in Samba to the government.

Six of the 12 local commercial banks feature some sort of foreign ownership, often materialized by minority joint ventures (see Table 2.3). The joint ventures have been

historically a mean for foreign banks to compete indirectly on the rather protected, but highly profitable, Saudi market. Links with foreign owners are often enhanced through technical management agreements, whereby the foreign partner seconds key staff and provides technical support, a competitive advantage in market where experienced staff is a scare resource. As a result, most banks have strong management skills by emerging market standards. Nevertheless, this leaves some of them vulnerable to a risk of management disruption in the unlikely event that dramatic social turbulence triggers a massive departure of expatriate workers from Saudi Arabia. The extensive presence of Saudi nationals in the management teams increasingly mitigates and offsets this risk, however.

Table 2.3: Banks with Foreign Ownership

Banks	Foreign Ownership
Saudi British Bank	HSBC Holdings PLC, 40%
Saudi Hollandi Bank	ABN AMRO Bank N.V., 40%
Arab National Bank	Arab Bank PLC, 40%
The Saudi Investment Bank	JPMorgan International, 7.4%
Bank Al Jazira	National Bank of Pakistan, 5.8%
Banque Saudi Fransi	Credit Agricole S.A., 33.1%
Source: Tadawul, 2012	

Public sector ownership remains a key feature of the Saudi banking system, which often gives the banks access to government business and enhances the probability of support in case of need (see Table 2.4). The largest, National Commercial Bank (NCB), is majority owned by the Saudi government through the Public Investment Fund (70%) and the General Organisation for Social Insurance (10%). The government holds various minority shares in many other Saudi-incorporated banks.

Table 2.4: Banks with Public Ownership

Bank	Public Ownership (%)
Alinma Bank	PIF, 10; GOSI, 10; Pension Fund, 10
National Commercial Bank	PIF, 70; GOSI, 10.0
Arab National Bank	GOSI, 10.8
The Saudi Investment Bank	GOSI, 21.5; Pension Fund, 17.3
Riyad Bank	PIF, 21.7; GOSI, 21.6; SAMA, 6.5
Banque Saudi Fransi	GOSI, 12.8
Al Rajhi Bank	GOSI, 9.9
Saudi British Bank	GOSI, 9.5
Saudi Hollandi Bank	GOSI, 9.6
Samba Financial Group	PIF, 22.9; GOSI, 11.7; Pension Fund, 15
Source: Tadawul, 2012	

Table 2.5: Banks with Private Ownership

Banks	Private Ownership
Saudi Hollandi Bank	Olayan Family, 20.8%
Arab National Bank	Al Rashid Family, 9.9%; Al Jabr Co., 5.6%
The Saudi Investment Bank	Saudi Oger Co. Ltd., 8.5%; National Commercial Bank, 7.3%
Bank Al Jazira	Al Rashid Family, 22.2%; Ittihad Co., 6.5%; Saleh Kamil, 5%
Banque Saudi Fransi	Al Rashid & Sons Co., 9.8%; Al Issa Family, 5.3%
Al Rajhi Bank	Al Rajhi Family, 44.8%
Riyad Bank	Mohammad Al Issa, 10.6%; Al Nahla Co., 9.9%
Bank Albilad	Al Sebeei Family, 23%; Al Rajhi Family, 13.4%
National Commercial Bank	Saudi Investors, 20%
Saudi British Bank	Olayan Family, 17%
Source: Tadawul, 2012	

2.7.4 Overview of the Case Banks

Influential Saudi families hold significant stakes in the Kingdom's banks, usually in addition to investments in groups of companies (see table 2.5). Family ownership is usually a negative factor for a bank, as families often do not wish to dilute their interest to support growth, or do not have adequate resources to assist the bank in times of need. In addition, when family members are present in top management, there is always the risk that decisions may not be based on merit, resulting in name lending and cronyism.

The Government Bank (GB), Saudi Arabia's oldest bank, was founded by royal decree in 1953. Originally the bank's legal structure was general partnership until 1997 when the Bank's was converted to a Saudi joint stock company. The conversion was due to the fact that the bank's capital was virtually wiped out by bad loans during the 1980s, and failed to produce financial statements for 1990 and 1991. The government was in rescue and acquired 80% of the bank's shares from its previous private shareholders.

The bank remains the largest state-owned bank today (80%) while private Saudi investors hold the remaining 20% of the bank. The GB has performed well in recent years, largely as a result of the recent implementation of a revenue diversification initiative, which has seen the bank boost fees and other incomes substantially in recent years. While the bank is technically government-owned, it is operated as an independent institution. The GB is widely expected to play a central role in the government's on-going infrastructure investment programmes.

The BG is considered from among the first Saudi companies that implemented the principle of Corporate Governance and the first bank in Saudi Arabia to implement self-regulatory corporate governance policies.

The GB suffered bad debts in the past but assumed that personal relations and political pressures still interfere with lending policy, as individuals and companies connected to the large ruling family still receive financial facilities. The Bank is the only bank that has highly regarded political board members, due to government control. SAMA and the Ministry of Finance have the power for direct appointments of at least four directors of the nine board members.

As of the end of 2012, the GB had total assets of SR345.3bn, up 14.6% from SR301.2bn in 2011 and SR282.4bn in 2010. The Bank's net income has nearly tripled since 2008, when it hit a low of SR2bn due to provisioning after the crisis, to reach SR6.4bn in 2012. Customer deposits reached SR273.5bn in 2012, up from SR239.5bn at the end of 2011 (see Table 2.6).

The Bank provides various banking products and services in the Kingdom and internationally. It operates in five segments: Consumer, Corporate, Treasury, Capital Market, and International. The Consumer segment provides banking services, including Islamic banking lending and current accounts to individuals, small sized businesses, and private banking customers. The Corporate segment offers banking services comprising various conventional credit-related products and financing products to medium and large establishments and companies. The Treasury segment provides a range of treasury products and services, such as money market and foreign exchange; and carries out investment and trading activities, and manages liquidity risk, market risk, and credit risk related to investments. The Capital Market segment offers wealth management, assets management, investment banking, and shares brokerage services. The International segment provides international banking services outside Saudi Arabia. The company operates 290 branches, 9 corporate service centres, and 28 Quick Pay remittance centres in the Kingdom of Saudi Arabia, as well as 2 overseas branches in Lebanon and Bahrain.

At the end of year 2012, the Bank operated 512 branches throughout the Kingdom with 9,631 employees, dedicated to Islamic and conventional Banking services. The Bank's customers surpassed more than 3.3 million clients.

The International Bank (IB) is a Saudi joint stock company that was formed 1979. The Bank commenced business on 1980 by taking over the operations of a foreign bank that has been sold due to the local incorporation of banks in the Kingdom.

The IB is engaged in the provision of commercial, Islamic and investment banking services to individuals and corporations. The Bank is organised into business segments: the Retail banking segment offers deposit, credit and investment products for individuals; the Corporate banking provides loans and advances, deposits and other credit products for corporate and institutional customers, small to medium sized businesses, and the Bank's London branch; the Treasury banking segment manages the Bank's trading and investment portfolios and the Bank's funding, liquidity, currency and commission risk, and the Investment and brokerage services segment includes Investment management services and asset management activities related to dealing, managing, arranging, advising and custody of securities.

The Bank operates through a network of 278 branches located across the Kingdom and one branch in the United Kingdom, to serve a customer base that exceeds 2 million clients, with 4,627 employees.

The Board of Directors comprises ten members of whom six represent the Saudi shareholders and are appointed in the Ordinary General Assembly Meeting for a term of three years. The foreign partner, who has 40%, appoints the remaining four members including the CEO. All directors may be reappointed. The major shareholder (foreign partner) is one of the top Arab banks that has a wide global network of operations in more than 15 countries.

The bank is categorised as a medium bank with a potential of becoming among the leaders in the industry in the Kingdom.

In compliance with the government's order stipulating payment of government employees' salaries through banks, the banks has secured and benefited from a considerable share of this initiative, which considered by others as a sign of strong connections with decision-makers in the Kingdom (Arab News, 2011).

As of the end of 2012, the IB had total assets of SR136.6bn, up 16.2% from SR117.5bn in 2011. The Bank's net income has fluctuating in the last five year, when it hit a low of SR1.9bn in 2010, to recover in 2012 to nearly SR2.4bn or an increase of 9.2%, with customer deposits of SR107bn (see Table 2.6).

The Islamic Bank (SB) is a joint stock company incorporated in the Kingdom on 1975. The Bank was originally a part of the overseas branch network of an international bank but became the first foreign bank to comply with the Saudi law requiring a 60% Saudi shareholding in all banks operating in the kingdom.

The Bank suffered of poor management and performance and began a restructuring process in 1992 with subsequent increases in capital in 1992 and 1994. The increased capital has come entirely from the Saudi shareholders, which resulted in significantly diluting foreign partner's shareholding to the current 5.8%. During this time, control of the Bank passed to three prominent Saudi families who have six of ten board seats.

A new management team was appointed in 1993 to continue the restructuring effort. The Bank successfully introduced state of the art technology, modern banking products and services and revamped its staffing portfolio. As a result, the bank became profitable in 1997.

In 1998, the SB Board of Directors took a strategic decision to convert the Bank from conventional banking into Sharia-compliant banking. This is the greatest challenge that any traditional bank can take as it requires mass changes to its infrastructure, offerings, legal environment, staff potentials, corporate values, etc. Thus, the bank became as one of the leading Sharia compliant fast growing financial institutions in Saudi Arabia.

In 2007, the SB witnessed its full conversion into a Sharia-compliant institution and simultaneously increased its paid up capital to become SR3bn which came entirely from the Bank's profits.

The Bank is organised into five segments: the Personal banking segment covers deposit, credit and investment products for individuals; the Corporate banking segment provides loans, deposits and other credit products for corporate, small and medium sized business and institutional customers; the Brokerage and asset management segment provides share brokerage and asset management services; the Treasury segment includes money market, foreign exchange, trading and treasury services, and the Takaful Taawuni segment provides protection and saving products services.

As of December 31, 2012, the Bank offers its services through a network of 54 branches located across the Kingdom, with a total number of 2,778 employees.

At year-end 2012, the Bank's assets increased by 31% to reach SR509m, making it the kingdom's third-smallest bank by total assets. The Bank has suffered huge losses in the

last five year but made a remarkable profit growth of 65% to reach SR501m (see Table 2.6).

Table 2.6 shows a summary of the case banks financial indicators while a complete financial data for each bank is provided in Appendix 4.

Table 2.6: Case Banks Financial Indicators for 2012

Indicator	Government Bank	International Bank	Islamic Bank
Total Assets (SAR)	**345,320,133**	**136,639,276**	**50,956,522**
Change %	14.6%	16.2%	31.0%
Sector Share %	19.6%	7.8%	2.9%
Return on Asset (ROA)	2.1%	1.9%	1.8%
Net Income (SAR)	**6,452,804**	**2,371,178**	**500,637**
Change %	5.7%	9.2%	65.3%
Sector Share %	18.4%	6.7%	1.4%
Total Operating Income (SAR)	**13,603,142**	**4,756,821**	**1,600,955**
Total Equity (SAR)	37,703,631	17,804,275	5,011,853
Return on Equity (ROE)	17.9%	13.8%	9.99%
Total Deposits (SAR)	273,530,090	107,560,443	41,675,290
Total Loans (SAR)	163,479,092	86,328,608	29,896,782
Ownership Structure	Local: 20% Gov't.: 80%	Local: 52.28% Foreign: 40% Gov't.: 7.72%	Local: 92.123% Foreign: 5.83% Gov't.: 2.047%
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2.7.5 Changes at the top

On December 13, 2011, the well-respected banker Dr Almubarak took over as governor of SAMA, the country's prime banking regulator. Mr Almubarak replaced Dr Al-Jasser, who had been governor since February 2009 and who had previously been vice-governor for 15 years. Mr Al-Jasser has become Saudi Arabia's minister of national economy and planning.

Mr Almubarak has been a well-known member of Saudi Arabia's financial community for many years and his transition to SAMA governor has been said to be well received and smooth. Previously, Mr Almubarak has worked in executive management positions providing investment management and corporate finance advisory services during most of his career. Recently he was chairman and managing director of Morgan Stanley Saudi Arabia.

He has served as a member of the Saudi Arabian Consultative Council and he was the Vice-Chairman of its economic and energy committee. He was the first chairman of Tadawul and was a member of the negotiating team which coordinated the partial privatisation of international oil companies in the Saudi Arabian natural gas industry. He has been on the board of several public and private companies.

Early this year, the Chairman of the Government Bank has resigned after 55 years of serving the Bank as a CEO for 30 years and subsequently a Chairman of the board. The retired chairman has been well known for his banking experience and dedication to maintain stability of the largest state-owned bank. However, the new chairman is a former Secretary-General of the Public Investment Fund, the largest investing government arm that has 80% in the Government Bank. Soon after appointment, the new chairman has accepted the resignation of the incumbent CEO, who got relieved of the position due to personal reasons according to the Bank. The new CEO is a well-known banker who began his career in one of the Saudi largest Islamic banks as the chief information officer and chief operation officer before becoming the director general of the personal banking group.

Similarly, the International Bank Chairman has stepped down in late 2012 after 31 years of service to give chances to emerging bankers of the new Saudi generation[15]. He was an active member of 31 boards in addition to a well-established family business while he was the Chairman. The new Chairman has been a board member for the last 18 years, representing his family that has controlling shares of the Bank.

The Islamic Bank has been stable for the last 10 years after the appointment of the incumbent Chairman who made significant changes in the strategic objectives and infrastructure of the Bank to become one of the leading Islamic banks in Saudi. In a common practice, at least among case banks, the major change was the replacement of the CEO when the incumbent Chairman was appointed.

Generally, the Saudi banks do not have frequent or large scale of changes in the boards' composition. The local and state -owned banks are usually maintaining long-term board tenure while the joint-venture banks limit their directors' tenure to a maximum of nine years (three terms).

2.8 Summary and Conclusions

Corporate governance became the topic of recent business studies due to a major corporate crisis. The governance problem has emerged due to the separation of ownership and management in organisations which resulted in agency conflict between shareholders and management. The Anglo-American model of corporate governance became the sensible approach by which to resolve this conflict in order to give primacy for shareholders to fulfil their interests. However, this model has been criticised for not

[15] There are speculations that he was forced by SAMA to resign due to his passive role while in office.

considering the cultural and institutional contexts of different countries, particularly the emerging economies.

The adoption of the western model of corporate governance has resulted in poor outcomes in emerging countries due to national and institutional differences. Furthermore, the implementation of corporate governance without considering local circumstances and needs will result in a weak governance system.

The literature shows that corporate governance is important for financial organisations. The recent financial crisis is partly attributed to the lack of an effective governance structure. It is however, imperative to consider the internal and external governance mechanisms by which to implement and enforce better governance structure. One of the main internal governance mechanisms is the board of directors. The board is responsible for directing and controlling the firm so as to satisfy the interests of shareholders and the needs of other stakeholders at large. Therefore, the selection of board members has to be in accordance with the firm needs and based on human and social capital of directors.

Corporate governance in Saudi Arabia is relatively new, but offers an opportunity to understand how emerging countries adopt and practice governance. The previous research on Saudi corporate governance shows that the country is still in the early stages of having efficient and effective corporate governance. The country needs to have better mechanisms for enforcing governance regulations, improving the coordination of supervisory and legal systems and limiting political and social interventions.

In the context of this thesis, it is worth pointing out that regulatory authorities play a significant role in corporate governance. When the legal and supervisory authorities are weak, informal institutions may provide proper substitutions to provide a governance mechanism.

The following chapter provides a discussion of institutional perspectives as the theoretical framework adopted for the governance change and the role of boards and their subsequent impacts.

CHAPTER 3: THEORETICAL FRAMEWORK

3.1 Introduction

This study is drawn on new institutional 'sociology' theory (hereinafter referred to as NIS) as the theoretical foundation which is concerned with the processes by which schemes, rules, norms, and routines become established as authoritative guidelines for social behaviour (Meyer and Rowan, 1977; DiMaggio and Powell, 1983, 1991; Scott, 2005). This perspective suggests that organisational survival is subject to some form of conformity to prevailing values or standards for appropriate behaviour. Firms adopt such behaviour and norms in response to institutional pressures to maintain legitimacy. Firms under the influence of legitimization effects will adopt similar structures through a process called institutional isomorphism (Meyer and Rowan, 1977; DiMaggio and Powell, 1983, 1991). Furthermore, this perspective of organisations is useful to address the aspects concerning the institutionalization and evolution of governance practices and the effects on the internal working of boards (Enrione et al, 2006).

Institutional perspective is primarily concerned with how organisations interact with their institutional environment, as well as how organisational practices reflect social expectations (Dillard et al, 2004). This perspective is grounded on the belief that organisational success depends on factors other than technical efficiency. It is suggested that institutions can still survive by observing formal structures. Meyer and Rowan (1977: 352) make a claim that "…independent of their productive efficiency, organisations which exist in highly elaborated institutional environments and succeed in becoming isomorphic with these environments gain the legitimacy and resources needed to survive." This argument has resulted in studying an institution from different perspectives. The general theme of the institutional perspective is that an organisation's survival requires it to conform to social norms of acceptable behaviour as much as to achieve levels of production efficiency.

Maintaining that traditional agency perspective fails to explain corporate governance practices in developing countries have forced different authors (for example, Covaleski et al., 2003; Major and Hopper, 2004; Lubatkin et al., 2005; Yazdifar and Tsamenyi, 2005; Enrione et al., 2006; Yoshikawa et al., 2007) to use other theoretical foundations and NIS framework has been a popular choice. Consequently, Section 3.2 explains the role of boards and governance changes from agency perspectives and discusses the agency-based assumptions which make it inappropriate for emerging economies. Thus, institutional perspective is particularly applicable in the case of emerging economies

because of the variation in institutional contexts and the effects that these contexts have on "social structures and behaviours" (Scott, 1995: 146).

Section 3.3 provides a detailed discussion of the institutional perspectives, including the new institutional theory (NIS) assumptions to understand the adoption of CG in Saudi and the role of directors; while the institutional isomorphism provides an explanation of these three (coercive normative and mimetic) different pressures that may be exerted on an organisation to adopt certain structures or practices which may lead to organisational homogenisation.

The concept of organisational field, discussed in section 3.4, is an important element linking institutional pressures and the adoption of structures and processes within organisations. Section 3.5 provides a summary and concludes the chapter.

3.2 Agency Perspectives

Agency theory has been the dominant theory in corporate governance studies (Zajac and Westphal, 2002; Daily et al., 2003) that has provided the first satisfactory explanation of the separation between ownership and control in organisations (Jensen and Meckling, 1976). The separation of ownership and control in organisations often gives rise to a basic agency problem, where the interests of management (agents) and shareholders (principals) are not perfectly aligned and principals cannot observe managerial actions (Berle and Means, 1932; Jensen and Meckling, 1976). It describes the board of directors as being a governance mechanism designed to deal with the conflict of interests between 'agents' and 'principals' (Shleifer and Vishny, 1997; Daily et al., 2003; Denis and McConnell, 2003) and places great emphasis on the board's monitoring role (Langevoort, 2001; Sundaramurthy and Lewis, 2003).

In general, scholars and practitioners alike agree that corporate boards have three primary roles, namely: (i) monitoring and oversight of management, (ii) linkage of the firm to external resources (or boundary spanning), and (iii) providing advice and counsel to management, particularly the CEO (Finkelstein et al., 2009). The first role is generally referred to as the 'control' role while the other two are often grouped together and called the 'service' role. Rather than viewing these two roles as polar opposites, governance scholars have advocated a balanced approach towards dealing with the inherent tensions associated with the board's two primary roles (Demb and Neubauer, 1992; Roberts et al., 2005; Sundaramurthy and Lewis, 2003). Framing the issue around control and collaborative approaches to governance, Sundaramurthy and Lewis (2003) present a framework that emphasizes the value of monitoring, as well as

empowerment, in ensuring the effectiveness of the board in executing its control and service roles. Roberts et al., (2005: S5) expand on the concept of control and collaboration by introducing accountability as a central concept in explaining how boards can operate more effectively by challenging the "dominant grip of agency theory on governance research" in order to understand the "board processes and dynamics."

As the board serves as a surrogate for the firm's owners, the CEO (management) becomes the board's agent. Accordingly, boards serve to minimise the potential for managerial self-interest (Eisenhardt, 1989a) and assume responsibility for the ratification and monitoring of decisions that are initiated and implemented by management. Hence, agency theory mainly assumes that the board plays the role of monitoring, while ignoring other possible roles such as service or resource provision roles (Zahra and Pearce, 1989; Hillman and Dalziel, 2003).

Agency theory draws attention to the theoretical and practical issues related to the board's controlling role in organisations. The theory asserts that there are two problems for intra- and inter-organisational settings which are, namely, adverse selection and moral hazard (Eisenhardt, 1989a). According to agency theory, information asymmetry occurs when management (agents) have the competitive advantage of access to information over that of the owners (principals). This would thereby limit the principals' ability to control and monitor the desired actions of the agent (Arnold and de Lange, 2004; Gomez-Mejia and Wiseman, 2007). In this context, the principal would not be able to "distinguish between agent cooperation and defection when it comes to fulfilling the goals of principals" (Gomez-Mejia and Wiseman, 2007: 82). The consequence is that the agent might engage in unacceptable choices behaviour, which will result in a moral hazard problem (Eisenhardt, 1989a; Jensen, 1994). However, some recent studies have indicated that outside directors might provide support to boards in mitigating information asymmetry problems by engaging in behaviours aimed at increasing the information they possess (Roberts et al., 2005; Rutherford and Buchholtz, 2007).

Dalton et al., (2007) suggest three principal approaches for mitigating the agency problem, namely: director independence, equity ownership, and the market for corporate control. The independence approach assumes that directors' independence from management is more likely to provide boards with effective monitoring abilities in order to protect the interests of the shareholders. Furthermore, the theory suggests

that when managers hold equity in a firm, their interests are more likely to be aligned with those of shareholders. In addition, the market for corporate control is an important governance mechanism where active merger and acquisition markets serve to discipline mischievous managers.

The theory suggests that if board members' interests are closely aligned to those of management rather than owners, they will not carry out their monitoring responsibilities effectively (Young et al., 2000). Thus, the effectiveness of a monitoring role is associated with the board's independence (Daily et al., 2003; Peng, 2004; Conyon, 2006). Fama and Jensen (1983) argue that the establishment of an independent board of directors is one way to ensure that the interests of principals and agents are properly aligned. Independent board members are believed to help neutralise the agency problem, and bring alignment between the management and the shareholders' interests (Daily et al., 2003; Peng, 2004). Zajac and Westphal (2002) argue that the agency theory assumes that the board of directors is the most appropriate principal delegate to mitigate agency costs associated with managerial conflicts of interest. Thus, the theory advocates that a board's ability to mitigate this possibility could be related to the board structure of having a large proportion of outside independent members.

Hermalin and Weisbach suggest that "firms with higher proportions of outside directors and smaller boards tend to make arguably better—or at least different—decisions" (2003: 8). Furthermore, in a study of 523 CEO appointments in UK firms, Dahya and McConnell (2005) found a significant positive correlation between the likelihood of an outside CEO appointment and the fraction of outside directors on the board. The results of Dahya and McConnell indicate that increasing the representation of outside directors on the board is likely to influence one of the key decisions of boards, which is namely the appointment of inside or outside CEOs.

Most of the empirical research to date has attempted to capture the independence of outside directors, but there have been various definitions of what constitutes an outside director. For example, Weisbach (1988) classifies directors as inside, outside or grey; with "grey" directors being those directors who are not employees or managers, but who may not be independent of current management because of business dealings or family relationships. Affiliated directors include those who have business dealings with the firm, or are relatives of current or former executives or employees. Daily and Dalton (1994) provide a further refinement of the outsider classification, defining an

outside director as someone who was appointed to the board prior to the incumbent CEO. Given the importance placed on independence of the board in agency theory, this lack of a clear definition of what it means to be an outside director does create difficulties in measuring the effect of board composition on firm performance. Some authors suggest that 'independence of mind' is the key attribute rather than a notional measure of independence (Roberts et al., 2005; Zattoni and Cuomo, 2010).

A number of studies conducted on boards of directors have focused on establishing a relationship between demographic variables (e.g. outsider ratio, board size, or CEO duality) and board performance (Johnson et al., 1996) or a firm's performance (Daily et al., 2003). The ability of demographic variables to capture the characteristics of the intermediate processes leading to board effectiveness has been debated for a considerable period of time (Pettigrew, 1992; Pye and Pettigrew, 2005; Roberts et al., 2005). Pfeffer (1983) argues that demographic variables may be superior when compared to perceptual measures (such as attitudes or values), since the former are directly observable and hence more reliable compared with the latter. However, in the presence of complex processes and group dynamics, as in board decision-making, the use of demographic variables can lead to biased results (Johnson et al., 1996; Forbes and Milliken, 1999; Dalton et al., 1998, 2003).

The agency theory assumption that management and board actions and interactions are primarily outcomes of economic forces is closely related to the wealth maximization assumption (Zajac and Westphal, 2002). However, beyond assuming the adequacy of aligning managerial financial incentives with the financial incentives of principals (as does the wealth maximization assumption), this assumption also often ignores the social and political aspects of manager and board member relations. Westphal (1999) has shown that friendly relationships between board members and CEOs often play an important role in providing advice and consultation to management without sacrificing the board's function of controlling and monitoring. Specifically, Westphal (1999) found that the collaborative advice and counsel function of the board of directors is augmented with increased CEO and board member friendships. At the same time, the controlling and monitoring activities of the same relatively friendly boards are no less than in less friendly boards. He also found that firm performance was not diminished for corporations with boards having high levels of CEO/ board member friendships, when compared with those corporations having lower levels of CEO/ board member friendships.

Furthermore, the agency theory holds to the assumption that each board of directors acts as a single unitary actor (Zajac and Westphal, 2002). Although agency theory generally treats boards as though they perform as one individual actor, boards are affected by social, psychological, and cultural processes that are inherent in all types of small groups. The monitoring and controlling actions of one board member may differ from those of other board members. Hence, the resultant monitoring and controlling actions of the board of directors as a whole are products not only of combined individual intentions, but also of social and cultural small group processes. In a rare study of intra-board processes, Westphal and Milton (2000) examined demographic minorities in boards of directors and found that their level of influence within the board of directors is related to their prior experience as board members on other boards, as well as their social relationships with other board members on the focal board.

An alternative body of research focused on the impact of multiple board appointments. Fama and Jensen (1983) contend that multiple board appointments can signal director quality. The appointment to numerous boards might be the result of the superior performance enjoyed earlier by the firm for which the individual serves as a board member, either as an outsider or as an executive. Gilson (1990) suggests that the number of directorships held by a director might act as a proxy for reputational capital, with persons holding multiple directorships being a signal of high quality. Similarly, Certo (2003) suggests that multiple board directorships would enable board members to be a key source of various resources based on human and social capital. Theoretical support for this proposition is provided by a resource dependence theory, as serving on multiple boards allows firms access to a wider range of resources, such as expertise and advice, from individuals with wide experience (Pfeffer and Salancik, 1978). This will be further discussed in Section 3.3.

Empirical support for Fama and Jensen is provided by Ferris et al., (2003) who found that a firm’s performance has a positive effect on the number of appointments held by a director. Furthermore, Ferris et al., (2003) found that busy boards (which are defined as those boards in which a majority of outside directors hold three or more directorships), do not have any harmful effects upon shareholder wealth. However, the results from Fich and Shivdasani (2006) provide an opposite conclusion. They found that firms with busy boards are ineffective monitors of management.

In a discussion of the importance of ownership structure to corporate governance, Dalton et al., (2003) suggest that concentrated shareholdings may facilitate the monitoring of management performance that might lead to improved firm performance. Thus, if shares are widely dispersed, shareholders are unlikely to have much incentive to monitor management. Similarly, Hart argues that monitoring has the characteristics of being in the public interest, in that "if one shareholder's monitoring leads to improved company performance, all shareholders benefit" (1995: 681).

According to Demsetz and Lehn (1985) the ownership shares of two types of outside owners, namely, institutions and "blockholders" are sufficiently large that these equity owners are in a position to closely monitor management to ensure that they serve their interests. Furthermore, large institutional investors have the ability to monitor agents (Khan et al., 2005), as they have the incentive to exercise oversight and control of management decision-making, thus reducing agency costs and protecting shareholder interests (Ingley and van der Walt, 2004; Khan et al., 2005).

There is, however, evidence of significant variance across countries in the degree of block ownership, which suggests the possibility of national institutional influences (La Porta et al., 1998, 1999; Franks et al., 2009). For example, La Porta et al., (1999) conducted a cross-country study on the ownership structure of 27 developed economies. They found that large firms in countries with low shareholder protection and mostly controlled by families or the State are more likely to be in control of firms which lead to another agency problem of the expropriation and protection of minority shareholders' rights.

In this context, Levine (2004) notes that "the problem in banking is frequently that politically powerful families control the banks and the political system, so that regulatory policies are frequently used to impede, not support, effective corporate governance." Furthermore, a study by Caprio et al. on the ownership of 244 banks in 44 countries suggests that families frequently enjoy control over banks through pyramid and other schemes (2007). Thus, the regulatory restrictions on ownership structure do not prevent family control but, rather, defend the existing owners from competition for control (Levine, 2004; Caprio et al., 2007).

This leads to a question about the role of the regulatory and supervisory authorities in the field of implementing and promoting good corporate governance. Even though regulation can be considered as an additional mechanism of corporate governance; in most situations it reduces the effectiveness of other mechanisms in coping with

corporate governance problems. For example, in the banking industry, regulators are among the main stakeholders, yet their interests may clash with those of other stakeholders (Diamond, 1984; Levine, 2004), thereby creating a new form of agency problem. Moreover, when regulators intervene directly in the shareholding of financial institutes, this conflict of interest is compounded. Such a conflict casts doubts on the efficacy of supervision and modifies stakeholder incentives to control managers (La Porta et al., 2002). Therefore, Levine suggests that the way "to improving regulation is to align the interests of regulators with society."

Whilst there is some support for agency theory with a variety of corporate governance mechanisms, there is increasing evidence casting doubt on the efficacy of agency theory and its associated prescriptions with regard to the crucial governance role played by the board of directors (Dalton et al., 2003; Hermalin and Weisbach, 2003).

The empirical testing of agency theory predictions shows limited support for linking structural characteristics of boards to board outcomes or firm performance (Hermalin and Weisbach, 2003; Roberts et al., 2005). The overall conclusion of the many empirical studies shows that there is no relationship between proxies of board independence (e.g., CEO duality or outsider ratio) and the performance of firms (Bhagat and Black, 2002; Daily et al., 2003; Hermalin and Weisbach, 2003).

Other studies suggest that agency theory insufficiently models boards and their functions by ignoring the important dynamic element of the relationship between board and CEO (Lynall et al., 2003; Hermalin and Weisbach, 2003; Shen, 2003). Furthermore, the board-CEO relationship has agency implications relating to the role of the CEO in the selection of board members (Hermalin and Weisbach, 2003; Huse, 2007). However, the CEO involvement in the appointment of board members is associated with his respective power and influence over the selection process and his long tenure of service (Young et al., 2000).

Moreover, board theorists such as Forbes and Milliken (1999) and Pettigrew (1992) argue that agency theory tends to examine the impact of input variables (e.g., board composition) to output variables (e.g., firm performance) without examining the processes that link inputs to outputs. In this context, a recent trend in board studies has been to focus on board behaviours (Forbes and Milliken, 1999; Roberts et al., 2005) in order to understand the working processes of effective boards.

The agency theory assumption related to managers' opportunistic behaviour (or self-interest) has been criticised as some scholars argue that managerial opportunism

cannot be generalised as being the behaviour of all managers (Davis et al., 1997; Donaldson and Davis, 1991; Hendry, 2002). For example, stewardship theorists argue that many managers are stewards whose interests are aligned with those of owners (Donaldson and Davis, 1991). Similarly, agency theory emphasises the board's monitoring role and fails to consider the wider role of a director including their resource, service and strategy roles (Dalton et al., 1998; Dalton et al., 2003; Daily et al., 2003).

Moreover, Hendry (2002) argues that agency theory does not recognise the importance of managerial competence and thus executives and managers are limited in their competence to meet shareholders' objectives. Similarly, it has been argued that the assumption of managers' self-serving and opportunistic behaviour is a rather simplistic view of human nature (Hendry, 2002; Daily et al., 2003) and would not adequately explain the way people behave (Jensen and Meckling, 1994; Hendry, 2005). Furthermore, Hendry (2005) notes that boards usually include executive members, which may weaken their primary role of monitoring the actions of management. As a result, Hendry suggests that there would appear to be a logical inconsistency arising from agency theory assumptions and its predictions (2005).

In sum, agency theory developed largely in the Anglo-American context and thus unable to give a better explanation on the diversity of corporate governance arrangements across different institutional contexts (Aguilera and Jackson, 2003) and has consequently been criticised for its limited applicability to different institutional settings (Aguilera et al., 2008). In particular, the agency-based assumptions are not appropriate for emerging economies which do not hold the same attributes of the Anglo-American model of corporate governance (Roberts, 2004; Paredes, 2005; Siddiqui, 2010).

Therefore, institutional perspective has become particularly applicable in the case of emerging economies because of the variation in institutional contexts, and the effects that these contexts have on governance choices (Hoskisson et al., 2000; Peng, 2003; Wright et al., 2005).

3.3 Institutional Perspectives

Institutional perspective views organisations as seeking legitimacy, resources, and ultimately survival by ensuring their structures conform to institutional norms (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1987). Such norms are part of the external social environment in which firms are embedded (Scott and Meyer, 1994).

Organisations seek legitimacy within a society by conforming to societal norms and values and by alignment with the rules of the game that gives them competitive advantages in resource mobilisation and performance (North, 1990).

The institutional perspective suggests that organisations adopt new institutional designs in order to conform to societal or institutional requirements and, thus, to become legitimate. Legitimacy is 'a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions' (Suchman, 1995: 574). The legitimacy brings support by and acceptability in society. Since many organisations in a specific field or sector try to become legitimate, this results in isomorphism, that is, in similarity across several organisations.

New institutional perspective as developed by (Meyer and Rowan, 1977) and (DiMaggio and Powell, 1983) forms part of a much larger field of research that put institutions at the heart of explanations for the observed behaviour of organisations. A common aim of all institutional paradigms is their attempt to explain what role is played by institutions and how these institutions shape both organisations and individuals. However, institutionalism does allow analysis to be carried out at different levels ranging from the study of behaviour at micro, organisational level to macro, societal level (see Oliver, 1991; Powell, 1991; Greenwood and Hinnings, 1996; Scapens, 2006). According to this perspective, Carpenter and Feroz (2001: 569) assert that "organisations adopt structures and management practices that are considered legitimate by other organisations in their field, regardless of their actual usefulness." Legitimacy is the fundamental consequence of firms' convergence and involves the acceptance of the organisation by the external environment (Meyer and Scott, 1992; Deephouse, 1996).

Accordingly, organisations do not compete just for resources and customers, but for political power and institutional legitimacy, and for social as well as economic fitness (DiMaggio and Powell, 1983). The search for legitimacy may push firms to adopt organisational structures and practices for a ceremonial purpose rather than for rational reasons of improving efficiency (Meyer and Rowan, 1977). Institutional theorists believe that firms adopt certain social norms and values into their social systems (or culture) to render a sense of symbolic meaning or identity which offers alternative means of existing beyond the usual technical and economic reasons (Selznick, 1957). Institutional perspectives suggest that organisations are driven to incorporate the

practices and procedures defined by prevailing concepts of what is rational. Thus new and existing organisations may adopt structures and practices in efforts to become increasingly similar to their institutional environments (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1998). For example, institutional theorists suggest that boards of organisations in the same institutional context will tend to be more similar to each other than to the boards of organisations outside of their context (DiMaggio and Powell, 1983).

An institutional perspective emphasises that organisations, organisational fields, and nations are more than a means to produce goods and services—they are also social and cultural systems. As such, organisations, and organisational actors, not only compete for resources (Judge et al., 2008), but they ultimately seek legitimacy (Suchman, 1995). From this perspective, one of the keys to understanding social systems is by studying the institutional environment because it is these forces which guide or constrain legitimacy seeking. While the concept of "institution" has been conceptualised in diverse ways (Scott, 1987), it generally refers to relatively enduring systems of social beliefs and socially organised practices associated with varying functional areas of societal systems (e.g., religion, work, politics, laws, and regulations) (Scott, 2001).

The institutional perspective emphasises the influences of the systems surrounding organisations that shape social and organisational behaviour, as "it is difficult if not impossible to discern the effects of institutions on social structures and behaviours" (Scott, 1995: 146). The institutional structure of the environment is impacted by market pressures, legislation and regulations, established practices of the field, social expectations and the actions of leading organisations. The perspective suggests that organisational structures in such an environment become symbolic displays of conformity and social accountability rather than achieving efficiency (Meyer and Rowan 1977).

According to Scott (1987: 498) "organisations conform to social expectations because they are rewarded for doing so through increased legitimacy, resources, and survival capabilities." They are influenced by their institutional context and networks of social organisation and exchange which carry rationalised myths (Greenwood et al., 2008). Hence, the essence of institutional perspective is that an organisation is shaped by wider cultural, social and symbolic elements that constitute its institutional environment (DiMaggio and Powell 1983; Scott, 2001).

An institutional perspective draws attention to the fact that, over time, firms tend to adopt similar organisational structures and behaviours (DiMaggio and Powell, 1991; Scott, 2001). By adopting structures that conform to institutional requirements, organisations show conformity to social norms and thereby gain legitimacy for their operations and reduce uncertainty (DiMaggio and Powell, 1991). Legitimacy refers to whether or not organisational actions are accepted and approved by internal and external stakeholders (Kostova et al., 2008). In this context, firms might adopt an organisational structure, not merely to improve their efficiency and effectiveness, but rather to convey the impression to their stakeholders that they are behaving in a responsible and legitimate fashion (Meyer and Rowan, 1977; Scott, 2001).

According to the institutional perspective, Young et al., (2000) assert that the board of directors has two primary roles: linkage and administration. In the linkage role, the board of directors is interested in establishing a relationship between the corporation and the external environment; however, in the administrative role, the board of directors is concerned with overseeing the performance of top management, in particular the CEO. The external governance environment determines the relative importance of the different roles that boards fulfil and thus it affects the board structure. It is well established that the structure of corporate governance varies a great deal across countries (Jenkinson and Mayer, 1992; Shleifer and Vishny, 1997; La Porta et al., 1999). These variations arise due to differences in the national cultures, and institutional norms and assumptions about the role and importance of different stakeholders in the functioning of an organisation (Khanna et al., 2006; Li and Harrison, 2008).

The basic purpose of corporate governance, according to an institutional perspective, is to assert that an organisation is linked to an environment by clarifying and defining its goals, which should accord with the expectations of the environment (Judge and Zeithaml, 2004). Thus, according to this perspective, corporate governance should be involved in defining the organisational goals of the corporation in the context of an existing value system within the firm and the relevant external environment. Furthermore, corporate governance is viewed as a change in the organisational processes and structures which "fulfil ritualistic roles that help legitimise the interactions between the various actors within the corporate governance mosaic" (Cohen et al., 2008: 187).

In order to match external expectations about rational behaviours, and gain legitimacy, organisations become ‘isomorphic’, i.e., conform to accepted prescriptions of appropriate behaviour (DiMaggio and Powell, 1983). The board of directors is one such primary mechanism to gain legitimacy, so that the board structure and its behaviour may be understood as responses to external institutional pressures. Decoupling of symbolic practices from the board’s ‘technical core’ (i.e., ceremonial conformity) may occur whenever conformity conflicts with requirements of technical efficiency of CEO-board relations. In this context, organisations’ quest for legitimacy results in the homogenisation of organisations with respect to their most visible attributes (e.g., board composition). Firms have the tendency to attract homogeneous individuals into institutions which makes the board members less inclined to challenge each other or the management (Tuttle and Dillard 2007).

Institutional theorists argue that board composition will be determined largely by prevailing institutionalised norms in the organisational field and society. The institutional perspective suggests that boards of organisations in the same institutional setting will tend to be more similar to each other than to the boards of organisations outside of their set (DiMaggio and Powell, 1983). Organisations may strategically comply with the institutional demands for more outside directors, while subtly limiting the independence of the board on the other hand (Oliver, 1991; Zajac and Westphal, 1996; Westphal, 1999). Thus, the institutional perspective argues that greater outside board representation is not necessarily linked with higher firm performance. However, external ties through board members help the focal organisation in gaining legitimacy and reputation (Hambrick and D‘Aveni, 1992; Daily and Schwenk, 1996; Certo et al., 2001).

The institutional perspective has become the predominant theory for analysing management in emerging economies (Hoskisson et al., 2000; Wright et al., 2005; Young et al., 2008), where it is particularly applicable because of the variation in institutional contexts, and the effects that these contexts have on strategic choices (Young et al., 2008). Firms in emerging economies often replicate practices of Western economies in the pursuit of legitimacy but firms in emerging economies have weaknesses when it comes to implementing their counterparts practices effectively (Newman, 2000), because countries differ substantially in cultural values, norms, and the traditions that govern the behaviours, attitudes, and actions of individuals. Consequently, an institutional perspective might explain why firms in different regions

adopt the same governance practices but the performance implications of these practices may vary from region to region (Young et al., 2008). That is, the corporate governance structures in emerging economies often resemble those of developed economies in form but not in substance (Backman, 1999; Peng, 2004).

Consequently, informal ‘governance’ mechanisms merge to fill the corporate governance vacuum whereby each emerging economy has a corporate governance system that reflects its institutional conditions (Young et al., 2008). The theories used by researchers often implicitly assume that the institutional conditions found in developed economies are also present in emerging economies, although this is not necessarily so. As a result the organisational activities and outcomes can differ considerably from those found in developed economies (Wright et al., 2005).

Prior research suggests that institutional environments can be broadly categorized into two types based on the dominant exchange regimes, namely; contract-based and relationship-based environments (North, 1990; Pearce, 2001; Peng, 2003). In the contract-based environment, individuals rely on third-party contract enforcement, where formal legal and regulatory regimes govern the transactions with others; whilst in the relationship-based environment people rely on social networks to facilitate transactions with others (Peng, 2003; Yoshikawa and Zhu, 2012).Hence, this type of institutional environment is common in many developed economies, such as the US and the UK (Yoshikawa and Zhu, 2012). However, Peng (2003) argues that the relationship-based transactions are widely common among most developing and emerging economies. In relationship-based transactions, people tend to rely on personal relationships and extended social networks to facilitate transactions with others due to ineffective formal sanction mechanisms (Peng, 2003). In this context, building strong social networks and developing trust among stakeholders is the way for organisations to survive uncertainty and mitigate the risk of opportunism and moral hazard (Peng, 2003; Yoshikawa and Zhu, 2012). On the contrary, personal relationships are insignificant in the contract-based institutional environment because formal rules and regulations are predominant in conducting transactions (Yoshikawa and Zhu, 2012).

According to the institutional perspective, organisations comply with procedures and practices considered to be the socially accepted norms and rationalisations of how the organisations’ operations should be structured (Meyer and Rowan, 1977). As such conceptions of rationality evolve and change over time, this provides some insight as

to why organisations change (Fogarty, 1996). New institutional theorists take the view that rational rules are adopted by organisations to ensure they are perceived as legitimate, rather than for reasons of efficiency (Meyer and Rowan 1977; Oliver, 1991; Palmer et al., 1993). This infers that rules are not adopted to control behaviour in organisations but to secure external stakeholder confidence in their operations (Pfeffer and Salancik, 1978). Integral to such arguments is the possibility that those organisations will then go to great extremes to ensure institutionalised rules remain visible to their external constituents (Scott, 1998). For example, Covaleski et al., (1985) suggest that organisations can change budget systems to dramatise commitments to efficiency and rationality even when internal systems do not foster such objectives. Theoretically, this conformity with social expectations for improved efficiency and rationalisation is thought to improve organisations' ability to secure resources, reduce the likelihood of their conduct being questioned and improve their survival prospects (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Tolbert and Zucker, 1983; Scott, 1987; Covaleski et al., 1996).

This perspective highlights the significance of the wider social and cultural environment in which organisations are situated (Meyer and Rowan, 1977; Scott, 2001). Thus, organisations and decision-making process within organisations cannot be understood without considering their institutional context. Basically, individuals do not only draw on rational factors when making decisions but also on factors like norms, trust, culture, advice, rules, history, and authority. Additionally, individuals make decisions based on rules of thumb and other heuristics, which make at least part of their behaviour 'habitual' or 'reflexive' (Scott, 2001). All individuals are constrained in their capacity to make fully rational decisions, due to the cost and lack of availability of appropriate information and because of their own cognitive limitations (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Jepperson, 1991; North, 2005). Rather than searching for 'optimal' or 'maximising' decisions, individuals quite often tend to select the decision alternative that simply seems 'appropriate' or 'legitimate' against the background of perceived institutional norms, values, and beliefs (Meyer and Rowan, 1977; Jepperson, 1991; Suchman, 1995).

The institutional perspective seeks to explain how various pressures affect decisions made by board of directors (Boyd et al., 2011) making a distinction between ceremonial and actual substantive change in order to show differences between practices that are formally adopted and practices actually in use (Kostova et al., 2008).

For example, governance mechanisms may be somewhat ceremonial, designed to enhance external legitimacy but loosely coupled with actual oversight (Carcello et al., 2011). Some organisations, however, fail to incorporate institutionalised elements due to tension between substantive change and ceremonial gestures.

According to Fogarty (1996) the key attribute of an institutional perspective lies in its ability to highlight the distinction between what organisations actually accomplish and what their structures suggest to the external environment they should accomplish. Meyer and Rowan (1977) propose that organisations may be decoupled, whereby they exhibit to the external environment that they are operating in line with expectations; whereas internally they are not actually following the operating procedures expected by the external environment. For example, the audit committee is often described as a symbolic mechanism of control, which signals to outsiders that management is under control while in reality the inside workings may be quite different (Fogarty and Kalbers, 1998; Cohen et al., 2002; Gendron et al., 2004).

Institutional theorists recognise that organisational participants can be constrained by institutional arrangements that limit the choices available, restraining certain patterns of resource allocation and prohibiting certain courses of actions (Powell and DiMaggio, 1991). Within institutional influences, there are some invisible forces pressing the organisation to adhere to taken-for-granted rules and norms (Oliver, 1991). Nevertheless, institutional pressures do not automatically force an organisation to conform. Indeed, various powers and interests within an organisation will determine how its actors respond to such pressures.

This perspective is grounded on the understanding that external pressures such as pre-existing socio-cultural norms, relationships that exist between organisations, or the political pressures imposed by governments provide pressures to change organisational routines (DiMaggio, 1991; Scott, 1995; Scott and Christensen, 1995; Dacin, 1997). However, organisations respond to pressures from their institutional environments and adopt structures and procedures that are socially accepted as being the appropriate organisational choice.

Institutional theorists suggest that organisations could generate different responses when they are facing institutional pressures (Oliver, 1991). Oliver (1991) distinguishes five strategic responses to institutional pressures, namely: acquiescence, compromise, avoidance, defiance and manipulation. However, these responses vary in their degree of active resistance to institutional pressures, depending on the nature and context of

the pressures themselves. It is suggested that existing institutions play a role in the constraint of the implementation of a certain response; despite any responses the organisation makes (Scapens, 1994). The reason organisations adapt to the environment is that they wish to be seen as competent and acceptable. Accordingly, to comply with socially accepted beliefs, organisations tend to adopt similar structures and practices (DiMaggio and Powell, 1991; Covaleski et al., 1993).

3.3.1 New Institutional Theory (NIS)

The early NIS theorists distinguished between technical and institutional environments, and argued that they each place different pressures on the organisation (see Meyer and Rowan, 1977). The former relate to the need to achieve technical efficiency in the operations of the organisation, whereas the latter relate to the need to embrace the rules, social norms and expectations of others outside the organisation. In this respect, organisations have to appear legitimate to their broader constituencies and stakeholders to secure the resources they need for their continued survival. To gain this legitimacy organisations have to be seen to conform to what is expected of them (DiMaggio and Powell, 1983).

NIS differentiated from modern organisational theory since it focused on the homogeneity of organisations rather than on differences in their structure and behaviour. DiMaggio and Powell (1983) focused on the homogenisation process and tried to explain the institutional factors affecting such process in organisations. Actually, DiMaggio and Powell (1983: 148) brought into attention that "there is an inexorable push towards homogenisation" in organisations. Both normative pressures and cognitive constrains can make organisations "embrace forms regarded as appropriate or legitimate for organisations of the type to which they belong" (Scott, 1994: 74), since organisations need "social acceptability and credibility" for their own survival (Scott, 2001: 58). In particular, DiMaggio and Powell focus on explaining the high degree of similarity between organisations. They state:

> *"We ask why there is such startling homogeneity of organisational forms and practices; and we seek to explain homogeneity, not variation. In the initial stages of their life cycle, organisational fields display considerable diversity in approach and form. Once a field becomes well established, however, there is an inexorable push towards homogenisation." (1983: 148)*

Organisational practices can become "infused with value beyond the technical requirements at hand" (Selznick, 1957:17) and be adopted for the sake of legitimacy

rather than improved performance (DiMaggio and Powell, 1983). Thus, over time, organisations reflect the enduring rules institutionalised and legitimated by their social environments (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1995).

The new institutionalism is more concerned with legitimacy, the embeddedness of organisational fields and the centrality of classification, routines, scripts and scheme (Meyer and Rowan, 1977; DiMaggio and Powell, 1991). It focuses more on the cognitive aspects of institutions, and therefore on culture, as carriers of institutions (Scott, 2001). In addition, NIS places a particular focus on understanding the bases of stability of social forms and the meanings associated with them, while differing in identifying the elements that create these conditions (Scott, 2003).

The recognition of influence of broader societal factors and the rejection of neoclassical model is common to NIS as "institutions consist of cognitive, normative, and regulative structures and activities that provide stability and meaning to social behaviour" (Scott, 2001: 48). Based on this definition of an institution, there are three pillars of institutions that have formed the fundamentals of legitimacy for an organisation which include a cognitive pillar, a normative pillar, and a regulative pillar. The cognitive pillar covers symbols, beliefs, and social identities. The normative pillar covers duties, norms, and social values. The regulative pillar covers regulations, laws, and sanctions. According to NIS, organisations are affected by the institutional environment surrounding them, since institutions can shape organisational behaviour (Scott, 1994) and thus it recognises the role of cultural and cognitive models as institutional factors affecting organisational forms (DiMaggio and Powell, 1991).

The importance of both cognitive and normative elements in affecting organisations is clearly stated by Scott (1994), in his attempt to give a theoretical synthesis to institutional perspective. According to the Author, "institutions are symbolic and behavioural systems containing representational, constitutive and normative rules together with regulatory mechanisms that define a common meaning system and give rise to distinctive actors and action routines" (Scott, 1994: 68). The consideration of cognitive elements beyond the traditional normative ones constitutes the "new" perspective offered by NIS, which tries to identify those elements that shape organisations and their structures, forms and values.

In addition to understanding the nature of the external pressures on organisations, NIS looks at actions and pressures within organisations that can enable researchers to look more closely at institutions within organisations to focus on the internal pressures and

constraints that shape internal practices (see Oliver, 1991; Powell, 1991; Greenwood and Hinnings, 1996; Scapens, 2006).

NIS explains why different organisations structure themselves in a similar manner. Suchman (1995) states that the principal difference between the early management theories, where enterprise was viewed as a rational system, and the NIS, lies in the introduction of the concept of organisational legitimacy. For example, organisations may seek legitimacy to provide resources to organisations or to extend creditability to the organisation (Jepperson, 1991; Meyer and Rowan, 1991). Organisations that are legitimate are approved of, respected and understood by the wider society thus bringing benefits to the entity.

In explaining homogenisation of organisations, DiMaggio and Powell (1983: 148) introduced the concept of isomorphism, which is a "constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions." DiMaggio and Powell saw isomorphism as "the modification of the organisational characteristics in the direction of increasing compatibility with environmental characteristics" (1983: 149). According to their contributions, isomorphism can have two different natures: competitive and institutional. Competitive isomorphism grows in settings where competitiveness is high and open and affects organisations that are competing for resources and customers. In particular, these organisations are defined as "technical organisations" employing specific technologies and producing measurable outputs and their success is measured on their efficiency to generate high quality outputs (DiMaggio and Powell, 1983: 149). Institutional isomorphism, on the other hand, is the main focus of NIS which exists when competition for resources gives way to legitimisation needs (DiMaggio and Powell, 1983: 150).

One question NIS proposes is why organisations within the same sector adopt homogeneous organisational structures, management practices, and operational procedures. In response to this, DiMaggio and Powell (1983) propose the concepts of coercive, mimetic and normative isomorphism to describe the manner in which an organisation conforms to be considered legitimate by other organisations in its field, regardless of the immediate efficacy and actual usefulness of the acquired structures, practices, and procedures. NIS explains homogeneity in organisational forms and practices mainly through isomorphic processes (Meyer and Rowan, 1977; DiMaggio and Powell, 1983) as a result of both exogenous and endogenous factors, such as the

regulatory environment (Granlund and Lukka, 1998) and market pressures (Tsamenyi et al., 2006). Indeed, each isomorphism implies specific institutional pressures which drive the homogenisation of the organisation to the institutional environment at different levels.

These three isomorphism mechanisms cause organisations to become increasingly alike. The coercive isomorphism stems from political influence and problems of legitimacy; mimetic isomorphism is a result of a standard response to uncertain environments and normative isomorphism is associated with professionalism (DiMaggio and Powell, 1991: 67). The three mechanisms of institutional isomorphism are discussed later in this chapter.

Sometimes, organisations are subject to a common legal environment and thus are forced to change their structures in response to these regulations, and this may lead to an isomorphic organisational structure throughout the industrial field. Additionally, organisations may experience direct imposition of regulations from outside government, such as professional bodies, or other interested parties. As organisations in the same field are subject to similar coercive, normative, and mimetic pressures, they tend to develop similar sets of administrative structures. For this reason, institutional pressures result in organisational homogeneity (Scott, 2001). Meyer and Scott (1992) suggest that organisations frequently engage in activities that aim to meet with the approval of the society in order to seek legitimacy externally. Institutions become more similar over time, perhaps by mimicking "best practices" of other firms seeking to enhance their legitimacy in the eyes of outsiders (DiMaggio and Powell 1983; Cohen et al., 2008). Meyer and Rowan (1977: 344) claim that "institutional techniques are not based on efficiency but are used to establish an organisation as appropriate, rational and modern. Their uses display responsibility and avoid claims of negligence." However, they see these actions as 'myths' which are not true actions but ensure that the company is seen to be behaving appropriately and fulfils its obligations (Meyer and Rowan, 1977).

On the other hand, institutional pressure leads organisations to adopt similar processes through the need to manage in a way that is similar to other organisations in the same environment (DiMaggio and Powell, 1983). Therefore, these characteristics can be defined as structures and management practices deemed legitimate and socially acceptable by other organisations, regardless of their actual effectiveness (Meyer and Rowan, 1977). Having said this, the rules and regulations that exist within the

institutional environment do not necessarily ensure continued efficient operations of organisations (Meyer and Rowan, 1977; DiMaggio and Powell, 1983).

3.3.2 Institutional Isomorphism

Isomorphism is a key term used extensively within NIS. As mentioned earlier, DiMaggio and Powell (1983:149) define it as "a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions." Similarly, Dillard et al., (2004: 509) assert that "isomorphism refers to the adoption of an institutional practice by an organisation." Furthermore, Carpenter and Feroz (2001: 566) argue that due to isomorphism process "organisations will become increasingly homogeneous within given domains and conform to expectations of the wider institutional environment."

In contrast to 'economic' approaches, institutional theorists argue that adoptions of some organisational practices are often determined by culture, norms and cognitive factors (Scott, 1992, 2001; Baxter and Chua, 2003), i.e. organisations become isomorphic with external institutional environment (DiMaggio and Powell, 1983, 1991). Often, organisations feel threatened by the prospect of being singled out, and they decide to be isomorphic with other successful organisations. Institutional pressures force organisations to adopt similar practices. Organisations must conform to institutional pressures if they are to gain and increase legitimacy within their organisational field. Similarly, Carpenter and Feroz (2001: 569) suggest that:

> *"…an organisation's tendency toward conformity to predominant norms, traditions and social influences in their internal and external environments will lead to homogeneity among organisations in their structures and practices".*

NIS addresses the behaviour of organisations as motivated by forces in wider society. It argues that organisations will seek legitimacy by adhering to rules and norms that are valued by society and, more specifically, by certain institutions in its environment. The concept of legitimacy can be seen as a symbolic value to be displayed in a manner such that it is visible to outsiders for the purpose of acceptance and to provide "cultural support for an organisation" (Meyer and Scott, 1983: 201). Carpenter and Feroz (2001) further argue that successful organisations are those that receive support and legitimacy by conforming to social pressures. The act of pursuing legitimacy has resulted in organisations conforming "or become isomorphic" with institutionally accepted norms and values.

DiMaggio and Powell (1983, 1991) noted two types of isomorphism: competitive isomorphism arising from market forces and institutional isomorphism arising from competition for political and organisational legitimacy. They were primarily interested in institutional isomorphism. Accordingly, DiMaggio and Powell (1991: 67-69) identified three types of institutional isomorphism: coercive, mimetic and normative. Coercive isomorphism stems from the necessity of the organisation to follow legal rules in order to achieve legitimacy. Scott (1987:91), however, distinguishes two types of imposition under coercive isomorphism. The first is 'formal' imposition by authority and the second type is 'informal' imposition by coercive power. Often, changes imposed by authority meet with less resistance than those imposed by force (see Tolbert and Zucker, 1983). Structural changes associated with authority are expected to achieve higher levels of compliance and stability, as these changes are less superficial than changes imposed by coercion. Mimetic isomorphism occurs as a result of the phenomenon of organisations copying each other because they have no means to cope with environmental uncertainty. When organisations face uncertainty about organisational technologies and environmental expectations, organisations often imitate internal structures and procedures adopted by other leading organisation, often perceived as successful organisation. Firms at this stage become receptive to new ideas, options and changes to 'imitate' the latest trend in the field. Normative isomorphism stems from an organisation being obligated to adopt patterned behaviours institutionalized by the authorities. In this context, it is related to the pressure from group norms to adopt notable institutional practices. Such isomorphism mechanisms can be disentangled in theory, since they originate from different conditions and can lead to different results, but they "intermingle in empirical settings" (DiMaggio and Powell, 1983: 150). A discussion of these institutional isomorphisms is made in the following subsections.

An organisation needs to adapt to its institutional context and address all three of the identified institutional pressures: coercive (government regulations and laws); mimetic (the need to copy other organisations in times of environmental uncertainty); and normative (cultural and societal expectations) (DiMaggio and Powell, 1983; Powell and DiMaggio, 1991). By addressing these pressures, the organisation aims towards social legitimacy. Conforming to institutional demands, the organisation may achieve social support and ensure its survival because it goes along with accepted conventions. The institutionalism theorists agree that institutionalisation is a social process, whereby regardless of the different actors' own views, they all share a common definition of

how things are done or ought to be done (Scott, 1987). Indeed, each isomorphism implies specific institutional pressures which drive the homogenization of the organisation to the institutional environment at different levels. In referring to organisations, DiMaggio and Powell (1983) indicate as the appropriate context for the application of institutional theory the organisational field, which comprise different level of organisations and offer a wider context to detect isomorphism (Scott, 1994: 70-71).

Institutional theorists recognize that organisations may vary in the degree to which they conform to changes in their external environment (DiMaggio and Powell, 1983). For example, an organisation's own traditions and history may affect the extent to which it conforms to isomorphic pressures (Eisenhardt, 1988). However, institutionalised organisations adopt homogenised practices, processes and structures as a result of the pressures of mature organisational fields and this phenomenon results in organisational isomorphism (Greenwood et al., 2008). Institutional pressures affect all organisations because generally organisations are sensitive to their institutional context. This sensitivity provokes organisations to respond to the demands of their organisational field and gain legitimacy for their survival. However, conformity to institutional pressures can work against efficiency and this compliance can also be ceremonial (Oliver, 1991).

Accordingly, the legitimated organisational structure or management practices of an organisation can spread to other organisations in the same field through coercion, mimetic or normative pressures (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1987). Institutional forces influence organisations to adopt new structures and behaviours institutionalized by their peers or superior forces. Sometimes, this situation is comfortable because by adopting institutionalized elements the organisation might avoid its behaviour being questioned (Meyer and Rowan, 1991).

DiMaggio and Powell (1983) work to provide distinction between "coercive, mimetic and normative" processes of social reproduction has inspired Scott (2008) to pursue and elaborate their lead by differentiating between three types of institutional pillars that underlie institutional order, namely: regulative, normative, and cultural-cognitive pillars. Regulative elements stress rule-setting, monitoring, and sanctioning activities (Scott, 2008, p. 52). Normative elements "introduce a prescriptive, evaluative, and obligatory dimension into social life" (Scott 2008: 54), while cultural-cognitive elements emphasise the "shared conceptions that constitute the nature of social reality

and the frames though which meaning is made" (Scott 2008: 57). These three institutional pillars are diverse in nature and provide different types of legitimacy such as legal; moral; and cultural (Scott, 2008: 61) but are interlinked with one another. For example, the regulative pillar confers legitimacy to those organisations which comply with established legal requirements. The normative pillar furnishes legitimacy to those organisations which conform to certain internalised controls and both extrinsic and intrinsic rewards exist for conformant organisations. The cultural-cognitive pillar provides the legitimacy to those organisations which follow common beliefs, taken-for-granted understanding and similar frame of reference (Scott, 2008: 61). However, Scott (1995) asserts that no one institutional pillar dominates the others. Rather, all three pillars must be considered together to obtain a comprehensive understanding of social phenomena.

Organisations presenting a lack of legitimacy may be challenged and their behaviour may be punished (Scott, 1991). Lack of conformity to institutional pressure can be sanctioned accordingly. However, organisations are not totally at the mercy of the institutional order; they may also act to change the institutions themselves (Holm, 1995; Barley and Tolbert, 1997) or act to manage an appearance of 'legitimacy' (Suchman, 1995).

3.3.2.1 Coercive Isomorphism

The "coercive" isomorphism stems from threats to public legitimacy and/or governmental oversight and monitoring (DiMaggio and Powell, 1983). The problem of political influence and the problem of legitimacy are central to the coercive isomorphism. Within the coercive mechanism, organisations become similar through coercive isomorphism, as they influence individual organisations in a compelling manner.

Coercive isomorphism is the results of "formal and informal pressures exerted on organisations by other organisations upon which they are dependent and by cultural expectations in the society within which organisations function" (DiMaggio and Powell, 1983: 150). Such pressures can be government mandates or law requirements, which can actually affect many aspect of an organisation. Powell and DiMaggio (1991:66-67) identified some features that characterise coercive isomorphism as,

> *"The greater the dependence of an organisation on another organisation, the more similar it will become to that organisation in structure, climate, and behavioural focus"*

and,

> *"The greater the centralisation of organisation A's resource supply, the greater the extent to which organisation A will change isomorphically to resemble the organisations on which it depends for resources."*

Coercive pressures have been associated with the obtaining of compliance, on the part of organisations within the field in which they operate. North (1990) emphasises the use of rules and regulatory mechanisms in facilitating this compliance. When these rules and regulations are breached, punishment is enforced. The fact that the creation and enforcement of effective state regulations depend, in part, on the capacity of external actors – such as regulatory agencies, unions, consumers and other stakeholders – to participate in and monitor these regulatory processes. Such pressures could possibly be requirements issued by governmental bodies or standards defined by regulatory associations with the related power to impose expectations. In the case of corporate governance practices, the coercive pressures come from deliberate actions of governments and regulatory agencies. For example, the increasing requirement by stock exchanges of many countries for the adoption of ACs is illustrative of coercive isomorphism.

Coercive pressures become more complex; companies are not only required to respond to legislation pressures, but also to the direct imposition of standardised rules which may also occur beyond the control of legal prescriptions and laws. Organisations gain and maintain legitimacy by conforming to 'public expectations and demands' (Clarke et al., 1997: 166) and by being acceptably organised from a legal point of view, even if the organisational changes made in response to those regulations are more formal than substantial (DiMaggio and Powell, 1983). This can be achieved not only by conforming to externally enforced rules and regulations but also by simultaneously internalising similar regulatory systems. Although compliance with these forces can be largely ceremonial (Oliver, 1991), lack of conformity to institutional pressures can result in sanctioning activities (Scott, 1995). Thus, organisations conform to accepted prescriptions of appropriate behaviour in order to gain legitimacy vis-à-vis external constituencies, and thus improve their chance of survival. Organisations conform to accepted norms of their populations either voluntarily or through coercion (DiMaggio and Powell, 1983).

3.3.2.2 Mimetic Isomorphism

Mimetic isomorphism is another process in which organisations adopt homogenised practices. According to Powell and DiMaggio (1991: 69) not all institutional isomorphism is coercive. They suggest that uncertainty is an additional powerful force that encourages organisational imitation. Accordingly, mimetic isomorphism is the result of the pressure coming from uncertainty, which is "a powerful force that encourages imitation" (DiMaggio and Powell, 1983: 151). Uncertainty stems from different causes affecting an organisation: ambiguous goals, unclear solutions, and vague paths. To reduce such uncertainty, organisations tend to model themselves on other 'leading' organisations, which they perceived as more successful, or legitimated (DiMaggio and Powell, 1983: 152).

In this form of isomorphism, the social actors have the tendency to imitate other social actors which are viewed as successful and legitimate. Imitation among members of a social system can occur for competitive reasons when firms learn from each other how to operate more efficiently and/or effectively (Scott, 2001). One area where imitation might take place is in the area of corporate governance practices, especially with respect to situations where legitimation pressures are paramount (Aguilera and Cuervo-Cazurra, 2004).

Besides coercive pressures, organisations may sometimes be influenced by mimetic pressures, i.e. pressures arising from the drive to reduce uncertainty. When organisations are faced with conditions of uncertainty, the imitation of successful peers is deemed to be a safe strategy. This is consistent with DiMaggio and Powell (1983:152) statement that,

> *"Organisations tend to model themselves after similar organisations in their field that they perceive to be more legitimate or successful. The ubiquity of certain kinds of structural arrangements can more likely be credited to the universality of mimetic processes than to any concrete evidence that the adapted models enhance efficiency."*

Therefore, mimetic isomorphism can be regarded as a response to organisational uncertainty in pursuing the best course of action. According to Palmer et al. (1993: 104):

> *"Institutional theory assumes that organisations will select among alternative structures [or practices] on the basis of efficiency considerations, primarily at the*

time that their organisation field are being founded or reorganised. Subsequently, they adopt forms that are considered legitimate by other organisations in their field, regardless of these structures' [or practices'] actual efficiency."

Institutional theorists state that mimicry is a successful institutional rule in a competitive environment (DiMaggio and Powell 1983; Meyer and Rowan, 1977). When sufficient organisations in an environment take the same action, other organisations will copy that action without a great deal of thought (DiMaggio and Powell, 1983). Mimetic isomorphism will take place when organisations perceive that the internal audit function will contribute to an improvement in organisational control and operational performance leading to it being adopted. As a consequence, an increasing number of organisations establish internal audit departments over time. Institutionalised organisations adopt homogenised practices, processes and structures as a result of the pressures of mature organisational fields and this phenomenon results in identical organisations as the outcome of 'institutionalisation processes' (Greenwood et al., 2008: 6).

3.3.2.3 Normative Isomorphism

Normative isomorphism results from professionalization as a mechanism to establish the necessary conditions to be member of a specific organisation. Professionalisation provides two sources of isomorphism, as recognized in DiMaggio and Powell (1983: 152): "[o]ne is the resting of formal education and of legitimization in a cognitive base produced by university specialists; the second is the growth and elaboration of professional networks that span organisations and across which new models diffuse rapidly."

Normative isomorphism basically arises from professionalisation (DiMaggio and Powell, 1983: 152-153). The occupants of a certain profession exert pressure for defining their working conditions and gaining occupational autonomy for their profession. In this struggle, however, they not only have to compete at organisational level, but they must also deal with regulators, pressure groups and clients who can put pressure on them (DiMaggio and Powell, 1983: 153-154). The formal educational system and network of professionals are two important sources of normative isomorphism. Normative isomorphism thus forces organisations to comply with their social obligations and creates identical organisational practices and processes (Greenwood et al., 2008: 6-7). Similarly, professional bodies at national and international level exert pressures on their respective professional members to comply

with professional norms and this phenomenon can generate homogenised practices and processes across different organisations.

Furthermore, professionalisation occurs not only through formal education but also through professional associations, trade associations, and professional media DiMaggio and Powell, 1983). It may as well be generated by external sources such as professional networks and knowledge introduced into an organisation by a manager. Therefore, an organisation making a new decision or adopting a new practice can be derived from some aspects of its manager‘s personal attributions. The formal and informal inter-personal networks of an organisation‘s senior directors may also influence its decision-making and organisational actions. These professionals have strong ties with their professional bodies, which determine the criteria for "proper" and professional behaviour (Greenwood et al., 2002).

According to Scott (2001:175), normative isomorphism "introduces a prescriptive, evaluative and obligatory dimension into social life, reflecting the values (what is preferred) and norms (how things should be done) of the social system. Social actors working in particular organisational roles are expected to fulfil certain social commitments and obligations." Individuals, therefore, are engaged in 'appropriate behaviour' whereby people do what they are supposed to do and is based on behavioural patterns that are socially expected and accepted by other actors. Consequently, these expectations are usually perceived to be external pressures to which one must conform, and normative isomorphism is a product of the professional roles that the organisational actors play.

To some extent, normative isomorphism is distinct from mimetic isomorphism in having an underlying evaluation tone. On one hand, mimetic isomorphism gives a shared frame of reference, of 'how things are done around here'; on the other hand, normative isomorphism takes place on a moral base, 'what is right to do around here' (Marquis et al., 2007).

3.4 Organisational Field

As discussed in the previous sections, NIS assumes that organisations respond to pressures from their institutional environments and adopt structures and practices that are socially accepted as appropriate organisational choices and are considered legitimate by other organisations in their field (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Carpenter and Feroz, 2001). Thus, institutions represent the forces that exert pressure on firms to adopt similar behaviour and practices to other firms in

the same societal context. These institutions form at different levels of society. Scott (2008: 85) claims that measurement of any phenomenon in terms of 'time, space and number of affected persons' determines the respective analytical level.

The new institutional perspective asks questions about how social choices are shaped, mediated, and channelled by the institutional environment (Hoffman, 1999), and one of its underlying assumptions is that most organisations share certain characteristics with others. Therefore it is important to study and understand the institutional environment, which is commonly thought to be composed of organisations and organisational fields. According to DiMaggio and Powell (1983: 148) an organisational field is the set of those organisations which "constitute a recognised area of institutional life." These organisations include suppliers, resource and product consumers, regulatory agencies and other organisations that produce similar services or products. Organisational field illustrates the existence of a community of organisations that carries a common meaning system and essentially its participants interact with one another more than with other actors who are outside the field (Scott, 2008: 86). According to Hoffmann (1999: 364) organisational fields cannot only be established around markets, technologies or policies, but it can also emerge from central conflicts and problems. Hence, the field reflects the interests and objectives of a specific collective of organisations.

When viewed through the institutional lens, a core assumption in the analysis of organisational fields is that organisational strategies and practices within the same organisational field increasingly converge and become isomorphic over time (DiMaggio and Powell, 1991). However, before the institution appears in the organisational field, divergent strategies and practices exist when institutional pressures are uncertain and complex. In an organisational field, when the institutional context is stable and institutional pressures are constant, the structures and practices of organisations operating within the field start to imitate and learn from each other. Within an institutional field, different types of isomorphic pressures sustain the institution common to the field. Depending on the institutional field, different pressures may have more influence in one field than the other resulting in field fragmentation, complexity, and ambiguity on organisational forms and processes (Scott, 2008).

Institutionalised organisations adopt homogenised practices, processes and structures as a result of the pressures of mature organisational fields and this phenomenon results

in organisational isomorphism (Greenwood et al., 2008). Institutional pressures affect all organisations because generally organisations are sensitive to their institutional context. This sensitivity provokes organisations to respond to the demands of their organisational field and gain legitimacy for their survival. In any field, organisations tend to become homogenous in both process and structure over time. Though institutional innovations may spread at first for performance reasons and organisational desire to be seen as being in the vanguard, later in the diffusion process innovations are apt to be adopted for reasons of legitimacy and reducing uncertainty rather than reasons of promoting actual performance.

Organisational fields can be identified by different means and one organisation can be categorised into a number of organisational fields (Scott, 2008). At any one time, in any one organisational field, it could be anticipated that a variety of different institutions influence organisational behaviour and practice. Therefore, when an organisation belongs to different fields, it could be facing different types of isomorphic pressures at the same time. Different types of institutions exert different institutional pressures, and one institution may exert multiple isomorphic pressures at the same time. It is thus argued that, in practice, there is a blurring of the boundaries between coercive, mimetic and normative isomorphic pressures, with several institutions plausibly spanning the boundaries between two or even all three types of isomorphism.

3.5 Summary and Conclusions

This chapter explains the chosen theoretical framework for the research. Agency theory has been the dominant theory in corporate governance studies. However, the agency perspective fails to explain corporate governance practices in developing countries, such as Saudi Arabia, which have forced different authors to use other theoretical foundations and NIS framework has been a popular choice. The chapter discussed the agency-based assumptions that are not appropriate for emerging economies and thus, new institutional perspective (NIS) was adopted as the theoretical framework for this research.

NIS is based on the premise that organisations act in response to various pressures from their institutional environments and adopt organisational structures and management practices that are considered to be the appropriate choice by the society and considered legitimate by other organisations in their field, regardless of their actual usefulness (Meyer and Rowan, 1977; DiMaggio and Powell, 1983). The Institutional perspective contradicts earlier organisation perspectives that say that organisations

always function rationally to achieve their goals. The perspective defines other reason for organisations actions that are driven by both formal and informal rules created by the surrounding. The perspective focuses on how organisations affect and are affected by the context their institutional environment.

The institutional perspective suggests that organisations adopt new institutional designs in order to conform to societal or institutional requirements and, thus, to become legitimate. The legitimacy brings support by and acceptability in society. Since many organisations in a specific field or sector try to become legitimate, this results in isomorphism, that is, in similarity across several organisations. NIS has been very useful in drawing attention to the need to recognise the way in which organisations tend to conform to what they perceive as the expectations of their broader environment.

DiMaggio and Powell (1983) suggest that institutional pressures would drive organisations to adopt similar characteristics through the desire to organise themselves in a manner that is similar to other organisations in the same environment. They argue that a process of isomorphism could take place in three ways, namely, coercive isomorphism, mimetic isomorphism and normative isomorphism.

According to institutional perspective, firms might adopt practices or regulations as a result of coercion from a legislator who imposes some practices by force in order to improve organisational effectiveness. On the other hand, firms may accommodate themselves on similar organisations in their field which they perceive to be more legitimate or successful (DiMaggio and Powell, 1983). However, there is no prediction that the adoption of these regulations will improve organisational effectiveness.

NIS assumes that organisational form is predominantly the outcome of external factors. These factors are more influential than profit maximising objectives and result in organisations which operate in the same environment becoming similar (or isomorphic) to each other. DiMaggio and Powell "contend that the engine of rationalisation and bureaucratisation has moved from the competitive marketplace to the state and the professions" (1983:147). That is legitimacy is conferred predominantly by the actions of the state and professions although networks in organisational fields also play an important role in providing stability and permanence.

The next chapter outlines the research approach and procedures for this study.

CHAPTER 4: RESEARCH METHODOLOGY

4.1 Introduction

This study seeks to understand the role of boards in the governance of Saudi banks. It provides insight and evidence into the effects of both national and institutional governance on the selection process of directors, as well as their dynamics and interactions in and around boardrooms. More specifically, it explores directors' actions and behaviours and the consequences of these, at both individual and bank levels, having specific regard to Saudi institutional contexts. To achieve the aim of this study, a qualitative case study approach has been used to generate data relying on interviews with board members and regulators. Also, archival information was obtained from publicly filed reports, business press coverage and internal reports that were made available by banks and regulators.

Therefore, this chapter describes the research design and methodology (including the selection of a case study approach, sampling, data collection and analysis). The chapter is structured as follows. A background profile on the research approach is provided in Section 4.2, including a discussion of the use of case study strategy. Section 4.3 is primarily concerned with the data collection process and primary source of collection, including the case selection of sample, interviews and related issues. Section 4.4 provides a description of how data is analysed and coded. The final section, 4.5 provides a summary and concludes the chapter.

4.2 Research Approach

The case study approach is a response to researchers' calls to rely more on in-depth research methods in studying boards and corporate governance (Pettigrew and McNulty, 1995; McNulty and Pettigrew, 1999; Roberts et al., 2005; Parker, 2008). Moreover, there are a limited number of qualitative studies which have been carried out on boards and corporate governance in Saudi Arabia (AlHarkan, 2005; AlAjlan, 2005; Falgi, 2009).

A case study research is defined as an "empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially when the boundaries between the objects of study and context are not clearly evident" (Yin, 2003:13). A case study is a research strategy which concentrates on perceiving the dynamics present within single settings (Eisenhardt, 1989b). Therefore, the case study method is a powerful means of studying an issue that is not well understood and of which little is

known (Patton, 1990; Yin, 2003) and for “examining contemporary events, but when the relevant behaviours cannot be manipulated” (Yin, 2003: 7).

A case study is particularly good for examining “why” as well as “how” and “what” questions, which are enquiries about a contemporary set of events over which the investigator has little or no control (Yin, 2003; Saunders et al., 2009). Accordingly, case studies can be classified into three research strategies, namely: exploratory, descriptive and explanatory (Yin, 2003; Saunders et al., 2009). An exploratory research method aims to explore or search through a problem to gain new insights and understanding of a situation or a problem, where the area of study is still new or unknown. Therefore, this method can be used through searching literature, interviewing experts in the ‘subject’ and conducting focus group interviews. An explanatory research is a study that seeks to establish casual relationships between variables. Thus, it provides an explanation of the causes or effects of one or more variables in a particular context. The descriptive research provides a description of an accurate profile of a social phenomenon in order to identify patterns and trends in a situation. For this type of research, it is important for a researcher to have a clear picture of the situation in order to present conclusions from the data that are described. Yin, however, suggests that a more appropriate view would be a pluralistic one where each type of research strategy could be used for all three purposes. There is no exclusivity between these types of case studies and thus such labels need to be used with care (Scapens, 1990; Ryan et al., 1992). The approach adopted in this study has many of the features of both exploratory and explanatory case studies.

4.3 Data Collection

The data collection for this study involved two primary sources, namely: interviews and archives. The primary data collection was through semi-structured interviews conducted with board members and regulatory representatives. Archival information was obtained from publicly filed reports, business press coverage and internal reports that were made available by banks and regulators.

4.3.1 Case selection

This study was conducted on three banks of which only two are publicly traded on Tadawul. Gaining research access to corporate boardrooms is extremely difficult even at the best of times. As LeBlanc and Schwartz observed, boards “tend to be closed groups, bound by confidentiality, privilege and custom, with significant access difficulties and other practical limitations as well” (2007: 845). Thus, the access to

banks' boards was not an easy task and was a lengthy and time-consuming process. The access would not have been granted without the assistance of the researcher's sponsor and the use of a "snowballing" technique to gain access to more interviews than would otherwise have been difficult to secure.

To overcome concerns with confidentiality, the research assured complete anonymity to the banks under study, as well as to the board members and regulatory representatives (compliance and inspection officers). Moreover, the researcher enhanced credibility and access by presenting participants with sponsorship letters from the Saudi Cultural Bureau in London and the University of Manchester Business School.

There are twelve (12) Saudi banks which can be categorised based on different variables. All banks are listed on Tadawul except one (which is primarily controlled by the government). They may be divided into three groups in terms of the capital and assets of the bank, namely: large, medium and small. The banks, moreover, have two different banking systems. These are comprised of namely: the conventional banking system, the Islamic banking system, or both. The last variable is the ownership structure, regarding whether it is government, local or a joint venture with foreign partners.

Case selection relied upon both purposeful selection (Maxwell, 2005) and theoretical sampling (Corbin and Strauss, 2008). Purposeful selection "is a strategy in which particular settings, persons, or activities are selected deliberately in order to provide information that can't be gotten as well from other choices" (Maxwell, 2005: 88). Theoretical sampling complements purposeful selection and is a method of data collection that allows the flexibility to "go where analysis indicates would be the most fruitful place to collect more data that will answer the questions that arise during analysis" (Corbin and Strauss, 2008: 145).

The banks were geographically diverse; with two located in the capital city of Riyadh and one on the west coast of Saudi Arabia. The average tenure of service by a board member was nine years, ranging from three to nearly forty years. Of the total of twenty-seven (27) male board members serving on these boards, only four are non-Saudis.

The research had conducted twenty-one (21) interviews; of which ten were with board members, seven with audit committee members and four with regulatory

representatives (see Table 4.1). A Complete profile of all interviewees is presented in Appendix 2.

The selected boards are heavily represented by controlling shareholders (55%), whereas only two of the three boards have more than a one-third (37%) ratio of independent directors and as many as seven non-executive directors[16]. It is worth pointing out that the definitions of independent and non-executive directors, provided by SAMA and CMA, are slightly vague as it is stated that an independent member is:

> *"A member of the Board is someone who enjoys complete independence. This means that the member is fully independent from management and the bank. Autonomy is the ability to judge things after taking into account all relevant information without undue influence from management or from other external entities." SAMA and CMA*[17]

And the non-executive director is:

> *"A member of the Board who provides opinions and technical advice and is not involved in any way in the management of the bank and is not receiving a monthly or annual salary." SAMA and CMA*

The problem with these definitions is that a board member will not be considered independent or non-executive[18] if he:

- Owns 5% or more in the bank or any of its affiliated companies.
- Is a representative of a legal person holding five per cent (5%) or more of the issued shares of the bank or any of its affiliated companies.
- Has a relationship of the first-degree with any member of the Board, any member of the senior executives or any member of the affiliated companies of the Bank.
- Was a partner or an employee of one of the external auditors (or one of its subsidiaries) during the last two years.
- As discussed in the literature studies and the discussion chapters, the ownership structure of banks is difficult to verify, except for those who have 5% or more as required by CMA listing regulations. In this context, it is not possible to

[16] There was no information available on the board of the Government Bank.
[17] SAMA and CMA provided identical definitions for both independent and non-executive directors.
[18] SAMA and CMA Reports, 2009-2012

know how many members of one family hold shares in one or more banks[19]. Likewise, it is very complicated to unveil the real owners and their shares in the Government Bank, as the Bank is not listed and thus is not subject to CMA regulations.

Table 4.1: List of Interviewees

Interviewees	Government Bank	International Bank	Islamic Bank
Board Chair	-	-	SBC
Board Member	GB1 GB2 GB3 GB4	IB1 IB2	SB1 SB2
Chief Executive Officer	-	ICEO	-
Audit Committee Chair	GACC	-	SACC
Audit Committee Member	GAC1 GAC2	IAC1 IAC2	SAC1
Regulatory Authorities	RS1 and RS2		RC1 and RC2

Of the seven Audit Committee (AC) interviewees, only two were AC chairmen and the remainder were AC members. The ACs in all banks are chaired by a representative of the controlling shareholders (Table 4.2). However, the selected ACs are heavily represented by independent members from outside the banks (who are predominantly in the academic domain).

The four regulatory representatives were carefully selected from among the financial market regulatory and supervisory authorities.

4.3.2 Interviews

The interview approach, which is one of the most comprehensively applied methods of data collection in social sciences, helps the researcher to gather the validity and consistency that are relevant to research questions (Saunders et al., 2009). In addition, interviews are deemed to be an appropriate technique in certain cases involving complicated and highly confidential information (or when the required information cannot be collected by other techniques) (Hussey and Hussey, 1997).

[19] See chapter 7 on the ownership structure in respect to family and relatives relationships that were not considered in the existing laws and regulations.

The researcher used triangulation method of data collection to facilitate validation of data through cross verification from interviews, archival information that was obtained from publicly filed reports, business press coverage and internal reports that were made available by banks and regulators.

Table 4.2 List of AC members

BANK	AUDIT COMMITTEE [AC]*
GOVERNMENT	AC Chairman, Govt/Major Shareholder AC Member, Govt AC Member, Private AC Member, Independent AC Member, Independent
INTERNATIONAL	AC Chairman, Foreign Partner/Major Shareholder AC Member, Independent AC Member, Independent
ISLAMIC	AC Chairman, Private/Major Shareholder AC Member, Independent AC Member, Independent AC Member, Independent
* AC independent members are from outside the bank.	

Furthermore, the researcher prepared a list of questions and issues that were tested in a pilot study interviews with random subjects. The outcomes of these interviews, in addition to archival information, produced a list of themes and patterns that have refined the final list of questions to ensure that the research truly measures which it was intended to measure. Subsequently, random subjects were asked to review the researcher's synthesis of interviews for accuracy and that the interpretation reflects the original data. A copy of the interviews questions can be found in Appendix 3.

After obtaining initial agreement of the case banks to participate in the research, access and interviews with board members were gradually negotiated. Although the order of interviews varied depending upon the availability of the participants, the researcher was able to conduct interviews with the controlling shareholders and their representatives on boards and on audit committees. As the case study progressed, further participants were identified and interviews conducted. In this context, a "snowball" technique was utilised. This is a technique where some interviewees recommended other key directors (who seemed to be important) to be interviewed in order to gain more insightful information. Thus the researcher was able to gain access to other interviewees who were willing to participate.

Data was collected in three phases, allowing the researcher time to reflect on initial findings at the end of each phase, make adjustments and prepare for the next data

collection phase. These phases were not so much pre-planned as the result of accommodating the participants' availability. The first phase included initial pilot interviews with two board members and a regulatory representative. The second phase included interviews with board and AC members in all case banks. Following that, interviews with regulatory representatives were the last phase. However, there were follow-up[20] interviews with some key participants to ensure and enhance the quality of the gathered data. This process was both time and cost-consuming as it required the researcher to travel more frequently and to spend more time in planning and arranging for interviews.

Prior to interviews, the researcher would gather together and study all relevant information on the participating banks and interviewees. Hence, each interview began with an overview of the research and the objectives whilst highlighting the significance of such research on studying boards and corporate governance in the Saudi Arabian context.

All interviews were conducted face to face mostly in the interviewees' offices, although some interviewees were met outside their offices. All the interviewees refused to be tape-recorded so the researcher had to take notes. This rejection of tape-recording was expected by the researcher due to social and cultural issues where local people tend to feel more comfortable and free to speak their minds without disclosing their identities. The duration of interviews ranged from forty minutes to three hours and they were carried out at different premises and locations that were convenient to the participants, thereby enabling them to talk more freely about the issues.

At the beginning of each interview session the researcher explained the purpose of the study and the contributions that interviewees could make to the study. Each interview lasted between one and two hours. During the interviews, attempts were made to answer all the interview questions; issues that were expected to be sensitive were left until the end of the interviews, as the longer the interviewees are in discussion with the researcher the more likely it is that their trust and confidence will increase (Healey and Rawlinson, 1993). However, the contents of interviews were largely governed by the flow of the interviewees' thoughts and the researcher would probe for a further explanation, or interrupt to ensure the interview session remained on track.

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[20] Participants did not ask to review the interview notes; therefore the follow-up interviews were useful in enhancing data quality.

4.3.3 Data translation

This study investigates the role of boards in the governance of Saudi banks, which was conducted in a country where Arabic is the official language. In addition, all participants felt comfortable to speak in their home language, even for those directors who can speak in English. The interviews and note- taking were all done in Arabic and therefore, a translation of the interview questions and answers were required.

The researcher acknowledges the implications of data translation process that might cause some data to be lost in during the process. Consequently, the researcher acknowledges the significance of the data translation and therefore professional translation agencies and linguistic specialists were engaged in the process to ensure quality of translation and consistencies in terminology definitions.

The translation process was a very important stage in this study since any mistakes in translation could change the meaning and context of the interviews outcomes. The initial questions were written in English then translated into Arabic by a linguistic specialist in English-Arabic translation. The Arabic version was then reviewed by the researcher and a professional language-translating agency and was ready to be used.

Subsequently, all of the interviews notes were recorded by the researcher and then given to a professional language-translating agency, together with the translation of some specific terminology definitions. Following that, both versions of the transcripts (English and Arabic) were reviewed for consistency by a second translating agency. The final transcript was then reviewed by a professional English tutor to complete the translation process. Finally, the translation process was checked and validated by multiple professional language-translating agencies.

4.3.4 Data collection issues in Saudi Arabia

The social and cultural settings of Saudi Arabia have a major impact on business conduct and processes. The researcher would not have been able to conduct interviews without personal and professional relationships that provided access to boards in which some board members facilitated access to further board members. During the process of data collection, the researcher encountered a number of difficulties which he was able to overcome to complete the collection of data.

First, data access is very limited and is restricted by mandatory permission at the discretion of the subject. More specifically, access becomes extremely difficult in a heavily regulated industry such as banking. In this context, conducting interviews of

any research type holds less attraction for local business people. In some cases, they would question the significance of the outcome of such research in relation to their businesses.

Second, the availability of data in the public domain is generally sparse and thus, the researcher had to obtain it from case banks, which was a time-consuming process. However, the data obtained through public means or from banks were, in most cases, out of date which required the researcher to make requests for updated data.

Third, the available data sources, in most cases, are written in Arabic which presents difficulties for non-Arabic speaking researchers in trying to obtain relevant information. Thus, researchers will be obliged to translate data into their respective languages, which may cause inconsistency if the translation is not used with care.

Finally, participants assume that research interviews are similar to those in the media and thus tend to be inclined to exercise sensitivity in discussing certain issues. However, the researcher's credentials and ability to assure them of confidentiality did overcome this issue.

4.4 Case Analysis

Data was analysed through a process of coding as soon as it was collected and was then used to supplement subsequent interviews. This process began as soon as the initial interviews had been transcribed by the researcher. The initial transcriptions set in motion an iterative process whereby findings from initial data provided new prompts which could be included in later interviews. This provided the opportunity to pursue emerging concepts in later interviews and subsequent new interviews. Data was collected to the point of theoretical saturation, which meant that conceptual categories and their contents had been pursued to exhaustion and no new categories had emerged in transcribing later interviews. Thus central themes emerged and were coded in an iterative process of identifying concepts and highlighting their constituent sub-categories.

The data was then analysed by assigning open codes to the interviews in which the researcher "broke the data apart and delineated concepts to stand for the blocks of raw data" (Corbin and Strauss, 2008: 198). Portions of potentially salient text, "codable moments", were identified and labelled (Boyatzis, 1998). These "codable moments" were then assigned to either existing or newly created codes.

The researcher continued to identify additional relationships between the collected data and new discoveries by testing the coding schema, as well as reviewing and analysing patterns and themes. These open codes were then grouped under more abstract codes – commonly referred to as axial codes – by the patterns or themes that emerged from comparing their shared meanings and characteristics. These themes were then organised under higher-level constructs to show how emergent themes could be used to develop a conceptual framework. A comparison of the within-case coding outcomes was then coupled with a cross-case search for patterns (Eisenhardt, 1989b).

Finally, this research study used multiple sources of evidence that supported construct validity during the data collection phase of the research. The researcher followed a similar data collection procedure for each case with the use of a consistent set of questions in each interview. Moreover, patterns and causal links have been identified across cases in establishing internal validity during the data analysis period. Thus, the findings of the multiple cases support the replication of results to be generalised to other banks (see Chapter 8).

4.5 Summary and Conclusions

This chapter discussed the research design and methodology, including, namely: the selection of the case study approach, sampling, together with data collection and analysis. The use of case study strategy and sampling were discussed and justified. The primary source of data collection was achieved through conducting interviews with board members and regulators. The researcher highlighted the main issues related to the data collection in terms of access and translation. Later, the chapter discussed how the data analysis was processed and addressed issues of data validity and reliability.

The subsequent chapters 5, 6 and 7 provide the empirical work of this thesis which is related to the recruiting and selection process of directors, the interactions of directors and the contextual constraint of governance.

CHAPTER 5: DIRECTOR SELECTION PROCESS

5.1 Introduction

This thesis is comprised of three empirical chapters. The first empirical chapter here relates to the directors' selection process. It provides empirical evidence as to how directors are selected, what are the selection determinants and the factors that influence the selection and their determinants. The subsequent chapters (6 and 7) are related to the directors' interactions inside and outside the boardroom and the external factors of the banks that influence directors' selection and interactions.

The directors' selection process is the formal process by which individuals are identified, screened, nominated and appointed to corporate boards. This chapter provides empirical evidence relating to the process that drives the selection of individuals to boards and audit committees in Saudi banks. The chapter is structured as follows. A brief background on the director selection process is provided in Section 5.2, including the formal and informal processes. Section 5.3 is primarily concerned with rational and social determinants of director selection, including factors that influence director selection. The final section, 5.4, provides a summary and conclusion of the chapter.

5.2 Director Selection Process

Saudi banks are dominated by the government and a few prominent families who eventually occupy most of the boards' seats. Therefore, they or their representatives tend to serve on boards for considerable periods of time. Besides that, new appointments are extremely scarce and are limited to the controlling shareholder. In this context, the starting point for the directors' selection process will be an analysis of the formal and informal re-election process of board members. The new appointments process created by new vacancies or by expansion will be dealt with in Section 5.2.2.

The Nomination and Compensation Committee (NCC) is the board committee responsible for leading the process for reviewing and evaluating the nominated members of the boards and determining the compensation mechanisms for board members.

The basic requirements of the NCC are to identify and recommend nominees for selection as executive and non-executive directors and to determine an incentive system of compensations. Thus, the NCC initiates the re-nomination process by sending out the nominees' names to SAMA to obtain the agency's approval before

proceeding with a formal nomination and appointment. This process excludes directors who may not be re-elected as a result of retirement, resignation, death, and (in rare cases) removal[21].

Prior to January 2010, the NCC was not mandatory for listed firms and the executive committee[22] performed the functions of the NCC. The executive committee is usually composed of the major actors in the board, such as the chairmen of the board and audit committee respectively, as well as representatives from the controlling shareholders.

However, there were a few firms (including some banks) that had established NCCs although these committees were not active in terms of nominations. At the same time, banks were mandated by SAMA to establish a remuneration committee which was mainly concerned with directors' compensations and remunerations.

The following section provides evidence on both the formal and informal processes of directors' re-election, where most of the seats on the banks' boards are occupied by founding families or controlling shareholders (such as the governments or foreign partners). Therefore, the starting point of the directors' selection will be the re-election process.

5.2.1 Formal and informal board re-election process

There are formal and informal processes for the re-election of the incumbent board members. The underlying informal selection process goes hand in hand with the formal process. As illustrated in Figure 5.1, the formal process starts when the incumbent board members reach the end of their service term and show interest in being re-elected.

The basic requirements of the NCC are to identify and recommend nominees for selection as executive and non-executive directors and to determine an incentive system of compensations.

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[21] All of the interviewees asserted that resignation and removal are very rare cases. However, when a director is no longer needed (regardless of whether it is for economic or social reasons), the chairman of the board may ask him to leave, but in many cases, the board would actually allow him to complete his term.

[22] The Executive Committee is usually composed of the board chairman, CEO and four other board members. The committee meets on average twice a month and acts as a general management committee with authority delegated by the board of directors. This committee is responsible for implementing bank's policy, monitoring business performance, managing risks and ensuring the effectiveness of internal controls, approving sizable capital expenditure (Banks Reports, 2010).

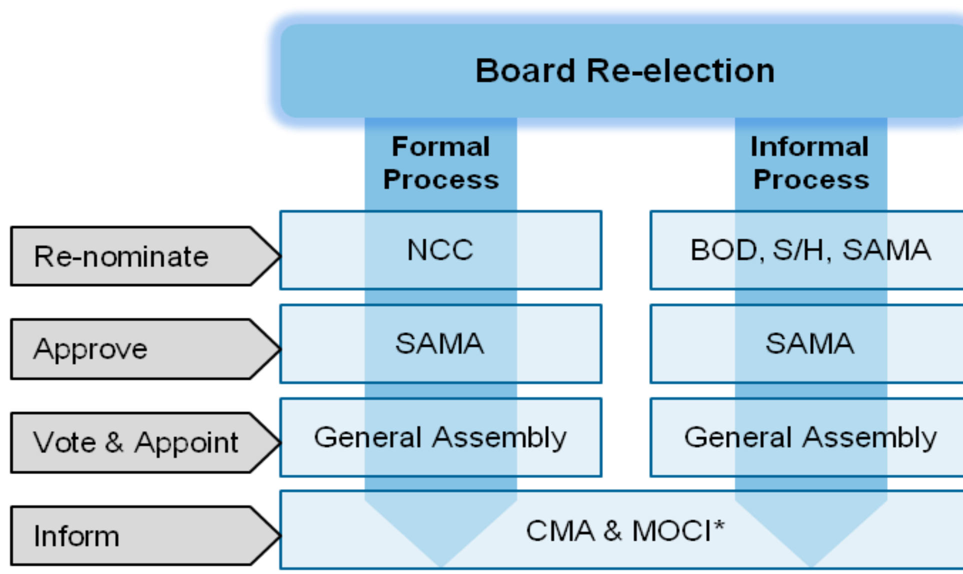

Figure 5.1 Formal and informal board re-election process
* Ministry of Commerce and Industry

The banks should consult with SAMA for approval, expressing the interests of the existing board members to serve for an additional term. The Banking Control Law (1966) states that:

> *"No person shall be elected as a director or shall become a manager of any bank without prior written approval of the Agency".*

The issue of SAMA's approval in directors' selection is restated in SAMA's recent publication on Principles of Corporate Governance for Banks Operating in Saudi Arabia (SAMA CGR) (2012) stating that:

> *"The bank should consult with and inform SAMA and obtain its written non-objection before the nomination for the appointment or removal of any board member or any employee from senior management".*

The reason that the formal process starts with the NCC is due to regulatory requirements that necessitate mandated banks to have an NCC. The CMA that regulates the capital market issued a resolution in 2010 to mandate all listing companies to establish an NCC[23].

The CMA Corporate Governance Regulations (2010) states that:

> *"The board of directors [of listed companies] shall set up a committee to be named the Nomination and Remuneration Committee."*

[23] Note that CMA names the committee as Nomination and Remuneration Committee while SAMA names it as Nomination and Compensation Committee. For consistency, NCC is used throughout the thesis.

Its main function is to:

> *"Recommend to the Board of Directors appointments to membership of the board in accordance with the approved policies and standards ... and the preparation of a description of the required capabilities and qualifications for such membership."*

Simultaneously, SAMA, which is responsible for regulating the commercial banks, released their rules on compensation and nomination practices in 2010, asking all banks to implement similar guidelines. Prior to the existence of the NCC, boards of the commercial banks and other actors (i.e., controlling shareholders or SAMA) would start the re-nomination process.

The SAMA CGR (2012) states that:

> *"Each bank should form a Nomination and Compensation Committee (NCC)."*

Hence, the main function of the NCC is to:

> *"The functions of the committee include reviewing the curriculum vitae and evaluation of nominated members of the board ... the committee shall interview the [board] candidates and examine their qualifications."*

Some interviewees questioned the significance of having NCC and claim that the formation of NCC is to show compliance with regulatory requirements:

> *GB2: "I can't see anything new that has changed with NCC except that they [SAMA] want more paperwork to be done. Yes, we have to go by SAMA rules but at the end of the day, we [the board] are in charge of our business not just the NCC."*

Another board member argues that the NCC has no substantial role due to management control[24].

> *SB1: "Before we had the [NCC] committee, the [board] chairman and some other board members were controlling what NCC is supposed to do. Now [with NCC], they are still in control 'officially' as chairman and members of the [NCC] committee and no one would question them. For example, the chairman fired our CEO and brought a new CEO without going back to us [the board]."*

[24] Management control means the control of CEO, board chairman or any board member.

However, other interviewees do see the intervention of SAMA more positively. SAMA has created a secure level of screening of directors that is deemed necessary by some boards.

> *GACC: "It is very important that SAMA is involved in the selection of directors because we can't validate the qualifications of the new directors."*

This is reinforced by the comment of another director emphasising SAMA's role in directors' selection:

> *GB4: "SAMA is responsible for banking business and therefore should carefully appoint those people who are trustworthy."*

Interestingly, a board chairman believes that SAMA intervention is good for banks:

> *SBC: "When SAMA decides on who sits on the board, then banks should not be worried about the background and credentials of those who are selected! This way we [the banks] will be more focused on getting things done rather than wasting time watching them fearing the unexpected."*

Most of the respondents stress that it is difficult for an individual to join a bank's board due to SAMA restrictions and the limited possibilities to find individuals with the required knowledge of financial institutes.

> *GB2: "Do you think SAMA will choose an unknown person from the public to be in charge of making decisions that might have a disastrous effect on us? I do not think so. I trust SAMA to choose what is best for banks and the country. It [SAMA] has its own standards that are keeping our financial system safe in these terrible times. Also, show me those who are capable of running our banks. Having a degree in business or inheriting a family business doesn't make someone a good [bank] director."*

In contrast to those directors who are in support of SAMA intervention, a small number of directors question the real added value of the SAMA role. They claim that the banks' stakeholders should have the capacity to select qualified directors without internal or external pressures.

> *ICEO: "Each bank is supposed to have its own charter that lays out the process of directors' appointment in accordance with the bank's strategic and operational goals. Banks are different in their strategic and operational goals*

so SAMA may be used to help banks in finding qualified directors but not to force appointments of directors who may not be in line with these goals."

In some cases, SAMA (or the controlling shareholders) may reject the re-nomination of a director, in which case there is an informal process to support that director or nominate a replacement. In most cases, a director would not run for re-election without the support of the controlling shareholders and his board members to obtain SAMA's approval. Thus, the controlling shareholders of a bank work closely with SAMA to nominate and select individual directors who are more likely to be approved by SAMA. Therefore, this informal process considers personal and professional relationships to select individual directors who are closely related to the main actors (e.g. controlling shareholders and SAMA). This is explained further within section 5.2.2.

Recruitment of board directors in the case banks

While the aforementioned general process holds good for any bank, there are differences that are visible in the specific case banks as follows.

The board of the Government Bank (Table 5.1) is composed of eight directors of whom four (including the board chairman) are selected and appointed by the Minister of Finance (MOF). The involvement of MOF in the directors' selection is specific to the government bank only and thus MOF was not part of the standard selection process as highlighted in Figures 5.1 and 5.2.

Table 5.1: Government Bank	
Facts	Ownership: Government 80% | Not listed Capital: US$4bn | Assets: US$75bn
Board of Directors (BOD)	• Eight Directors (seven non-executive directors & CEO) • Four appointed by government including the chairman
Nomination and Compensation Committee (NCC)	• Four Directors (non-executive directors) • Head of NCC: Chairman of the board
Audit Committee (AC)	• Five Directors (three non-executives & two outside the bank) • Head of AC: Government Representative

Government Bank Financial Reports 2010/11

The appointments made by the Minister of Finance are not subject to the SAMA approval process, as those selected directors are active or retired government officials holding senior positions (e.g., minister, deputy minister or governor).

GB2: "I[25] *was appointed by the [Finance] Minister with the other three [board] members. He [the Minister] called me asking me to join the bank and [I] could not refuse his request."*

In the context of the International Bank (Table 5.2), the charter of the bank states that:

"The board of directors is composed of ten members of whom six represent the Saudi shareholders and are appointed in the ordinary general assembly meeting for a term of three years. The remaining four members [including the CEO] are appointed by [the foreign partner]."

However, the appointments of the joint venture representatives have to be cleared with SAMA before formal appointments.

In the context of the Islamic Bank (Table 5.3) which is mainly controlled by a small number of Saudi families, the board and sub-committees are dominated by these families. For example, one board member claims that certain other board members are systematically appointed and re-appointed due to the ownership structure. The controlling shareholders in some banks are family businesses and those families have representatives on the bank's board.

GAC2: "There are people on our board and many other boards who are there because their families have big shares. I know a CEO in one bank who runs it like a family business with no regard to anybody else in the bank."

Table 5.2: International Bank	
Facts	Ownership: Foreign Partner 40% | Listed Capital: US$2.2bn | Assets: US$31bn
Board of Directors (BOD)	• Ten Directors (five independent, four not independent & CEO) • Four appointed by foreign partner including the CEO
Nomination and Compensation Committee (NCC)	• Five Directors (two independent, a non-independent & CEO) • Head of NCC: CEO*
Audit Committee (AC)	• Three Directors (a board member & two outside the bank) • Head of AC: Foreign Partner Representative (not independent)

International Bank Financial Reports 2010/11
**The executive committee was assuming NCC functions until 2011 when NCC was formed.*

Consequently, the next step in the recruitment process is that a bank will hold a general assembly meeting, after securing SAMA approval, for the shareholders[26] to formally nominate and vote for the appointment of the re-elected (or new) directors under the

[25] This director is a former governor and active chairman (or member) of other boards.
[26] Each shareholder holding at least (10) shares will have the right to attend the assembly meeting and vote.

supervision of SAMA and the MOCI). Some interviewees contend that decisions on selecting directors are made before the general assembly meeting but banks hold these meetings to fulfil the regulatory requirements.

> *GB1: "When I was approached to join the board, he [board chairman] didn't talk about the general assembly and I was not bothered about attending the meeting. To be honest, it was a done deal for me."*

Table 5.3: Islamic Bank	
Facts	Ownership: Saudi Arabian Investors 90% | Listed Capital: US$800ml | Assets: US$9bn
Board of Directors (BOD)	• Nine Directors (six independent, three non-executives) • Three of the controlling shareholders are on board
Nomination and Compensation Committee (NCC)	• Three Directors (two independent & a non-executive) • Head of NCC: Chairman of the Board
Audit Committee (AC)	• Four Directors (a board member & three outside the bank) • Head of AC: Government Representative* (non-executive)

Islamic Bank Financial Reports 2010/11
**The government owns 5% of the bank's shares.*

Recruitment of audit committee members

With respect to audit committees, the selection process of the committee members is the responsibility of the board of directors but SAMA approval is required. For example, the guidelines of SAMA for organising audit committees in banks (1994) state that:

> *"The [audit] committee is selected by the board and has a direct reporting relationship to the board as a whole… The appointment of all members of the [audit] committee will be cleared with SAMA."*
>
> *"For the appointment of all audit committee members including the chairman, a 'no objection' from SAMA should be obtained."*

Confirming the previous statement, an audit committee member argues that the membership at the AC level is similar to those of boards where banks are required to obtain SAMA approval.

> *SAC1: "It is very hard to join a board of any bank unless you have proper qualifications and proper contacts. This applies to board committees, especially the audit committee, which is seen as being very important and a sensitive board committee. Because of its importance, the [audit] committee chairman has to be a board member."*

The previous statement suggests that audit committees' memberships are subject to SAMA control, as well as the committee's chairperson who should be a board member, as per SAMA regulations[27], as follows:

> *"One of the members of the board shall be appointed as the chairman of the [audit] committee by the board of directors. He shall serve for a minimum of three years in this capacity. Furthermore, he shall not be the chairman of the board, or related to any member of the board or senior management of the bank. He should be approved by SAMA."*
>
> *"While the members of this committee would be highly qualified individuals from within and outside of the Board, the* ***Chairman of the Committee must always be a member of the board of directors*** *and is a non-executive."*

Interestingly, the audit committees' chairmen in all of the case banks are representatives of the controlling shareholders (Banks Reports, 2010) and concurrently are board members. Surprisingly, the case banks are not in compliance with their own charters or regulatory recommendations. For example, one of the case banks has appointed one of the board members as a chairman of the audit committee while the charter clearly states that "*the chairman of the Audit Committee* ***cannot*** *be a bank board member.*"

On the other hand, another case bank contravenes SAMA rules by appointing an audit committee chairman who is associated with the CEO, with both directors being part of the foreign firm that has joint venture partnership with the local bank. This practice challenges SAMA rules on ACs that "*the Chairman of the audit committee should not have any relationship with executive directors or key executives of the bank that could affect his independence*."

The approval process of directors' selection by SAMA lacks transparency as argued by some directors.

> *ICEO: "Banks have to get SAMA approval to appoint [AC] directors which worries me in terms of selecting the right people for the job. SAMA selection requirements are vague and can be interpreted in many different ways. I think SAMA should give banks the opportunity to choose their AC directors following the standards of best practices."*

[27] SAMA Guidelines Manual for Regulating Audit Committees in Saudi Banks, 1994

Furthermore, the audit committee in the Government Bank is composed of five members, of whom three are board members while SAMA rules stipulate that "*the [audit] committee members from* ***outside*** *the Board shall be* ***more than*** *those from* ***inside*** *the Board*." Although the composition of the government bank's audit committee is not in compliance, SAMA approval of the committee's formation implies that SAMA treats banks differently and thus has implicit collusion with the government bank in this particular case.

The appointments of the audit committee members are put into effect upon SAMA approval, as mentioned earlier. However, the process is slightly different with CMA, whereby the appointments of the audit committee members have to be formally performed through the general assembly of shareholders. The CMA CGR (2010) states that:

> *"The General Assembly of shareholders shall, upon a recommendation of the Board of Directors, issue rules for appointing the members of the Audit Committee and define the term of their office and the procedure to be followed by the Committee."*

The audit committee membership term is three years and is tied to the term of the board of directors, which expires upon the appointment of a new board. In the event of a new board of directors, the new board may re-appoint the existing audit committee or any of the existing members for another three years or appoint a new audit committee.

Finally, the names of the new board (or AC) members will be recorded by MOCI and CMA (if the bank is listed) and will be published and listed on the Saudi Stock Exchange (Tadawul) website. However, if a director (or the board as a group) was rejected by SAMA then it will be treated as a board vacancy. The bank will then start searching for new candidates, and will have to identify and screen prospective directors before seeking SAMA approval.

5.2.2 Formal and informal board vacancy or expansion process

This section discusses the formal and informal selection process for board vacancy or expansion positions. As illustrated in Figure 5.2, NCC initiates the process by identifying prospective board candidates and then making recommendations to the existing board to review (jointly with management) the candidates' profiles and interview those who have the potential to be selected.

In practice, the prospective board candidates are identified by the controlling actors in and beyond boardrooms, namely; the chairman of the board, CEO, controlling shareholders and SAMA.

> *GB4: "The chairman recommendations are taken into consideration when there is a new [board] term. This is a government bank and he has direct contact with the person [Minister of Finance] who is responsible for the selection of government representatives."*
>
> *SBC: "SAMA has the authority to reject any board nomination while it has the authority to directly appoint a board member in those banks that are controlled by government. I remember when SAMA appointed one of its people to be the CEO of Riyad bank after its merger with Al-Watany bank."*

Those actors utilise the informal process in order to supersede any written charters, regulations or rules to undertake desirable actions as mentioned in the previous section. This occurs where some directors are appointed due to personal or professional relationships (as in the Islamic and International Banks) or due to the influence of the controlling shareholders as in the case of the Government Bank.

The formal process for appointing a new director is similar to the one for re-electing a director. However, the underlying process signifies the importance of existing boards of banks and influential actors when selecting directors who are capable of continuing and maintaining the "work" and "process" of retiring boards.

A number of interviewees state that a controlling shareholder may wish to exercise his power over the boardroom to expropriate minorities' voting rights and to exploit private benefits.

> IB1: "*controlling shareholders may push to grant loans to individuals or companies without proper security to guarantee repayment because they [controlling shareholders] have common interests with those people.*"
>
> *GB3: "It is a government bank and if they want, they can give loans or facilitate financial access for individuals and companies."*

To retain the ability to behave in this way the shareholder must ensure that new members on the board can be controlled. One board member (SB2) comments that "*when you have this complex network and shared business interests, those people in control will do everything to keep their control and to keep the business as usual by*

having family members or relatives on board." Furthermore, another board member confirms the previous statement saying that when a board member is about to retire:

> *SB1: "Plan to appoint his son or relative to replace him to keep a strong family presence in the boardroom. Other directors, of course, will not refuse such a thing because some of them owe their presence [in boardroom] to the retiring director."*

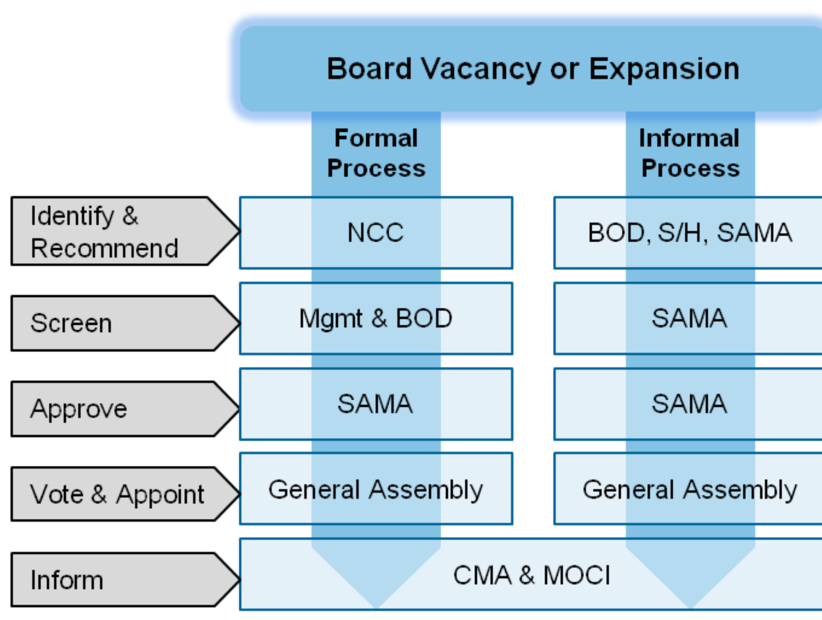

Figure 5.2 Formal and informal board vacancy/expansion process

The interesting part of selecting and appointing new directors is the counterbalance of power between stakeholders, especially the controlling shareholders and regulators (i.e., SAMA). In most cases, SAMA would ratify the choices of controlling shareholders to appoint their nominees simply because they limit their choices to themselves (or their representatives), as they exercise their voting rights, or they choose directors who are "in line" with SAMA selection requirements. These requirements are not defined or known to the public but those actors come to realise them over time and by interacting with SAMA. A board member (GB3) offers an interesting view of this by saying that "*SAMA needs loyal and collaborative people on boards to maintain stability of the financial system by keeping banks under their control. So, people outside the banking system know the difficulties of being a board member in any bank without the help of SAMA. Therefore, when someone is brought in and approved by SAMA, this person will not challenge or think of making noises that would bring attention to what directors are actually doing*." This director justifies the actions of directors to join boards while they remain controlled by others claiming that he "*… know(s) that most of the [board of] directors are not adding value to boards but*

this is the way of life here. When you receive a call from a minister or an old friend to join their boards, you have to show respect and accept their invitations. At the end of the day, you might be the only trusted person for them to be on their boards."

On the other hand, SAMA recognises the effort that controlling shareholders are making to comply with their selection requirements by supporting these banks in financial crises and providing directors with secretive protection. For example, banks have to obtain SAMA approval for any director removal, which means that SAMA may overrule any dismissal of a director. Moreover, all of the interviewees' directors claim that the issue of a director's dismissal or termination has never happened or been documented. It might be illogical to find a single case of a director's dismissal or termination in a banking system that has been in business since 1952.

> *GB4: "Termination of a [board] member for any reason is one of the sensitive issues. Mainly, we did not hear of any director who had been terminated, but mostly, the director who does not wish to continue may withdraw or complete the term, but the issue of termination has never been the case".*

The issue of these unique relationships between SAMA and banks are discussed in more detail later in Chapter 7 of this thesis.

The formal and informal selection process for a board vacancy or expansion position continues after the screening stage subject to the approval of SAMA. Next is the formal voting and appointment of directors at the general assembly meeting, followed by informing CMA and MOCI of the names of new directors.

5.3 Determinants of Director Selection

This section provides evidence relating to directors' selection factors that can be categorised into two distinct determinants — rational and social determinants. It starts with the rational determinants of director selection, considering director's capital, board diversity and institutional influences. The section then concludes with the social determinants of director selection, together with consideration of director's capital, board cohesion and social and institutional influences on the director selection process.

5.3.1 The rational determinants of director selection

The rational determinants of director selection concern the prospective candidates' abilities that relate to their capacity to provide economic benefits based on the needs of the firm and its shareholders.

The focus of this section is to provide empirical evidence relating to the rational determinants of director selection in terms of director capital, board diversity and institutional influences.

Board capital

Board capital encompasses the human and social abilities of a director to perform his board functions. Human capital refers to the director's skills, knowledge and experience, whereas social capital refers to the director's reputation and network connections.

Literature suggests that directors are selected and appointed based on the specific human capital that they bring to boards so as to benefit banks. The interviewee directors show that the case banks seek certain and relevant human capital when selecting prospective directors. Candidates with banking knowledge and leadership skills, together with business (not specifically banking) experience are more likely to gain directorships.

A board's chairman indicates that the selection of banking directors is quite competitive due to a shortage of qualified individuals. Banks are in competition to select the right and the best 'potential' directors or executives from a limited pool of individuals.

> *SBC: "Finding the right person for the job is very hard because we do not have many Saudis in banking. So, board members may serve for long periods because they cannot find experienced replacements. The other way is to hunt for those who have the capabilities and happen to be with you on other boards."*

Another board member argues that board memberships in banking are different from other industries due to the nature of the financial sector and strict regulations:

> *GACC: "The selection of directors in banking business is to meet the needs of these banks and is also subject to strict regulations. It is a very complex and dangerous environment to work for a bank, so if you do not have the qualifications you will not be on-board."*

The previous director's statement makes reference to SAMA directors' qualifications requirements that "*Board of Directors should be of a high level of knowledge, experience and skill, in addition to having a continuous desire to learn and develop*."

However, a board member is making the following statement to justify the long tenure of his board chairman, suggesting that his long term of service has given him the capacity to continue leading the board, provided that the controlling shareholders are satisfied with his performance.

> *IB2: "The chairman [of the board] has been re-elected for many years [31 years] simply because he has the knowledge and experience to run the bank. The bank is making profits and the shareholders are satisfied with his performance, so why change him?"*

Similarly, directors are selected and appointed based on the specific social capital that they bring to boards to benefit banks. The director's network of appointments and relationships is regarded by some interviewees as a sign of good reputation and proficiency. A board member argues that a director who develops a personal reputation of being trustworthy in boardrooms will strive to retain this reputation, as it becomes a quality of a director to be selected for appointments.

> *IB2: "When you work for many years and you become a well-known person in your area of business, then you will fight to keep your name clean and I guarantee you that you will be easily selected for more boards."*

The interviewees are sensitive about the issue of reputation as they agree that the extent of damage to a director's reputation is beyond recovery.

> *SB1: "Your name is not just important in the market but also in your social life. If you lose it for any reason then you lose everything. Our business life is very much attached to our social life. This is our culture and way of life."*

On the other hand, respondents recognise the importance of a director's networks and connections to banks. They highlight that access to resources through these networks and relationships provide banks with a competitive advantage.

> *SACC: "Sitting on a number of boards gives us [the bank] the chances to access business opportunities and in return, provide financial services."*

Another board member in the Government Bank argues that the presence of senior government officials on a board benefits the bank in securing access to resources.

> *GB4: "They [senior government officials] can bring you business and opportunities because of their contacts."*

Noting the importance of multiple directorships, a board chairman claims that directors with multiple board memberships can bring a diversity of experience to their boards and provide access to external resources.

> *SBC: "Our board members have many memberships in different companies and businesses, which helps us [the board] to exchange experience and share knowledge. Those directors bridge the gaps with important players in our business environment."*

Board diversity

This section provides evidence relating to board diversity in terms of selecting board members with different views, backgrounds or experiences. The basic assumption of board diversity is to enhance the board's ability to make better decisions and thus achieve better performance. When directors have different views or backgrounds, they look at problems (and solutions) in a more innovative way.

Some interviewees argue that diversity improves the knowledge base of directors that effectively contributes to the decision-making process in the boardroom. A board member suggests that diversity is significant to the work of his board and can enhance the decision-making process.

> *SB1: "We have different people on the board coming from different backgrounds and in different businesses. I think this is helpful because not everyone has the knowledge of everything but we help each other on specific issues to make decisions."*

This is reinforced by the comments of a board chairman who confirms that diversity is an important factor in providing key resources to banks.

> *SBC: "Diversity of directors' qualifications in the boardroom not only brings resources to the bank but also brings knowledge and expertise of those who hold multiple directorships."*

Further, the board chairman continues to confirm that the board's diversity may create some distance between directors in terms of intellectual capabilities, however the board is able to overcome this by selecting directors who possess social and cultural values and norms.

> *SBC: "Our board members share common things amongst them so they act as one team regardless of the business type they work in or the types of boards they sit on.*

They are different in how they approach and solve problems but of course they work together and contribute collectively to resolve problems and make decisions."

The responses suggested that banks are claiming to be keen on board diversity in order to gain the potential benefits of such diversity. However, there is a gap between a potential situation and reality, where directors' quotes showed that they often feel annoyed by individuals with views and backgrounds very different from their own. The perception of diversity appears to be limited to select directors who may have diverse 'business' backgrounds but share the same background 'values' and social identity.

<u>Institutional influence</u>

At a macro-level, it has been argued that firms tend to select and appoint directors in response to external factors relating to organisational and environmental changes (Zahra and Pearce, 1989; Finkelstein et al., 2009) or legal and regulatory requirements (Luoma and Goodstein, 1999).

The banking environment influences the selection of directors whereas banks' stakeholders search for directors who have the qualifications and qualities to be a bank's board member. The form of these qualifications and qualities might be tangible or intangible, and formal or informal. For example, banks insist on selecting directors who have related banking expertise or board experience, because they claim that the complexity of the banking environment requires directors to manage risks and uncertainties. Therefore, many responses suggest that recruiting directors with banking experience may be limited due to a shortage of qualified individuals and thus, banks tend to hire expatriates to assume management positions.

A board member explains that boards' memberships require certain qualities of leadership.

> *SB2: "Directors in banks are people who spent many years working for banks or in leadership positions. They know how to run the business and how to deal with difficult times. We are dealing with people's money and if we fail, the whole system fails.*

Similarly, a board member confirms that working for a banking board is a unique experience that is different to other type of businesses.

ICEO: "Working for a bank is completely different from any other business. The degree of risk and complexity requires great attention from directors. I cannot say that all of our directors have the same level of attention, but they complement each other."

Furthermore, the CEO contends that the formal requirements for the foreign partner to appoint four directors to the board is "*helping the bank to have directors with banking experience*" which, in return, will ensure that "*shareholders have confidence in the management of the bank*." A possible explanation of the CEO's previous statement is to justify the control of a foreign partner over the selection and appointment of half of the board, provided that the perspective of the value added by international bankers to banking boards was not commonly mentioned prior to the financial crisis.

The legal framework dictates that banks follow certain processes of selection, as discussed in Section 5.2. There are formal and informal processes that banks have to follow in order to appoint directors. The involvement of SAMA (and MOF) in a bank selection process might protect some stakeholders or be in the national interest.

A board chairman explains that SAMA's process of approving directors' selection reassures banks in their selections.

SBC: "SAMA has the ultimate say on appointing directors. Usually, they do not reject directors unless there is something 'fishy' about the nominee or the combination of the board does not fit. There is no doubt that they work hard to protect our financial system and so they pay close attention to those who run banks."

5.3.2 The social determinants of director selection

The social determinants of director selection are related to the fact that the selected directors are not necessarily those individuals who can optimally serve the best interests of the banks overall but, rather, reflect the preferences and biases of those who are charged with the director selection.

The focus of this section is to provide empirical evidence relating to the social determinants of director selection in terms of director capital, board cohesion and social and institutional influences.

Board capital

A director has human or social capital that affects the process of his selection to a board. The director's capital includes interpersonal behaviour, their reputation and personal and professional relationships.

However the findings from the case interviews suggest that directors who develop ingratiating behaviour toward influential directors[28] are most likely to be selected and appointed to boards. The ingratiating behaviour is evidenced by the director's willingness to ratify management decisions without challenging the decision-maker or demanding explanations. A board member in the Government Bank indicates that directors who lack professional credentials tend to engage in ingratiating behaviour in order to gain access to board appointments.

> *GAC2: "I have seen many 'yes' directors who feel inferior to others. They joined the board and yet do not know their roles. I think the shortest way for them to join boards is to continue blessing others' decisions."*

The ingratiating behaviour or passivity of some directors is argued by interviewees as being part of the corporate culture that individuals take for granted. The following statement illustrates this notion of thinking in boardrooms.

> *ICEO: "It is common to see directors who are just there [on board] to complement the number of the board of directors. Most of these types of people are appointed to boards because of their connections. They do not add value to the work of the board... it is like the old saying 'you can't get blood out of stone'."*

Reputation[29] is a human capital of a director that can lead to appointment gain. In the Government Bank, there are senior government officials on board to gain access to government support and to maintain the prestigious setting of the bank.

> *GB1: "The Minister of Finance appoints those retired directors to maintain contact with him and other government entities. The other active directors are senior government officials who do not have the time for us but it is their name and job title that matter."*

Another board member confirms the previous statement saying that:

[28] Influential directors include the chairman of the board, the CEO or a controlling shareholder representative.
[29] Social class or title is regarded as part of a director's reputation.

GB2: "The chairman of the audit committee holds a senior position in the government and is a member of many boards and committees. Why do they choose him? I have no doubt that he was chosen to limit SAMA control over the bank."

Some other directors join board sub-committees such as the audit committees, for different reasons that may include searching for a professional career or building a reputation. This is reinforced by the comments of an audit committee member.

GAC1: "I am delighted and honoured to be on this bank's audit committee. It is an opportunity that may not happen again and therefore, I chose to leave my previous [audit committee] position at a petro-chemical company".

GAC1: "There is no doubt among us [directors] that being on an audit committee of a bank is a huge step forward in any professional career and on a social level as well".

<u>Board cohesion</u>

Despite the differences of the case banks in terms of ownership structure and type of services and products (Islamic versus conventional), all case banks' boards tend to be socially similar.

These boards maintain similarity in a board's structure, their demographics and personal characteristics. For example, it would be logical to assume that the board (or its subcommittees) of the Islamic Bank has an Islamic background or Islamic educational credentials, but in fact the whole of the board members come from competitive and conventional banks and some of them are active members of non-Islamic compliance firms' boards. An audit committee member of the Islamic Bank states that although such banks may provide Islamic products and services they are governed by SAMA conventional banking laws.

SAC1: "We provide Islamic services and products based on the recommendations and approvals of our Shariah committee. All banks in Saudi Arabia are the same when it comes to SAMA because SAMA does not have a written law on Islamic banking."

Another board member, however, states that board members rotate and limit board memberships to their closed group.

IAC1: "The directors of banks have not changed for the last twenty years or so. They exchange seats sometimes but you can see the same family names over and over."

Furthermore, a board member argues that banks' owners and directors are related in different ways.

SB2: "When you look at the names of directors in all banks, you will see names that share common things like related family members, being regionally related or business related."

The previous statement suggests that a director needs to be a social fit to be part of the 'elite and social' network. A board member argues that in diverse boards, the decision-making process tends to be slower due to the fact that communications and coordination become formal and less effective.

ICEO: "Board members tend to recruit other board members from their network. That is either their social network or from other boards they have been on. It's kind of comfortable to have people they know and trust."

Social influence

In the context of this research, some board members (i.e., CEO or the chairman of a board) tend to exercise influence over the board selection process by favouring personal friends and other individuals with whom they have close social ties. In fact, some interviewees confirm that directors who represent controlling shareholders exercise similar influence over the selection process.

In the Government and International Banks, the controlling shareholders have the legal right to directly appoint their representatives, which implies that the selected directors do not necessarily hold accountability to the board. For example, directors in the Government Bank have special relationships with the Minister of Finance who appointed them, and this relationship promotes informal meetings and communications.

GB3: "The chairman [of the board] is very knowledgeable and experienced but there is a gap between us and him. I think the support he gets from outside [MOF] gives him confidence to act alone sometimes."

Furthermore, a board member acknowledges that most of the directors have been selected due to their connections rather than their professional qualifications.

> GAC2: "Many of the bank members are ex-government employees, even current officials whose average ages are relatively high and they have not worked for banking, nor do they have proper qualifications."

Nevertheless, appointments based on representative models can potentially undermine the effectiveness of the board since directors are more likely to show loyalty to those they represent and those who had initial influence on their appointment. Directors are primarily concerned with the interests of those they represent rather than the interest and success of the bank.

Banks may appoint certain directors to serve for social purposes rather than for economic justification. For example, all case banks started to select and appoint professors in finance and accounting to audit committees after it became mandatory for banks to establish audit committees. However, audit committee members claim that their existence is to comply with legal requirements without providing substantial benefits to banks.

> *IAC2: "Banks started appointing specialists to the board's sub-committees, for instance, specialists in accounting and finance to audit committees, not because they are satisfied with their roles, but as a way to comply with regulatory requirements."*

Furthermore, another audit committee member (IAC1) from the International Bank argues that "*the control over the [audit] committee is in the hands of the committee chairman who is representing the controlling shareholder. The chairman and the CEO are very close which gives us no chance to highlight any wrongdoings to the board*."

5.4 Summary and Conclusions

This chapter provided empirical evidence relating to the process that drives the selection of individuals to boards and audit committees in Saudi banks. It has provided some interesting insights on the formal and informal factors, as well as the determinants, of the directors' selection process.

The directors' selection process is the formal process by which individuals are identified, screened, nominated and appointed to corporate boards. The selection of directors has a twofold approach, namely; formal and informal board re-election processes and formal and informal board vacancies or expansion processes. Each approach has certain steps that directors need to fulfil in order to be selected. However, it was evident that both approaches are influenced by the controlling shareholders and

SAMA. Furthermore, the selection process of board and management members is subject to SAMA approvals and thus, other stakeholders' roles in the selection process are insignificant. Moreover, banks have adopted NCC in response to regulatory requirements with limited scope which is mainly relevant to directors' compensation plans and does not have any substantive role in the selection process.

The chapter shows that the directors' selection process is influenced more by external pressures such as controlling shareholders or regulatory authority (e.g., SAMA) and that, selected directors are significantly influenced by personal ties and relationships. This implies that those selected directors are perceived to be 'shadow directors' who may not be selected due to their qualifications but, rather, to their loyalty to protect the interests of those who selected them (hence the controlling shareholders). Furthermore, Saudi banks are dominated by the government and a few prominent families who eventually occupy most of the boards' seats. Therefore, they or their representatives tend to serve on boards for considerable periods of time. Most of the respondents stressed that it is difficult for an individual to join a bank's board due to, both, regulatory restrictions imposed by SAMA – with the support of controlling shareholders families - and due to the limited selection of qualified individuals.

Although the director selection process is similar, each bank shows different interests in selecting directors to serve particular roles. For example, the government bank tends to appoint directors who can provide legitimacy and access to government resources. However, in the international and Islamic banks, the presence of controlling shareholders, who occupy half of the board seats in both banks, is more likely to maintain control over the decision-making process and also provide access to critical resources though pyramidal ownership structure and close ties to government.

The selection process of audit committee members is identical in all banks. Paradoxically, banks select highly qualified members but their selection does not materialise as they continue to depend on external auditors and, at the same time, undermine the AC role. The plausible justification of this 'symbolic' selection represents a bank's response to institutional pressure to select AC directors with certain qualifications. A key issue is that in their effort to maintain control over ACs, the chairperson of each AC in the case banks is a representative of the controlling shareholders.

Moreover, this chapter provides evidence that there are two main determinants of the directors' selection process, namely; rational and social determinants. The rational

determinants of director selection are concerned with the prospective candidates' abilities that relate to their capacity of providing economic benefits based on the needs of the firm and its shareholders. The social determinants of director selection are related to the fact that the selected directors are not necessarily those who can optimally serve the best interests of the banks overall but, rather, reflect the preferences and biases of those who are charged with the director selection process. However, due to shortage of qualified individuals, banks tend to rely more on the social determinants whereby directors social skills, reputation and network connections provide banks with a competitive advantage in securing access to external resources. The selection of directors with long terms of government service is a classical example.

The evidence provided in the chapter also suggests that a director's human or social capital affects the process of his selection to boards. The most sought after capital includes interpersonal behaviour, reputation and personal and professional relationships. However, potential directors with ingratiating behaviour toward influential directors are most likely to be selected and appointed to boards. The ingratiating behaviour of some directors is argued by interviewees as being part of the corporate culture that individuals take for granted. The evidence shows that directors join audit committees for different reasons that may in some cases include searching for a professional career or building a reputation that would promote him to join subsequent boards. However, the perceptions reported by interviewees suggest that any board that lacks individual directors who possess the necessary mix of human and social capital is more likely to have negative implications in performing monitoring and resource provisioning functions.

The evidence shows that directors are primarily concerned with the interests of those they represent rather than the interest and success of the bank. which could potentially undermine the effectiveness of the board since directors are more likely to show loyalty to those they represent and to those who had initial influence on their appointment. Banks may appoint certain directors to serve for social purposes rather than for economic justification. For example, all case banks started to select and appoint professors in finance and accounting to audit committees after it became mandatory for banks to establish audit committees. However, audit committee members claim that their existence is to comply with legal requirements without providing substantial benefits to banks. The nature of how board members are selected

is one factor affecting the contribution of directors and their involvement in board meetings. For example, directors who are selected based on pre-existing relationships are especially reluctant to bring matters to the boardroom which would challenge management or the chairman, as this may ultimately impair their independence, as suggested by some responses.

The chapter provides evidence related to how banks are claiming to be keen on board diversity in order to gain potential benefits of diversity among directors. The evidence shows that there is a gap between a potential situation and reality, where directors' quotes from the interviews showed that they often feel annoyed by individuals with views and backgrounds very different from their own. The perception of diversity appears to be limited to selecting directors who may have diverse 'business' backgrounds but share the same cultural background 'values' and social identity. However, some board members assert that boards are able to overcome this by selecting directors who possess social and cultural values and norms.

Despite the differences of the case banks in terms of ownership structure and type of services and products (Islamic versus conventional), all case banks' boards tend to be socially similar. All of the boards have similar structures, demographics and personal characteristics.

The behaviour of the Saudi banks actors is consistent with the expectations of the NIS theory. It may be argued that the similarity among the case banks' boards structures reflect coercive isomorphism, where they are forced to change their directors' selection processes due to formal and informal pressures applied by external forces or actors (DiMaggio and Powell, 1983). At the same time, banks actors may engage in activities that would signal legitimacy to outsiders, such as holding AGMs to approve directors' selection, but in reality these activities are more likely to be of ceremonial nature. Furthermore, this could also be indicative of mimetic behaviour, where case banks might be following established practices for the sake of defending their legitimacy, as for example, by selecting a certain category of professionals (academics) to serve on audit committees.

Moreover, the selection of 'academics' to serve on ACs could also be indicative of normative pressure steming from SOCPA[30],. Membership of SOCPA is being used as an entry criterion to senior posts within banks thus diffusing the profession throughout ythe organisational field. The organisational re-configurations of banks, due to

[30] Saudi Organisation for Certified Public Accountants

changing legislation, or coercive authority, can be in large part ceremonial, but that does not mean that they are inconsequential. Rather, they convey the message to the various stakeholders in the bank that the bank is responsive to the preferences of the society in which it operates. This adherence to societal preferences helps the organisation to secure economic resources, influence and power (DiMaggio and Powell, 1983; Meyer and Rowan, 1991). Thus, the search for legitimacy may push firms to adopt organisational structures and practices for a ceremonial purpose rather than for rational reasons of improving efficiency (Meyer and Rowan, 1977).

The chapter provides evidence related the importance of the governance roles of informal social networks that link an organisation with its external partners. When the formal external governance mechanisms are weak, informal mechanisms may provide proper substitutions. The use of informal communications, for example, to resolve conflicts within and/or outside banks is perceived to be a valuable mechanism.

In sum, institutional theorists argue that board composition will be determined largely by prevailing institutionalised norms in the organisational field and society. The institutional perspective suggests that boards of organisations in the same institutional setting will tend to be more similar to each other than to the boards of organisations outside of their set (DiMaggio and Powell, 1983). On the one hand organisations may strategically comply with the institutional demands for more outside directors, while subtly limiting the independence of the board on the other hand. Thus, the institutional perspective argues that greater outside board representation is not necessarily linked with higher firm performance. However, external ties through board members help the focal organisation in gaining legitimacy and reputation. Within institutional influences, there are some invisible forces pressing the organisation to adhere to taken-for-granted rules and norms (Oliver, 1991). Nevertheless, institutional pressures do not automatically force an organisation to conform. Indeed, various powers and interests within an organisation will determine how its actors respond to such pressures.

However, the current selection process of directors has implications for the dynamics and interactions of directors in and beyond boardrooms that may affect their contributions to the company as discussed in the following chapter.

CHAPTER 6: DIRECTOR DYNAMICS AND INTERACTIONS

6.1 Introduction

This chapter provides empirical evidence relating to the dynamics and interactions of directors both in and beyond boardrooms (Figure 6.1). The chapter is structured as follows. Section 6.2 is primarily concerned with the board of directors' interactions, including the roles of the board, boardroom climate and the influence of the board chair. Sections 6.3 and 6.4 are mainly concerned with the interactions between board members, as well as both management and audit committees. Section, 6.5 provides evidence relating to the consequences of these interactions on the decision-making process. The final section, 6.6, provides a summary and conclusion of the chapter.

Figure 6.1 Directors multi-level interactions

6.2 Intra-Boardroom Interactions

This section provides empirical evidence relating to directors' interactions both in and beyond the boardroom. The section starts with seeking understanding of the roles of the board, then discusses the boardroom climate to finally show evidence relating to the perceptions of interviewees about the influence and power of the board chairman.

6.2.1 Board roles

To understand the work of a board of directors it is necessary to examine the extent of directors' knowledge about their roles and responsibilities. Directors have different levels of expertise and experience and so make unequal contributions to banks. There is a divergence of views among directors on understanding their roles and responsibilities. Most participants note the importance of roles and responsibilities but some disagree as to what exactly this role entails.

GB2: "The role of the board does not exceed supervising the administration work, direction and approval of the loans and appointments in senior positions."

Yet another director, who happens to be a non-executive director, seemed unclear on any of the definite responsibilities of an independent director.

IB2: "I do not understand the role of the independent director; I do not know how he can be objective in making decisions, while he is not knowledgeable about the bank's business."

Prior literature research has indicated that directors' roles are shaped by the degree to which they participate in any given task, rather than on pre-defined roles. For example, a board member from the Government Bank, who is actively involved in reviewing and approving loans, says:

GB1: "The main and most important role is to review and approve loans for our clients. I am talking about loans for mega projects."

The way directors perceive regulations about board roles has implications for their contributions in boardrooms as they interpret regulations and responsibilities of a board differently. Directors claim that these regulations are not well-defined and there is an overlap of regulations, rules and policies between regulators.

> *SB1: "There are three or four regulators and each one of them has his own laws. If you look at each company working here, you will see that companies understand these laws differently based on their capacity. Specific terms of laws do not mean anything to companies as long as they follow the general guidelines and regulators are happy with them."*

Furthermore, an audit committee member argues that some directors are taking advantage of the current state of the ambiguity and overlapping rules to use them in their favour in the decision-making process in boardrooms.

> *SAC1: "Directors who are in control or are a bit more knowledgeable about the business ...they use their influence to selectively choose the laws that interest them and tell other directors about them. Those other directors will not bother themselves with searching for the truth."*

The most important issue pertaining to the lack of directors' understanding about board roles is the ability of a director to perform his duties effectively. A director who avoids complete acceptance and understanding of the duties and responsibilities of his role is

seen by some directors as a proxy for his lack of competency. Other directors consider it as a proxy for a personal weakness, or feelings of inferiority compared to other influential directors.

> *ICEO: "If you have got the 'know how' and talent then nobody will look down at you and your opinion will be heard, whether they consider it or not is not the issue, as long you do your homework."*

Some responses suggest that there are directors who lack the competencies and the capabilities to engage in decision-making processes and thus they are inclined to rely on their colleagues to perform required tasks.

> *GB3: "It is very easy, if you do not know just pass it to the chairman [of board] or someone who knows and you will not be liable for it. This is how our senior board members work around here. They do not know how things are done around here and have no desire to know as long someone else is taking care of the job."*

> *GB4: "It is not my job to know everything! I do participate in some issues but we have a very experienced chairman who knows better and we trust his judgement."*

The way the board is composed and structured may create a ground for influential actors to engage in decision-making domination due to holding a formal and hierarchical position. As discussed in the previous chapter, the composition of boards is subject to internal and external factors that influence the decision-making process in the boardroom. For example, the chairman of the board may exercise his hierarchical authority to align the boardroom direction with his interests. Equally, power can be associated with representation of controlling shareholders or directors' personal shareholdings whose interests are aligned and act on behalf of shareholders.

The lack of a clear and well-defined set of roles limits directors' contributions, as they are influenced by the directions and decisions of other powerful members. For example, one director explains that their board chairman is so powerful that he can make decisions individually, without needing to refer to the board.

> *GB1: "It is normal that he [chairman] takes decisive and critical decisions without going back to us [the board] because he finds support from outside, or, say, from decision makers who put him as chairman."*

The importance of relationships is evident in all areas; this research reveals that most of the respondents' directors are serving on boards by invitation and therefore they do not find it appropriate to challenge the controlling shareholders over roles and responsibilities.

> *GB3: "I was called by the minister [of finance] to join the bank. To be honest, I was enjoying my retirement and don't need a job but you know – you can't refuse the invitation."*

The outside directors who are not part of the controlling shareholders' circle are under the dual pressure of fulfilling their duties without jeopardising their relationships inside the boardroom. They appear to prefer to maintain the status quo within their group, rather than risk social sanctioning or exclusion by acting alone. One director sums this up in the following way, referring to his preference to take a backseat, rather than draw attention to himself for having a different opinion.

> *GB4: "It is the Government Bank and they know what is best for them. Why should I bother myself when everything is moving smoothly?"*

Another director referred to the presence of the founding families as a factor in influencing the activeness of his own role.

> *SB1: "We have members of the founding families on the board who are, for sure, more careful about their business than anybody else. I think they are in control and personally my role is to support them."*

External directors also noted the importance of informal communications in order to express their concerns to other board members. The issue of avoiding division in the boardroom prevents most directors from coming forward in boardrooms. External directors often use informal processes to discharge their duties, taking advantage of their personal attributes, such as expertise or experience, to indirectly gain the confidence of the controlling shareholders and the powerful directors. For example, one director suggested that his work experience as a deputy minister is helping him to have informal direct contact with the board chairman.

> *GACC: "Most of the sensitive loan cases are discussed with the chairman before [the] board meetings. Sometimes, we have to decide which cases are important to go to the boardroom and which cases can wait."*

Apart from understanding the roles of directors, the boardroom environment needs to be examined to understand the surrounding factors that have effects on the actions of directors.

6.2.2 Boardroom climate

Prior literature research has stated that the interactions inside boardrooms are shaped by directors' skills, behaviours, norms and cultural factors. The individual personality traits, demographic variables and directors' networks define how boards interact and thus influence board functioning. The director network of relationships is significant in linking a bank to external resources. Ultimately, these directors' relations and characteristics determine 'what goes on' within the board.

Some responses suggest that competent directors are more likely to be consulted before making decisions on major cases in and beyond boardroom meetings.

> *SBC: "Not every board member has the ability or skills to speak his opinion! We have big decisions to make every day and there are few directors on my board whom I trust to talk to when I need feedback."*

Similarly, influential and powerful directors are more likely to win arguments inside and beyond boardroom meetings and seem to claim the trust of other board members due to their abilities to achieve desired outcomes.

> *GB2: "Well, there are two directors on my board that you cannot go head to head with; the chairman and the audit [committee] chairman. They always know better solutions and have the means to proceed and finish the job."*

Some of the director's characteristics or attributes define the extent of his involvement in the decision-making process in the boardroom. For example, a board chairman argues that personal connections are significantly important to banking business.

> *SBC: "There are directors from different backgrounds and different business sectors who can positively contribute to our operations. For example, there was a client who failed to repay his huge debt and I was hopeless in getting our money back until I talked to one of my fellow members of the board who managed, through his connections, to get his hands on a large property that paid off the debt."*

Some responses suggest that outside[31] directors are selected due to their personal and professional relationships, which are the determining factor for board membership.

> *GB4: "We [independent directors] may not be fully aware of the banking system but most of us have the experience and connections to be used for expanding the bank business options."*

> *IB2: "I have never worked for a bank but I am certain that they [the bank] are going after my connections."*

However, the CEO of the International Bank argues that the presence of independent directors is ceremonial in nature and thus has no added value to the outcomes of the boardroom.

> *ICEO: "The participation of independent members is often ineffective as they are not familiar with the nature of the banking business and their participation in the discussion is just a formality."*

Some directors suggest that board members are expected to be independent and actively involved in the boardroom meetings. However, although board members are seen as independent in theory, according to existing regulations, this independence is not always realised in practice.

> *GB1: "The complexity of relationships between directors makes it very hard to go against another director even if it was just an opinion! The feeling of being in debt to others makes it hard for some directors to make everyone happy; otherwise, they might lose their seats."*

The procedure for meetings of boards is similar among all three case banks. The structure is of a fairly unconventional nature and is seen as a social and ceremonial event, where the agenda, which has been sent ahead of time, is not usually read. The research reveals that directors share common cultural values which form their interactions within and outside the boardroom. Generally, directors tend to know each other based on business or personal relationships. This closed circle of relationships has created a sense of belonging to the 'elite' group and thus each member would not undertake any action that would damage the image of another director, and/or result in his own exclusion.

[31] The term 'outside director' has been used by interviewees to describe independent directors.

ICEO: "We usually send the agenda and the materials for the proposed meeting at least 15 days prior to the date of the meeting. But, directors do not make the time to read them so we waste about half of the meeting reading the materials for them!

GB3: "Board meetings are important to keep up with work progress and a chance to see other members who are busy with their other businesses or commitments."

GAC2: "These [board] meetings are more like social gatherings and to catch up at some stage. If you attend one of these meetings, you will see the chairman and his CEO walking around to tell everyone that everything is under control."

Most of the participants highlighted the importance of communications between directors with particular emphasis on the effectiveness of informal channels. Some responses suggest that the board normally expect disputes to be resolved before they come to them.

GACC: "We have open communications with the chairman and the CEO to anticipate and resolve upcoming problems that cannot wait for a board meeting."

IB2: "I think informal communications are very important to act quickly. I had a case when the CEO phoned me while I was out of Kingdom on a personal trip to ask to discuss an issue that could not wait for my return."

However, criticising a director in public (including inside the boardroom) is considered as an indication of disrespect. One director highlights the significance of the boardroom as a public sphere as well as the importance of informal "alliances" in the following quotation:

SBC: "A smart director is one who pursues others to be on his side and earns their trust to support him when he needs their support. As a board chairman, I am keen on observing our cultural values and to make everyone happy to be on my board."

This board member perceives that there are some opinions which are acceptable and others that may not be and that there are limits to which one can argue with the senior members. However it is also clear that directors accept and welcome informal discussions and, in many cases, they use these discussions to resolve issues before they reach the boardroom. One director stated that the chairman, before having built up

certain relationships and the ability to work informally, used to engage in many formal discussions. In later meetings, he took a ‘back seat’ and allowed the senior members to take control.

> *SB1: “I noticed in early [board] meetings that our chairman was concerned and much of the talk was done by the senior members. I guess he later controlled that by making close friendships with other members outside of the boardroom.”*

The board member explained how the chairman resolved the cultural issue of respect, which he was not receiving, by building alliances informally. The importance of informal relationships and support is reinforced by the comment of another director who remarked:

> *SAC1: “I have no problems in talking confidentially to the chairman as long as he listens to the voice of right and do right.”*

He indicates here that the chairman uses informal meetings to secure support prior to the formal board meetings, meaning that he does not always listen to the board members once the opinion has been formed and he is secure in his support.

Although the interviewees acknowledge the importance and advantages of informal discussions and communications, the close network and relationships formed can also lead to difficulties for directors in carrying out their roles, particularly in confronting others or making a move which may upset the status quo – specifically in light of the significance of personal relationships.

> *GB2: “Let me tell you something. You cannot stay suspicious about any action taken by your colleagues who work with you and trust you. If there is an issue, there are many ways to talk to them about it.”*

This sentiment suggests that a director is to be trusted and considered innocent until there is a reason to prove otherwise; the reluctance of board members to point out mistakes is emphasised by one board member from the International Bank:

> *SACC: “We are not here to track people and highlight their mistakes! We are one team and if someone acts differently that will not make him a hero.”*

Clearly, these statements show that directors are conforming to the local norms and values to maintain the status quo within their groups, rather than risk social sanctioning or exclusion.

The nature of how board members are selected is one factor affecting the contribution of directors and their involvement in board meetings. For example, directors who are selected based on pre-existing relationships are especially reluctant to bring matters to the boardroom which would challenge management or the chairman, as this may ultimately impair their independence, as suggested by some responses.

> *IB1: "The issues of relationships and 'saving face' are affecting the board independence because directors are dependent on their personal connections to win a seat. They are dependent on others because they lack proper skills and qualifications."*

Some participants argue that social and cultural norms are used or practiced in boardrooms to justify actions of wrongdoing. Respect is one such example, manifested in the context of seniority and external stature and prestige. For example, one director refers to respect in the context of boardroom politics whereby some directors may not be challenged due to seniority or director's class[32].

> *GB3: "There is no doubt that working with senior government people is a very rewarding experience. But you have to know the politics of the boardroom to deal with those people. You have to know your boundaries and be aware not to cross the line."*

This sentiment is confirmed by other responses where they provide an interesting perspective on how social and cultural norms are perceived in boardrooms.

> *SB2: "I do value the issue of respect in boardrooms but some directors abuse the system and take advantage of you being 'respectful' to persuade you to follow him."*

> *GB2: "Unfortunately, I worked, and still have, with some directors who think that being humble and respectful is a sign of personal weakness. It is a very delicate issue to be respectful and at the same time a challenger in a boardroom."*

On the other hand, a board chairman argues that directors have the opportunity to be active and responsible in the boardroom whilst maintaining a high level of respect.

[32] For example, some directors are ministers, deputy ministers or governors.

SBC: "I do not think that being respectful would prevent a director from asking questions and raising issues in the boardroom as long as he has a valid argument."

Furthermore, he argues that some directors cannot differentiate between respect and trust saying that:

SBC: "Respect and trust are important between directors but I consider trust as one of the main problems that lead some directors to depend on others and end up being inactive in the making of decisions. Those directors either lack knowledge or have fear of commitment. When you have a director who is totally dependent on others claiming that he respects their knowledge, then there is a problem."

Other directors argue that respect and trust are essential norms in the boardroom, but have to be realised with care and attention.

GACC: "You cannot work with other directors without showing trust and respect. There are many directors that make you believe in them because of their talent and experience. In the end, you cannot have the knowledge or experience about everything that goes on in the board so there has got to be someone else to depend on and who can help you out."

Directors who take advantage of social or cultural factors to pursue personal gains are aware of the fact that their interests are aligned with those of the controlling shareholders and therefore no one will hold them accountable. In this context, a director may use his social status and relationships to win certain bank's projects for his personal firm. For example, a director in the Islamic Bank has a real estate firm that the bank uses to evaluate and purchase lands and properties[33]. The sense of security by those directors is based on the influence and power exerted by the controlling shareholders in the banking system.

SAC1: "The system works perfectly for those [directors] who are protected and well connected with those 'invisible' people."

Some other responses suggest that the opportunistic behaviour of some directors is attributed to the fact that the power is distributed unequally and thus actions are accepted by people without further justifications.

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[33] The real estate firm is registered with the bank as a trusted partner (Bank Report, 2010) and the firm may engage in purchasing other board members' properties at inflated rates. There are speculations that this director is a front for a royal family member.

GB3: "When you are appointed by the government and realise that no one will come after you, then you will do everything that makes you happy and pleases the government, regardless of anything outside of this circle."

IB1: "There is no accountability system! Is it possible that for nearly 60 years not one single director has been charged or fired – I have never heard of one case! I and other people try to take advantage of joining these boards to make changes but it will take time."[34]

6.2.3 Influence of the board chairman

There may be situations where several people are more powerful than others and this may result in those who have the greater power influencing the behaviour of the others to get things done. For example, the power that a CEO or chairman of a board has can be used to gain personal benefits or expropriate the rights of other directors. A board member indicates that their CEO uses his power and personal relationships to influence the chairman.

IAC2: "In my opinion, the separation between the position of chairman and CEO is an important issue to protect shareholders, but it is not really applied in all companies. The separation is applied in appearance but not in practice. In most companies the CEO has a close relationship with the chairman that impairs accountability."

A CEO of one of the case banks has extensive financial experience, which has led to a degree of credibility that non-executive directors would not challenge.[35]At the same time, he is well supported by the board chairman (who happens to be a member of one of the major shareholder families of the bank) and the international partners.

IB1: "The chairman is dependent on the CEO and therefore trusts him to run the business. All directors are aware of that and they can't do anything about it."

However, the same CEO acknowledges his own vulnerability within the framework of the power of relationship networks that affect directors' appointments and the overall process of business.

[34] There are three Saudi banks which had major banking problems but none of their management or executives were publicly dismissed or indicted. These cases are discussed in more detail in Chapter 2.
[35] This is the perception of some directors that when there is a knowledgeable director, others would not challenge him!

ICEO: "Since I got this job, I find that all of them [board directors] know each other and 'speak the same language'. I am very cautious during meetings with other banks' directors; who knows who will be sitting on my board next year!"

Some participants highlight the important qualities of a board chairman in different ways. A response of a board member shows that a chairman with banking knowledge and experience is more likely to be trusted when making decisions.

GACC: "Before he [board chairman] became a chairman, he was the CEO and he knows the business very well so I really trust his judgment."

Some other responses suggest that a chairman's personal traits are equally important in boardrooms.

ICEO: "We have an understanding Chairman with a strong personality and he is a decision maker. Decisions are often taken based on his guidance and in fact I am confident in his decisions and his vision."

However, it must be noted that at least some participants perceived that when a bank is doing well, the management (CEO in particular) would have greater power over the board. This would suggest on one hand that management can influence the board decision-making process and, on the other hand, board members would not actively undertake their roles due to the fact that the bank is performing well. The problem with this issue is that the board members may not be aware of the performance indicators and thus cannot truly observe whether the bank had improved its performance or not.

SACC: "I do think that management usually gets stronger when they are performing very well. But how well they are doing is another question."

In general, the influence and power of a board chairman is derived from different sources. In all of the case banks[36], the chairmen of the boards are very influential because they were directly appointed by the controlling shareholders, through government, partners or family ownerships.

In the Government Bank, the chairman of the board served as a CEO for a long time before he became the chairman. Although the bank has separated the roles of the chairman and CEO, interviewees of the bank argue that he still exercises the roles of both positions, relying on his talent, experience and government support.

[36] This is true for all Saudi banks. In fact, a recent study shows that 66% of board seats in the country's banks are controlled by 12 Saudi families (Aleqtisadiah, 2012).

GB1: "The chairman came up with the idea of splitting board and management positions in 1997. I thought it was a move in the right direction until I joined the board and found that he is actually running the whole show. He is the chairman, the CEO and he is a member in every committee."

This statement shows that the chairman maintains control of the bank operations by being a member in all board committees and influencing the selection of the CEO. In this case, the management may seem independent to the public, but is actually under the chairman's control.

In the Government Bank, the knowledge, experience and external support of the chairman of the board have influence on the board and its members.

GAC2: "The chairman is very powerful and knows the business very well. In some cases, he would make decisions without going back to us. I think he would not do that if the government were not supporting him.

GB3: "I trust his [the chairman] knowledge but he should give a chance to other directors to participate in decision making and feel that they are part of the group."

In the international bank, the chairman is a very busy 'business' person who runs a group of family companies. The chairman's family business is one of the major shareholders of the bank. Some directors of the bank argue that the chairman's 'outside' commitments have given the CEO the chance to play the chairman role.

IB1: "Our chairman is a businessman and has no time to run the board. He treats the bank as one of his companies because his family owns a big share of the bank and he therefore delegates his responsibilities to the CEO."

Finally, the chairman of the board of the Islamic Bank was brought in by the controlling shareholders, which has been a source of power to control the board. When he was appointed, the incumbent CEO was powerful and knowledgeable, which subsequently led to a clash between them that ended in replacement of the CEO. The influence of the chairman to replace the existing CEO without the board members' consent is evidence of the chairman's power and influence.

SB1: "The chairman knew that he could not control the board and management while the existing CEO was in office. He [the chairman] felt that he needed to prove himself so he removed the CEO and brought in a new one.

We [board members] could not do anything about it because he was supported by shareholders."

The shareholders' support is aligned with their personal interests that may differ with some of those directors in the boardroom or the management.

IAC2: "The shareholders care about making profits regardless of what and how the banks do it. Take for example the banks' dirty games with some family businesses to go public [IPOs] or the role of shareholders on government spending. They [shareholders] do not look into the whole picture of what a bank should do. They simply 'milk' their banks for money only – no regard to people, the economy or anything."

The divergence of interests between those actors has created unique relationships and interactions between boardroom directors on one hand, as discussed above, and between board and management on the other hand, as in the following section.

6.3 Board and Management Relationships

The interaction between board and management is an essential part of any firm's daily business. In the context of this thesis, however, there are inevitable tensions that arise during board and management interactions due to personal and institutional factors, which are discussed in the following sections.

6.3.1 Board and management interactions

It has been mentioned earlier in this chapter that the ability of board members – individually and collectively – to contribute and add value to the firm is related to their understanding of their roles and responsibilities. Likewise, boards tend to isolate themselves from outsiders, such as management. The literature suggests that a board's main roles are to control and monitor management and thus boards are required to interact with management. Hence, boards rely on management to perform daily activities and to access information.

GB2: "All of the board members have good relations with the CEO but we hardly see the other management team members."

IB2: "I have an excellent relationship with the CEO. I find him active and willing to help."

The board of directors meets at least four times a year to 'formally' make decisions. However, board members interact among themselves and with the senior management

team on a daily or regular basis. For example, the chairmen of the three case banks have offices in their banks' headquarters which they attend on a daily basis[37]. In addition, some of the board's subcommittees have regular meetings (on average once or twice a month) (such as the executive and audit committees).

Some responses suggest that many board members would rely on the chairman of the board to be the formal channel of communications with management.

> *GB3: "Of course, I depend on him [the chairman] to instruct management to do what we [the board] have agreed upon. He [the chairman] is very close to management and knows them well."*

> *GACC: "I think he [the chairman] is the best person to handle this [communicating with management] because most of us are basically busy with other commitments."*

On the other hand, a management member (CEO) indicates that a director's' understanding of the purpose of the board and members' roles has a great impact upon their contributions.

> *ICEO: "Directors are not all the same and they are coming with different backgrounds. Some of them are just here to complete the headcounts while a few are effective."*

Furthermore, the CEO argues that "the most important aspects of our [board] work is to get involved in forming strategies and making decisions", whereas active directors are distinguished and utilised to perform their roles. The literature suggests that involvement of directors in strategy formulation and strategic decision-making demands greater and active participation by directors in constructive communications with other board members and the senior management team.

The development of a trust-based culture among directors and relationships promoted the 'informal' settings of communications beyond boardroom meetings. Yet, some responses suggest that the informal communications are controlled by the governance actors.

> *IB2: "I talk to the CEO when there is an issue in the bank and I trust him to do his best to resolve it with his team."*

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[37] With exception of the chairman of the International Bank who has an office in a different city to where he lives and thus tends to stay in his home town to attend his family businesses.

GB3: "We [board] regularly meet on social occasions and sometimes we talk about issues when there is a chance and everyone is happy to leave it to the chairman to sort things out, especially sensitive issues that need to be discussed in more detail."

On the other hand, the most debated structural feature of the board is the separation of the chairman and CEO roles. Saudi banks were considered to be pioneers in leading local firms in separating these two roles in the late 1990s. However, some directors argue that banks did not 'split the two roles' merely due to regulatory requirements, but to find a mechanism to accommodate the interests of the controlling shareholders to keep banks under their control. At the same time, they were signalling to the public that banks were under independent supervision. Therefore, some responses suggest that the presence of boards is merely a front for the controlling shareholders due to insignificant monitoring and controlling roles.

SB1: "The foundation of banks as family businesses has given [banks] owners absolute power and control. But as things have changed and government and foreign partners became major players, the founders [of banks] are still in control through family members, relatives or friends sitting on these boards."

GB2: "Well, once you are in control of the majority shares then you are in control of the whole thing. This [government] bank started as a family business but when the government took over, they brought their people in to make sure it is in the right direction."

Consequently, senior management teams and executives realise that the pathway to boardrooms has to be through the controlling shareholders. However, the influence of controlling shareholders has implications on the board and management relations as members of both teams are inclined to strengthen the relationship with the controlling shareholders at the expense of the other team. For example, an executive may not follow the firm's hierarchy and structural process in direct reporting and alternatively he would have direct contact with parties outside the chain of command.

GB4: "There are very serious issues between the CEO and the CFO. The CEO once told me that the CFO was talking directly to the PIF representative[38] on certain issues. The CEO was complaining that he [CFO] should report to him [CEO] before approaching anybody else."

[38] The Public Investment Fund (PIF), Ministry of Finance.

IB2: "There are a few rumours going around that our CEO is in direct contact with our [foreign] partners. Well, to me it might be ok if he needs their input for urgent decisions but I'd rather not put the board in the shadow, if he did talk to them."

IB1: *"I can understand that he [CEO] feels loyal to them [international partner] because they brought him in but this is professional business and there is a chain of command in the bank that he should stick to. Sometimes in board meetings, I feel that our partners know more than we do! How? We are supposed to get the same amount of information, right."*

The interviewees argue that board members are usually looking for good relationships with management for accessing information. The other reason for building relationships with management is to secure additional board appointments and thus the senior management and executives of banks are commonly board members of many private and public firms[39].

6.3.2 CEO influence

The literature studies suggest that a CEO's influence and power stem from his control of information, knowledge of business and his tenure in office. These three factors are interrelated, as long-tenured CEOs are more likely to acquire business knowledge and thus control the flow of information to others, namely the board of directors.

While CEOs are expected to provide strategic focus and develop initiatives to achieve the firm's goals, their most significant proposals must be accepted by the board before they can be implemented. CEOs therefore need to influence their board members to accept their plans.

However, a board chairman resembles an opposing force to a CEO's influence in order to maintain control of the board and the firm at large. For example, in the Islamic Bank, the newly-appointed chairman of the board found that the incumbent and long-tenured CEO was a source of threat to his influence and power and therefore the removal of the CEO was inevitable. The removal of the incumbent CEO was done at the end of the board term and thus he was not re-elected. This formal process of 'removal' was utilised to maintain stability of the bank and to provide a 'face-saving' for the CEO, in order for him to maintain his reputation and the respect of the business community.

[39] SAMA and CMA require that banks should list in their annual reports directors' memberships in other listed joint stock companies' boards.

SB1: "The chairman knew that he could not control the board and management whilst the existing CEO was in office. He [the chairman] felt that he needed to prove himself so he removed the CEO and brought in a new one. We [board members] could not do anything about it because he was supported by shareholders."

However, the new CEO utilised the close relationship with the chairman to control other senior management and influence the decisions of some board members as well.

SB1: "The chairman and the new CEO are closely related which is good in getting things done but not good when other management people complain about the CEO for not giving them opportunities to reach out."

The CEO of International Bank has long years of financial experience, which has led to a degree of credibility that non-executive directors would not challenge.[40]At the same time, he is well-supported by the board chairman and the international partners.

IAC2: "The CEO has been around for years and got the support of his team and the chairman."

However, the long-tenured CEO and controlling shareholders' support created an adverse effect as the (IAC2) director continues to say that the CEO "would not listen to other senior management members and undertake initiatives that he considers are a waste of money and time."

However, it must be noted that at least some participants perceived that when the bank is doing well, the management (CEO in particular) would have greater power over the board.

SB2: "I do think that management usually get stronger when they are performing very well. But how well they are doing is another question."

This would suggest on the one hand that management can influence the board decision-making process and, on the other hand, board members would not actively undertake their roles due to the fact that the bank is performing well. The problem of this issue is that the board members may not be aware of the performance indicators and thus cannot truly observe whether the bank's performance had improved or not.

[40] This is the perception of some directors that when there is a knowledgeable director, others would not challenge him!

6.4 Boards and Audit Committees Relationships

The audit committee (AC) enables participation by the board of directors in control over financial and operating activities. The AC is an important internal mechanism by which to support the board in controlling and monitoring management actions and financial reporting activities.

AC ensures constant interaction of the board of directors with other governance actors to carry out internal control and audit functions. However, there are a number of factors that influence the nature of interactions between boards and ACs as discussed in the following sections.

6.4.1 Board and audit committee interactions

There has been an increased focus on ACs and their effectiveness in carrying out their respective roles. Yet this research reveals mixed results relating to the role and effectiveness of the ACs in Saudi banks. Some of the participating directors are still sceptical about the role and effectiveness of ACs and lacked the confidence and/or the willingness to rely on ACs to carry out their duties and responsibilities. They question the efficacy of ACs in relation to the business expertise of AC members, as it has been argued that many AC members lack knowledge of the banking industry.

> *SB1: "The audit committee is not doing what it's supposed to do. The committee members do not have the knowledge and experience to help us make better decisions."*

However, AC members argue that their qualifications and auditing experience are sufficient to apply the principles and the framework of auditing in financial firms.

> *GAC2: "Auditing financial companies is not that big a difference from non-financial companies, as long you have the knowledge and tools to perform an audit. Besides, it is a matter of a short time to understand how banking activities are done and you are set to do your job."*

Some responses consider the establishment of ACs as a form of compliance with regulations in which ACs would not provide substantial benefits to banks. The plausible explanation of this perspective is the board members' lack of understanding of the AC role as it is normally understood, or that they have different expectations.

> *GAC2: "There are some board members who think that the committee is there only to comply with SAMA laws."*

GB3: "I do not count on the audit committee. I think they [audit committee members] don't take their job seriously so they don't have what it takes to limit any wrongdoing."

IAC1: "There are individuals in the board and management who think that our job is to cover up their mess and help external auditors to do it professionally."

However, a few directors indicated that ACs are important to their firms and suggested that time will lead more directors to believe in ACs.

SACC: "ACs are new to many directors who do not know the added value of having an AC in the bank. We just need some time to get those people adjusted to the extended board duties carried by these committees."

The structure of the audit committees in all cases are set up in accordance with laws and regulations which seem to be well organised in theory; however, practically, its effectiveness is at stake as other board members question the background of the audit committee members. Hence, all of the outside members of the audit committees are full-time academic professors.

GB2: "Our audit committee has knowledge and qualifications in accounting. The outside directors are PhD holders but with no banking experience."

However, some responses argue that AC members may have the proper qualifications but they lack time commitments due to their full-time jobs. This lack of commitment has implications on AC members to earn trust

ICEO: "Most of the AC members are working in the academic domain and hardly have time to attend their meetings. If I have a concern or a question I would rather ask my internal auditors or send a message to our [external] auditing friends."

GACC: "The contribution of our [AC] committee members is important but the issue of making the time to learn the business and then be able to contribute is a concern."

Some board members noted that ACs are not performing their obligated roles or discharging their duties properly. Thus, some board members argue that they would feel better off relying on external auditors rather than on ACs.

GB2: "I feel that they [AC] are relaxed and not willing to go the extra mile. I cannot blame management for going to external auditors to do the job."

This is reinforced by a comment from another director. The statement shows that some directors have a lack of trust in the AC's ability to carry out its responsibilities and thus the external auditors are more likely to be the proper alternative.

> *IB1: "We cannot afford to waste our time and money educating them while we have professional auditors who are approved by SAMA and know the business inside out."*

AC members indicated that many board members do not appreciate the fact that the AC has members from outside the bank. Thus, those board members feel superior to AC outsiders, which may result in a poor coordination between the board and its subcommittees. Accordingly, banks tend to separate the internal auditing and the ACs; where the former reports to the CEO and later (in theory) reports to the board.

> *GAC2: "Some directors (and management) think that we work to serve them and ignore the fact that we are equally directors who work for the same bank!"*

> *SAC1: "Although we are part of the board, we have no access to the board except through our chairman or the CEO."*

Furthermore, ACs argue that boards are more dependent on external auditors and use ACs simply to justify the selection of external auditors. Board members however, argue that external auditors are subject to regulatory authority and they have to be approved by them before undertaking any auditing work. Therefore, board members see the work of external auditors as an assurance against any non-compliance or violations of the laws or regulations.

> *SB2: "External auditors are not our employees and if they find problems they will tell us. My problem with the [audit] committee is that they don't know the business and try to please those at the top."*

In contrast, the AC members claim that they have the qualifications and expertise to perform their work effectively, provided that boards believe in them and support their actions. For example, a director argues that the relationship between external auditors and the board is built on more than doing the right job.

> *GAC1: "I am not quite happy with the [external] auditors work! I see the same faces every year and they are getting deep with management. It seems that they have a solution for every problem!"*

Another AC member also voiced his concerns as to the actual impartiality of external auditors.

> *SAC1: "The management and auditors' close relationships is not a secret. They always have these informal meetings to sort things out... I sometimes feel that they (auditors) are working for management or the board to clean up their mess. I don't want to offend anybody but those people (auditors) don't care about business ethics."*

In general, the research findings suggest that there are gaps between board members and audit committees in all cases. In most cases, a board would communicate with the AC through the AC chairman, who is a board member and a representative of the controlling shareholder. An audit committee member claims that the lack of direct communications with board members stems from a feeling of superiority to the AC outside directors.

> *GAC1: "Most of the AC outsiders are not in the same category of social class as board members. I personally never thought of being an AC director in a bank but my PhD in accounting and the publication of my articles in local newspapers were quite enough for them to invite me to join them."*

As a board sub-committee, it would be sensible for ACs to have a direct reporting line to boards, which is well-emphasised in the reports of all cases. However, AC interviewees argue that in practice the committee works under management control.

> *GAC2: "We rely on management to give us reports and information. The internal audit works under management and would not give us any piece of information without going back to the CEO."*

6.4.2 Influence of the audit committee chairman

The chairmen of ACs have an important role in managing their committees, which significantly have effects on the firm's system of internal control and external financial reporting obligations. As discussed in Chapter 5, the AC is accountable to the board of directors and the committee chairman is selected from among the board members. Generally, Saudi banks assign a board member who represents the controlling shareholders to chair the AC, which is proven to be true in the case banks (Table 6.1).

This process of appointment gives the AC chairman the power and influence to control the committee and its members, which gives the controlling shareholders a source of comfort and assurance that their interests are protected.

GAC1: "The [AC] chairman is in full control; he calls for meetings, sets the agenda and deals with management and external auditors."

GAC2: "We [AC members] attend meetings to listen to and bless the decisions that have already been made. We do not have the chance to discuss nor object to any of these decisions. But, there are a few chances to get involved like when the chairman needs explanations of sensitive financial issues or on auditing processes."

IAC1: "Well, I cannot say that we have real and fruitful discussions in our meetings! He [AC chair] might ask any [AC] member about important financial issues but still he has the final say."

Table 6.1: Audit Committees in Case Banks

Bank	**Audit Committee [AC]**
GOVERNMENT BANK	AC Chairman (Government Representative of PIF*) AC Member (Government Representative) AC Member (Government Representative) AC Member (Independent) AC Member (Independent)
INTERNATIONAL BANK	AC Chairman (Major Shareholder/Foreign Partner) AC Member (Independent) AC Member (Independent)
ISLAMIC BANK	AC Chairman (Major Shareholder/Private) AC Member (Independent) AC Member (Independent) AC Member (Independent)

* A majority stake of the bank is owned by the Saudi government represented by the Public Investment Fund (PIF).
Banks Annual Reports (2009-2011)

These sentiments of AC members show that the dominance of AC chairmen has implications on the AC process in meeting its responsibilities. It is also useful to rely on for monitoring managerial activities. The skills and expertise of AC members are not fully utilised or used, which would affect the committee's outcomes. Besides, the ACs' chairmen tend to use the committees' members to educate them on financial issues which indicate that those chairmen may lack financial and auditing expertise.

SAC1: "The AC chairman is technically weak and we have no means to change him. We have no access to board or shareholders. In fact, the [AC] chairman is related to the main shareholders."

This statement provides evidence on the lack of financial expertise of ACs' chairmen and suggests that the support of the controlling shareholders is the main reason to

remain in service. In this context, AC members tend to avoid any direct confrontation with the AC chairman as they might lose their dispute and membership, as well[41].

However, there is an interesting comment made by AC member when referring to the AC chairman's behaviour of concealing information from other AC members.

> *GAC1: "I can understand that there might be things that should be kept in the shadows… you can't expose every single action or case to everyone in the committee when it comes to the strategic levels that are related to our major shareholder (government). Sometimes, it may harm rather than help! So, I have full respect for our chairman and trust his judgement."*

Similarly, one AC member suggests that banking complexity requires the committee's members to be dependent on its chairman as he has access to the board.

> *IAC2: "The banking business is very complicated and hard to understand in just the few hours we spend in a meeting. Mostly, when we [AC members] have problems, we leave it to our chairman to sort them out with management and board."*

The AC chairman in the International Bank is a foreign director representing the foreign partner. Interestingly, an AC director from the bank claims that the AC chairman's behaviour changed over time to reflect our local culture.

> *IAC1: "We started a new term together. He was new to Saudi Arabia and was very eager to know everything about us. I used to get emails from him about setting the agenda and discussing other issues. After completing one year, he became a different person; he did not have time and meetings became short, he was hard to reach and it seemed that our opinions did not matter anymore."*

Furthermore, the same AC member argues that "*the control over the [audit] committee is in the hands of the committee chairman who has a very close relationship with the CEO*" which gives him an advantage for easy access to information and provides him with a 'cushion' to 'fall short' of his AC duties. In this context, the AC member suggests that managerial financial concerns are to be resolved before they are presented to the committee due to "*their [AC and CEO] relationships as board members and the desire of the board chairman to keep things in-house and under control.*"

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[41] Board and management members tend to avoid commenting on AC chairmen whilst criticising AC members.

Some responses suggest that an AC chairman must use this power with discretion so that the committee does all that it is expected to but does not exceed its remit.

> *SBC: "It is the [AC] chairman's responsibility to hold his [AC] team to carry out their designated obligations and duties."*

> *IB1: "I expect the AC chairman to be active and in control to enable his team members to make timely and influential decisions."*

The external audit is regarded as being extremely valuable by AC chairmen, as it brings assurance to them on the quality of the financial statements and ensures compliance with regulatory requirements. They consider the external audit as an essential part in controlling the system of financial reporting and it therefore assists them to meet their responsibilities and duties.

> *GACC: "they [external auditors] provide assurance that everything we do and present to the shareholders are presented with confidence."*

> *GACC: "they [external auditors] have the expertise and can easily tap into knowledge to draw our attention to new accounting and financial standards and new regulatory requirements."*

Similarly, AC chairmen consider the work of external auditors valuable in highlighting the weaknesses of the firm's internal controls, of which they may not otherwise have been informed.

> *SAC1: "He [AC chairman] is very keen on their [auditors] work to gain access to internal control and to be the first to know if they find any weaknesses or concerns."*

AC members, however, claim that the extent of board and management reliance on the external auditor is beyond the auditing scope, as it jeopardises audit quality.

> *GAC1: "Auditors are making friendship relations with some board and executive members and those members are seeking their advice on business strategies at the expense of focusing on the core services that auditors should provide."*

Other AC members argue that the reliance on auditors has a deleterious effect on the image of the committee and internal control as well.

SAC1: "The AC has no substantial value to most of the people here. The board does not give it [AC] the attention it deserves and they would allow themselves and the management to bypass the committee."

IAC2: "When you hear the [AC] chairman say that auditors are his eyes and ears on the ground then I understand that he does not believe in us to do our job at least."

On the other hand, AC Chairmen value the feedback and the competencies of auditors relative to their AC members. They argue that the AC members lack the business sense and practical expertise that are the qualities of auditors.

SACC: "I have PhD holders in my committee but their experience is so much in reading the books."

GACC: "It is about personal skills and behaviours that you cannot get from books. Yes, books are important, but they will not teach you how to read people and judge their actions and behaviours accordingly.

An interesting point is made by a management member who argues that internal auditing teams and functions are of value to a firm and deserve some credits as *"the value obtained from external auditors is complemented by the value derived from our internal auditing functions."*

AC chairmen, however, state that auditors 'speak their minds' and ask relevant and challenging questions that would bring important issues to light.

GACC: "We are happy when a partner comes to us and speaks his mind if there is something not right. We work in a professional environment and have respect for each other, but they need to come forward and speak if they do not agree or if there is something which may cause a problem down the road. We cannot afford to turn a blind eye to serious problems."

This statement suggests that AC chairmen are keen on creating a collaborative working environment with auditors to resolve issues which may arise, but they argue that the confrontational approach towards management or the board is not a constructive way of doing business and thus, scepticism should be expressed in a professional manner.

6.5 Board Decision-Making Process

The primary work of boards of directors is to make decisions. The quality of decisions is based on the effectiveness and the capacity of each director's participation and

contribution. Some of the responses suggest that decisions are made in open discussion and based on the consensus of the majority, yet the analysis of their responses suggests otherwise. It has been mentioned earlier in this chapter how influential board actors dictate the decision-making process having no regard for other board members.

Moreover, the research reveals that decisions in the boardroom are made by the most influential directors, and that some of the most important decisions even take place outside boardrooms. As discussed earlier in this chapter, there are structural and behavioural factors for boards of directors that resemble the extent of power and influence of a director.

For example, some responses suggest that representatives of controlling shareholders are more likely to have greater power relative to other directors in the boardroom and thus, they have greater impact on the process of decision-making.

> *GB4: "The impact of the government representative is significant in some decisions, as he has a voting power and represents our major shareholder."*
>
> *ICEO: "There is no doubt that our job is to satisfy our shareholders' interests and this can be achieved in the boardroom through their representatives."*
>
> *SBC: "We have representatives of the major shareholders and we do pay close attention to their recommendations."*

Similarly, a board member argues that their board chairman has the controlling shareholder support which gives him the freedom to make decisions out of the boardroom.

> *GB2: "It is normal that the [board] chairman is directing the board in his favoured direction; he is looking after our shareholders' interests. There are situations where he might act alone but I guess other board members understand why he might do that."*

This sentiment regarding the chairman's action could contribute to a lack of accountability due to outsiders' support. This sense of security – the knowledge that their decisions will not be questioned and that they are protected by outsiders from the risk of losing their position - could enable some directors to act without thinking of the consequences of their actions.

There are some interesting responses suggesting that social class, knowledge or personality of some directors have implications for their participation in boardroom

discussions. For example, a board member argues that the long-tenured chairman has given him the credibility to dictate the decision-making process.

GACC: "I simply trust him ... years of experience and hard work makes him valuable to the bank."

SB1: "Well, it is unusual to have a heated discussion with a senior member[42] *in public and will become a disaster if he loses the debate. If you have an issue with a particular senior member, try to resolve it before coming to the meeting or talk to someone who knows him well."*

There is a divergence of views on the director's behaviour in respect to making decisions independently. A few interviewees argue that some directors are at a 'crossroad' when it comes to their obligations. For example, they suggest that some directors tend to focus on the interests of the controlling shareholders while ignoring the interests of other stakeholders. In this context, they do not feel obligated to the firm per se but, rather, feel that controlling shareholders' interests resembles the ultimate purpose of the existence of the firm.

SB2: "Some directors have this feeling of inferiority to those who brought them on board. Basically, they work for them not for the bank and their decisions are managed by remote control."

ICEO: "We work to deliver the best results for our shareholders but we should also consider the wider aspect of this process and pay attention to how this is affecting our bank and our people."

However, those directors who promote shareholders' primacy argue that satisfying controlling shareholders' interests would ultimately benefit other stakeholders as well.

GB3: "Stakeholders are more exposed to risk than others and legally they are responsible for everything. Besides, when the bank is making profits then everyone will be happy not just the shareholders."

SACC: "If it was not for the shareholders' money and investment then we would not have this bank in the first place! It is just not practical to make huge investments in business and then lend yourself to others."

[42] Senior member is an expression used to make reference to a director's age, class, or position.

A board member claims that their foreign partners did not participate effectively in the bank's development to expand its operations nationwide, but were mainly concerned with achieving high profitability.

> *IAC2: "Although they [foreign partners] own the biggest bank in the Middle East and control half of the board, our partners did not offer us any real help towards the growth of this bank."*

The impact of the power imbalance has created negative approaches towards problems which arise and issues with respect to boardroom discussions. Ultimately, only the most influential directors control the decision-making process, which would subsequently have negative effects on the meetings. This has created a tendency for some directors to accept 'good' judgments rather than searching for optimal solutions. Moreover, a plausible explanation of this is that this is the way in which directors handle conflicts and controversial issues. Some directors perceive conflicts as a personal issue and thus act irrationally.

> *GB1: "Unfortunately, some directors use culture for the confiscation of opinion of other directors. They cannot deal with opposing views and even feel irritated by open discussion."*

In this context, most of the influential board members show similar patterns of treatment with management and audit committees. Some interviewees argue that those 'actors' show a very low level of tolerance toward 'subordinates'.

> *SAC1: "I have spent two years now with the AC and I have not met a board member, except our committee chairman. I think they [board] have serious ego problems."*

A board member explains that he has a good relationship with the CEO and that other members viewed this relationship with suspicion, saying that:

> *IB2: "I do respect the CEO for his talent and behaviour. We once spent a short holiday together because I felt comfortable in his company. Anyhow, I usually hear my board colleagues whispering about this relationship – they think that I am taking advantage of this relationship to gain something!"*

This statement shows that cultural norms and behaviours may alter such professional relationships between directors. It also shows how board directors are isolating themselves from management and subcommittees to preserve their 'prestigious' status.

Significantly, all of the directors involved in the study advocate that the dismissal of a director has never been an issue of discussion. The following statement by one director clarifies why directors act without fear of consequences.

> *SBC: "Termination of a board or management member is a very sensitive issue and it will damage your bank's image in the market. In extreme cases, if a director is no longer welcomed then he will issue a statement to the media saying that he is leaving for personal circumstances."*

When some directors do not appreciate, or lack the ability, to have effective interactions in and beyond the boardroom, it reduces the likelihood that even an independent director would be willing to express dissenting opinions. Hence, this will result in subordinates showing deference to those actors. The attributes of an effective decision-making process (such as a system for constructive conflict) can help to overcome structural and informal biases and promote decisions that are substantively sound and independently made.

6.6 Summary and Conclusions

This chapter provided empirical evidence relating to the dynamics and the interactions of directors in and beyond boardrooms. The chapter is primarily concerned with the interactions among board members and between the board and other governance actors (e.g., board subcommittees and management).

The most important finding is the interviewees' perceptions about the link between the ability of a director to perform his duties effectively and his understanding or lack thereof about board roles.. An incomplete acceptance and understanding of the duties and responsibilities of his role is seen by some directors as a proxy for lack of competency. Other directors consider it as a proxy for a personal weakness, or feelings of inferiority compared to other influential directors. Some responses suggest that there are directors who lack the competencies and the capabilities to engage in decision-making processes and thus they are inclined to rely on their colleagues to perform required tasks.

The interviewees report that board members' lack of bank-specific knowledge has severe problem in Saudi banking industry. This problem is exacerbated as there is a larger distance between the board and management, which makes it more difficult for the board members to know about the inside activities of the bank. To ask the right

questions and be able to request relevant information, board members' knowledge of the bank's underlying business becomes more important.

The way the board is composed and structured would create a ground for influential actors to engage in decision-making domination due to holding a formal and hierarchical position. As discussed in the previous chapter, the composition of boards is subject to internal and external factors that influence the decision-making process in the boardroom. For example, the chairman of the board may exercise his hierarchical authority to align the boardroom direction with his interests. Equally, the representation of controlling shareholders can be another source of power exercised by the board member. Furthermore, the nature of how board members are selected is one factor affecting the contribution of directors and their involvement in board meetings. For example, directors who are selected based on pre-existing relationships are especially reluctant to bring matters to the boardroom which would challenge management or the chairman, as this may ultimately impair their independence, as suggested by some responses. The importance of relationships is evident in all areas; this research reveals that most directors are serving on boards by invitation and therefore do not find it appropriate to challenge the controlling shareholders over roles and responsibilities. Clearly, these statements show that directors are conforming to the local norms and values to maintain the status quo within their groups, rather than risk social sanctioning or exclusion.

Some participants argue that social and cultural norms are used or practiced in boardrooms to justify actions of wrongdoing. Respect is one such example, manifested in the context of seniority and external stature and prestige. For example, one director refers to respect in the context of boardroom politics whereby some directors may not be challenged due to seniority or director's class[43]. Directors who take advantage of social or cultural factors to pursue personal gains are aware of the fact that their interests are aligned with those of the controlling shareholders and therefore no one will hold them accountable. In this context, a director may use his social status and relationships to win certain bank's projects for his personal firm. The sense of security by those directors is based on the influence and power exerted by the controlling shareholders in the banking system.

The director network of relationships is significant in linking a bank to external resources. Ultimately, these directors' relations and characteristics determine 'what

[43] For example, some directors are ministers, deputy ministers or governors.

goes on' within the board. Some responses suggest that competent directors are more likely to be consulted before making decisions on major cases. Similarly, influential and powerful directors are perceived to be more likely to win arguments inside and beyond boardroom meetings and seem to claim the trust of other board members due to their abilities to achieve desired outcomes.

The responses imply that the capacity of directors has an enormous effect on the board's interactions and dynamics which might be attributed to the selection process of directors, as discussed in the previous chapter. There have been some discussions about the separation of roles, power and influence of certain directors. These discussions provided evidence that some governance actors (i.e., a board chairman, CEO or AC chair) play substantial roles in controlling the decision-making process in and beyond boardrooms. Likewise, the role and influence of those governance actors have extended effects on regulatory compliance and on the auditing process in their banks.

The domination of controlling shareholders has long been a salient feature of the Saudi business environment and thus, the responses collected in this research show that it is also clearly manifested in banking. In this context, family businesses have been the focus of this domination and they are likely to maintain this control of the financial sector for years to come. However, there are other major players who have similar patterns of control of banks and these include government and foreign partners.

The chapter provide evidence that directors operate in a set of roles, a web of relationships with internal and external groups and individuals. They are constrained by their own structure of reality - norms and values embedded in the act of management, which is influenced by normative pressures and accepted ideas on 'proper' behaviour.

In order to match external expectations about rational behaviours, and gain legitimacy, organisations become 'isomorphic', i.e., conform to accepted prescriptions of appropriate behaviour (DiMaggio and Powell, 1983). The board of directors is one such primary mechanism to gain legitimacy, so that the board structure and its behaviour may be understood as responses to external institutional pressures. Decoupling of symbolic practices from the board's 'technical core' (i.e., ceremonial conformity) may occur whenever conformity conflicts with requirements of technical efficiency of CEO-board relations. In this context, organisations' quest for legitimacy results in the homogenisation of organisations with respect to their most visible

attributes (e.g., board composition). Firms have the tendency to attract homogeneous individuals into institutions which makes the board members less inclined to challenge each other or the management (Tuttle and Dillard 2007).

According to Fogarty (1996) the key attribute of an institutional perspective lies in its ability to highlight the distinction between what organisations actually accomplish and what their structures suggest to the external environment they should accomplish. Meyer and Rowan (1977) propose that organisations may be decoupled, whereby they exhibit to the external environment that they are operating in line with expectations; whereas internally they are not actually following the operating procedures expected by the external environment. For example, the audit committee is often described as a symbolic mechanism of control, which signals to outsiders that management is under control while in reality the inside workings may be quite different.

Eventually, all of these factors have had implications on the decision process of the board of directors of banks, which may result in adverse effects. In addition, there are other factors at national and institutional levels that are discussed in the following chapter. The researcher will attempt to show how these external factors may be linked to the actions and behaviours of directors as discussed in Chapters 5 and 6. It shows how contextual factors influence and shape the process of board governance of banks.

CHAPTER 7: CONTEXTUAL RESTRAINTS ON GOVERNANCE

7.1 Introduction

This chapter provides empirical evidence relating to the contextual restraints on governance. It shows how contextual factors influence and shape the process of board governance of banks. The chapter is structured as follows. Section 7.2 is primarily concerned with the political framework, including the role of the government in the process of governance and the ownership structure. Section 7.3 provides evidence on the legal system as part of the regulatory and supervisory framework. Section 7.4 is mainly concerned with the interactions between cultural, social and ethical factors (such as national culture, social expectations, accountability and corruption). The final section, 7.5, provides a summary and the conclusion of the chapter.

7.2 Political Framework

This section highlights the political interference in economic activities and the political factors which influence the form and substance of corporate governance (CG). This chapter shows that while political intervention has a large influence on the governance practice of banks, it can also be argued that the corporate governance system cannot be effective without political support. It also looks at the patterns of ownership and control and their implications for the practice of governance.

7.2.1 Political Interference

The political system is deeply involved in the work of regulatory and supervisory authorities. All of the regulatory and supervisory authorities are government bodies and thus, they are not independent. Moreover, the government has control and ownership in many financial and non-financial firms that are subject to the regulatory and supervisory authorities.

It is notable that most of the interviewees highlighted the importance of government support for banks. For example, during the financial crisis of 2008, SAMA actively intervened to provide liquidity injections and guaranteed commercial banks' deposits (Ramady, 2010). In times of financial crisis, governments are normally willing to provide support to banks to prevent their failure. However, in addition to preventing banks' failure, the Saudi government has a further incentive to support banks, which is namely, protecting its stakes and shares in these banks. Furthermore, banks that are controlled by the government are more likely to have boards with strong political connections that, on the one hand, serve the interests of the government and, on the

other hand, provide support to their banks through their connections. For example, the government controls 45% of the top twenty (20) listed companies with an estimated value of $116 billion in banks, petrochemicals, communications and public utilities companies (Alriyadh, 2012).

The government has shares in all local banks ranging from 5% to 80% (SAMA, 2011) and therefore, state shareholding enables the government to remain involved in the decision-making process by appointing government officials as outside directors. For example, 30% of the board members in the case banks of this study are government officials who have been appointed as outside directors. Because they promote government interests, these directors who are politicians and representatives of political organisations constitute a source of additional political interference in the firms.

In 1976, the Saudi government implemented a policy of "Saudization" of foreign banks, where the share of a foreign partner should not exceed 49% (SAMA, 2010). In this context, one of the regulatory representatives argues that the public lost faith in the system due to inequality of power and wealth distribution. He argues that the Saudization of foreign banks, and the privatisation of other local firms, has transferred the public monopoly into private hands, which further strengthens the power of family conglomerates at the expense of a weakened and less diversified economy and results in rising inequality.

> *RS1: "The government started nationalising and privatising local companies to move towards open and competitive markets but the problem is that the process (was one) of transferring ownership of many of these companies into the hands of controlling families."*

One interviewee argues that political interference in the appointments of directors would jeopardize the director independence and objectivity.

> *GAC1: "Once they [government] choose you, then you will be obligated to serve their interests regardless of what you think!"*

Some interviewees suggested that people who were thought to have political connections were feared and not criticised for fear of retribution; such individuals tended to become untouchable in their firms. For example, a board member argues that some directors may approve certain decisions despite other directors' reservations.

GB4: "This is a government bank and when they need loans they simply get it through the support of their board representatives."

Furthermore, an AC member argues that the board chairman is incapable of removing the AC chairman in spite of his lack of financial and auditing knowledge, due to his political connections.

SAC1: "He [AC Chair] has nothing to do with the financial or auditing business. But, he is the chairman and a member of some very big government companies' boards. Some appointments of these boards are through royal decree."

Some of the interviewees argued that when an individual was appointed on the basis of personal connections with the employer (or on political grounds), nothing might be done about malpractice by that employee. It was suggested that there would be a considerably influential officer behind the person and hence the other company officials would be afraid of taking action against him.

The Saudi Government provides substantial funding to businesses, both financial and non-financial, and in return expects a 'pro-rata' representation of its employees on the respective boards. These officials then serve on boards, often with no financial literacy or business acumen. This lack of knowledge and necessary experience are detrimental to the boards, as Government officials rarely contribute to the decision-making process as a whole, or to the process of running a commercial business.

GB2: "*The Government invests through its funding in financial and non-financial firms. It has many memberships in these firms, as a result of the funding, in which employees of the Government are distributed to represent the investment. Those employees are joining boards without proper qualifications, the necessary experience or training. They cannot give a thing to boards because they have nothing to give."*

Another factor contributing to the lack of participation of Government representatives on boards is their passive style or behaviour during boardroom meetings.

IB1: "*Usually the Government representative is quiet and calm during our meetings."*

Their seeming lack of involvement within meetings clearly highlights the deficiency in the skills, knowledge and experience necessary to contribute effectively. They also

demonstrate no sense of accountability or responsibility for any of the outcomes or consequences of board decisions.

In direct contrast to this, the passivity of Government representatives is turned on its head as certain individuals are visibly manipulated from the outside, or even from insiders, when making crucial business decisions. This is especially so where the Government has much larger stakes within a bank. There exists a very definite dichotomy within the role that Government representatives undertake.

Another factor which influences boardroom decisions is that Government officials often employ other employees who also lack proper qualifications and skills, such as family members. The major implication of nepotism within Saudi banks is that preference is given to family members rather than minority and other stakeholders when it comes to making boardroom decisions. The rights of minority shareholders are at great risk due to personal relationships and this hinders their own influence and power.

It has previously been explained that Government funds to Saudi firms necessitates a 'pro-rata' representation of their own officials on the firms' boards. Usually, these low paid officials receive monetary bonuses and other financial rewards as remuneration for their work.

> *GB4: "I think that these funds which assign employees to firms'boards, compensate them for their low salaries. They are highly rewarded through board bonuses and the system works well for every party."*

The placement of these officials onto boards has two distinct advantages; Government interests are protected via the presence of their own employees, and the officials receive a higher income for attending meetings, due to board bonuses and other rewards.

Government officials on boards have a tendency to claim expertise and knowledge of the business despite their lack of skills. This 'acting' ability masks their incompetence and sometimes it is difficult for directors to identify just who possesses the 'know-how'.

> *GAC1: "And we like to stay in the grey area. In the grey area, we can mix things and claim expertise or knowledge and escape responsibilities when the winds do not blow as the ships wish."*

Scheduled board meetings, which meet three to four times per year, are viewed as a somewhat social affair, especially with family members and personal colleagues present. This is sometimes planned intentionally by the board chairman, as board members usually have very busy and demanding calendars. With the reading of pre-defined agendas normally taking up the bulk of the time during meetings, there is little room for more important issues and other areas of concern. The trust in the board chairman and the ability of the CEO to make crucial corporate decisions allows the passive Government officials to take a 'back seat' and keep their lack of competency well-hidden.

> *SB1: "The chairman has to play his role effectively to change the settings of scheduled meetings. Board members should do their homework before attending a meeting and the agenda must be flexible to include items that can be discussed openly and with the intention to come up with solutions."*

The general consensus was that a nation's political environment affects the practice of corporate governance and the setting up of regulatory and supervisory agencies.

7.2.2 Ownership Structure

The ownership structure has important implications for corporate governance initiatives (Shleifer and Vishny, 1986). For instance, the form and nature of company legislation that differs from country to country influences the financial system and ownership system substantially. Unlike the United States or other industrial nations, the ownership structure in developing nations consists of a high proportion of family and state ownership.

When there is a concentration of ownership by only a few families, it will lead to a situation in which these families will possess the power to lobby government agencies and authorities for preferential treatment and allotment of contracts. This would also affect the evolution of a proper legal system in the country. Therefore, the ownership structure of the corporate entities is an important phenomenon in the economic development of any nation.

The ownership structure in Saudi Arabia is found to consist of majority holdings owned by families to the extent of 75% of the corporate entities. Government and individual founders own the shares in the remaining 25% of the firms. With the eagerness of the government to encourage private participation in the economic development of the nation, the Saudi government has been embarking upon a number

of privatization programmes. However, the government retains the control and ownership of large public utilities.

Family businesses that have existed over a long period of time have converted themselves into large companies and have gone through the route of Initial Public Offering (IPO) to get them listed in the stock exchanges. This is one of the major reasons for significantly large stockholdings by families. Since there is no provision to issue different classes of shares having different voting rights, the families consider it prudent to hold the shares in bulk with family ownership. Another reason for block holdings may be found in the nature of the Saudi societal framework. Traditionally commercial activities have been in the hands of only a few well-to-do Saudi families, with the remaining families earning their living by hard labour. With limited sources of income, the other families were not in a position to enter into trading in stocks. This led to an ownership structure where large stock holdings were controlled by the government or large families.

In the context of the financial sector, government, large families and foreign partners retain the control and ownership of local banks. One regulator interviewee argues that although SAMA has effective control over changes in bank ownership, there are no legal provisions on the transfer of significant ownership. In other words, SAMA controls who can own significant shares and subsequently those owners are trusted parties who can be relied upon to maintain the transfer of ownership within 'an approved list of owners.'

> *RS1: "It is not something that is open to the public to be a controlling shareholder in any bank! Look at the names of controlling shareholders in all banks; they are very limited and well known families."*

It is argued that concentrated ownership structures allow controlling owners to use their effective control over firms to influence the information disclosure.

The control of shares in a few hands enabled some business groups to influence day-to-day operations and bank management through board representation. Also, it influenced the voting systems which undervalue the significance of assembly general meetings.

A study of Saudi banks found that 72 out of the 108 board seats in the country's banks are held by local families, which accounts for 66% of the total seats (Aleqtisadiah,

2013). The study also indicated that the most prominent of these are twelve (12) families who control 33% of the total banks' seats.

These families retain their control by a close mutual relationship with the government by inviting government representatives to serve in their controlled banks. In the past, these founding families (or banks) used to work as a central bank providing cash to the government. In return, the government minimised external competition, distributed the local market among banks and provided protection to the banks' owners and directors. The business elites are involved in the politics in various capacities in order to secure and advance their interests. As a result, they would not be keen to give up their controlling shares, as indicated in Aleqtisadiah study (2013).

The long-standing relationship between banks' owners and the government has resulted in tolerance of nepotism and kinship ties, which has served to override economic rationale. For example, regulators are 'turning a blind eye' (RS1) to those who are not qualified to serve on banks' boards, and, indeed, they are permitted to do so because of these ties. These close ties have policy implications when it comes to forming and implementing the code of law and enforcing regulations.

> *SB1: "Wherever you go, you will find family members and relatives who are willing to help you out, whether you are right or wrong. It is some sort of code of practice that everyone follows in order to benefit from this cycle of relationships."*

A number of interviewees, especially AC directors, complain that senior[44] directors lack the basic skills to effectively contribute to the process of decision-making. AC directors claim that senior directors treat banks in much the same way as they treat any family business. They continue to attend meetings in order to keep their presence on boards, but without making substantial contributions. They tend to focus on compliance – ignoring wider issues, in order to fulfil the regulatory requirements.

> *GAC2: "Those directors are already over 60 or 70 years old and have no motivation to learn new things. They are here [on board] because they were asked to be here."*

> *IAC1: "We have three of the major shareholders on board who are over 70 years old. They are very busy with their family businesses and only attend meetings to make sure that the bank has no problems."*

[44] Senior directors include elder and long serving members of government or family representatives.

On the other hand, one of the regulatory representatives argues that the reason that controlling shareholders of banks resist some political (regulatory) pressure for reform changes is largely due to the existing rents that they could lose after reforms. He remarked as follows:

> *RS2: "They will lose part of their wealth and privileges if they agree to changes like holding them responsible for their actions or removing a director."*

Interference by owners or non-executive board members in the day-to-day management of corporations was seen as a possible setback for good corporate governance.

A view was also expressed that continued government ownership of shares in "privatised" corporations was a breeding ground for political interference in the running of those organisations.

Interestingly, another regulator interviewee stated that regulations are confusing in many cases, such as the use of "first-degree relative" in bank ownerships and transactions. The regulator interviewee stated that:

> *RC2: "We are in a society that has extended families and is rooted in tribal relationships. So, when SAMA or CMA use the term 'first-degree relative' in the appointments and conflict of interests provisions, it is something that concerned me. They should define the term to ensure that close family relationships are taken into account."*

In this statement, RC2 is making reference to CMA and SAMA regulations[45] that define first-degree relatives as parents, spouses and children. In this context, this definition has a legal defect, as it does not consider other family, social and tribal ties. The breach of independence, for example, being limited to first-class kinship is illogical because it excludes other family members (brothers, cousins or nephews) and others who may serve on boards because of their relationships.

The interviews illustrated that with the concentrated ownership structure that enables controlling shareholders to dominate the firms' board of directors, there is a real concern that Saudi firms are confining their accountability relationship to the controlling shareholders and do not consider the interests of minority shareholders.

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[45] See CMA, 2010 and SAMA, 2012

Publically available data on the ownership of Saudi listed companies is very limited. According to the Economist Intelligence Unit (2003), ownership of Saudi listed firms is highly concentrated. Approximately one-third of the market's total capital is owned by the government (including public pension funds), and another one-third is held by block holdings (large families).

7.3 The Regulatory and Supervisory Framework

The foundation for any corporate governance is provided by the basic legal framework that encompasses the rule of law and a sound system of enforcement. This section provides evidence related to the legal, regulatory and supervisory authorities.

7.3.1 Legal System

When discussing a particular system of corporate governance, it is useful to identify the main external legal institutions which affect corporate governance practices in that system. By 'the external factors affecting corporate conduct' is simply meant the composite of rules and regulations which corporations are required to observe. Whether these regulations have been imported from outside by way of legal transplants or have been a product of local factors is also another issue of concern.

An external factor which needs to be given particular attention when addressing the issues that matter in any system of corporate governance is the regulatory authorities. These institutions have two main tasks, namely: first, setting up rules and regulations which are effective in protecting investors and preserving the market's integrity; and second, overseeing whether these rules have been convincingly implemented. The term 'legal authorities' means (at least in the Saudi context) an arena where distinct institutions overlap in a complex way, namely: all the legislative, executive and judicial bodies empowered by the King to take responsibility for monitoring stock companies. These bodies include, namely; the Ministry of Commerce and Industry (MOCI), the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA).

CMA, as argued by regulatory responses, has employed consultants and experts to work on drafting the CG Code. Similarly, CMA has called the public, including businesses and academics, to debate these drafts and provide recommendations to draw a final draft that suits regulatory and businesses needs alike. However, a regulatory respondent explains that, due to the lack of knowledge on the issue of governance,

people did not participate effectively in the formation process of the Code. He stated that:

> *RC1: "CMA has to draw these [governance] regulations based on best practices. The problem is that most of the listed companies are family businesses or were family businesses that have recently become public. Typically, they don't appreciate regulatory control and the corporate governance resembles such feelings."*

The findings suggest that one of the problems the Saudi legal and supervisory system is facing is the weakness of the enforcement mechanism; as a strong regulator is required to enforce appropriate implementation of standard laws and regulations. Interestingly, some responses question the effectiveness of the CG Code when enforcement mechanisms are not present.

> *RS1: "CMA doesn't have the power to penalise the 'big' players in the market. Companies may appear to be complying with the [corporate governance] regulations but this is not the reality."*

> *RC2: "We have the best of laws and regulations ... it is a matter of enforcing them."*

In harmony with the previous statement, most of the interviewees are calling for greater CMA operational independence (e.g. to exercise its powers and responsibilities). They argue that CMA needs to clarify its role in conjunction with the Ministry of Commerce and Industry (MOCI) and identify the current boundaries of each regulator's jurisdiction.

The issue of identifying the boundaries of each regulator's jurisdiction is more complex in respect to the financial sector. Regulators need to clarify their roles, especially where there is a regulatory overlap. For example, there is some overlap regarding the obligations imposed by the CMA and MOCI. It is unclear how they would be enforced in the event of a major case of a listed company's failure to comply with corporate governance obligations.

In addition to CMA and MOCI, the financial sector is regulated and supervised by SAMA, which creates an overlapping jurisdiction that may lead to duplicative or conflicting regulations.

The magnitude of the overlapping problem could be worrying when SAMA and CMA do not have a memorandum of understanding (MOU) by which to share information

and thus consolidate the supervision authority. In respect to corporate governance, interviewees of both regulators (SAMA and CMA) show that the other party lacks the expertise and resources to provide effective supervision. For example, a SAMA interviewee stated that:

> *"It has been SAMA's job for a long time to monitor [the] capital market. We have the knowledge, experience and the staff to do so. Banking business is very complex and risky in a way that CMA can't comprehend."*

Similarly, another SAMA interviewee noted that,

> *"We [SAMA] started corporate governance practices a long time ago by introducing boards' responsibilities in 1982 and audit committee guidelines in 1994. I understand the need for the listing requirements, but CMA or even MOCI don't understand the nature of banking business that is subject to international standards. Banks are ahead of the rest of the businesses in terms of governance due to SAMA's strict supervision."*

On the other hand, a CMA interviewee argues that "*SAMA may possess the resources to oversee banks operations, but corporate governance is a completely different process that needs maintenance by a specialised regulatory body*".

The establishment of CMA (in 2003) was a starting point by which to regulate and develop the local capital market by issuing required rules and regulations for implementing the provisions of Capital Market Law (CML). Therefore, the introduction of the CGR[46] (in 2006) was logically expected to develop and improve the regulatory framework. CMA claims that it took the best practices of the CG between principal-based and rule-based approaches, while taking into account the local cultural values. However, a closer look at the CG Code would indicate that CMA is oriented more towards a rule-based approach. The process of implementing the code was gradual as the CG articles were not mandatory for listed companies except those that are already mandatory in the Company Law (CL). Subsequently, CMA started to enforce the implementation of certain articles that would promote the concept of corporate governance, provided that companies are ready and prepared to accommodate mandatory articles.

[46] CMA calls it "corporate governance regulations in the kingdom of Saudi Arabia"! The word "regulations" may give an indication of CMA's desire to stress the importance of the obligation to follow the CG articles rather than calling it a Code – I think it is the effect of local cultural context to give more weight to the CG.

A board member argues that changes in supervising the local financial system are notoriously slow.

> *SBC: "The change base here is very slow and may take years to implement (if approved) but still I believe that regulators are keen to make changes. Even a small change will count."*

This is most likely due to the fact that the Government is opposed to making any sudden changes, because of the adverse consequences that may occur.

> *RS1: "The point here is that they do not want to make big and fast changes that people and businesses are not familiar with! There will be market chaos ... not to mention the readiness of authorities."*

Representatives working for SAMA do not usually consider the wider aspects of their employment. It is customary practice in Saudi Arabia that Government officials have guaranteed job security, with the only reason for dismissal being non-attendance for work. This means that any performance-related issues are not normally questioned, evaluated or criticised. Their jobs are safe. The main issue with this is that their supervision of the markets can be adversely affected by this comforting fact and extra effort at work is rarely seen.

> *RS2: "The issue of job security in SAMA is negatively affecting the level of the agency's supervision."*

In an ideal and effective regulatory system, every bank follows the same rules and adheres to regulatory authority control and supervision. There are exceptions, however, where certain banks can bypass this control and be excused for their unlawful actions, much to the disgust of other banks. Special treatment of some banks exists and consistency and conformity is lacking. One board chairman stated that:

> *SBC: "I expect that SAMA or CMA treat all banks on a 'level playing field' so that every bank has an equal chance. Yes, there might be cases where they [SAMA/CMA] would allow a bank to bypass certain regulations, but this only happens in rare cases which are deemed necessary by regulators."*

Informal communications amongst bank directors is common practice, but this practice goes beyond banks to the regulatory authorities.

> *GACC: "Informal communication to resolve banks' problems are common practice and can save all parties a great deal of time and effort."*

RS2: "Yes, our senior officials may talk to [banks] directors to clarify something or to resolve issues that should not go public."

Interestingly, some responses suggest that this relaxed and undefined conduct is usually effective and, most importantly, issues are tackled quickly. However, informal communication is often utilised to override banking regulations and laws.

GB3: "Of course SAMA has the upper hand and is in total control. What I am against is that informal communications should not be treated as the basis for the system."

Within the Saudi legal system, there are two important factors that influence whether a legal matter will be dragged out for years. Firstly, the lack of resources can cause great impact on the timescale for resolving the issue in question; and secondly, legal officials often demonstrate a lack of responsibility towards these cases, which causes frustration with the system.

RS2: "People are frustrated with the legal system as it takes years to settle cases. It is sometimes confusing to know where to go to complain, as regulators lack jurisdiction over the subject matters or have conflicting rules."

The legal process in itself, apart from being very drawn-out and lengthy, also causes concern due to the unclear process for filing or pursuing a case. Multi-regulatory authorities have created a 'minefield' of procedures to follow. Some regulators simply do not accept complaints due to their own lack of jurisdiction, leaving the multi-regulatory authorities in a far superior position.

SAC1: "For some cases, you really do not know where to go! If you go to SAMA they say go to CMA and CMA would say go to court and so on…"

The 'elite' boardroom members (the more superior directors of Saudi banks) have a certain perception that they are above the law and they tend to look down on regulators' representatives due to this heightened and somewhat egotistical character trait. More often than not, they are senior Government officials or from wealthy families with strong political connections. They often view regulators as having a far inferior job role, with routine and menial responsibilities.

RS1: "Those who are behind closed doors do not see us as anything but reporters coming to 'tick boxes' and leave after dinner. They have no fear of or respect for the law."

Some responses suggest that directors are more concerned with basic compliance and ignore the wider issue of understanding how their businesses function with the help of laws and regulations.

> *RC2: "It is not healthy that some directors promote their superiority to regulators. Showing respect to authorities' representatives indicates a respect for the law and for the system."*

There is a tendency for Government policies and company regulations to be publicised, rather than strictly followed. The major disadvantage of this is that implementation of these policies would create a strong and effective banking system, which would result in a considerable impact on the current state of affairs.

> *RS1: "Well, my 30 years of experience has shown me that the Government and companies publicise most of their policies or regulations to 'throw dust in the eyes'. If these regulations were taken seriously, the magnitude of change would have been very evident. There are many positive changes but the rate of change is very slow."*

Although some regulators acknowledge the positive changes that have occurred, they are disappointed with the time scale of these positive changes and how regulations are enforced. Nevertheless, it is understandable that political institutions determine the formation and quality of the corporate governance, thus changes in corporate governance are likely to emerge slowly. The framework of corporate governance also depends on the legal and regulatory environment.

Saudi Arabian business culture has traditionally been built around close personal connections and family relationships. These connections are the 'backbone' of any firm and the regulatory representatives acknowledge this. There is a 'fine line' between what they can and cannot do, without causing disruption and tension. Personal pride is of significant importance to Saudi businessmen and regulatory representatives are well aware of this.

> *RS2: "The inspector needs to find a balance between his job duties and social needs. We live in a very small world and you do not want to mess with someone who might be of help to you in the future or who happens to be related somehow to your family."*

The importance of close family and personal ties within Saudi firms serves to create an atmosphere of safety for senior employees. Board control can be maintained via these

relationships and respect and support for the law is often neglected due to this ‘safety zone’.

> *RS1: “It is very important to understand how those ‘top’ people work in controlling their businesses and interact with authorities. They have close relationships through marriage or friendships which creates a safe zone for them to work in without fear of any consequences.”*

Non-compliant behaviour of Saudi firms is a regular occurrence and regulators often complain about this. Although the Saudi government supports the enforcement of banking regulations there still exists a conscious ignorance of the law.

> *RS1: “We have the government’s support and direct instruction to force regulations upon listed companies. The King himself publicly stated that everyone, regardless of his name or position, is subject to the law.”*

> *RC1: “Banks are good with governance compared to other companies but they have serious issues with providing details of compensations paid to their management and executives.”*

There is a growing concern among regulatory interviewees regarding the conflict of interest posed by a former or current employee of regulatory authority sitting on a bank boards.

> *RS2: “All of the regulators are government bodies and therefore not fully independent. This setting creates confusion and a conflict of interests as a good number of banks’ directors were part of the regulatory authorities or vice versa.”*

Some responses question the role of SAMA in providing vigilant and ‘equal’ monitoring of all banks. This role is brought into question by the influence of senior employees and other major players in and around banks.

> *RS2: “SAMA shows to the public that it’s in control but, in fact, banks are in the driving seat. SAMA treats banks carefully because of the power and influence of some of those in charge of banks.”*

Interviewees suggest that the culture has an effect on people relationships and thus, personal or professional connections are key factors in how business is done. For example, they argue that informal communications are widely used between known

parties; but, at the same time, some responses suggest that such communications may result in an intervention of laws and regulations.

> *RS1: "SAMA is like any other government agency; they resolve problems and concerns with bank directors over phone calls. This is because they [SAMA officials] and those 'top' directors are somehow related and well connected."*

In this context, regulatory authorities often deal in a different manner with different banks. This can be attributable to a lack of power and influence when imposing certain laws and regulations on a particular bank, due to the directors' political and family connections.

> *RS1: "SAMA and CMA lack the power and ability to equally enforce regulations upon banks. For example, one bank might be penalised for something that the other bank is doing freely, simply because the management of this bank has the power to do such a thing."*

Within business practice, the issue of non-compliance often dominates the day-to-day running of firms. This could be attributable to the traditional business ethics of long-serving employees who have sat in senior positions for many years.

> *RC1: "We have a serious issue of making people adhere to rules and obey the law."*

Regulators complain that, although banks are in compliance with the standard corporate governance requirements, their compliance is not translated and reflected upon their operations and behaviours, which is the basic purpose for having laws and regulations.

> *RC2: "In general, banks are complying with the basic requirements of corporate governance, but they are not realising the intent of those who wrote it."*

This may explain why banks try to meet the minimum requirements while, on the other hand, have legal violations – it may be difficult for them to realise the 'intangible' side of the added value of compliance.

For the regulation of corporate governance for listed firms, there is some overlap regarding the obligations imposed by the CMA and MOCI. It is unclear how they would be enforced in the event of a major case of a listed firm's failure to comply with these corporate governance obligations, which involve serious breaches of directors'

duties. Additionally, there is some overlapping in the area of supervising listed banks where the responsibility is divided between CMA and SAMA.

Finally, prior literature (Claessens et al. 2000) suggests that the possible endogeneity of legal systems implies that future legal and regulatory reforms in some countries may need to be associated with changes in ownership structures and concentration of wealth. The control of the banking sector by a few families hampers the development of institutional reforms, as these groups of families control access to resources and would not challenge the status quo of the current institutional environment.

7.3.2 Corporate governance Principles

Corporate governance can be defined as being the rules, regulations and policies imposed upon firms in order for them to comply with strict regulatory requirements of control. With specific regard to Saudi banks, a corporate governance form of control has been mandated upon listed firms, with SAMA also publishing their own set of corporate governance regulations (CGR).

The local stock market crash in 2006 resulted in millions of Saudis losing considerable sums of money. As a direct result of this, a corporate governance code was established, especially as the Saudi stock market was becoming particularly interesting to international investors.

> *RC2: "Of course, the stock market crash in 2006 was a driving force in establishing the [corporate governance] code. There was growing interest in the Saudi market and the Government wanted to restore and improve confidence in the system."*

The following statement highlights very clearly that the director views corporate governance as simply being a 'trendy' technique for management to utilise. He implies that there is more enthusiasm for the title, than for the outcomes of the control system. It also demonstrates his distinct lack of understanding for this system of rules and why they are needed, especially within a boardroom setting.

> GB3: *"Corporate governance is another management fad. People get fascinated with big titles like 'corporate governance' but do not pay attention to the effects of these things on business. Personally, I have not seen any 'good' changes to our bank after adopting a corporate governance form of control."*

There are many Saudi firms that are not listed and are therefore not legally mandated to comply with corporate governance regulations. However, there is a tendency for

some of these firms to adopt corporate governance into the running of their businesses for different firm's objectives. For example, an adoption of corporate governance is sometimes due to the personal desire of just one individual, rather than the board as a whole.

> *GB1: "The bank was the first Saudi bank to adopt a corporate governance initiative. The initiative was the board chairman's idea; he pushed for it and hired a consultancy firm to implement it. The board did not know about it until the consultancy firm came to give us a presentation and we did not see a problem in supporting the chairman's initiative."*

The chairman's satisfaction with corporate governance has been a major factor in the adoption of corporate governance, because of the chairman's power to control and influence the bank. The power and influence of the chairman is clearly demonstrated by his actions here. He shows little regard for other board members and also takes an autonomous role in the decision-making process. It is assumed his reasons for this were to imitate international banking standards, with no real drive or determination to actually carry out the requirements of the corporate governance code.

Support for autonomous decision-making from the chairman does exist amongst board directors, regardless of the fact that he has broken corporate rules in doing so. An interesting comment is made by a board member trying to justify the decision-making process in his bank and the behaviour of the board chairman.

> *GACC2: "No, it was the chairman's idea and his own beliefs led him to make this decision. The chairman is a very experienced director and I think he came up with the idea to put the bank at the fore-front of the 'banking world'. But honestly, I cannot tell if it has changed the way we do business, but I know for sure that our people are bragging about it wherever they go."*

The quote also reiterates the adoption of corporate governance here as being simply ceremonial in function. It is regarded as something 'you want to do' as a "management fad" rather than something 'you have to do'.

However, the opportunities for capital market development are seriously hampered by the challenges faced by the Saudi capital market. These challenges include, namely: a rapidly changing marketplace, the need for more enforceable information disclosure by listed companies, fair valuation of new issues, introduction of world- class regulatory standards, the strengthening of corporate governance and the cross-listing of stocks on

regional stock exchanges (Khaleej Times, 2006). In addition, another problem facing the economy is the lack of adequately qualified people, especially in finance services and other key areas (Khaleej Times, 2006).

Most directors of Saudi banks value compliance and the laws that are put into place for how minority shareholders and other investors are treated. However, the actions of those directors proved to be otherwise. Hiding sensitive financial information from those outside the business puts controlling shareholders and insiders at a distinct advantage in terms of accessing this information. They are then in a much better position to make better decisions.

> *SBC: "This is very sensitive and confidential information that we cannot share with the public. The cost of paying fines is much less damaging than disclosing this information."*

A board member asserts that his bank is serious about complying with regulations; however he makes a contradictory comment in an earlier quote that the violation of regulations to protect confidential information is acceptable. As discussed previously, banks are more than willing to pay fines for their misdemeanours, as this is seen as less damaging to the business than following the rules. The authorities view the publication of financial information to be highly important, however they do not view this information as being confidential.

> *SBC: "The bank deals seriously with regulators' directions and makes sure that their requirements are fulfilled. At the same time, the bank has the choice of not complying with non-mandatory rules based on the relevant circumstances. So, regulators should not misjudge a bank's compliance if the bank is only meeting the minimum requirements."*

The regard held by the major players of directors for the concept of compliance is clearly demonstrated by this statement. Banks tend to meet the minimum requirements merely to fulfil regulatory demands, rather than aiming for better performance in terms of following regulations and guidelines.

Major shareholders of Saudi banks are usually assigned top priority in the decision-making process, which gives them the power to intercede directly and frequently in the boardroom process. The interests of minor stakeholders are often ignored in favour of the bank meeting the interests of controlling shareholders.

SB1: "As long as the bank is making a profit then I care less about other things. The bank cannot be doing badly and making a profit at the same. Our shareholders want to see profitability and that is what we are working on."

7.4 Cultural, Social and Ethical Environment

7.4.1 National Culture

Saudi society is divided into many tribes, and generally the regulation of these tribes depends on the personality of the individual in the tribe with the authority to make regulations; it is almost always the head of the tribe who is in this position (Alkhtani, 2010). Therefore, there is considerable evidence to suggest that power is not distributed equally among people where certain actors are more influential. Thus, the literature suggests that Saudis accept hierarchical order, that subordinates expect to be told what to do and the ideal superior is a 'benevolent autocrat'. In this context, leaders would be 'culturally' entitled to intervene in fellow members' conflicts to provide solutions.

Some banking directors look at profit margins only and this success leads them to ignore key business strategies and new opportunities.

ICEO: "It is Saudi culture to value peaceful relationships and to try not to 'rock the boat'. Some boards prefer to accept a passive or silent director rather than a wise one who strives for the good of the bank. Other directors appreciate numbers and figures without giving more thought into strategic thinking or searching for better business opportunities."

A typical career path is dependent upon an individual's qualifications, performance and the ability to learn and acquire new knowledge. Apart from that, a typically well-connected individual can reach the summit of his career with the support of his family and close personal relationships in the Saudi context. There exists an 'old boys club' network that looks after the interests of those working in the financial industry at senior levels.

IB2: "The financial industry is like a big club where everyone knows each other. You start your career in MOF or SAMA then one day you become a board member. Later, if they like you, then you will become a chairman and then a board member of Tadawul[47]. If you're really lucky and your parents'

[47] Tadawul is the Saudi Stock Exchange

prayers are answered, you might be promoted one day to be a deputy minister or even a minister.”

Regulatory representatives are often considered as being in a more inferior position than board members. This is mainly due to issues of culture; the class system within Saudi Arabia being the main attribute. Often, directors of banks do not consider the efforts of regulatory authorities as a way of helping to identify areas of improvement. A hostile attitude towards their work often exists and their efforts are in vain. Job performance can be negatively affected and the regulatory representatives recognise and sometimes accept this, without complaint.

> *RS2: “People look down on those who come to inspect or supervise their banks’ activities. They accuse them of making a living out of others’ mistakes. In some cases, inspectors feel embarrassed to highlight or to report wrongdoings in order to escape this bad image.”*

Some responses indicate that in some cases regulatory authorities may not be in a state to recognise or act upon illegal activities that banks might be doing. It is questionable therefore whether regulatory representatives actually possess the necessary qualifications, skills and ‘know how’ to tackle these wrongdoings.

> *RS2: “There are regular and scheduled visits to inspect banks but the issue is the competency of the inspectors.”*

This can also be attributable to different factors, the most important being the lack of resources and power that regulatory authorities have.

> *RC2: “It is a very hard job to track bankers’ activities because they find smart ways to hide things and always be ahead of us.”*

Interestingly, all of the interviewee directors expressed the opinion that regulations are important and claim to follow them. However, the research reveals that directors tend to depend heavily on the use of informal processes and relationships in their businesses. The issue of ‘non-compliance’ culture is widely accepted as part of the business environment.

> GB3: *“Rules are put in place to follow but when you can do something without harming others then I don’t see a problem with that. Everything is changing and you have to be flexible.”*

As an illustration of the importance placed on directors' personal traits (e.g. high levels of honesty and integrity), one director remarked:

> *"We lack methods of discovering fraud as well as punishing them. In addition to that there is the impact of the culture of mercy towards a person whose honour is compromised. "*

7.4.2 Social Expectations

Culture and social norms provide the basis for people to construct social expectations. The normative behaviour that an individual observes in society impacts on the way he perceives others. When something becomes normative, it becomes not only permissible to do but rather obligatory. Thus, people tend to respond to this pressure by adopting social norms and tailor their behaviour to meet the expectations that those norms provide. When an individual does not meet these expectations, misunderstanding and conflict can result in social pressure where he might be sanctioned to conform to the expectations of others.

In the Saudi context, people are unable to articulate many of the social instances, for example, why they do certain things or act in certain ways. Their conformity reflects the demands of their social network without any reflective process to produce awareness of those demands. For example, one regulatory representative argues that board members and top management of certain banks are perceived to be different compared to their counterparts.

> *RS2: "There are some directors, especially in government banks, who feel that meeting with someone like a SAMA employee is a waste of time. And when it happens and you meet with one of them, then they expect you to show high respect and appreciation."*

Further, a board member argues that certain groups of individuals have the privilege to sit on leading firms where those who are not part of these groups or minorities would not have the opportunity to join these boards.

> *SB2: "All of the top companies' board positions are held by top government officials and wealthy families. You just cannot see a normal or a minority individual sitting on these boards! This is how it goes."*

In this context, those individuals adopt the leading roles perfectly by behaving in certain ways that are expected of them and thus they meet others' expectations.

Society holds high expectations towards an individual's age and professional activity. People value seniority in the sense that a higher age implies a certain amount of life experience and wisdom. However, a board member argues that the "seniority" issue can be misleading and may create conflicts, as "seniority" does not guarantee valuable experience.

> *IB1: "The perception that old people know better is not valid all the time in business. Otherwise, we will be basing our decisions on emotions and irrational reasons."*

The individual's age (or seniority) issue has implications on the work of regulatory authorities, as the age difference plays a major role in possible confrontations.

> *RS2: "When there is something big happening in a bank, we then have problems dealing with those older and eminent directors. There are social barriers when it comes to such situations where you cannot make a direct accusation."*

Some responses suggest that the media and the press portray the social life of certain groups in a way that influences peoples' expectations about them.

> *RC1: "banks pay good money to media and newspapers for advertisements. So, you always see those banks' directors doing interviews or talking publicly about many issues."*

Further, the influential directors realise the social expectations of others towards them and thus they engage in actions or behaviours that may not be in the bank's interests.

> *GAC2: "When a former minister becomes a director, he brings with him the social legacy to the board. They give orders and do not like to be asked about their actions. Basically, they think of the [bank's] employees as followers and try to maintain this social gap."*

Furthermore, another interesting statement is made by a board member who argues that the chairman acts in total control as he expected to do, due to his long-serving experience and the support of the controlling shareholder.

> *GB4: "It is quite interesting to see our [board] chairman act as if he is the 'godfather' who knows the best for the bank and its employees!"*

Moreover, some directors suggest that board chairmen or controlling shareholder representatives may put their trust in certain board members who are perceived by them as being trustworthy rather than considering their qualifications.

> *IB2: "The chairman has no time for the bank and therefore he is putting the fate of the bank in the hands of two or three members who are close to him."*

The interviewees suggested that social expectations in business might provide insights of an expected behaviour of an individual and thus people can be prepared to react accordingly. However, the evidence provided shows that in some cases those directors may use these expectations to exercise influence on an individual's decisions and behaviour.

7.4.3 Accountability

All of the interviewees share similar perceptions of the importance of accountability and that individuals should be accountable for their actions within a predefined framework of authorities and responsibilities. They suggest that promoting accountability is an essentially important factor in performing their activities.

> *GACC: "Accountability is the basic principal that every person should have, not only in business. But, it should also be clear what the limits are so people can know what is expected from them."*

> *RS1: "I cannot imagine a legal system without clear lines of responsibility and accountability defined at all levels in any given company."*

While the participants unanimously declared that the mechanism for accountability exists in relevant regulations, especially in the Companies Law (CL), the majority of them nevertheless indicated that regulations are failing to clearly define accountability and the consequences for breach of accountability.

> *SAC1: "In our religion, every one of us is accountable for his actions. Also, our culture is built around accountability and trust but the problem for many of us is to apply this in our daily activities. In business, for example, people are not afraid of being liable for their actions because we haven't seen anybody being punished for wrongdoings."*

As an illustration of the absence of public accountability, the regulatory authorities did not hold any press conferences to describe what has happened since the stock market

crash of 2006, nor has it held any individuals or companies responsible for investor losses.

> *RC2: "It was very depressing to see people who lost their savings, properties and everything in the collapse of the stock market, yet the Government failed to identify who was responsible for that disaster."*

The strength of influence of political connections on government actions seems to be a plausible explanation here, especially in terms of bringing misdemeanours to justice.

However, a board member provides an interesting view of accountability which is manifested in running the bank in the interest of shareholders.

> *SBC: "There are many goals ... being accountable to our shareholders is the main goal for the board to achieve, otherwise we are not doing our job properly."*

What is evident in this statement is that accountability is sought after by shareholders and thus, boards would not have been given the chance to work against their interests.

Furthermore, there was a divergence of views on whether the local culture has any effects on the role of accountability. Most participants noted that accountability is important, as discussed earlier, but some noted that this varies. They noted that accountability differs based on the perception and understanding of an individual, which might have a direct relationship to his working environment, in some cases.

> *RS2: "How do you define accountability? Think of a director, for example, who might look to outsiders as misusing the resources of a company; but on the other hand it might not be the case for the shareholders."*

> *RC1: "...about banking where directors are more accountable to their major shareholders not to the system. When a director knows that no one, other than those who brought him in, can fire him or question his actions then mentally he is comfortable."*

There are some responses that suggest that firms may undertake certain actions to avoid liabilities. For example, there is a tendency within the management of banks to give verbal instead of written instructions, especially when there is a case of law or policy breaking. As a direct result of this, internal and external auditing may find it difficult to identify those responsible and thus hold them accountable.

IAC2: "The worst things that are taking place in banks are the verbal instructions which make it hard to internally trace the decision-maker or who is responsible for the action."

Furthermore, a very serious issue exists within Saudi banking, where some directors treat their banks as being their own personal property and thus, they are more likely to consider any associated firm to the bank as customers rather than partners. They exert total control yet have no sense of responsibility because they have nothing to fear from society (their family and other personal connections) or the enforcers of the law.

RS1: "We have cases where banks' directors would put real estate mortgages and trusts under their personal names. Beneficiaries may take years to make successful claims on their monies because some of those directors attempt to bargain in order to release them."

It has been mentioned in previous chapters that a director's dismissal or termination is one of the local taboo subjects that interviewees avoid during the interviews. However, there have also been a number of responses that deny the idea of dismissing or terminating the employment of a director. In this context, a director is more likely to have less regard for regulatory authorities and the public at large.

7.4.4 Corruption

Corruption is becoming a major issue of national concern in Saudi Arabia. In 2010, local newspapers (Aleqtisadiah; Alriyadh; Okaz) reported that the General Auditing Bureau (GAB) had complained to the King about the increase in corruption. They reported that some Government officials are involved in the illegal spending of public funds, whilst others are awarding projects to firms that are not delivering or complying with budgetary allocations. Following persistent complaints about widespread mismanagement and other malpractices in the public sector, the GAB stated that:

"What happened in Jeddah[48] clearly illustrated the poor performance of government departments because of bribery and widespread corruption....these institutions are also suffering from the lack of clear policies and action plans in addition to bureaucratic complications in decision-making...this is only putting pressure on the budget and increasing economist costs."(Okaz, 2011)

[48] The GAB is making reference to the catastrophic floods and rains that hit the Red Sea city of Jeddah in 2010.

Furthermore, he asserted that the lack of qualified auditing personnel in government bodies is one of the major issues for ensuring discipline and attempting to curb financial malpractices.

> *"Government bodies in Saudi Arabia need to be supported by qualified auditing personnel to pinpoint difficulties facing them so they can tackle all problems inside them and increase their role and competitiveness." (Okaz, 2011)*

In response to this, a National Anti-Corruption Commission was established in May 2011 to combat corruption and put all the government bodies under its jurisdiction, focusing on upholding transparency and combating financial and administrative fraud in the government. However, despite these efforts, rates of corruption are rising.

> *RC2: "It is funny that everyone nowadays is fighting corruption including the King and still the rate of corruption is increasing."*

> *RS1: "Nothing will change until we determine and respect peoples' rights and assign punishments as we assign rewards."*

As an illustration of the importance of government bodies and its officials to promote good governance and thus set good examples of compliance with laws and regulations, some responses suggest that the effect of this is questionable when government officials are perceived as being corrupt.

> *RS1: "If there is corruption within the government circles then they cannot enforce good governance in companies. The government officials serving on boards of many companies also cannot enforce good governance in their companies if they are perceived to be corrupt."*

In a recent report on corruption, Shalabi (2012) predicted a rise in the per-capita income in Saudi Arabia from $20,000 to $83,000 should the concerned parties put an end to the financial and administrative corruption in the Kingdom. He also revealed that the Saudi private sector currently spends $20 to $30 billion per year on bribes, while global corruption costs $2 trillion, according to recent World Bank reports.

Corruption, however, is positively related to monopoly and negatively related to accountability. That is, the greater the monopoly of power in the hands of a few people and the more discretion they are given, the greater will be the size of corruption.

Despite efforts taken by the National Anti-Corruption Commission to minimise corruption rates, Saudi Arabia still ranks unfavourably on the International Corruption Perceptions Index.

7.5 Summary and Conclusions

This chapter provided empirical evidence relating to the contextual restraints on governance. It shows how contextual factors influence and shape the process of board governance of banks. These contextual factors are categorised as, namely: political framework, regulatory and supervisory framework, and cultural, social and ethical framework.

The political system is deeply involved in the work of regulatory and supervisory authorities, as all of these are government bodies and thus, not independent. Moreover, the government has control of and ownership in many financial and non-financial firms that are subject to the regulatory and supervisory authorities. This chapter shows that while political intervention has a large influence on the governance practice of banks, it can also be argued that the corporate governance system cannot be effective without political support.

In particular, the issue of government ownership in banks raises questions about the ability of the regulatory authorities to provide proper regulation of the banking system. In this context, the findings yielded equivocal results on the effects of government intervention in these banks. The government has shares in all local banks ranging from 5% to 80% (SAMA, 2011) and therefore, state shareholding enables the government to remain involved in the decision-making process by appointing government officials as outside directors. For example, 30% of the board members in the case banks of this study are government officials who have been appointed as outside directors. Likewise, the findings indicated that the extent of the ownership structure, of both government and family, of local banks have effects on banks' boards and thus influence the decision-making process. Further, the ownership structure that sees blockholders (large families) controlling 66% of banks' board seats have implications for the corporate governance process at large. In this context, Levine (2004: 17) notes that "the problem in banking is frequently that politically powerful families control the banks and the political system, so that regulatory policies are frequently used to impede, not support, effective corporate governance". Consequently, the regulatory restrictions on ownership structure do not prevent family control but, rather, defend the existing owners from competition for control (Levine, 2004; Caprio et al., 2007).

This leads to a question about the role of the regulatory and supervisory authorities in the field of implementing and promoting good corporate governance. Even though regulation can be considered as an additional mechanism of corporate governance; in most situations it reduces the effectiveness of other mechanisms in coping with corporate governance problems. For example, in the banking industry, regulators are among the main stakeholders, yet their interests may clash with those of other stakeholders (Diamond, 1984; Levine, 2004), thereby creating a new form of agency problem. Moreover, when regulators intervene directly in the shareholding of financial institutes, this conflict of interest is compounded. Such a conflict casts doubts on the efficacy of supervision and modifies stakeholder incentives to control managers (La Porta et al., 2002). This is consistent with the Saudi banking industry where SAMA is the central bank and has shareholding of all banks simultaneously. In this context, regulatory authorities might limit the power of markets to discipline the banks (Ciancanelli and Reyes, 2001) or they may even pursue their own interests as a regulator when they intervene in the shareholdings of banks (Santomero, 1997; La Porta et al., 2002). These constraints could come not only by government regulation, but also by government involvement in the corporate governance of individual firms through ownership and board ties (Wiseman et al., 2011).

The chapter provides evidence that the Saudization of foreign banks, and the privatisation of other local firms, has transferred the public monopoly into private hands, which further strengthens the power of family conglomerates at the expense of a weakened and less diversified economy, causing the public to lose faith in the system due to inequality of power and wealth distribution.

The ability of the regulatory and supervisory authorities to implement and enforce laws and regulations has been an issue of concern among the participants of this study. In spite of the adoption of world-class laws and regulations in Saudi, the findings suggest that the legal system is failing to enforce these laws and regulations. Moreover, regulators need to clarify their roles, especially where there is a regulatory overlap. For example, there is some overlap regarding the obligations imposed by the CMA and MOCI in regard to listed companies. In addition to CMA and MOCI, the financial sector is regulated and supervised by SAMA, which creates an overlapping jurisdiction that may lead to duplicative or conflicting regulations. Regulatory authorities complain that, although banks are in compliance with the standard corporate governance requirements, their compliance is not translated into or reflected upon their operations

and behaviours, which is the basic purpose for having laws and regulations. The evidence here suggests that banks tend to meet the minimum requirements merely to fulfil regulatory demands, rather than aiming for better performance in terms of following regulations and guidelines.

Furthermore, banks' boards are open to an array of cultural, social and ethical pressures from external environments. According to Scott (1987: 498) "organisations conform to social expectations because they are rewarded for doing so through increased legitimacy, resources, and survival capabilities." They are influenced by their institutional context and networks of social organisation and exchange which carry rationalised myths (Greenwood et al., 2008). Hence, the essence of institutional perspective is that an organisation is shaped by wider cultural, social and symbolic elements that constitute its institutional environment (DiMaggio and Powell 1983; Scott, 2001). The influence of these pressures on directors has shaped their actions and behaviours to avoid cultural and social exclusion. In this context, individuals or organizations who align themselves with prevailing cultural-cognitive institutions feel competent and connected, while those who challenge these institutions are regarded as "clueless" or "crazy" (Scott, 2001: 59). In Saudi, regulatory representatives are often considered as being in a more inferior position than board members. This is mainly due to issues of culture; the class system within Saudi Arabia being the main attribute. Often, directors of banks do not consider the efforts of regulatory authorities as a way of helping to identify areas of improvement. The interviews suggest that a hostile attitude towards their work often exists and their efforts are in vain.

In the context of social expectations, society holds high expectations towards an individual's age and professional activity. People value seniority in the sense that a higher age implies a certain amount of life experience and wisdom. However, a board member argues that the "seniority" issue can be misleading and may create conflicts, as "seniority" does not guarantee valuable experience. The individual's age (or seniority) issue has implications on the work of regulatory authorities, as the age difference plays a major role in possible confrontations.

While the chapter provides evidence related to the importance of accountability, the majority of directors nevertheless indicated that regulations are failing to clearly define accountability and the consequences for breach of accountability. As an illustration of the absence of public accountability, the regulatory authorities did not hold any press conferences to describe what has happened since the stock market crash of 2006, nor

has it held any individuals or companies responsible for ($500 billion) investors' losses. It has been mentioned in previous chapters that a director's dismissal or termination is one of the local taboo subjects that interviewees avoid during the interviews. However, there have also been a number of responses that deny the idea of dismissing or terminating the employment of a director. In this context, organisations can demonstrate compliance with norms and values in society by having structures and practices that are (partly) ceremonial, while the actual ways of working are not greatly affected (DiMaggio and Powell, 1983 and Meyer and Rowan, 1991). Thus, the banks are able to decouple particular structural features of the organisation from its primary activities.

Following is Chapter 8 that will discuss the findings of empirical chapters (5, 6 and 7) and attempt to show how these chapters are interrelated in terms of internal and external factors affecting directors' selection process and their dynamics and interactions within the Saudi context, in order to better understand the governance role of directors.

CHAPTER 8: FINDINGS AND DISCUSSION

8.1 Introduction

This research study seeks to understand the role of boards of directors in the governance of Saudi banks. It provides insight and evidence into the effects of both national and institutional governance framework on the selection process of directors, as well as the consequences of these governance issues on directors' dynamics and interactions, with regard to Saudi institutional, and banking, contexts.

Analysis presented in this chapter indicates that, consistent with development of CG initiative in other emerging economies, Saudi has also adopted the shareholder model of CG despite the fact that this model was designed for developed economies and is based on assumptions that may not hold in developing economies (Section 8.2). By analysing the CG framework and the role of different actors in Saudi Arabia, this research finds that these actors are exposed to different levels of institutional pressures and governance concerns that have subsequent effects on their behaviours, as presented in Sections 8.3 and 8.4.

8.2 Scope of Corporate Governance

The Saudi Arabian model of corporate governance has been influenced by the Anglo-American shareholder model of corporate governance. Paredes (2005) mentioned that the success of the Anglo-American model of CG actually depends on agency-theory-based assumptions that is characterised by dispersed ownership, a well-developed legal framework, efficiency of the capital market and availability of qualified personnel to supplement the capital markets. The corporate governance structures in emerging markets often resemble those of developed markets in form but not in substance (Backman, 1999; Peng, 2004). As a result, state intervention, concentrated ownership and other informal mechanisms emerge to fill the corporate governance vacuum. Hence, agency theory fails to acknowledge the full range of institutional influences relevant to corporate governance (Aguilera et al., 2008).

Therefore, it is argued that emerging markets have corporate governance systems that reflect their institutional conditions. So for example, emerging markets typically do not have an effective and predictable rule of law which, in turn, creates a 'weak governance' environment (Dharwadkar et al., 2000; Mitton, 2002). This is not to say that emerging markets have no laws dealing with corporate governance. In most cases, emerging markets have attempted to adopt legal frameworks of developed markets, in

particular those of the Anglo-American system, either as a result of internally driven reforms or as a response to international demands. However, formal institutions such as laws, regulations and their enforcement are either absent, inefficient or do not operate as intended. Therefore, standard corporate governance mechanisms have relatively little institutional support in emerging markets (Peng et al., 2003; Peng, 2004). This results in informal institutions, such as personal relationship ties, business elite groups, family connections, and government contacts, all playing a greater role in shaping corporate governance (Young et al., 2008).

The findings of this current study show that the political system is deeply involved in the work of regulatory and supervisory authorities. All of the regulatory and supervisory authorities (MOCI, CMA and SAMA) are financially dependent on the government and their members are chosen by the government as well. Therefore, the government exercises a significant influence on these bodies. In its efforts to join the WTO, the government has established the CMA to promote free market economy and to behave in an acceptable and legitimate manner. However, the stock market collapse of 2006 created severe problems of legitimacy for the CMA and therefore, the CMA developed the CG regulations to restore investors' confidence in the capital market, as explained by the CMA representative (RC2):

> *"Of course, the stock market crash in 2006 was a driving force in establishing the [corporate governance] code. There was growing interest in the Saudi market and the Government wanted to restore and improve confidence in the system."*

The adoption of the CG 'shareholder model' is consistent with NIS framework suggesting that late adopters of CG codes will tend to mimic established practices for the sake of legitimacy (Enrione et al., 2006). It is worth pointing out that the CMA has not recovered from problems of legitimacy yet, as CMA representative (RC2) further explains that:

> *"It was very depressing to see people who lost their savings, properties and everything in the collapse of the stock market, yet the Government failed to identify who was responsible for that disaster."*

The regulatory authorities did not hold any press conferences to describe what has happened since the stock market crash of 2006, nor has it held any individuals or companies responsible for investors' losses, of nearly $500 billion.

Moreover, SAMA has issued (in 2012) a new CGR for banks operating in Saudi Arabia, confirming that these CG regulations complement other CG regulations, rules and circulars issued by SAMA and CMA. Interestingly, SAMA's CGR is remarkably similar to that of CMA. It would appear that, responding tothreats to its legitimacy, SAMA chose to follow the safe path of adopting the shareholder model of CG, as deemed legitimate by the international banking community. SAMA's search for legitimacy has also pushed it to adopt IFRS while SOCPA accounting standards apply to all other, non-financial, Saudi companies, listed and unlisted.

The process of implementing the CG was gradual as the CG articles were not mandatory for listed companies except those that are already mandatory in the Company Law (CL). Subsequently, CMA started to enforce the implementation of certain articles that would promote the concept of corporate governance, provided that companies are ready and prepared to accommodate mandatory articles. The board member (SBC) argues that changes in supervising the local financial system are notoriously slow.

> *"The change base here is very slow and may take years to implement (if approved) but still I believe that regulators are keen to make changes."*

This is most likely due to the fact that the Government is opposed to making any sudden changes, because of the adverse consequences that may occur and possibly due to embedded business practices in the field that are difficult to change over short period of time, as argued by (RS1):

> *"The point here is that they do not want to make big and fast changes that people and businesses are not familiar with! There will be market chaos ..."*

In this context, Scott (1987) argues that institutions created with a significant involvement of the state will exhibit more bureaucratic features that lead to centralised structures.

In spite of the issuance of the Capital Market Law in 2003, the principal actors (CMA and SAMA) of the 2006 stock market crash ironically were given the opportunity to drive CG reform which put it at risk of becoming "rationalized myths" (Meyer and Rowan, 1977). Instead of addressing the issues and problems that caused the market to crash, those actors started adopting, and mimicking, a shareholder model of CG that is based on assumptions that only hold in developed economies and thus would not be very effective in emerging countries such as Saudi Arabia (Paredes, 2005; Siddiqui,

2010). Thus, this adoption of the shareholder model of CG is a response to institutional pressure to gain external legitimacy.

This leads to a question about the role of the regulatory and supervisory authorities in the field of implementing and promoting good corporate governance. The ability of the regulatory and supervisory authorities to implement and enforce laws and regulations has been an issue of concern among the participants of this study. The results show that the regulatory authorities lack resources and enforcement mechanisms with which to effectively perform their supervisory role, as explained by (RS1), (RC1) and (RC2) respectively:

> *""SAMA and CMA lack the power and ability to equally enforce regulations upon banks."*
>
> *"We have a serious issue of making people adhere to rules and obey the law."*
>
> *"We have the best of laws and regulations ... it is a matter of enforcing them."*

This is consistent with other emerging countries where formal institutions such as laws, regulations and their enforcement are either absent, inefficient or do not operate as intended (Peng et al., 2003; Peng, 2004; Al-Abbas, 2009). Moreover, the institutional context of emerging markets makes the enforcement of agency contracts more costly and problematic (North, 1990; Wright et al., 2005) due to the prevalence of concentrated ownership (Dharwadkar et al., 2000).

However, regulators need to clarify their roles, especially where there is a regulatory overlap. There is some overlapping regarding the obligations imposed by the CMA and MOCI when it comes to corporate governance matters. It is unclear how rules would be enforced in the event of a major case of a listed company's failure to comply with the corporate governance obligations, which involve serious breaches of directors' duties. Listed companies have to comply with the CL and the mandatory articles of the CGRs[49]. In addition, there is a lack of clarity as to how interdependent provisions (Chapter 2) are interpreted and operate in practice, particularly as some are comply and explain, some are, mandatory and the language of the CL and the CMA requirements appears not to be identical.

Directors claim that these regulations are not well defined and there is an overlap of regulations, rules and policies between regulators, as explained by (SB1):

[49] None of the mandatory Articles in the CGRs are imposed by the CL. The non-compliance of a non-mandatory requirement of the CGRs constitutes a violation of the CL which is handled by MOCI.

"There are three or four regulators and each one of them has his own laws. If you look at each company working here, you will see that companies understand these laws differently based on their capacity."

Furthermore, an audit committee member argues that some directors are taking advantage of the current state of the ambiguity and overlapping rules to use them in their favour in the decision-making process in boardrooms, as explained by (SAC1):

"Directors who are in control or are a bit more knowledgeable about the business ...they use their influence to selectively choose the laws that interest them and tell other directors about them. Those other directors will not bother themselves with searching for the truth."

This statement has a number of indications. The first indication is that some directors exercise their influence to steer the organisation in directions aligned with their interests. Secondly, it indicates that some directors, on the other hand, are unwilling to explore and examine related rules and regulations. When everyone in the organisation does not recognise that they have individual compliance responsibility and that they do not understand what is expected of them then it is more likely to develop a 'non-compliance culture.' Therefore, directors will only be compliant if they can see a benefit in doing so, as indicated in (SACI) statement above.

Claessens et al. (2000) suggest that the possible endogeneity of legal systems implies that future legal and regulatory reforms in some countries may need to be associated with changes in ownership structures and concentration of wealth which challenges the current Saudi ownership structures status quo.

The institutional perspective provides a plausible explanation suggesting that the selective compliance of banks is attributed to the understanding that governance practices and regulations are introduced by legislators for political influence and legitimacy (DiMaggio & Powell, 1991), without necessarily having any regard to substantial improvement of organisational effectiveness. In this context, banks tend to develop similar organisational structures and behaviours which results in organisational homogeneity (DiMaggio and Powell, 1991; Scott, 2001). NIS explains that different organisations would structure themselves in a similar manner for organisational legitimacy (Suchman, 1995).

In addition, the overlapping of regulations and laws between regulatory authorities created loopholes and ambiguity in the legal system. The issue of identifying

boundaries of each regulator's jurisdiction is more complex in the banking sector. Moreover, the financial sector is regulated and supervised by SAMA, which creates overlapping jurisdiction with CMA that may lead to duplicative or conflicting regulations. One of the recent major issues is the development of SAMA's corporate governance policy for banks. This creates a problem for listed banks that are subject to CMA corporate governance regulations, as part of the listing requirements.

The magnitude of the overlapping problem could be worrying when SAMA and CMA do not have a memorandum of understanding (MOU) by which to share information and thus consolidate the supervision authority. In this context, interviewees of both regulators (SAMA and CMA) show that the other party lacks the expertise and resources to provide effective supervision. For example, a SAMA interviewee states that:

> *"It has been SAMA's job for a long time to monitor [the] capital market. We have the knowledge, experience and the staff to do so. Banking business is very complex and risky in a way that CMA can't comprehend."*

On the other hand, a CMA interviewee argues that CG needs to be implemented and supervised by an agency, like CMA, that has the speciality to oversee CG matters.

> "*SAMA may possess the resources to oversee banks operations, but corporate governance is a completely different process that needs maintenance by a specialised regulatory body*".

These above two statements of both regulatory authorities show competing views of who should supervise CG which may indicate the quest of each agency for 'legitimacy', ignoring that a real consolidated supervision is might be a way forward for supervision of CG. Also, these views would affect the public perception of the quality of market supervision.

Subsequently, employees of the regulatory authorities' perceptions of their role as advocates of corporate governance reform have changed to reflect the 'ritual' role of their agencies. For example, representatives working for SAMA do not usually consider the wider aspects of their employment. It is customary practice in Saudi Arabia that Government officials have guaranteed job security, with the only reason for dismissal being non-attendance for work. This means that any performance-related issues are not normally questioned, evaluated or criticised. Their jobs are safe. The main issue with this is that their supervision of the markets can be adversely affected

by this comforting fact and extra effort at work is rarely seen. Interview (RS2) argues that due to job security, SAMA employees are not performing their duties as supposed to be done which may affect the agency's level of supervision:

> *"The issue of job security in SAMA is negatively affecting the level of the agency's supervision."*

On the other hand, the following statement highlights very clearly that the director views corporate governance as simply being a 'trendy' technique for management to utilise. Director (GB3) implies that there is more enthusiasm for the title, than for the outcomes of the control system. It also demonstrates his distinct lack of understanding for this system of rules and why they are needed, especially within a boardroom setting.

> *"Corporate governance is another management fad. People get fascinated with big titles like 'corporate governance' but do not pay attention to the effects of these things on business. Personally, I have not seen any 'good' changes to our bank after adopting a corporate governance form of control."*

The Government Bank director (GB3) statement reflects the view that the adoption of CG in the Bank was purely driven by gaining legitimacy, understanding that the bank is unlisted and thus not subject to listing rules. As a government bank, the CG initiative was possibly to signal to outsiders that the bank is as legitimate as any other bank in the field.

When people start to question and criticise the efficacy of the legal system and the government is seen to be unresponsive, then interviewees suggest there is a tendency to 'informally' manage their interactions and relationships through established social and cultural systems. However, it cannot be guaranteed that all social and cultural norms promote a better working environment, when markets lack both adequate transparency and accountability. The findings show that accountability is not a universal concept and thus, different people interpret and implement corporate accountability in differing ways that reflect the diversity of their corporate governance systems. In the context of corporate governance, effectiveness in the broadest sense involves the accountability of corporate decision-makers and the legitimacy of decisions with regard to their different economic and non-economic goals and values (Aguilera et al., 2007).

It is notable that since the inception of SAMA in 1952, there has not been a single case of a director being prosecuted, dismissed or terminated. In support of this perspective, a board member states that people who were thought to have political connections were feared and not criticised for fear of retribution; such individuals tended to become untouchable in their firms:

> *"When an individual (director) feels protected from being subject to laws and regulations, he develops a sense of security that he is 'untouchable'. He thus has the freedom to pursue personal interests with no fear of being penalised for his actions".*

Furthermore, director SAC1 argues that people understand accountability and they would call for promoting higher levels of accountability among directors but in practice it is a different story.

> *"In business, for example, people are not afraid of being liable for their actions because we haven't seen anybody being punished for wrongdoings."*

However, the impact of social norms, values and networks that are embedded in the institutional environment explain the behaviour of the business' principal actors when a director is in breach of fiduciary duties. In this context, organisations will not pursue with legal action but instead directors would be asked to retire. Settlement of disputes is eased by this inherent embedded quality of business in social relations. The professional networks and personal ties are made up of people with influence and status. Since these relationships are under the control of those influential actors, the banking industry will likely remain short of qualified directors as the network of relationships becomes exclusive.

In the banking industry, regulators are among the main stakeholders, yet their interests may clash with those of other stakeholders (Diamond, 1984; Levine, 2004), thereby creating a new form of agency problem. Such a conflict casts doubts on the efficacy of supervision and modifies stakeholder incentives to control managers (La Porta et al., 2002). Regulatory authorities might limit the power of markets to discipline the banks (Ciancanelli and Reyes, 2001) or they may even pursue their own interests as a regulator when they intervene in the shareholdings of banks (Santomero, 1997; La Porta et al., 2002). These constraints could come not only by government regulation, but also by government involvement in the corporate governance of individual firms through ownership and board ties (Wiseman et al., 2011).

Political interference in the banking industry is becoming the norm in Saudi, as the government intervenes in the operational procedures of banks and approving their selection of directors. For instance, bank reports show that some lending activities were politically influenced through government directors or board chairmen. The implication is that banks' boards have failed to take appropriate actions to safeguard the interests of the shareholders, where banks may not recover their debts in the event of default[50]. In addition, banks are required to obtain SAMA approval before launching a service or a product. The problem is that banks do not have written procedures of what they can offer their clients, as SAMA has great discretion in accepting or rejecting such services or products.

In this context, banks would engage in mimetic isomorphism as a result of a standard response to uncertain environments. The NIS theory through mimetic pressures explains how and why organisations tend to model themselves like similar organisations in their field that they perceive to be more legitimate or successful. Accordingly, mimetic isomorphism is the result of the pressure coming from uncertainty, which is "a powerful force that encourages imitation" (DiMaggio and Powell, 1983: 151). Uncertainty stems from different causes affecting an organisation: ambiguous goals, unclear solutions, and vague paths.

Moreover, the government has control of and ownership in many financial and non-financial firms that are subject to the regulatory and supervisory authorities. This research shows that while political intervention has a large influence on the governance practice of banks, it can also be argued that the corporate governance system cannot be effective without political support. Directors have opposing view in regard to government intervention. For example, one interviewee (ICEO) argues that political interference in the appointments of directors would impair the director independence and objectivity while most other directors, (GACC), (SBC), (GB4) and (GB2) for example, suggest that the intervention is part of the government responsibilities to safeguard the business field and would have positive impact on the business.

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[50] According to a Saudi economist the volume of defaulted debts by Saudi businessmen is more than $40 billion (AlFallaj, 2012).

The plausible explanation of the passive role of controlling shareholders[51] against (political) interference by SAMA is due to a number of reasons. First, the controlling shareholders recognise the importance of government support in the event of a financial crisis. This proved to be true during the recent crisis where the government provided a liquidity injection and guaranteed commercial bank deposits (Ramady, 2010). Second, the controlling shareholders have strong ties and relationships with the government based on mutual benefits. Banks tend to provide financial facilities to individuals from prominent families, including the royal family, and firms that do not possess sufficiently sound securities to guarantee repayment. In return, the controlling shareholders enjoy certain privileges such as immunity from legal requirements, granted by authorities or statutes, and the ability to minimise banking competition whereby influencing SAMA control over granting licenses of new banks. Finally, the controlling shareholders and the government do not have the incentive to change or reform the banking system, as the current situation serves their best interests.

The issue of government ownership in banks raises questions about the ability of the regulatory authorities to provide proper regulation of the banking system. In this context, the findings yielded equivocal results on the effects of government intervention in these banks. The government has shares in all local banks ranging from 5% to 80% (SAMA, 2011) and therefore, state shareholding enables the government to remain involved in the decision-making process by appointing government officials as outside directors. For example, 30% of the board members in the case banks of this study are government officials who have been appointed as outside directors.

Likewise, the findings indicated that the extent of the ownership structure, of both government and family, of local banks have effects on banks' boards and thus influence the decision-making process. Further, the ownership structure that sees blockholders (large families) controlling 66% of banks' board seats have implications for the corporate governance process at large. This is consistent with Levine (2004: 17) notes that "the problem in banking is frequently that politically powerful families control the banks and the political system, so that regulatory policies are frequently used to impede, not support, effective corporate governance". Consequently, the regulatory restrictions on ownership structure do not prevent family control but, rather,

[51] The researcher believes that it is the controlling shareholders, who are board members as well, who are in total control of banks, not the bank officials. Thus, they should be standing behind any change initiative to promote better regulation and supervision of the banking industry.

defend the existing owners from competition for control (Levine, 2004; Caprio et al., 2007).

There is a serious issue of SAMA independence that has implications for its supervisory role. For instance, SAMA cannot grant a new bank license without the approval of the Council of Ministers[52] which implies that SAMA has a limited role when it comes to major financial issues. In addition, it implies that the government may override SAMA decisions and thus SAMA might become a representation of the government legitimacy to provide control mechanism for banking. In the event that this happens, its position as a regulator with supervisory responsibilities would be weakened and would create a public perception of an organisation with a negative image of legitimacy.

Socially, banks' boards are open to an array of cultural, social and ethical pressures from external environments. According to Scott (1987: 498) "organisations conform to social expectations because they are rewarded for doing so through increased legitimacy, resources, and survival capabilities." They are influenced by their institutional context and networks of social organisation and exchange which carry rationalised myths (Greenwood et al., 2008). Hence, the essence of institutional perspective is that an organisation is shaped by wider cultural, social and symbolic elements that constitute its institutional environment (DiMaggio and Powell 1983; Scott, 2001). In the Arab world, like Saudi, corporate boards and management are influenced by traditional values and norms (e.g., personal relations, preference for individuals from influential tribes, etc.) that might affect their orientations and behaviour (Ali, 1990). They are caught between the pressure for change and their own tradition where individuals are not prepared to work outside the tribe or the family circle. The influence of these pressures on directors has shaped their actions and behaviours to avoid cultural and social exclusion.

In this context, individuals or organizations who align themselves with prevailing cultural-cognitive institutions feel competent and connected, while those who challenge these institutions are regarded as 'ungrateful' individual. Regulatory representatives are often considered as being in a more inferior position than board members. This is mainly due to issues of culture; the class system within Saudi Arabia being the main attribute. Often, directors of banks do not consider the efforts of

[52] The Saudi Council of Ministers is the Cabinet of the country that is chaired by the King, who is also the Prime Minister.

regulatory authorities as a way of helping to identify areas of improvement. A hostile attitude towards their work often exists and their efforts are in vain.

The social class system could bring negative consequences to corporate governance practices, i.e. with regard to the way people behave in the organisations. The impact of social system is more significant considering the culture of Saudis, who normally would not question a superior person. Consequently, this affects how governance is practiced in organisations, as explained by (SB1) and (GAC2):

> *"Well, it is unusual to have a heated discussion with a senior member*[53] *in public and will become a disaster if he loses the debate."*

> *"I have seen many 'yes' directors who feel inferior to others... I think the shortest way for them to join boards is to continue blessing others' decisions."*

In this context, organisations' quest for legitimacy results in the homogenisation of organisations with respect to their most visible attributes (e.g., board composition). Firms have the tendency to attract homogeneous individuals into institutions which makes the board members less inclined to challenge each other or the management (Tuttle and Dillard, 2007).

In the context of social expectations, society holds high expectations towards an individual's age and professional activity. In Saudi context, people value seniority in the sense that a higher age implies a certain amount of life experience and wisdom. However, a board member argues that the "seniority" issue can be misleading and may create conflicts, as "seniority" does not guarantee valuable experience. The individual's age (or seniority) issue has implications on the work of regulatory authorities, as the age difference plays a major role in possible confrontations. The Hofstede (1980) cultural dimensions view the Arab culture as being high in "power distance" between the different parties involved in the society (e.g., rulers and ruled, employers and employees, etc.). In such a context of high power distance, accountability tends to be lower, which results in significant corporate governance implications, especially when the CEO dominates both the boardroom and the management.

In this context, organisations can demonstrate compliance with norms and values in society by having structures and practices that are (partly) ceremonial, while the actual ways of working are not greatly affected (DiMaggio and Powell, 1983 and Meyer and

[53] Senior member is an expression used to make reference to a director's age, class, or position.

Rowan, 1991). Thus, organisations can decouple particular behavioural and structural features of the organisation from its primary activities.

8.3 Corporate Board Selection

The directors' selection process is the formal process by which individuals are identified, screened, nominated and appointed to corporate boards. The selection of directors has a twofold approach, namely; formal and informal board re-election processes and formal and informal board vacancies or expansion processes. Each approach has certain steps that directors need to fulfil in order to be selected. However, it was evident that both approaches are influenced by the controlling shareholders and SAMA. Furthermore, the selection process of board and management members is 'legally' subject to SAMA approvals and thus, other stakeholders' roles in the selection process are insignificant. Moreover, banks have adopted NCC in response to regulatory requirements with limited scope which is mainly relevant to directors' compensation plans and does not have substantive role in the selection process, as explained by (SB1) and (GB2):

> *"Before we had the [NCC] committee, the [board] chairman and some other board members were controlling what NCC is supposed to do. Now [with NCC], they are still in control 'officially' as chairman and members of the [NCC] committee and no one would question them.*
>
> *"I can't see anything new that has changed with NCC except that they [SAMA] want more paperwork to be done".*

Accordingly, regulations that are imposed by the state possess coercive powers throughout the organisational fields and enactment of laws confers legitimacy to conform or otherwise be illegal and subject to sanctions as defined by the state and its delegated institutions (DiMaggio and Powell, 1983, 1991). Hence, lack of conformity can be viewed as illegitimate but not always if the law or the state itself loses legitimacy which may explains the tendency of some organisations non-compliance behaviour.

The selection process of directors is the key factor in building an effective board of directors. This research study has identified both formal and informal processes for board member re-election and for board vacancy or expansion. In principle, the formal process gives an equal opportunity for all shareholders to participate in the selection process of the directors. In this context, the minority shareholders exercise their voting

rights in the general assembly meeting to select or re-elect board members. Consistent with NIS, this selection process indicates that banks seek legitimacy by conforming to SAMA requirements, in response to coercive forces. The formal process of selection is an attempt of banks to gain legitimacy, not only in economic terms, but also in social terms.

However, the findings show that there is an informal process underlying the formal one that in practice controls the selection of directors. In general, the controlling shareholders and the board chairman of the bank start the informal director selection process by endorsing the incumbent board or nominating new members. The appointment is subject to SAMA's approval. In this context, the NCC's 'intended' role in the director selection is questionable as the committee is dominated by influential actors (e.g., controlling shareholders and board chairmen) who use this dominance to influence the director selection decisions and thus the NCC only has a symbolic role that is used to legitimise the selection process.

The informal selection process is a product of normative isomorphism. According to Scott (2001:175), normative isomorphism "introduces a prescriptive, evaluative and obligatory dimension into social life, reflecting the values (what is preferred) and norms (how things should be done) of the social system. Social actors working in particular organisational roles are expected to fulfil certain social commitments and obligations." Individuals (or actors), therefore, are engaged in 'appropriate behaviour' whereby people do what they are supposed to do and is based on behavioural patterns that are socially expected and accepted by other actors. Consequently, these expectations are usually perceived to be external pressures to which one must conform, and normative isomorphism is a product of the professional roles that the organisational actors play.

Furthermore, SAMA has total control over directors' selection in terms of approving directors' appointments, while the controlling shareholders and chairmen influence the 'short listing' of nominees. In this context, labelled as coercive influences, SAMA exercises its authority to impose regulations, as the powerful actor in shaping the institutional environment. In the context of this research, the downside of this process, imposed by SAMA, is that SAMA may reject qualified applicants for political reasons. It is, however, worth pointing out that the short listing of nominees is developed with the implicit objective of meeting SAMA approval criteria, which became a 'common practice' within the banking field and embedded in the act of banks' management. The

display of compliance with the SAMA formal process of director selection is consistent with the terms of 'decoupling' in NIS theory, where there is a gap between formal structures from actual work activities in order to maintain "ceremonial conformity."

It is, however, not clear how SAMA administers the process of directors' selection, as this process is not disclosed to the public[54] but appears to be known to the banks. The findings show that SAMA has some degree of tolerance in allowing some banks to appoint their preferred directors (such as the appointment of government directors in GB) which may suggest that the rules and imposed laws can in themselves be modified by the cultural and cognitive influences so that the nature of the regulation itself is altered and not just the response to the regulation (Scott, 2008).

Interestingly, most of the board members' responses suggest that SAMA interference in the director selection process is a desirable action and can be justified. Their views of SAMA intervention may indicate their lack of competence and confidence to effectively carry out their defined roles and duties. In periods of ambiguous and uncertain environments the board and AC may emphasise ceremonial and symbolic roles. In this context, those directors are imitating other influential actors in the organisational environment to avoid exclusion and fulfil the need for legitimacy.

The appointment of directors (specifically non-executive) tends to be rather informal and in the hands of influential actors. This is consistent with the findings of the Higgs Review in the UK (2003) which discovered that almost half of the non-executives surveyed were recruited through personal and professional contacts or friendships. Accordingly, potential directors are not selected based on their ability to serve the optimal and best interests of the firm (Westphal and Stern, 2006; Withers et al., 2012) but, as seen in previous chapters, some banks' directors are selected based on personal and professional relationships.

This implies that those selected directors are perceived to be 'shadow directors' who may not be selected due to their qualifications but, rather, to their loyalty to protect the interests of those who selected them (hence the controlling shareholders). Furthermore, Saudi banks are dominated by the government and a few prominent families who eventually occupy most of the boards' seats. Therefore, they or their representatives

[54] Although each bank must get SAMA approval before the appointment of board members and members of board committees, SAMA has refused to provide the researcher with documentations on the actual process of selecting/rejecting directors.

tend to serve on boards for considerable periods of time. Most of the respondents stressed that it is difficult for an individual to join a bank's board due to SAMA restrictions and the limited possibilities to find individuals with the required knowledge of banking.

Despite the differences of the case banks in terms of ownership structure and type of services and products (Islamic versus conventional), all case banks' boards tend to be socially similar. These boards maintain similarity in a board's structure, their demographics and personal characteristics. The findings also suggest that boards are similar regardless of the ownership structure which is consistent with the institutional isomorphism perspective. This refers to the tendency of organisations to resemble the practices of other organisations that operate under similar environmental conditions (DiMaggio and Powell, 1983). However, external ties through board members help the focal organisation in gaining legitimacy and reputation. Within institutional influences, there are some invisible forces pressing the organisation to adhere to taken-for-granted rules and norms (Oliver, 1991).

These findings are consistent with institutional theorists who argue that board composition will be determined largely by prevailing institutionalised norms in the organisational field and society. The institutional perspective suggests that boards of organisations in the same institutional setting will tend to be more similar to each other than to the boards of organisations outside of their set (DiMaggio and Powell, 1983) which is evident in the selection process of director and the similarity of board structure of all case banks as well as the structure of the ACs.

The selection process of audit committee members is identical in all banks. Paradoxically, banks select highly qualified members but their selection does not materialise as they continue to depend on external auditors and, at the same time, undermine the AC role. The plausible justification of this 'symbolic' selection represents a bank's response to institutional pressure to select AC directors with certain qualifications. Furthermore, in their effort to maintain control over ACs, the chairperson of each AC in the case banks is a representative of the controlling shareholders.

Nevertheless, appointments based on representative models can potentially undermine the effectiveness of the board since directors are more likely to show loyalty to those they represent and those who had initial influence on their appointment. Directors are primarily concerned with the interests of those they represent rather than the interest

and success of the bank. Banks may appoint certain directors to serve for social purposes rather than for economic justification. For example, all case banks started to select and appoint professors in finance and accounting to audit committees after it became mandatory for banks to establish audit committees. However, audit committee members claim that their existence is to comply with legal requirements without providing substantial benefits to banks. The nature of how board members are selected is one factor affecting the contribution of directors and their involvement in board meetings. For example, directors who are selected based on pre-existing relationships are especially reluctant to bring matters to the boardroom which would challenge management or the chairman, as this may ultimately impair their independence, as suggested by (GAC1) and (IB1).

> *"Once they [government] choose you, then you will be obligated to serve their interests regardless of what you think!"*
>
> *"The issues of relationships and 'saving face' are affecting the board independence because directors are dependent on their personal connections to win a seat."*

Accordingly, banks are undertaking symbolic action by explicitly stating their compliance with CGR of establishing ACs in order to gain legitimacy whilst in reality they continue to do business similar way as they have done prior to the mandate of ACs. These changes are therefore 'largely ceremonial' but according to DiMaggio and Powell (1983) they are not necessarily inconsequential. The evidence shows that some board members believe that ACs need more time to be integrated into the work of boards to realise the potential benefits of its internal control and to limit the abusive role that is played by external auditors, as suggested by (GB2) and (SAC1):

> *"Our audit committee has knowledge and qualifications in accounting".*
>
> *"I don't want to offend anybody but those people (external auditors) don't care about business ethics."*

The findings show evidence related to how banks are claiming to be keen on board diversity in order to gain potential benefits of diversity among directors. Board diversity assists firms in the linkage to their environment in order to secure critical resources including prestige and legitimacy (Singh, 2005). The evidence shows that there is a gap between a potential situation and reality, where directors' quotes showed

that they often feel annoyed by individuals with views and backgrounds very different from their own.

The perception of diversity appears to be limited to select directors who may have diverse 'business' backgrounds but share the same background 'values' and social identity. However, some board members assert that boards are able to overcome this by selecting directors who possess social and cultural values and norms which is consistent with Scott (1998) who argues that environmental pressures that make an organisation conform to social and cultural worlds are central to institutional theory.

Furthermore, the research has found that banks select directors in order to maintain the cohesion structure of the board by selecting individuals who reflect similar social and cultural norms. Some board members suggest that banks are keen on diversity, but the findings suggest that banks consider the concept of diversity in a different manner. The banks select and appoint directors with different backgrounds and experiences in order to (rationally or socially) benefit the banks, however, those directors are more likely to be selected because they have similar social characteristics to those in power, as explained by (ICEO):

> *"Board members tend to recruit other board members from their network. That is either their social network or from other boards they have been on. It's kind of comfortable to have people they know and trust."*

Moreover, the selection of 'academics' to serve on ACs could also be indicative of normative pressure stems from SOCPA[55], where the members of SOCPA are using this as entry criteria to senior posts within banks thus diffusing the professions throughout organisational fields. The organisational re-configurations of banks, due to changing legislation, or coercive authority, can be in large part ceremonial, but that does not mean that they are inconsequential. Rather, they convey the message to the various stakeholders in the bank that the bank is responsive to the preferences of the society in which it operates. This adherence to societal preferences helps the organisation to secure economic resources, influence and power (DiMaggio and Powell, 1983; Meyer and Rowan, 1991). Thus, the search for legitimacy may push firms to adopt organisational structures and practices for a ceremonial purpose rather than for rational reasons of improving efficiency (Meyer and Rowan, 1977).

[55] Saudi Organisation for Certified Public Accountants

The research findings also lend support to the importance of the governance roles of informal social networks that link an organisation with its external partners. When the formal external governance mechanisms are weak, informal mechanisms may provide proper substitutions. The use of informal communications, for example, to resolve conflicts within and/or outside banks is perceived to be a valuable mechanism. This is consistent with decoupling, the informal structure from the formal structure, so that companies may retain both efficiency and legitimacy. Decoupling creates a buffer between the formal and informal structures (Meyer and Rowan, 1977, Oliver, 1991).

In general, the selection of directors is determined based on a firm's rational and social needs, while a potential director is selected based on his human and social capital that underlies his ability to contribute to the board and the firm. While the apparent process suggests choice is made dependent on rational needs; in practice, choice is determined by social capital. It is worth pointing out that the Saudi market lacks directors with banking experience and thus banks tend to capitalise more on social determinants. The banks recognise the fact that radical changes may publicly signal that that current board composition is ineffective, thus incremental changes in board characteristics and processes are more likely to take place. This idea leads banks to prolong directors' services and consequently, the reappointment of board members at the end of their term becomes the norm.

Moreover, due to shortage of qualified individuals, banks tend to rely more on the social determinants whereby directors social skills, reputation and network connections provide banks with a competitive advantage in securing access to external resources. The selection of directors with government links to serve on a bank's board is a classical example.

The evidence provided in the chapter suggests that director human or social capital affects the process of his selection to boards. The most sought after capital includes interpersonal behaviour, reputation and personal and professional relationships. However, directors with ingratiating behaviour toward influential directors (or actors) are most likely to be selected and appointed to boards. The ingratiating behaviour of some directors is argued by interviewees as being part of the corporate culture that individuals take for granted. Similarly, some directors join audit committees for different reasons that may include searching for a professional career or building a reputation that would promote him to join subsequent boards. This is consistent with

Westphal and Stern (2006; 2007) who find that ingratiatory behaviour may be another way that both top managers and directors receive additional appointments.

Moreover, the regulatory agencies lack of effective monitoring of the formation of ACs has given banks the opportunity to provide a surface compliance without real impact on the ACs internal processes and thus may result in the ACs role being more likely ceremonial in nature. Besides, these regulatory agencies and controlling shareholders are failing to change the institutional values and preferences at individual and firm levels. However, it is imperative to consider that perceived "superficial" adoption of institutional requirements could become more significant over time (Scott, 2008).

This research shows that the controlling shareholders and SAMA have developed a counterbalance of power in their relationship. A relationship that is not defined or known to the public, but those involved in the process, come to realise it over time and thus the 'rules of the game' have become understood by the principal actors. Therefore, directors are constrained by their own structure of reality, which is influenced by normative pressures and accepted ideas on the "proper" behaviour. The compliance with normative pressures is enforced through strong feelings of conformity of norms that is manifested in director's behaviours and the social obligation plays a central role in the framework felt by those who conform to the norms (Scott, 2001).

The evidence presented above concerning the influence of social mechanisms on board appointments gives an indication that, to some extent, board appointments are not made with the spirit of purely achieving efficiency as advanced by economic theorists. As corporate governance actors pursue their interests, the social mechanisms shape their interpretation of the field and the actions of the others. Therefore, corporate governance itself, in particular board appointments, is used as a mechanism to achieve their objectives.

The behaviour of the Saudi banks' actors is consistent with the expectations of the NIS theory. It may be argued that the similarity among case banks boards structures reflect coercive isomorphism, where they are forced to change their directors' selection due to formal and informal pressure applied by external forces or actors (DiMaggio and Powell, 1983). At the same time, banks' actors may engage in activities that would signal legitimacy to outsiders, such as holding AGMs to approve directors' selection, but in reality these activities are more likely to be of ceremonial nature. Furthermore, this could also be indicative of mimetic behaviour, where case banks might be

following established practices for the sake of defending its legitimacy, as the case of selecting certain category of professionals (academics) to serve on audit committees.

8.4 Governance Effects on Corporate Boards

There is a divergence of views among directors concerning the understanding of their roles and responsibilities, although most agree that the roles and responsibilities are important. Most participants note the importance of roles and responsibilities but some disagree as to what exactly this role entails. One director (GB2) claim that the board roles are limited to:

> *"... supervising the administration work, direction and approval of the loans and appointments in senior positions."*

While other director (GB1) who is on the same board with (GB2) claims that the main role of the board is to:

> *"... review and approve loans for our clients. I am talking about loans for mega projects."*

These statements may indicate how a director perceive his actual role and not what the board, as a group, should do as per bank charter and regulations. Those directors working in these particular organisational roles are expected to fulfil certain commitments and obligations that deemed necessary for organisational survival. NIS framework realises the role played by the actors in shaping and sustaining the institutions and thus individuals will have different preferences and power relationships that will impact on the institutions (Lawrence, 2008). Also, Young et al., (2000) assert that organisations respond differently to institutional pressures which may have implications for the role of boards.

Boards have a number of roles. An agency perspective may be suitable for understanding the role of board monitoring management, but it does not explain the other roles of boards. An agency perspective is not informative with respect to directors' resources, services and strategy roles. Similarly, agency theory does not take the issue of competency into account. Thus, even if incompetent managers are honest (or are made honest by board control) they will still be limited in their ability to meet shareholder objectives. It is not enough to provide people with incentives to get a task done; they must have the ability to carry out the task (Hillman and Dalziel, 2003).

Under an institutional perspective, the role of the board of directors is seen as an effective means of obtaining scarce resources for the organisation, including namely:

advantageous contacts, enhancing the legitimacy of the organisation, and accessing other scarce resources (DiMaggio and Powell, 1983; Scott, 1987). Accordingly, findings are consistent with the institutional perspective which describes how some directors recognise that they have been appointed to boards in order to provide legitimacy, which therefore suggests that their role is more likely to be ceremonial in nature. For example, the government directors who are appointed by the Minister of Finance are mostly retired senior government officials who have no motivation to provide a substantive monitoring role due mainly to lack of banking expertise and the perception that other directors will assume responsibilities but as (GB4) suggest they can *"bring ... business and opportunities because of their contacts."*

The board members' lack of bank-specific knowledge has severe problem in Saudi banking industry. This problem is exacerbated as there is a larger distance between the board and management, which makes it more difficult for the board members to know about the inside activities of the bank. To ask the right questions and be able to request relevant information, board members' knowledge of the bank's underlying business becomes more important. Lack of expertise and knowledge on the part of individual directors leads to lack of challenge at board meetings as suggested by (ICEO):

> *"The participation of independent members is often ineffective as they are not familiar with the nature of the banking business and their participation in the discussion is just a formality."*

Directors have fiduciary duties towards the company; and, in order to discharge those responsibilities, directors should be able to make informed decisions. However, directors are constrained by their own structure of reality - norms and values embedded in the act of management, which is influenced by normative pressures and accepted ideas on 'proper' behaviour. Furthermore, (Young et al., 2000) argue that ownership structure might be a significant source of resistance to institutional pressures. For example, some ownership types may not conform to changing norms concerning the role of boards due to the organisation having strong traditions that are deeply rooted in their formation and development (Eisenhardt, 1988). Besides, institutional theorists argue that adoptions of some organisational practices are often determined by culture, norms and cognitive factors (Scott, 1992, 2001; Baxter and Chua, 2003).

Moreover, some board members define the purpose of ACs in ways that vary from the agency perspective understanding of an AC, as a monitoring mechanism. This subsequently creates an operational gap between board expectations and AC

contributions. Interestingly, the results show that AC members accept AC appointments in order to advance their personal and professional careers. They find that joining an AC in the banking industry is a shortcut to access 'elite' networks and thus boost one's personal and professional career through more board appointments. In support of this notion, AC members tend not to change the current state of how things are done in banks by not challenging the board or management. Although the AC chairmen in all case banks are representatives of the controlling shareholders, who have busy schedules and may not be qualified to lead an AC (such as in the Islamic bank), the outside 'academic' AC members have no intention of leaving their ACs, as their purpose of joining the ACs is to advance their career.

In this context, according to Fogarty (1996) the key attribute of an institutional perspective lies in its ability to highlight the distinction between what organisations actually accomplish and what their structures suggest to the external environment they should accomplish. Meyer and Rowan (1977) propose that organisations may be decoupled, whereby they exhibit to the external environment that they are operating in line with expectations; whereas internally they are not actually following the operating procedures expected by the external environment.

The findings suggest that the interrelationship between the AC and the board has significant effects on an AC's ability to fulfil its oversight functions. The board members displayed attitudes of superiority and lack of support and empowerment, which resulted in isolating the AC members. The negative attitude of board members stems from social class differences and the view that the 'academic' AC members lack business knowledge. The absence of coercive and normative pressures has created this gap between the board and the AC members whereby norms, rules and practices that circulate within a field are not enforced by the legitimated actors.

The way the board is composed and structured would create a ground for influential actors to engage in decision-making domination due to holding a formal and hierarchical position. As discussed in the previous chapters, the composition of boards is subject to internal and external factors that influence the decision-making process in the boardroom. For example, the chairman of the board may exercise his hierarchical authority to align the boardroom direction with his interests. Equally, power can be associated with representation of controlling shareholders or directors' personal shareholdings whose interests are aligned and act on behalf of shareholders. Although the role of power and control is implicit in the identification of coercive forces, it is

emphasised as being the main driver of institutional change (Scott, 1987; Oliver, 1991). Power plays an important role in this framework because isomorphism is achieved through the application of rules, controls and sanctions that prevent deviation from the accepted norms.

Furthermore, the nature of how board members are selected is one factor affecting the contribution of directors and their involvement in board meetings. For example, directors who are selected based on pre-existing relationships are especially reluctant to bring matters to the boardroom which would challenge management or the chairman, as this may ultimately impair their independence, as suggested by some responses. The importance of relationships is evident in all areas; this research reveals that most of the respondents' directors are serving on boards by invitation and therefore they do not find it appropriate to challenge the controlling shareholders over roles and responsibilities, as explained by (GB3):

> "*... when someone (director) is brought in and approved by SAMA, this person will not challenge or think of making noises that would bring attention to what directors are actually doing*."

Clearly, this statement shows that some directors are conforming to the local norms and values to maintain the status quo within their groups, rather than risk social sanctioning or exclusion. This is consistent with that directors will shape their actions and behaviours to avoid cultural and social exclusion (Scott, 2001).

It is expected that directors recognise their respective skills and expertise and thus limit their participations and actions to that capacity. This 'informal' understanding of boardroom rituals and business practices has implications for developing a framework of directors' dynamics and interactions both in and outside the boardroom. This framework emphasises the role of social and cultural values and norms required to draw boundaries in directors' relationships. For example, senior directors[56] expect other directors to show respect and deference to their actions or behaviours and thus, other directors would not challenge their decisions. In relation to this superior attitude, influential directors are more likely to disregard most of the decisions made by those directors due to their implicit understanding of the incompetency of those directors.

Those directors who lack motivation or competency tend to rely on other board members to engage in a mimetic behaviour. Often, they recognise the value of social

[56] Seniority refers to the director's age, social class or stature in society.

and cultural norms, such as trust and seniority, to avoid engaging in boardroom discussions or challenging behaviour. In this context, they appear to prefer to maintain the status quo within their 'elite' network, rather than risk social sanctioning or exclusion by acting alone. The institutional perspective suggests that directors seek to behave in ways that will not cause them to be noticed as different and consequently singled out for criticism or to come under normative pressures.

The findings reveal that informal communications comprise an important part of directors' interactions and the decision-making process. For example, the Islamic bank chairman asserts that competent directors are more likely to be consulted before making a decision on major cases in and beyond boardroom meetings. In the International bank, the CEO agrees that few board members are involved in the decision-making process which is mostly discussed outside the boardroom.

Those influential directors are keen to maintain social and cultural values and norms both in and outside boardrooms to preserve the uniqueness of the social identity of banks' boards. At the same time, they understand that not all directors have the capacity to serve the best interests of the bank. This indicates that board meetings are generally ceremonial in nature and are held to comply with legal requirements, at the same time maintaining social interactions between directors. The results show that decisions can be made in or outside boardrooms by influential directors with no regard to the rest of the board members, who interestingly would expect and accept this course of action. In support of this notion, the results show that the chairman of the Government bank is so powerful that he is able to make decisions on his own without even consulting his board.

Some participants argue that social and cultural norms are used or practiced in boardrooms to justify actions of wrongdoing. Respect is one such example, manifested in the context of seniority and external stature and prestige. For example, one director (Gb3) refers to respect in the context of boardroom politics whereby some directors may not be challenged due to seniority or director's class[57], stating that:

> *"There is no doubt that working with senior government people is a very rewarding experience. But you have to know the politics of the boardroom to deal with those people. You have to know your boundaries and be aware not to cross the line."*

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[57] For example, some directors are ministers, deputy ministers or governors.

Directors who take advantage of social or cultural factors to pursue personal gains are aware of the fact that their interests are aligned with those of the controlling shareholders and therefore no one will hold them accountable. In this context, a director may use his social status and relationships to win certain bank's projects for his personal firm. The sense of security by those directors is based on the influence and power exerted by the controlling shareholders in the banking system.

The director network of relationships is significant in linking a bank to external resources. Ultimately, these directors' relations and characteristics determine 'what goes on' within the board. Some responses suggest that competent directors are more likely to be consulted before making decisions on major cases in and beyond boardroom meetings. Similarly, influential and powerful directors are more likely to win arguments inside and beyond boardroom meetings and seem to claim the trust of other board members due to their abilities to achieve desired outcomes. Various interest groups, such as influential actors may exert normative pressure in adopting what is perceived as 'good practice' to legitimise their actions. Individuals, therefore, are engaged in 'appropriate behaviour' whereby people do what they are supposed to do and is based on behavioural patterns that are socially expected and accepted by other actors. Thus, mimetic isomorphism gives a shared frame of reference, of 'how things are done around here'; on the other hand, normative isomorphism takes place on a moral base, 'what is right to do around here' (Marquis et al., 2007). The 'outcome' of the directors' actions may represent both, normative and mimetic, isomorphisms. It is thus argued that, in practice, there is a blurring of the boundaries between coercive, mimetic and normative isomorphic pressures, with several institutions plausibly spanning the boundaries between two or even all three types of isomorphism (Scott, 2008).

CHAPTER 9: SUMMARY AND CONCLUSIONS

9.1 Introduction

This thesis sets out to investigate the roles played by boards of directors in the governance of Saudi banks. It explores the factors influencing the selection of board members and the subsequent effects. It also attempts to provide indications of how the selection process influences directors' interactions both inside and outside the boardroom. Furthermore, it presents indications of how the external contextual environment of banks influences the process of director selection and interactions. To achieve the aims of this study, a qualitative case study approach was adopted, involving directors of both listed and non-listed Saudi banks as well as financial regulatory authorities' representatives. This has provided rich insights into the complex web of factors which shape the effectiveness of Saudi banking boards.

The board of directors is considered to be an important governance device and boards are increasingly being held accountable for the organisations they govern. Recent high profile corporate collapses have raised serious concerns regarding the effectiveness of boards in protecting the interests of shareholders and other stakeholders. As a consequence, much of today's corporate governance reforms are directed at improving corporate governance through upgrading the manner in which boards function.

9.2 Review of Significant Findings

These findings challenge the agency perspective assumption of a principal-agent conflict identifying that the agency conflict in Saudi banking is due to principal–principal conflicts. The principal–principal agency conflict is a major concern for corporate governance in emerging economies where this occurs between controlling shareholders and minority shareholders. It results from concentrated ownership, extensive family ownership and control, in addition to weak legal protection of minority shareholders. However, the new institutional sociology (NIS) tends be completely appropriate for the purpose of the research being undertaken. It emphasises how organisations are influenced by their external environment, in the line of open systems approach. A key issue of NIS is to understand isomorphism which provides insights into why organisations exhibit relatively little variation among themselves, and in particular within their organisational fields. The important insights for NIS discussion is related to its focus on macro environmental pressures on organisations and how these organisations adapt to external pressures.

The overall findings suggest that the roles of boards in the corporate governance of banks are influenced by a number of factors. SAMA has total control over directors' selection and appointments. The findings show that controlling shareholders influence the short listing of nominated directors, yet the final approval of appointments rests with SAMA. Although SAMA's intervention procedure in the process of director selection is not formally documented and available to the public, this 'political' intervention implies that the government is inclined to remain in control over the banking sector. Banks showed similarity of director selection process, as well as other practices, as a result of institutional pressures exercised by SAMA in coercive form.

In addition, the findings show that government ownership in banks is an obstacle to having an effective monitoring system. The government representatives on banks' boards lack the proper qualifications to be able to provide a sound monitoring role. On the other hand, they are significantly important as a conduit for linking banks to the external environment and providing legitimacy and access to critical resources. Similarly, the outside directors in both the international and Islamic banks possess similar characteristics and roles. In this context, the controlling shareholders who are concurrently board members are assumed to provide the internal monitoring mechanisms.

The interview evidence in this research work suggests that the elite class is critical of the current corporate governance regime, but still abide with the implicit social contract of the Saudi Code to preserve stability in these turbulent times. Certainly, liberalising effect on Saudi society by young Saudis graduates of American and European universities has increased the contribution and involvement of Saudi highly educated financiers and bankers into the fiscal and monetary policy decision-making process and accordingly the demand for more transparent corporate governance in the banking system has been raised. The new generation of decision makers in the banking industry are making changes, demanding more amends and introducing reformation but with the Saudi Code and its social contract that minds the internal social dynamics of the Saudi society in their mind. To an outsider observer, it seems like that change and the potential to change is marginal and unaccounted for, but given the insight into such implicit social contract, this study can claim steady change within context of the internal social dynamics is considered unequivocal.

In spite of their criticism of the current corporate governance regime; the elite class did not show any effort to make changes. The plausible explanation is that the current state

of Saudi governance does not hold any threats to their interests and thus they would not challenge the status quo. Therefore, the current practices of business affairs will remain intact, realising that the system cannot be changed without their involvement. Moreover, the elite class recognises that the legal framework does not have the capacity to hold them accountable for their actions which means that changes are made at their discretion. Changes will not emerge when the institutional forces are ineffective, as they can affect the discretion of board members by enforcing the law and institutionalising legitimated practices and standards.

Therefore, findings indicate that boards' seats are dominated by controlling shareholders or their representatives. Boards that are dominated by directors who come through personal relationships are more likely to follow the interests of those who appointed them and be accountable only to them, ignoring other stakeholders. Personal ties and relationships have greater significance in the selection and appointment of directors to banks' boards rather than experience, qualifications or financial expertise. The selection and appointment of incompetent directors have substantial effects on the group dynamics and interactions both inside and outside the boardroom.

The findings show that boards are selected to provide multiple functions. From an agency perspective, the board of directors is an internal control mechanism designed to mitigate agency costs. The controlling shareholders or their representatives assume this role which may have different implications for the minority shareholders. On the one hand, minority shareholders may enjoy a "free ride" of not incurring any monitoring costs; but on the other hand, the controlling shareholders might use their control and abuse of power that would result in expropriation of minority shareholders' rights. It is of concern for regulators and banks alike to succeed in developing an individual-level perspective of the board appointments process. This may well be achieved by focusing on the human and social capital determinants of board appointments, in addition to focusing on the organisational, board, and environmental factors.

Consistent with institutional perspective, the board members provide linkage to a firm's environment in order to secure critical resources that may be vital to the firm's success, as well as providing advice and counsel to management (Hillman et al., 2002). The government and outside directors in all banks proved to be useful in connecting their banks to the external environment by providing access to resources. The findings show that those directors have healthy relationships with both their chairman and

CEO, which promotes a positive basis for the management to feel comfortable in consulting them for advice and mentoring.

Moreover, the institutional perspective considers board members as being a legitimacy-seeking mechanism, stressing the role of the firm's external and institutional pressures (Parker, 2007). The findings suggest that some board members (particularly the outside directors) were appointed in response to regulatory requirements. Those directors are usually passive and provide ceremonial actions in order to gain legitimacy. For example, the findings suggest that the appointments of AC members are merely a formality in order to comply with regulatory requirements. The AC members show that they are not providing any substantive role, as boards are more dependent on external auditors. This may be attributed to the misunderstanding of boards about the real function of ACs in the governance process.

The limitations of the regulatory and supervisory authorities in implementing and enforcing laws and regulations have an overall implication for a poor corporate governance framework. The controlling shareholders and influential actors (e.g., CEO or chairman) seem to be able to capitalise on social and cultural values (such as respect and seniority) in order to maintain control over other directors. Subsequently, those directors are more likely to engage in unacceptable ethical and moral behaviour.

The findings suggest that the financial regulatory bodies lack the resources by which to improve the implementation of corporate governance and demonstrate lack of law enforcement. The findings also show that regulators lack the will and motivation to change the current state of governance, which may indicate that the adoption of the initial corporate governance regulations is a process of imitation in response to international demands. The existence of multiple supervisory authorities has resulted in overlapping of regulations and laws between authorities which, in turn, created loopholes and ambiguity in the legal system.

The overall Saudi corporate governance framework is affected by the extensive influence and power of the controlling shareholders, mainly due to the ownership structure and the relative weakness of regulatory and supervisory authorities. As a result, there are concerns of ethical issues that go beyond issues regarding firms to damage society and the business environment at large. There are increasing calls to fight corruption and abuse of power by enhancing the level of directors' accountability. When the formal external governance mechanisms are weak, the informal mechanisms may provide proper substitutions. Thus, the regulatory and supervisory authorities may

consider informal governance mechanisms as a method by which to deal with the specific 'weak governance' environment in order to develop a corporate governance system that reflects its institutional conditions.

9.3 Contributions and Policy Implications

This study contributes to the growing stream of literature examining corporate boards and corporate governance, particularly in emerging economies. It provides a response to recent calls for studying corporate governance in different institutional environment utilising an alternative theoretical lens that challenges the domination of the 'agency' perspective. This study provides theoretical validity by suggesting that institutional perspectives may be more appropriate than agency perspective in describing the practices of boards of directors and corporate governance in developing countries such as Saudi Arabia.

A second contribution stems from the access and study of boards of directors in emerging markets, particularly Saudi Arabia, using an alternative research methodology. Thus far, mainstream board research has mostly been carried out using samples of non-emerging markets corporations and is inspired by quantitative research traditions using secondary data sources. It provides a novel contribution of the study of the selection process for Saudi banking directors. The practices and works of Saudi boards are similar to many boards around the world but this research was able to prompt directors to speak up about their actions and to understand the role of directors in their institutional settings.

A number of important policy implications flow from the findings of this research. The regulatory authorities should focus its effort on monitoring the implementation of self-regulatory corporate governance policies within companies to promote good corporate governance practices. At present, companies are adopting similar self-regulatory corporate governance policies without alterations that suit each individual company's needs. The regulatory authorities should create a committee consisting of representatives from both institutions to ensure that new corporate governance issues are dealt with in a timely fashion.

The regulatory authorities should strengthen its enforcement efforts towards full compliance with the CGR's 'comply or explain' requirements. They should continue to work on building their enforcement capacity, providing staff with proper training to better engage and guide listed companies in the application of the CGR.

In addition, the CGR demonstrates a lack of articulacy regarding the shareholders' right to sue and litigate against board members. The regulatory authorities should revise the CGR to clarify and enforce the litigation of board members by the shareholders. Similarly, the regulatory authorities should improve the role of the audit committees by implement new rules and measures that clarify the selection process and roles of audit committee members. Therefore, regulators should promote audit committee financial expertise in substance, which is pivotal to improving financial reporting quality.

The policy-maker may need to consider a fundamental change to the banks' ownership structures where certain families are in control of board seats, as well as the government role in banking industry that are bring independence of these institutions into questions. In addition, the policy-maker should review the directors' tenure, implementing and enforcing strict rules on the number of years a director spends on boards. Equally, the country has experienced a shortage of qualified banking directors in the past which is not the case in recent time where more qualified Saudis are available to join corporate boards.

However, it is still vitally important for the Saudi policy-makers to realise, without undue delay, the gargantuan duty to bring about radical, yet measured, changes not only to the formal structure of the governance system but also to the authorities empowered to key players in the administration of the market. Yet, the policy-makers are encouraged to consider the institutional context for the improvement of the corporate governance regulations.

9.4 Limitations and Suggestions for Future Research

Although this study has provided some significant insights into the governance roles of board of directors, it has a number of limitations. First, as with any method, the limitations associated with the use of the case study method apply to this study as well. Second, the issue of access to interviewees in the case banks and regulatory authorities, as evidenced in the varying depth of coverage in the cases, have limited the scope and extent of the issues examined. Furthermore, this relates to the issues of selection bias, as those who agreed to participate in the interviews may be more knowledgeable about corporate governance. Similarly, there were many who refused to be involved, due to their lack of awareness and knowledge about corporate governance, thereby limiting the generalisation of findings. However, this study has attempted to select a balanced number of participants in order to ensure equal findings.

Finally, this study showed that all interviewees in Saudi Arabia share the same reticent behaviour towards tape-recording of their opinions. This could well be attributed to social and cultural issues. This behaviour may drive the interviewee to avoid providing certain information, due to confidentiality or to hide his incompetence in providing beneficial feedback. Alternatively, he simply might not wish to give a bad impression of his bank, which compels him to provide ‘perfect’ answers.

Future empirical work is needed to enhance our understanding about the specific contingencies that would lead a board, for example, to conform to institutional pressures rather than performing monitoring roles or boundary-spanning functions. There is a chance to explore the varying utility of theories applied to board phenomenon whereby the concern is not simply a matter of choosing one theoretical perspective over another, but rather, identifying under which conditions each is more applicable.

In light of recent calls to consider corporate governance in its own context, researchers might need to examine how regulatory and informal institutions impact upon the processes of corporate governance in emerging markets. More specifically, the adoption of international principles of corporate governance should be accompanied by domestic regulations that prescribe specific rules and procedures for the governance of organisations, which address national differences in political, social and legal systems.

Overall, the limitations found when considered in the context of specific findings in the thesis, as well as in the extant literature on boards and corporate governance, suggest that the roles and functions of directors and their effects on aspects of corporate governance will continue to be a promising area of research at least for the foreseeable future.

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LIST OF APPENDICES

CAPITAL MARKET AUTHORITY

CORPORATE GOVERNANCE REGULATIONS IN THE KINGDOM OF SAUDI ARABIA

Issued by the Board of Capital Market Authority

Pursuant to Resolution No. 1/212/2006

dated 21/10/1427AH (corresponding to 12/11/2006)

based on the Capital Market Law

issued by Royal Decree No. M/30

dated 2/6/1424AH

Amended by Resolution of the Board

of the Capital Market Authority Number 1-10-2010

Dated 30/3/1431H corresponding to 16/3/2010G

English Translation of the Official Arabic Text

Arabic is the official language of the Capital Market Authority

The current version of these Rules, as may be amended, can be found at

CMA website: www.cma.org.sa

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PART 1: PRELIMINARY PROVISIONS

Article 1: Preamble

a) These Regulations include the rules and standards that regulate the management of joint stock companies listed in the Exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders' rights as well as the rights of stakeholders.

b) These Regulations constitute the guiding principles for all companies listed in the Exchange unless any other regulations, rules or resolutions of the Board of the Authority provide for the binding effect of some of the provisions herein contained.

c) As an exception of paragraph (b) of this article, a company must disclose in the Board of Directors` report, the provisions that have been implemented and the provisions that have not been implemented as well as the reasons for not implementing them.

Article 2: Definitions

a) Expression and terms in these regulations have the meanings they bear in the Capital Market Law and in the glossary of defined terms used in the regulations and the rules of the Capital Market Authority unless otherwise stated in these regulations.

b) For the purpose of implementing these regulations, the following expressions and terms shall have the meaning they bear as follows unless the contrary intention appears:

Independent Member: A member of the Board of Directors who enjoys complete independence. By way of example, the following shall constitute an infringement of such independence:

1. he/she holds a five per cent or more of the issued shares of the company or any of its group.

2. Being a representative of a legal person that holds a five per cent or more of the issued shares of the company or any of its group.

3. he/she, during the preceding two years, has been a senior executive of the company or of any other company within that company's group.

4. he/she is a first-degree relative of any board member of the company or of any other company within that company's group.

5. he/she is first-degree relative of any of senior executives of the company or of any other company within that company's group.

6. he/she is a board member of any company within the group of the company which he is nominated to be a member of its board.

7. If he/she, during the preceding two years, has been an employee with an affiliate of the company or an affiliate of any company of its group, such as external auditors or main suppliers; or if he/she, during the preceding two years, had a controlling interest in any such party.

Non-executive director: A member of the Board of Directors who does not have a full-time management position at the company, or who does not receive monthly or yearly salary.

First-degree relatives: father, mother, spouse and children.

Stakeholders: Any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community.

Accumulative Voting: a method of voting for electing directors, which gives each shareholder a voting rights equivalent to the number of shares he/she holds. He/she has the right to use them all for one nominee or to divide them between his/her selected nominees without any duplication of these votes. This method increases the chances of the minority shareholders to appoint their representatives in the board through the right to accumulate votes for one nominee.

Minority Shareholders: Those shareholders who represent a class of shareholders that does not control the company and hence they are unable to influence the company.

PART 2: RIGHTS OF SHAREHOLDERS AND THE GENERAL ASSEMBLY

Article 3: General Rights of Shareholders

A Shareholder shall be entitled to all rights attached to the share, in particular, the right to a share of the distributable profits, the right to a share of the company's assets upon liquidation; the right to attend the General Assembly and participate in deliberations and vote on relevant decisions; the right of disposition with respect to shares; the right to supervise the Board of Directors activities, and file responsibility claims against board members; the right to inquire and have access to information without prejudice to the company's interests and in a manner that does not contradict the Capital Market Law and the Implementing Rules.

Article 4: Facilitation of Shareholders Exercise of Rights and Access to Information

a) The company in its Articles of Association and by-laws shall specify the procedures and precautions that are necessary for the shareholders' exercise of all their lawful rights.

b) All information which enable shareholders to properly exercise their rights shall be made available and such information shall be comprehensive and accurate; it must be provided and updated regularly and within the prescribed times; the company shall use the most effective means in communicating with shareholders. No discrepancy shall be exercised with respect to shareholders in relation to providing information.

Article 5: Shareholders Rights related to the General Assembly

a) A General Assembly shall convene once a year at least within the six months following the end of the company's financial year.

b) The General Assembly shall convene upon a request of the Board of Directors. The Board of Directors shall invite a General Assembly to convene pursuant to a request of the auditor or a number of shareholders whose shareholdings represent at least 5% of the equity share capital.

c) Date, place, and agenda of the General Assembly shall be specified and announced by a notice, at least 20 days prior to the date the meeting; invitation for the meeting shall be published in the Exchange' website, the company's website and in two newspapers of voluminous distribution in the Kingdom. Modern high tech means shall be used in communicating with shareholders.

d) Shareholders shall be allowed the opportunity to effectively participate and vote in the General Assembly; they shall be informed about the rules governing the meetings and the voting procedure.

e) Arrangements shall be made for facilitating the participation of the greatest number of shareholders in the General Assembly, including inter alia determination of the appropriate place and time.

f) In preparing the General Assembly’s agenda, the Board of Directors shall take into consideration matters shareholders require to be listed in that agenda; shareholders holding not less than 5% of the company’s shares are entitled to add one or more items to the agenda upon its preparation.

g) Shareholders shall be entitled to discuss matters listed in the agenda of the General Assembly and raise relevant questions to the board members and to the external auditor. The Board of Directors or the external auditor shall answer the questions raised by shareholders in a manner that does not prejudice the company’s interest.

h) Matters presented to the General Assembly shall be accompanied by sufficient information to enable shareholders to make decisions.

i) Shareholders shall be enabled to peruse the minutes of the General Assembly; the company shall provide the Authority with a copy of those minutes within 10 days of the convening date of any such meeting.

j) The Exchange shall be immediately informed of the results of the General Assembly.

Article 6: Voting Rights

a) Voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied. The company must avoid taking any action which might hamper the use of the voting right; a shareholder must be afforded all possible assistance as may facilitate the exercise of such right.

b) In voting in the General Assembly for the nomination to the board members, the accumulative voting method shall be applied.

c) A shareholder may, in writing, appoint any other shareholder who is not a board member and who is not an employee of the company to attend the General Assembly on his behalf.

d) Investors who are judicial persons and who act on behalf of others -e.g. investment funds- shall disclose in their annual reports their voting policies, actual voting, and ways of dealing with any material conflict of interests that may affect the practice of the fundamental rights in relation to their investments.

Article 7: Dividends Rights of Shareholders

a) The Board of Directors shall lay down a clear policy regarding dividends, in a manner that may realize the interests of shareholders and those of the company; shareholders shall be informed of that policy during the General Assembly and reference thereto shall be made in the report of the Board of Directors.

b) The General Assembly shall approve the dividends and the date of distribution. These dividends, whether they be in cash or bonus shares shall be given, as of right, to the shareholders who are listed in the records kept at the Securities Depository Center as they appear at the end of trading session on the day on which the General Assembly is convened.

PART 3: DISCLOSURE AND TRANSPARENCY

Article 8: Policies and Procedure related to Disclosure

The company shall lay down in writing the policies, procedures and supervisory rules related to disclosure, pursuant to law.

Article 9[58]: Disclosure in the Board of Directors' Report

In addition to what is required in the Listing Rules in connection with the content of the report of the Board of Directors, which is appended to the annual financial statements of the company, such report shall include the following:

a) The implemented provisions of these Regulations as well as the provisions which have not been implemented, and the justifications for not implementing them.

b) Names of any joint stock company or companies in which the company Board of Directors member acts as a member of its Board of directors.

c) Formation of the Board of Directors and classification of its members as follows: executive board member, non-executive board member, or independent board member.

d) A brief description of the jurisdictions and duties of the Board's main committees such as the Audit Committee, the Nomination and Remuneration Committee; indicating their names, names of their chairmen, names of their members, and the aggregate of their respective meetings.

e) Details of compensation and remuneration paid to each of the following:

1. The Chairman and members of the Board of Directors.

2. The Top Five executives who have received the highest compensation and remuneration from the company. The CEO and the chief finance officer shall be included if they are not within the top five.

For the purpose of this paragraph, "compensation and remuneration" means salaries, allowances, profits and any of the same; annual and periodic bonuses related to performance; long or short- term incentive schemes; and any other rights in rem.

f) Any punishment or penalty or preventive restriction imposed on the company by the Authority or any other supervisory or regulatory or judiciary body.

g) Results of the annual audit of the effectiveness of the internal control procedures of the company.

PART 4: BOARD OF DIRECTORS

Article 10[59]: Main Functions of the Board of Directors

Among the main functions of the Board is the following:

a) Approving the strategic plans and main objectives of the company and supervising their implementation; this includes:

1. Laying down a comprehensive strategy for the company, the main work plans and the policy related to risk management, reviewing and updating of such policy.

2. Determining the most appropriate capital structure of the company, its strategies and financial objectives and approving its annual budgets.

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[58] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 9 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from the first board report issued by the company following the date of the Board of the Capital Market Authority resolution mentioned above

[59] The Board of the Capital Market Authority issued resolution Number (1-33-2011) Dated 3/12/1432H corresponding to 30/10/2011G making paragraph (b) of Article 10 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2012.

3. Supervising the main capital expenses of the company and acquisition/disposal of assets.

4. Deciding the performance objectives to be achieved and supervising the implementation thereof and the overall performance of the company.

5. Reviewing and approving the organizational and functional structures of the company on a periodical basis.

b) Lay down rules for internal control systems and supervising them; this includes:

1. Developing a written policy that would regulates conflict of interest and remedy any possible cases of conflict by members of the Board of Directors, executive management and shareholders. This includes misuse of the company's assets and facilities and the arbitrary disposition resulting from dealings with the related parties.

2. Ensuring the integrity of the financial and accounting procedures including procedures related to the preparation of the financial reports.

3. Ensuring the implementation of control procedures appropriate for risk management by forecasting the risks that the company could encounter and disclosing them with transparency.

4. Reviewing annually the effectiveness of the internal control systems.

c) Drafting a Corporate Governance Code for the company that does not contradict the provisions of this regulation, supervising and monitoring in general the effectiveness of the code and amending it whenever necessary.

d) Laying down specific and explicit policies, standards and procedures, for the membership of the Board of Directors and implementing them after they have been approved by the General Assembly.

e) Outlining a written policy that regulate the relationship with stakeholders with a view to protecting their respective rights; in particular, such policy must cover the following:

1. Mechanisms for indemnifying the stakeholders in case of contravening their rights under the law and their respective contracts.

2. Mechanisms for settlement of complaints or disputes that might arise between the company and the stakeholders.

3. Suitable mechanisms for maintaining good relationships with customers and suppliers and protecting the confidentiality of information related to them.

4. A code of conduct for the company's executives and employees compatible with the proper professional and ethical standards, and regulate their relationship with the stakeholders. The Board of Directors lays down procedures for supervising this code and ensuring compliance there with.

5. The Company's social contributions.

f) Deciding policies and procedures to ensure the company's compliance with the laws and regulations and the company's obligation to disclose material information to shareholders, creditors and other stakeholders.

Article 11: Responsibilities of the Board

a) Without prejudice to the competences of the General Assembly, the company's Board of Directors shall assume all the necessary powers for the company's management. The ultimate responsibility for the company rests with the Board even if

it sets up committees or delegates some of its powers to a third party. The Board of Directors shall avoid issuing general or indefinite power of attorney.

b) The responsibilities of the Board of Directors must be clearly stated in the company's Articles of Association.

c) The Board of Directors must carry out its duties in a responsible manner, in good faith and with due diligence. Its decisions should be based on sufficient information from the executive management, or from any other reliable source.

d) A member of the Board of Directors represents all shareholders; he undertakes to carry out whatever may be in the general interest of the company, but not the interests of the group he represents or that which voted in favor of his appointment to the Board of Directors.

e) The Board of Directors shall determine the powers to be delegated to the executive management and the procedures for taking any action and the validity of such delegation. It shall also determine matters reserved for decision by the Board of Directors. The executive management shall submit to the Board of Directors periodic reports on the exercise of the delegated powers.

f) The Board of Directors shall ensure that a procedure is laid down for orienting the new board members of the company's business and, in particular, the financial and legal aspects, in addition to their training, where necessary.

g) The Board of Directors shall ensure that sufficient information about the company is made available to all members of the Board of Directors, generally, and, in particular, to the non-executive members, to enable them to discharge their duties and responsibilities in an effective manner.

h) The Board of Directors shall not be entitled to enter into loans which spans more than three years, and shall not sell or mortgage real estate of the company, or drop the company's debts, unless it is authorized to do so by the company's Articles of Association. In the case where the company's Articles of Association includes no provisions to this respect, the Board should not act without the approval of the General Assembly, unless such acts fall within the normal scope of the company's business.

Article 12[60]: Formation of the Board

Formation of the Board of Directors shall be subject to the following:

a) The Articles of Association of the company shall specify the number of the Board of Directors members, provided that such number shall not be less than three and not more than eleven.

b) The General Assembly shall appoint the members of the Board of Directors for the duration provided for in the Articles of Association of the company, provided that such duration shall not exceed three years. Unless otherwise provided for in the Articles of Association of the company, members of the Board may be reappointed.

c) The majority of the members of the Board of Directors shall be nonexecutive members.

d) It is prohibited to conjoin the position of the Chairman of the Board of Directors with any other executive position in the company, such as the Chief Executive Officer (CEO) or the managing director or the general manager.

[60] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making paragraphs (c) and (e) of Article 12 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

e) The independent members of the Board of Directors shall not be less than two members, or one-third of the members, whichever is greater.

f) The Articles of Association of the company shall specify the manner in which membership of the Board of Directors terminates. At all times, the General Assembly may dismiss all or any of the members of the Board of Directors even though the Articles of Association provide otherwise.

g) On termination of membership of a board member in any of the ways of termination, the company shall promptly notify the Authority and the Exchange and shall specify the reasons for such termination.

h) A member of the Board of Directors shall not act as a member of the Board of Directors of more than five joint stock companies at the same time.

i) Judicial person who is entitled under the company's Articles of Association to appoint representatives in the Board of Directors, is not entitled to nomination vote of other members of the Board of Directors.

Article 13: Committees of the Board

a) A suitable number of committees shall be set up in accordance with the company's requirements and circumstances, in order to enable the Board of Directors to perform its duties in an effective manner.

b) The formation of committees subordinate to the Board of Directors shall be according to general procedures laid down by the Board, indicating the duties, the duration and the powers of each committee, and the manner in which the Board monitors its activities. The committee shall notify the Board of its activities, findings or decisions with complete transparency. The Board shall periodically pursue the activities of such committees so as to ensure that the activities entrusted to those committees are duly performed. The Board shall approve the by-laws of all committees of the Board, including, inter alia, the Audit Committee, Nomination and Remuneration Committee.

c) A sufficient number of the non-executive members of the Board of Directors shall be appointed in committees that are concerned with activities that might involve a conflict of interest, such as ensuring the integrity of the financial and non-financial reports, reviewing the deals concluded by related parties, nomination to membership of the Board, appointment of executive directors, and determination of remuneration.

Article 14[61]: Audit Committee

a) The Board of Directors shall set up a committee to be named the "Audit Committee". Its members shall not be less than three, including a specialist in financial and accounting matters. Executive board members are not eligible for Audit Committee membership.

b) The General Assembly of shareholders shall, upon a recommendation of the Board of Directors, issue rules for appointing the members of the Audit Committee and define the term of their office and the procedure to be followed by the Committee.

c) The duties and responsibilities of the Audit Committee include the following:

1. To supervise the company's internal audit department to ensure its effectiveness in executing the activities and duties specified by the Board of Directors.

[61] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 14 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

2. To review the internal audit procedure and prepare a written report on such audit and its recommendations with respect to it.

3. To review the internal audit reports and pursue the implementation of the corrective measures in respect of the comments included in them.

4. To recommend to the Board of Directors the appointment, dismissal and the Remuneration of external auditors; upon any such recommendation, regard must be made to their independence.

5. To supervise the activities of the external auditors and approve any activity beyond the scope of the audit work assigned to them during the performance of their duties.

6. To review together with the external auditor the audit plan and make any comments thereon.

7. To review the external auditor's comments on the financial statements and follow up the actions taken about them.

8. To review the interim and annual financial statements prior to presentation to the Board of Directors; and to give opinion and recommendations with respect thereto.

9. To review the accounting policies in force and advise the Board of Directors of any recommendation regarding them.

Article 15[62]: Nomination and Remuneration Committee

a) The Board of Directors shall set up a committee to be named "Nomination and Remuneration Committee".

b) The General Assembly shall, upon a recommendation of the Board of Directors, issue rules for the appointment of the members of the Nomination and Remuneration Committee, terms of office and the procedure to be followed by such committee.

c) The duties and responsibilities of the Nomination and Remuneration Committee include the following:

1. Recommend to the Board of Directors appointments to membership of the Board in accordance with the approved policies and standards; the Committee shall ensure that no person who has been previously convicted of any offense affecting honor or honesty is nominated for such membership.

2. Annual review of the requirement of suitable skills for membership of the Board of Directors and the preparation of a description of the required capabilities and qualifications for such membership, including, inter alia, the time that a Board member should reserve for the activities of the Board.

3. Review the structure of the Board of Directors and recommend changes.

4. Determine the points of strength and weakness in the Board of Directors and recommend remedies that are compatible with the company's interest.

5. Ensure on an annual basis the independence of the independent members and the absence of any conflict of interest in case a Board member also acts as a member of the Board of Directors of another company.

[62] The Board of the Capital Market Authority issued resolution Number (1-10-2010) Dated 30/3/1431H corresponding to 16/3/2010G making Article 15 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2011.

6. Draw clear policies regarding the indemnities and remunerations of the Board members and top executives; in laying down such policies, the standards related to performance shall be followed.

Article 16: Meetings of the Board

1.The Board members shall allot ample time for performing their responsibilities, including the preparation for the meetings of the Board and the permanent and ad hoc committees, and shall endeavor to attend such meetings.

2. The Board shall convene its ordinary meetings regularly upon a request by the Chairman. The Chairman shall call the Board for an unforeseen meeting upon a written request by two of its members.

3. When preparing a specified agenda to be presented to the Board, the Chairman should consult the other members of the Board and the CEO. The agenda and other documentation should be sent to the members in a sufficient time prior to the meeting so that they may be able to consider such matters and prepare themselves for the meeting. Once convened, the Board shall approve the agenda; should any member of the Board raise any objection to this agenda, the details of such objection shall be entered in the minutes of the meeting.

4. The Board shall document its meetings and prepare records of the deliberations and the voting, and arrange for these records to be kept in chapters for ease of reference.

Article 17: Remuneration and Indemnification of Board Members

The Articles of Association of the company shall set forth the manner of remunerating the Board members; such remuneration may take the form of a lump sum amount, attendance allowance, rights in rem or a certain percentage of the profits. Any two or more of these privileges may be conjoined.

Article 18: Conflict of Interest within the Board

a) A Board member shall not, without a prior authorization from the General Assembly, to be renewed each year, have any interest (whether directly or indirectly) in the company’s business and contracts. The activities to be performed through general bidding shall constitute an exception where a Board member is the best bidder. A Board member shall notify the Board of Directors of any personal interest he/she may have in the business and contracts that are completed for the company’s account. Such notification shall be entered in the minutes of the meeting. A Board member who is an interested party shall not be entitled to vote on the resolution to be adopted in this regard neither in the General Assembly nor in the Board of Directors. The Chairman of the Board of Directors shall notify the General Assembly, when convened, of the activities and contracts in respect of which a Board member may have a personal interest and shall attach to such notification a special report prepared by the company’s auditor.

b) A Board member shall not, without a prior authorization of the General Assembly, to be renewed annually, participate in any activity which may likely compete with the activities of the company, or trade in any branch of the activities carried out by the company.

c) The company shall not grant cash loan whatsoever to any of its Board members or render guarantee in respect of any loan entered into by a Board member with third parties, excluding banks and other fiduciary companies.

PART 5: CLOSING PROVISIONS

Article 19: Publication and Entry into Force

These regulations shall be effective upon the date of their publication.

APPENDIX 2: LIST OF INTERVIEW RESPONDENTS

INTERVIEWEE	ROLE	AGE	EXPERIENCE (YRS)	QUALIFICATIONS
GOVERNMENT BANK				
1. GB1	Board Member Member, AC/NCC	75	40+	• Former Governor of the Saline Water Conversion Corporation. • Former Member, Majlis Al Shoura (Consultative Council). • Bachelor Degree of Arts
2. GB2	Board Member Member, EC/CC	58	26+	• Vice Chairman, Qaseem Cement Company. • Assistant Governor for Investment, General Organization for Social Insurance (GOSI). • Chairman, Granada Center. Board Member • Bachelor Degree of Engineering
3. GB3	Board Member Member, NCC/RC	68	30+	• President of the General Authority for Civil Aviation. • Board Member, Saudi Arabian Airlines. • Chairman, Saudi Academy for Aviation. • Chairman, Middle East CANSO (Civil Air Navigation Services Organization). • Bachelor Degree of Engineering
4. GB4	Board Member Member, EC/CC	73	35+	• Director, Middle East Battery Company. • Chairman, Al-Jazirah Corporation for Press, Printing and Publishing. • Bachelor Degree of Arts
5. GACC	AC Chair Member, EC/AC/CC/RC/NCC	55	20+	• Financial Advisor, Public Investment Fund (PIF). • Chairman, Water and Electricity Company Holding. • Vice Chairman of the Board and AC Chairman, Saudi e-tabadul Company. • Director, Stusid Bank (Tunis). • Member of the Audit Committee, Saudi Telecom Company (STC). • Bachelor Degree of Accounting
6. GAC1	AC Member	46	10+	• Senior Lecturer. • Former President, Saudi Accounting Association. • Former Member of the Audit Committee, Saudi

				Telecom Company (STC). • PhD in Business Administration (Financial Accounting & Auditing).
7. GAC2	AC Member	48	20+	• Senior Lecturer. • Member, Majlis Al Shoura (Consultative Council). • PhD in Accounting
INTERNATIONAL BANK				
8. IB1	Board Member Member, EC/NCC	73	35+	• Director, Saudi Electricity Co. • Director, Southern Province Cement Co. • Director, Sanad Cooperative Insurance Co. • Director, Aldrees for Petroleum Services and Transportation • Director, Al-Yamamah Investment and Installment
9. IB2	Board Member Member, EC/NCC	61	30+	• Arab Paper Manufacturing Co. • Basic Chemical Industries Co. (BCI)
10. ICEO	Chief Executive Member, EC	60	30+	• Director, Saudi Home Loans Company (SHL) • PhD in Money and Banking
11. IAC1	AC Member	59	30+	• Former CEO, Chemical Company Ltd. • Former CEO, SADCO Company • Former Director, Sanad Cooperative Insurance Co. • Master Degree in Management
12. IAC2	AC Member	48	15+	• Senior Lecturer • Former Member of GCC Auditing and Accounting Authority • PhD in Accounting
ISLAMIC BANK				
13. SBC	Board Chair Member, EC/NCC	53	25+	• Chairman, Saudi Stock Exchange (Tadawul) Co. • Chairman and Co-Founder Derayah Financial Corp. • Former, SAMA Director of Banking Technology. • Former, Deputy General Manager of the Government Bank. • Management & Leadership Training at Harvard University and Stanford Executive Program. • Bachelor Degree in Computer Science.
14. SB1	Board Member	59	20+	• Chairman, Advance

	Member, EC			Polypropylene Company • Board member, Nama Chemical Company, Wala'a Insurance Company, Saudi White Cement Factory Company and Riyadh Cement Company. • Bachelor Degree in Finance
15. SB2	Board Member	42	5+	• Director, National Petrochemical Company • Representative of the General Organization for Social Insurance (GOSI)
16. SACC	AC Chair Member, EC/AC/NCC	47	20+	• Chairman, Aljazira Takaful Ta'awuni Company • Director, Qaseem Cement Company. • Member of the Advisory Board of TAIB Bank B.S.C. • Bachelor Degree in Petroleum Engineering
17. SAC1	AC Member	44	10+	• Saudi Indian Company for Co- operative Insurance • Wafa Insurance, Inc. • Master Degree in Management

REGULATORS				
18. RS1	Banking Inspection Officer	55	30	• Higher Diploma in Accounting
19. RS2	Banking Inspection Officer	36	5+	• Bachelor Degree in Accounting
20. RC1	Compliance Officer	33	5+	• Bachelor Degree in Accounting
21. RC2	Compliance Officer	38	5+	• Bachelor Degree in Management

BOARDS & COMMITTEES	**GOVERNMENT BANK**	**INTERNATIONAL BANK**	**ISLAMIC BANK**
Board of Directors [BOD]	BOD Chairman (EC/CC/RC/NCC) BOD Member, CEO (EC/CC/RC) BOD Member, Private (EC/CC) BOD Member, Govt (AC/NCC) BOD Member, Govt (EC/CC) BOD Member, Govt (NCC/RC) BOD Member, Govt (EC/AC/CC/RC/NCC) BOD Member, Private (AC)	BOD Chairman, Private/Major Shareholder BOD Member, CEO (EC)/Foreign Partner BOD Member, Private/Major Shareholder BOD Member, Private/Major Shareholder (EC/NCC) BOD Member, Private (EC/NCC) BOD Member, Private BOD Member, Private/Major Shareholder (EC/NCC) BOD Member, Foreign Partner BOD Member, Foreign Partner (EC) BOD Member, Foreign Partner (AC) (5) Independent | (4) Non-	BOD Chairman (EC/NCC) BOD Member, CEO BOD Member, Private/Major Shareholder (AC) BOD Member, Govt (EC/NCC) BOD Member, Private (EC/NCC) BOD Member, Private/Major Shareholder (EC) BOD Member, Private/Major Shareholder (EC) BOD Member, Private BOD Member, Private

		executive | (1) Executive	(5) Independent | (3) Non-executive | (1) Executive
Executive Committee [EC]	EC Chairman, BOD Chairman EC Member, CEO EC Member, Govt EC Member, Private EC Member, Govt	EC Chairman, CEO/Foreign Partner EC Member, Private/Major Shareholder EC Member, Private EC Member, Private/Major Shareholder EC Member, Foreign Partner	EC Chairman, BOD Chairman EC Member, Govt EC Member, Private/Major Shareholder EC Member, Private EC Member, Private/Major Shareholder
Audit Committee* [AC]	AC Chairman, Govt AC Member, Govt AC Member, Private AC Member, Independent AC Member, Independent	AC Chairman, Foreign Partner/Major Shareholder AC Member, Independent AC Member, Independent	AC Chairman, Private/Major Shareholder AC Member, Independent AC Member, Independent AC Member, Independent
Nomination & Compensation Committee [NCC]	NCC Chairman, BOD Chairman NCC Member, Govt NCC Member, Govt NCC Member, Govt	NCC Chairman, Private/Major Shareholder NCC Member, Private /Major Shareholder NCC Member, Private *NCC was the responsibility of Executive Committee until 2010*	NCC Chairman, BOD Chairman NCC Member, Govt NCC Member, Private

* AC independent members are from outside the bank
Banks Annual Reports (2009-2012)

APPENDIX 3: LIST OF INTERVIEW QUESTIONS

Interview Questions: Directors

Corporate Governance Framework

What is your view about the corporate governance regulations in Saudi Arabia?
Have you noticed any changes in your bank as a result of these regulations or initiatives?
To what extent do outcomes of the regulatory initiatives meet their objectives?
During your last regulatory exam, was your bank cited for any regulatory violations?
Have a board member been held liable for any breach of fiduciary duty and duty of care?

Director Selection Process

Can you describe the bank's process for selecting and nominating board members?
Do you think the selection criterion for non-executive directors and senior managers is designed towards the needs of the bank? How?
How would you describe the nature of the stakeholders' involvement in the selection process?

Directors Roles & Responsibilities

What do you think is the mandate for the board?
To what extent do members of the board understand their roles and responsibilities?
Does each member contribute equally to the board's effectiveness?
How would you characterise the role that each member plays during meetings?
Are you satisfied with the mix of tasks that come to the board?

Boardroom Dynamics

How would you describe the nature of the board discussions and deliberations?
Describe a good decision made by the board.
Describe a decision where the process was problematic.
Which board members emerged as the leaders in the boardroom? Is this consistent on all issues or did it vary depending upon the subject matters?
Is decision-making process handled differently in other boards on which you sit? How?
How do you handle disputes between board members?
What do you do about underperforming director? Can you think of an example?

Audit Committees

What are the roles of audit committee?
To what extent does it fulfilling these roles?
What skill sets does the audit committee require?
Who should sit on the audit committee?
Do you think the work of audit committee has direct impact on the board's outcomes?
Describe the nature of relationships between audit committee and the board and management.

Interview Questions: Regulators

1. How do you evaluate the state of the corporate governance in Saudi Arabia?
2. What sort of changes have you noticed in the market since the introduction of CG regulations?
3. How do you evaluate the companies' level of compliance?

4. What do you think of the pace of change in the Kingdom? Why?
5. How do you describe the relationships between the regulatory authorities?
6. How do you evaluate their level of control and supervision?
7. What are the key issues affecting their efforts to promote good corporate governance?
8. How do you evaluate the competency of regulatory authorities' personnel in implementing corporate governance regulations/listing rules?

APPENDIX 4: CASE BANKS FINANCIAL DATA FOR 2012

GOVERNMENT BANK						
Year	**Assets**	**Change %**	**Sector Share %**	**Net Income**	**Change %**	**Sector Share %**
2005	145,789	0.0%	19.9%	5,011	0.0%	18.6%
2006	155,706	6.8%	18.1%	6,273	25.2%	18.1%
2007	208,717	34.0%	19.4%	6,016	-4.1%	19.9%
2008	221,802	6.3%	17.0%	2,107	-65.0%	7.0%
2009	257,452	16.1%	18.8%	4,121	95.6%	13.8%
2010	282,372	9.7%	20.0%	4,724	14.6%	18.1%
2011	301,198	6.7%	19.5%	6,106	29.3%	19.7%
2012	345,320	14.6%	19.6%	6,453	5.7%	18.4%

** Saudi Riyals in Millions*
Government Bank Reports, 2005 – 2012

INTERNATIONAL BANK						
Year	**Assets**	**Change %**	**Sector Share %**	**Net Income**	**Change %**	**Sector Share %**
2005	67,492	0.0%	9.2%	1,828	0.0%	6.8%
2006	78,035	15.6%	9.1%	2,505	37.0%	7.2%
2007	94,468	21.1%	8.8%	2,461	-1.8%	8.1%
2008	121,307	28.4%	9.3%	2,486	1.0%	8.3%
2009	110,297	-9.1%	8.0%	2,370	-4.7%	7.9%
2010	116,035	5.2%	8.2%	1,911	-19.4%	7.3%
2011	117,574	1.3%	7.6%	2,171	13.6%	7.0%
2012	136,639	16.2%	7.8%	2,371	9.2%	6.7%

** Saudi Riyals in Millions*
International Bank Reports, 2005 – 2012

ISLAMIC BANK						
Year	**Assets**	**Change %**	**Sector Share %**	**Net Income**	**Change %**	**Sector Share %**
2005	14,169	0.0%	1.9%	874	0.0%	3.2%
2006	15,713	10.9%	1.8%	1,974	125.8%	5.7%
2007	21,564	37.2%	2.0%	805	-59.2%	2.7%
2008	27,520	27.6%	2.1%	222	-72.4%	0.7%
2009	29,978	8.9%	2.2%	28	-87.6%	0.1%
2010	33,018	10.1%	2.3%	29	4.7%	0.1%
2011	38,898	17.8%	2.5%	303	948.1%	1.0%
2012	50,957	31.0%	2.9%	501	65.3%	1.4%

** Saudi Riyals in Millions*
Islamic Bank Reports, 2005 – 2012