

THE WAQF FUND
Promoting ethics in finance through Shari'ah

Key takeaways – CG workshop no. 11
“Whistleblowing, Responsibilities to the Customer and the Purpose of the Corporation”

- To avoid a situation where an employee is forced to blow the whistle, listen to what your people are saying; if you don't take their concerns seriously, they will.
- Make sure your whistle-blowing policy doesn't just deal with “How to blow the whistle” and “Whistle-blower protections”, but also with what should happen after the whistle has been blown.
- Don't just rely on having a thorough whistle-blowing policy; create a culture that encourages choosing the right course of action and reward such behavior.
- If an allegation comes in over the whistle-blowing “line” that, if true, could have serious consequences, then think twice before having the inside team investigate it. If the allegation is serious, the inside team may have a difficult time being truly independent.
- It is only human nature to try to cover up in order to save oneself (“if we accept there was an internal control weakness it means repercussions for everyone – so denial is better”). Hence there may be a very good reason to have an external party conduct an investigation.
- A Board member has a fiduciary duty towards the institution and its shareholders/stakeholders, which means a duty of care, candor and loyalty.
- Duty of care demands of a Board member to:
 - Always be prepared
 - Do your homework
 - Read your Board package
 - Be alert
 - Ask questions
 - Attend all meetings, in person and in spirit
 - Do not act while uninformed / unconvinced
- Duty of candor requires:
 - Always be honest – with your Board, shareholders and regulator
 - Make full disclosure
 - Remember that bad news travels faster than good news
- Duty of loyalty means:
 - Always put the interest of the organization ahead of your own
 - No self-dealing
 - Any related party transactions must be fully disclosed, done at arm's length and approved by disinterested (non-conflicted) directors
 - Avoid to the greatest extent possible any conflicts of interest
 - Remember that shareholders' trust has to be earned (and retained) by the Board

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- There are obligations towards the customer, such as:
 - Truth in labeling your product
 - Truth in advertising
 - Prohibition of selling harmful products
 - Fraud prohibitions
- In an age of hyper media presence ethical considerations are no longer an option but a must, in order to sustain long term reputation, relationships and business.
- Pressures to deceive are pervasive, and we need to be prepared to be confronted by difficult moral decisions.
- Given the global populist mood and demonization of big business it is likely that new grounds will be broken regarding business's responsibilities towards customers.
- Businesses, and especially financial institutions, need to regain the lost trust of the society by going beyond the normal call of duty. Fulfilling merely the legal responsibilities is no longer enough.
- Remember the triple lens; only those activities should be undertaken that pass through all three lenses - economically profitable, legally allowed and ethically defensible.
- The Business Roundtable, an influential group of the largest US companies, has come up with a stakeholder (vs. shareholder) focused purpose of the corporation. It calls for companies to serve all the stakeholders by delivering:
 - Value to customers
 - Investing in employees
 - Dealing fairly with suppliers
 - Supporting the communities in which companies operate
 - Protecting the environment; and
 - Generating long term value for shareholders
- Both the shareholder and the stakeholder centric models converge in the long term:
 - Can you consistently create shareholder value without taking good care of your customers?
 - Can you abuse your employees and still create long-term shareholder value?
 - Can you continue to harm the environment or show apathy towards the community you do business in and avoid adverse consequences?
- Because of short term pressures it becomes critically important to consciously look at the world through the stakeholder lens, rather than the shareholder-only lens.

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Key takeaways – CG workshop no. 10
“The Fraud Triangle, M&A Structuring, Strategy & Disruption”

- Highly successful people are susceptible to violate the trust posed in them when they:
 - ...conceive of themselves as having a problem which is non-shareable (pressure)
 - ...are aware that this problem can be secretly resolved by violating the position of financial trust (opportunity)
 - ...are able to justify their behavior to themselves using various excuses (rationalization)

- According to the academic Cressey the three factors (pressure, opportunity and rationalization) must be present at the same time in order for an ordinary person to commit fraud.

- The pressure to be seen as successful and to match the success of the peer group is a strong motivator to contemplate wrongdoing.

- If a person thinks that he can abuse his position of trust to solve his financial problem with a low perceived risk of getting caught, he is more likely to commit fraud. Weak controls and a weak governance environment therefore increase the chance of wrongdoing.

- Majority of high profile fraudsters are first time offenders who do not view themselves as criminals but honest people who are caught in bad circumstances. They justify the crime to their conscience through various excuses (e.g. I was only borrowing the money; I was underpaid and I was entitled to this amount; I had to do it for my family, etc.).

- What can a board do to pre-empt such fraudulent behavior? What are some early signals?
 - Watch the CEO and senior executives if they are living beyond their means;
 - Watch for unbearable pressure created by unrealistic KPIs;
 - Adopt best in class governance practices, even beyond what is required by the regulator;
 - Look for rationalizing attitudes, e.g. “I deserve more”, “I am grossly underpaid”, “My employer is always taking advantage of me”

- In a merger / acquisition situation it is important to align the interests of both sets of shareholders.

- Share swap is a common method to combine entities in a merger situation vs. cash in an acquisition scenario.

- In a cash transaction the buyer (acquirer) has to take all the possible down side risk while in a share swap both the parties take risk on the performance post merger.

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- Successful M&As are typically always based on cost synergies (which are controllable); it is not advisable to price transactions based on revenue synergies (which are not controllable and highly uncertain).
- Mergers are like a pot of gold which is only accessible if both the sets of shareholders come together and divide it between them in a fair manner. If one party demands unrealistic pricing or tries to take undue advantage it does not work for either party.
- Failure to detect paradigm shifts in the business environment and tweaking strategy accordingly may lead to loss of market share or even bankruptcy.
- Look for disruptive technologies within your line of business; disrupt yourself before others disrupt you.
- Understand your own business, sources of profitability and vulnerabilities to disruptions such as Fintech innovations.
- Partnering up with innovators may be an effective way to cope in the emerging business environment.
- Since customer expectations are primarily driving disruption, it is crucial to remain close to customers and anticipate what they want.

Key takeaways – CG workshop no. 9

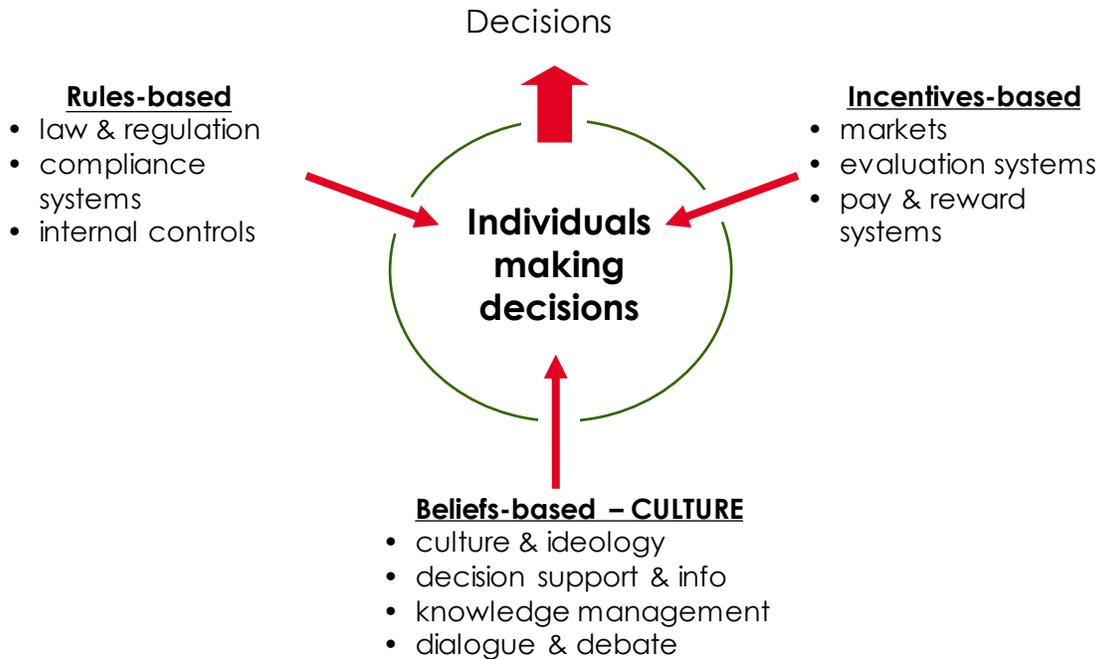
“Culture, Compensation Design and Conduct Risk – How Interconnected Are They?”

- Key Performance Indicators (KPIs) are a result of the strategic planning exercise. KPIs should always map to strategic objectives of the company.
- It is best to keep the KPIs simple, to the extent possible.
- A person should be held accountable only for factors that are within his/her control. If the cause and effect relationship is not well established it is counterproductive to include the factor in their KPIs.
- To choose the right KPIs three criteria must be kept in mind:
 - Alignment with strategy
 - Measurability
 - Linkage to value
- Three common problems while designing performance measurement systems are:
 - Controllability
 - Alignment (of all stakeholders' interests)
 - Interdependency (team performance vs. an individual's contribution)

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- Compliance with legal and regulatory requirements is a pre-requisite and cannot be compromised, no matter how good the financial performance may be.
- Reputational damage as a consequence of misconduct is far more serious than financial loss (e.g. due to penalties and fines). It does not make good business sense for companies to take this risk.
- Non-financial considerations relating to conduct should be integrated in a balanced way to performance assessment and compensation.
- Compensation policies and procedures should be transparent, consistent and fair in order to promote clear expectations and accountability for conduct.
- The consequences of misconduct risk may take years to materialize; companies should structure the compensation incentives to account for this long timeframe (e.g. through clawback).
- Sound governance, robust risk management frameworks and adequate involvement by control functions including human resources in compensation design and decision-making are critical to the effectiveness of compensation incentives in addressing misconduct risk.
- The ultimate responsibility for ensuring accountability for misconduct lies with the Board of directors. The Board should oversee and senior management should implement a compensation system designed to promote ethical behavior.
- Make it explicit to the employees what values / behavior / culture you expect of them.
- How leaders shape behavior? The following diagram explains the dynamics:

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Key takeaways – CG workshop no. 8
“How Independent are Independent Directors?”

- Independence is essentially a state of mind, but the importance of structures and incentives cannot be ignored. If an independent director is paid in equity then his independence can be compromised.
- If a person is an independent director on the parent company’s Board he may be nominated as independent director for its subsidiary’s Board, but not its associates. Nevertheless, it is not a clear-cut situation.
- When a CEO nominates his father’s best friend as Chairman of the company or his own best friend, he may not be breaching any law or regulation but the nominees may not be considered as truly independent.
- Regulators may need to place a ceiling on the number of years a person can remain as an independent Board member of a company. To be more effective companies may use a search firm to look for independent directors.
- Independent directors should not be afraid of asking tough questions especially when there is a whiff of self-dealing or when the CEO’s or CFO’s actions raise questions about their duty of loyalty.

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- It is important to design the CEO's performance incentives (Key Performance Indicators) correctly and carefully in order to elicit the kind of behavior that the Board wants to encourage. People do what you pay them to do.
- To be effective on a Board the independent director needs to build rapport and form alliances with other Board members (remember Warren Buffet's quote – 'Boards are 50% business enterprises and 50% social clubs').
- The job of an independent director becomes more difficult if other directors are conflicted or do not fully appreciate what is going on (due to lack of understanding of the business).
- The independent director should reassess whether he/she wants to remain in the Board in certain situations, e.g. overly defensive CEO while the other Board members are overly protective or accept management viewpoint unquestioningly.
- An independent director must be clear in his mind about his reasons to join a Board, what he is willing to do and what he is not willing to do.
- Regulators may consider taking a more proactive role to increase the effectiveness of independent directors.
- Diversity of opinions, backgrounds and perspectives on a Board is a very welcome thing and should always be encouraged.
- Board members must remember their duties of candor, care and loyalty – always make full disclosures, always be informed, always put the company's interest first.
- When a company becomes insolvent or approaches the "zone of insolvency" the directors need to prioritize the creditors' interests ahead of the shareholders'.
- Boards can rely on the management for facts, but they are entitled to question the management's judgment.

Key takeaways – CG workshop no. 7
"Shareholder Engagement – How to Tackle Shareholder Activism"

- As a director, regardless of who nominated you or how you got elected, your fiduciary duty is to the company and all its shareholders.
- When the interest of one group of shareholders conflicts with those of another, the directors are to look after the interest of the company.
- Conflicted directors must abstain from voting on related-party transactions.

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- Shareholder activism is a trend that is not going away.
- Board composition is one of many considerations when determining your vulnerability to activist attacks. A weak board, with unsophisticated members, is more likely to be seen as vulnerable and beatable.
- Social media makes it easier to reach a large number of shareholders to win a proxy fight.
- Successful performance, both operating and financial, is your best defense.
- Credibility with shareholders is not gained overnight. Long-term shareholder engagement is an absolute must if your shareholders are to be expected to support you in a crunch.
- Investor relations is now a board job. Active shareholder and stakeholder engagement is the responsibility of the board.
- Board relationships with management must become more transparent.
- Entrenched boards are vulnerable and not sustainable.
- Create shareholder value, or risk being thrown out.
- Trust is a key ingredient – and cannot be won during a crisis.
- Listen to your shareholders; if your strategy is not working, you may need to change course and / or bring in new blood.
- Boards should ask advisors to notify them of potential conflicts. While such conflicts may be unavoidable, boards should be vigilant about identifying and managing conflicts.
- When your regulator does not regulate you...regulate yourself. This is one of the many important roles of the board.

Key takeaways – CG workshop no. 6
“Robust Regulatory Compliance in Today’s Increasingly Complex and Demanding Environment”

- Bank boards have multiple constituents, and multiple lenses through which to view the world...shareholders, customers, staff and the public, to name the most obvious ones. In times of crisis, regulators will focus on protecting the public, and financial stability will be paramount.
- Banks and their boards must consider three aspects of every decision they make – economic, legal and ethical. Regulators will hold them to the highest standards of each.

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- There are always gaps between what goes on in the boardroom and the reality in the field. When the gap becomes a full-fledged “disconnect”, boards can and will get in trouble.
- Boards have a responsibility to gauge the extent to which their directives are being ignored, or worse, disregarded, in the field. This is more difficult in large organizations.
- Boards need to be on the constant look out for “Red Flags”. When board members see such red flags, or when they “smell a rat”, “niceties” need to take a back seat. Board members need to be relentless in seeking and getting answers to their questions.
- According to Warren Buffet the boards are 50% “Business Entities” and 50% “Social Clubs”. When you see violations of senior management’s duties of candor, care or loyalty, the “Social Club” aspect of the board needs to take a back seat.
- Best corporate governance practices might be a necessary condition to make boards great, but it is certainly not sufficient. The key is not structural, it is social. Board members have to be comfortable with each other socially and develop a chemistry among themselves in order to function as a board effectively.
- While banks are by no means expected to run the clients’ business, they really cannot afford to look the other way if they become aware of fraudulent activities.
- To build an effective board:
 - Create a climate of trust and candor – board members should be comfortable sharing difficult information with each other.
 - Foster a culture of open dissent – board members should have the capacity and willingness to challenge one another’s assumptions and beliefs without losing respect for each other.
 - Utilize a fluid portfolio of roles – no one should be pigeon-holed to their respective role only; people should be allowed the freedom to question about areas outside of their domain.
 - Ensure individual accountability.
 - Evaluate the board’s performance.
- Lessons from the ex-CFO of Enron (in his own words):
 - It is easy to justify unethical, materially misleading behavior by saying, ‘I’m following the rules.’
 - If I could sum it up in one word, I would use the word ‘loophole’. My title should not have been ‘Chief Financial Officer’; it should have been ‘Chief Loophole Officer’.
 - Very often, executives and directors don’t see the problem with their decisions – they rationalize.
 - Finally, I thought, ‘[The deals have] been approved. I don’t have to think about it.’
 - When I was at Enron, it never even dawned upon me that I might be committing fraud.

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Key takeaways – CG workshop no. 5
“Business Strategy, Ethics, Employee Behavior and Corporate Culture”

- The Board has a duty to ask questions even when it comes to technical issues such as accounting treatment. Incorrect reporting of financial results can create a crisis for the organization especially if it is publicly listed.
- Do not combine high operating leverage with high financial leverage; it reduces the margin of error and can potentially lead to bankruptcy if market conditions turn negative.
- Organizations can improve the behavior of their employees by clearly defining and communicating institutional values and training.
- Since people follow their leaders it is important that proper tone is set at the top, starting from the Board. The importance of role models cannot be over-emphasized.
- One has to be careful with slippery slopes – incremental steps into decline and decadence. It is important to draw the line early and remain steadfast.
- Organizations should invest in training. It gives people a chance to rehearse and be prepared for situations involving tough ethical choices.
- Assign responsibility and hold people accountable. Make it clear what is expected of each member of the team.
- Encourage a vigorous and candid debate during the decision making process; a healthy debate will always lead to a better outcome.
- Culture cannot be bought or hired; it can only be created. Use incentive mechanism to reward good behavior and discourage unwanted behavior.
- Be sensitive to the type of work environment and culture you create. Happy employees are more loyal and productive.
- Key Performance Indicators (KPIs) should never be developed in a vacuum but should be set as a result of a serious strategic planning exercise, with the buy-in of the entire organization and especially heads of departments.
- Incentives matter. If your value expectations are not reflected in the incentive mechanism (KPIs) for your employees they will behave in line with the latter.
- Pre-crisis planning is essential to prepare the organization for a crisis situation; the management should know when to shift from business as usual to crisis mode.

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Key takeaways – CG workshop no. 4
“The Board’s Responsibilities for Oversight and Proper Disclosure”

- The Board of Directors of a financial institution has a fundamental duty of care, candor and loyalty. The Board should challenge the management, question the experts on their assumptions (common sense check) and be careful in their public announcements in order not to mislead the investors and the general public.
- An active media in the digital age has put new pressures on institutions; they are expected to comply with the standards of tomorrow, not of today or yesterday.
- Make sure you agree with the minutes of the meeting, and if you don’t support a decision then have your disagreement documented in the minutes.
- Spend quality time in dispensation of your duties as a Board member. High impact boards spend an average of 40 days a year on being actively engaged vs. 19 days for low/moderate impact boards.

Key takeaways – CG workshop no. 3
“The Board’s Oversight Role with High Powered CEO and When Things Get Technical”

- A high-powered CEO requires a strong, independent and vigilant board. While such CEO is deserving of respect and deference, no one should be offered imperial treatment. The Board must be just as vigilant and engaged as it would be with an ordinary CEO. Additionally, if you have a super star CEO, make sure you have a super star Board as well.
- A lead director should take ownership of Board process and pay particular attention to hard and soft conflicts of interest.
- Should a CEO also be a member of the Board? Preferably yes but the key point is, how he is perceived by the management when he is part of the Board vs. when he is not.
- Boards (especially of listed institutions) should ensure that CEO compensation packages are well understood and well communicated in order to avoid a public backlash later on.
- Compensation plan should neither be too simple nor too complex. It should be designed primarily to motivate future performance. Compensation criteria must be within the control of the person being compensated.
- Board Members do not represent a segment of shareholders; they represent the interests of all shareholders and they must behave as such. Conflicted directors must be careful to disclose their conflicts and abstain from self-dealing.

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- Committees play an important role in the governance function – the Board needs to ensure that they are properly staffed, have adequate resources, and that they are fulfilling their duties effectively.
- Bank culture is greatly influenced by the actions of the Board, particularly through its role in setting performance targets and incentives. People do what you pay them to do.
- Good organizations establish an internally consistent and mutually reinforcing set of People, Culture and Incentives. Alignment in these areas does not replace the need for adequate oversight and direction, but increases the likelihood that individuals will act in a desirable manner, consistent with the organization's core values.
- Only the Board can and should set the organization's risk appetite and impose limits; such limits should not be changed "on-demand" or without appropriate analysis and thoughtful understanding of risks.
- Beware of these common red flags: (a) The slippery slope (first, a large leveraged bet, then, a small increase in risk limits, then, more increases in risk limits). (b) Excessive pride. (c) Absence of checks and balances. (d) Change in accounting treatment. (e) Unheard voices of doubt.
- Accounting rules leave room for judgment and managerial discretion. The Board and its committees need to be involved in exercising this judgment. Board and/or its audit committee should question the external auditors without management presence.
- Audit committee members have a particular duty to be thoroughly informed and to ask many questions, particularly when asked to approve technically challenging accounting treatments.
- One should remember the following accounting lesson: Financial statements are where companies go to hide their "rats". If there are no signs of rats, there are a few. If you smell a rat, the ship is infested. If you see a rat, the ship is sinking!
- A Board Member must understand the implications of a decision he/she is voting on. If he doesn't understand he should not vote on it.
- A Board Member should spend time to understand the key issues, ask questions, rely on his/her instincts, go against the tide and speak his/her mind.
- There is no shame in asking questions. If a Board operates in an environment where the Chairman or the CEO shames the Board Members for asking questions, such Chairman/CEO should be asked to leave.
- A well-defined process to arrive at a Board decision is the best insurance policy for a successful Board. The legal system will judge you on the soundness of the process you undertook.

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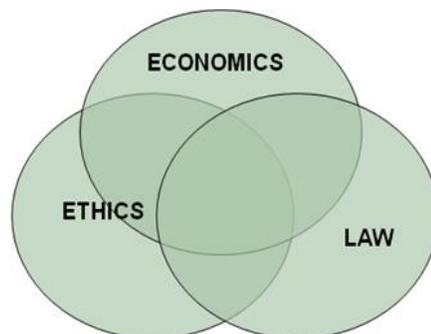
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- Being fully informed requires active engagement, following up on red flags, understanding and challenging assumptions, and ensuring the Board is constantly on high alert.
- The best insurance against crossing the ethical divide is a roomful of sceptics. CEOs must actively encourage dissent among senior managers by creating decision-making processes, reporting relationships and incentives that encourage opposing viewpoints.
- Compliance with legal standards and regulatory requirements is critically important, but it is not sufficient – Boards are increasingly being judged on the ethical standards of tomorrow, not of yesterday and not even of today. The Board and its committees need to exercise their judgment and careful oversight. Do not view a successful audit or approval from external legal counsel as an endorsement of the soundness of your financial practices.
- When your regulator doesn't regulate you, regulate yourself.
- A sound value system, strong independent voices on the board, and a vigorous idea exchange among the Board Members and their advisers are the best guarantee of sound decision-making.

Key takeaways – CG workshop no. 1 & 2

“Corporate Governance – To Whom Do We Owe Responsibility and the Nature of This Responsibility”

- Directors and CEOs have a fiduciary duty to their investors, customers, employees and the general public, which demands loyalty, care and candor of the highest order.
- Business owners need to carefully consider three dimensions before making any decision – Economic, Legal and Ethical. They can no longer afford to ignore the ethical dimension, which has gained increasing importance in recent times with innovation outstripping law, higher technical complexity leading to grey areas and the rise of media power.



- The above is true for all businesses but even more so in case of Islamic banks that have to fulfill the additional requirements of Shari'a compliance and governance.

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- The Board is the nerve center of corporate governance – but it isn't alone. It can and should be supported by internal and external governance centers such as internal audit and compliance.
- Board members should be prepared to give their judgment on matters which may not be black or white. Exercising sound judgment while fulfilling the duties of loyalty, care and candor is the best protection for board members and senior management.
- Board members should:
 - be serious about their role as director
 - do their homework prior to the meetings
 - pay attention in the meetings
 - not be afraid to ask a lot of questions, especially the “what if” questions
 - have the courage to go against group dynamics
 - get a consultant if assistance is needed on technical matters
 - disclose any real or perceived conflicts of interest and abstain from self-dealing (in Bahrain the Commercial Company Law addresses this matter extensively), and
 - be ready to own up the decisions instead of shifting the responsibility to other members or committees
- Every board – even of controlled companies – needs strong independent directors
- It is not only proper to ask questions and disagree with others in a board meeting, it is a must for better understanding of key issues and exercising sound judgment.
- Exercising sound judgment while fulfilling the duties of loyalty, care and candor is the best protection for board members and senior management.