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ARAB MONETARY FUND

Principles of dealing with systemically important family businesses

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Preamble

Family businesses play a pivotal and vital role in economic development and contribute to achieving comprehensive growth and job creation, as they represent about 70 percent of the total number of companies in the world. Accordingly, the supervisory authorities shall study the reality of this field to determine its size and nature and the risks and challenges associated with it, to form a database to understand the main trends and challenges facing family businesses, especially in light of the increasing importance of the role of these companies in supporting productive economic projects. Accordingly, this enhances financial stability, which is a major goal of central banks [1].

According to the IFC Family Business Guide, a family business refers to a company where the voting majority is in the hands of the controlling family; including the founder(s) who intend to pass the business on to their descendants.[2] However, it is difficult to find a unified definition of family businesses. Accordingly, it is difficult to describe and define family businesses' inaccurate or unified definition as it is considered multi-dimensional. However, the family business can be defined as “the business in which one family owns the majority of the share of the capital or owns assets therein enabling that family to manage the company, and thus to held in senior management positions and to have decision-making power in the business."[3] It is noteworthy that this definition has undergone changes through different historical periods, but at the same time, it is considered one of the most important widely used definitions. Some studies have used the previous definition as a starting point for further research in the field of family business governance, but specialists in the field have also pointed to other definitions of family businesses.

[1] Arab Monetary Fund (2020), Family Business Governance in the Arab Countries, Rami Obeid, Al-Mustafa Bintour, Al-Walid Talha.

2 World Bank Group, International Finance Corporation (2018), IFC Handbook of Family Business Governance.

[3] Colli, Andrea and Rose, Mary. 2007. “Family Business”. In *The Oxford Handbook Business History*, Edited by: Jones, Geoffrey and Zeitlin, Jonathan. 194–217. Oxford: Oxford University Press.

The reports issued by the competent authorities emphasized that the most prominent challenge facing family businesses is the aspect of governance. For example, "Deloitte, 2018" report shows that the most important challenges facing family businesses are internal rather than external challenges, as changing family relationships and succession of management are among the most important challenges that the company's activity is facing in the market. The same report indicates that family businesses follow a group of various methods of governance, such as the use of family forums, gatherings, and councils. The report also emphasizes that one of the most important priorities of family businesses is to form the next generation of leaders to maintain business continuity and family identity.

Qualifying the next generation and helping them understand the work, make them qualified to lead the business, move between generations, and reduce unexpected challenges and disagreements. In practice, about replacement plans for family businesses in the world, the "Deloitte, 2019" survey indicates that 30 percent of family businesses prefer to transfer the ownership and management of the company to family members, while 15 percent prefer to transfer management only, and 20 percent prefer to transfer ownership without management. On the other hand, despite the tendency of family businesses to maintain business within the family, only 26 percent of these companies have formal succession (replacement) plans for the CEO position, for example, while the majority does not have formal or informal replacement plans to hold key positions in the business .

On the other hand, a recent study issued by the Arab Monetary Fund (2020) showed that there is no clear legal definition of family businesses in Arab countries. There is no classification or definition for family businesses, as most Arab countries classify companies according to their size into small, medium, and large companies, without taking into consideration the special status of the family business. As for dealing with banks, there are controls for granting credit to corporate clients without discrimination. However, the total indebtedness of businesses and individuals in the group is taken into consideration in the event of a correlation in terms of ownership, management, or influence on the decisions or activities of the business. Credit exposures on individuals and their family businesses are grouped to verify the overall creditworthiness, and due diligence is taken accordingly, as the credit granted to the client, in his name or name of his relative, is considered an addition to the credit granted to the business within the credit concentrations of a single client.

According to the above mentioned, in light of the Arab Monetary Fund's keenness to provide advice to its member states, and because of the increasing importance of the role of family businesses in supporting economic projects, thus enhancing financial stability, which is a major goal of economic policies in Arab countries, the AMF has prepared principles for dealing with family businesses of systemic importance.

Principles of dealing with systemically important family businesses

First: Definition of systemically important family businesses

Principle (1)

To adopt a unified definition of family businesses at the state level, in coordination and consultation with the concerned official competent bodies and institutions, with exception of financial companies that are subjected to the supervision of the Central Bank.

Principle (2)

The relevant supervisory authorities shall coordinate between them to develop an appropriate methodology for identifying systemically important family businesses, based on several factors such as the size of the business's assets, amount of the capital, volume of activity and annual sales, and the number of workers.

Principle (3)

The relevant supervisory authorities shall review the methodology referred to in Principle (2) periodically and / or whenever necessary.

Second: Regulatory requirements to enhance good governance for systemically important family businesses

Principle (4)

The supervisory authorities/ Companies Control Departments shall issue governance instructions for family businesses. Further, family businesses shall prepare governance guidance that takes into account supervisory instructions as a minimum. The guidance shall also include the company's view regarding the concept of governance, its strategy, and the principles of strengthening its governance.

Principle (5)

It is appropriate for the competent supervisory authorities to issue rules and regulations as a guiding charter for family businesses at the state level, including, as a minimum, the following:

1. To clarify the company's values, to promote those values, and to develop its business.
2. To tell family members about their rights and obligations, and their role in maintaining the continuity of the company's business.
3. To adopt a common family vision towards the strategic goals of the company.
4. To ensure that there are no conflicts of interest between family members and the interests of the company.
5. To enhance the values of belonging to family members to preserve the company's reputation and commercial standing.
6. To neutralize the impact of family disputes on the company's business.
7. To maintain confidentiality and privacy of information related to the company.
8. Family Code of Conduct.

Principle (6)

Family business shall provide the supervisory authority with a copy of its "governance guidance", to obtain no objection to the same; so that it can be published on the company's website and included in its annual report.

Principle (7)

It is important to include the minimum conditions and standards, that shall be met in the family business’s board of directors and its committees, in the supervisory instructions for the governance of family businesses.

Principle (8)

The family business's board of directors shall include in its membership an appropriate number of independent members determined by the supervisory authority, taking into account that no independent member of the family business's board of directors shall be a partner or employee of the company's external auditor.

Principle (9)

To develop standards and conditions for family business's board meetings, including methods of attending the meeting, conditions for voting on decisions, principles for recording any member’s reservations, signing minutes of board and committee meetings, and method of keeping them.

Principle (10)

The supervisory instructions for the governance of family businesses shall include the duties and responsibilities of the business's board of directors, provided that the role of the board shall include the following, as a minimum:

1. To determine the strategic objectives of the business and how to achieve them.

2. To develop key performance indicators, and to evaluate the institutional performance.

3. To follow up on the business's financial condition.

4. To adopt internal control and monitoring regulations.
5. To ensure the independence of the external auditor.
6. To enhance risk management.
7. To approve the organizational structure of the business.
8. No conflict of interest policy.
9. To determine the financial operations that require the approval of the Board.
10. To adopt professional conduct rules.

Principle (11)

The family business's board of directors shall elect a chairman for it and shall specify the duties and responsibilities assigned to him/ her in detail .

Principle (12)

The family business's board of directors shall appoint a secretary for the board and shall define the tasks and responsibilities assigned to him/ her, including setting the dates for the board's meetings in coordination with the chairman and keeping the meeting documents.

Principle (13)

The family business's board of directors shall adopt clear limits on responsibility and accountability for all functional and administrative levels in the business and shall adopt appropriate controls to hold the executive management accountable.

Principle (14)

To take adequate measures to ensure that risk management, compliance, and internal audit departments in the family business are carrying out their duties to the fullest .

Principle (15)

It is not permissible to anyone to hold the positions of Chairman and General Manager of a family business at the same time .

Principle (16)

Family business's board of directors shall from committees from its members, at least an institutional governance committee, an audit committee, and a nomination and remuneration committee; and shall define the criteria and conditions that shall be met by members of the committees, as well as the committee's objectives, powers, and responsibilities per a documented policy, provided that the committees shall submit periodic reports to the board.

Principle (17)

Each committee, emanating from the family business's board of directors, shall include in its membership several independent members to be determined by the supervisory authority.

Principle (18)

To develop standards and conditions to verify that the members of the family business's board of directors and its executive management have credibility, integrity, experience, and competence according to a specific form designed for this purpose.

Principle (19)

To obtain no objection from the supervisory authority upon appointing a member of the family business board of directors, executive management, or risk and compliance officers; provided that the supervisory authority shall be provided with supporting documents and certificate of good conduct that proves the candidate's qualifications to hold the position or job.

Principle (20)

If any member of the family business's board of directors or executive management of the business wants to resign, the supervisory authority shall be informed of the same through an official letter stating reasons for the resignation.

Principle (21)

Family business shall develop a succession plan for the board of directors and all-important functional positions in the company, shall provide the supervisory authority with a copy thereof after approval by the board of directors, and shall review such plan annually.

Principle (22)

Job succession plans must identify important roles in the business and potential alternatives from the next generation, qualifying them early by providing them with expertise and the appropriate skills and developing training programs for the next generation under the supervision of the current generation, to gain scientific and practical experiences, and to ensure a smooth transition of leadership in the future, for purpose of reducing risks of transferring the company's management and/or ownership to the next generation.

Principle (23)

The family business's board of directors shall develop a documented, objective, and transparent plan to determine financial rewards for its members, in a manner that does not affect the financial position of the business or its level of cash flow.

Principle (24)

The family business's board of directors shall continually verify that internal audit, risk management, and compliance departments are performing their duties fully and independently.

Principle (25)

The family business's board of directors shall adopt an internal audit charter that ensures in detail the duties, powers, and responsibilities of the internal audit department .

Principle (26)

To develop a plan approved by the family business's board of directors that includes Risk Appetite and continuous assessment of the risks that the business may be exposed to, and to inform the Board of Directors of any violations to the Risk Appetite.

Principle (27)

To separate between the owners' accounts and financial liabilities, and the company's accounts and financial liabilities; and to develop documented controls and standards approved by the business's board of directors to manage the company's bank accounts, including borrowing and its limits, and the powers.

Principle (28)

Internal Audit Department and the external auditor shall review and audit the business's accounts, shall examine the balance sheet and the profit and loss account, and shall review the business's transactions with related parties and the movements of funds between accounts.

Principle (29)

To determine the potential risks that family business may be exposed to in a way that takes into account its privacy; for example, the risk of transferring management or ownership from the current generation to the next generation, availability of technical skills and scientific and practical expertise to the next generation, and impact of family disputes on the company's activities.

Principle (30)

Family business shall engineer its business in a way that takes into account the risk of a data breach or "cyber" risks. The following actions can be taken as a minimum:

- To establish information security programs, and to employ specialists for the same .

- To form a specialized committee to develop preventive plans against cyber risks.

- To for, a team to manage electronic crises, to develop the business's electronic systems, to keep abreast of developments, and protect data.

- To appoint a consultant specialized in information technology.

Principle (31)

The family business's board of directors shall replace the external auditor periodically. The replacement periods shall be determined according to the instructions issued by the supervisory authority.

Principle (32)

The family business’s board of directors shall continually verify that executive management has addressed or developed an acceptable time plan to address all weaknesses and observations contained in the internal and external audit reports.

Principle (33)

To establish a mechanism approved by the family business's board of directors regarding communication with stakeholders, and to take adequate means to ensure that they are provided with financial and non-financial information about the business's performance.

Principle (34)

The family business's board of directors shall adhere to the disclosures per International Financial Reporting Standards (IFRS) and/or the supervisory authority's instructions.

Third: Role of central banks in reducing the indebtedness risks of systemically important family businesses

Principle (35)

In light of the Central Bank's instructions regarding credit exposures, it is important to develop appropriate instructions, controls, and limits for exposures of connected persons clients, which require commercial banks to study family business risks, including inquiring about them from public credit registry and/or credit information companies/offices, in such manner that takes into account the credit exposures of the related clients before granting financing.

Principle (36)

To develop special controls for family businesses before granting credit, taking into account their special statuses; including, for example, ensuring the existence of alternative for the management, ensuring application of governance requirements, and level of debt of the existing business .

Principle (37)

The Financial Stability Department at the Central Bank shall develop micro and macro stress tests for family businesses that take into account their special status;

and shall provide the competent supervisory authority with copies of the test results.

Principle (38)

The Financial Stability Department at the Central Bank shall evaluate the systemic risks that may arise from family businesses, in light of efforts to enhance financial stability.

Principle (39)

To follow-up of the performance indicators of the systemically important family businesses, such as the amount of the business's debt, rate of change in the number of assets, rate of bank interest coverage, the annual sales volume, rate of return on assets, and rate of return on equity.

Principle (40)

To include indebtedness of the family business sector in a special chapter of the financial stability report issued by the Central Bank.