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Ruling Family Political Connections and Risk Reporting: Evidence from the GCC

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ABSTRACT

This study examines whether the presence of ruling family members on boards of directors influences the extent and the quality of risk reporting. Based on a sample of publicly listed financial firms of the Gulf Cooperation Council countries between 2007 and 2011, our regression results show that ruling family board members reduce the quality and extent of risk disclosures. Firms with ruling family board members also disclose significantly less during periods of financial distress and when they are subject to higher levels of risk. We find that risk reporting is negatively associated with the existence of a ruling family director acting as the board chairperson, negatively associated with increasing proportions of ruling family directors on the board, and negatively associated with increasing numbers of board members who are connected to ruling family directors. Our results suggest that politically connected directors seize private benefits at the expense of their firms' shareholders. Our regression results hold after a series of robustness checks that control for endogeneity and for alternative measures of ruling family membership.
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1. Introduction

This study examines whether the presence of ruling family members[1] on boards of directors influence the extent and the quality of risk reporting by Gulf Cooperation Council (GCC)-listed financial firms from 2007 to 2011. The GCC[2] provides an ideal setting in which to examine the relationship between the political connections of board members and the reporting transparency of firms. Many of the GCC-listed firms have at least one ruling family member on the board of directors (Halawi & Davidson, 2008). For instance, in the United Arab Emirates (UAE) in 2008, 56 directors from 101 listed firms were ruling family members (Halawi & Davidson, 2008). Furthermore, in Qatar, 78 (24%) of all listed companies had ruling family members on their boards. Similarly in Kuwait and Oman, there were 45 (21%) and 31 (26%) listed firms that had ruling family members on their boards, respectively. Leuz and Oberholzer-Gee (2006) and Chaney, Faccio, and Parsley (2011) call for further research into the effects that these political connections that GCC firms have on reporting transparency.

This study is motivated by the growing interest in the relationship between political connections and corporate transparency (Chaney et al., 2011; Leuz & Oberholzer-Gee, 2006). Polsiri and Jiraporn (2012) provide evidence that firms with ruling family connections may obtain economic benefits from their family ties. These researchers cite a case where firms belonging to the

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[1] The term “ruling family member” is equivalent to royal family member.
[2] The Gulf Cooperation Council (GCC) is an economic union of six countries in the Arab Gulf region, established in 1981. The GCC consists of Oman, Bahrain, Kuwait, Qatar, the Kingdom of Saudi Arabia (KSA), and the United Arab Emirates (UAE).

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King of Thailand were less likely to fail during the 1997 Asian Financial Crisis due to their ruling family connections. Few studies, however, have investigated the relationship between political connections and corporate risk transparency in emerging economies such as the GCC. Survey results (see, e.g., IFC & Hawkamah, 2008) suggest that adequate disclosures are of paramount importance in the GCC as a means to protect shareholders' rights, particularly because monarchial control is strongly entrenched. Effective disclosure of firms' risks can minimize rent-seeking activities by ruling family members and other controlling interests (Jaggi, Leung, & Gul, 2009). Risk disclosures are considered to be an integral component of good corporate governance structure, and such disclosures are particularly important to market and bank regulators, international organizations, and development institutions in the GCC, as these enterprises seek to consolidate firms' risk management frameworks and practices or to strengthen internal controls (Hertog, 2012; IFC & Hawkamah, 2008). The provision of adequate risk disclosures is an important factor in the regulation of publicly listed GCC firms.

Appointment of ruling family members on boards arise through their seniority among a monarchical group, being a founding member of a firm, their large equity and controlling interest in a firm, and appointment by a nomination committee (Hertog, 2012; IFC & Hawkamah, 2008). Generally, the board structures and legal provisions regarding the appointment of directors and their responsibilities follow those that are required under company law in a Western-based system, but there can be some significant local variations. The financial reporting frameworks of GCC countries are based on both company laws and royal decrees (Al-Shammari, Brown, & Tarca, 2008). Some firms are established through presidential decrees or other special statutes that give them particular benefits, including appointments of politically connected directors such as ruling family members. Thus, ruling family appointments to the boards are likely to be driven by a mixture of Western-based legal principles and political or family connections (Hertog, 2012).

The power of ruling family members over the GCC's economic and political regimes may undermine recent efforts by the region's regulators to enforce and improve corporate governance and to enable financial reporting transparency. First, to the extent that board memberships for ruling family members serve to protect these members' personal interests and the interests of related companies, the management of firms characterized by ruling family directorships may fail to disclose risk-related information, including disclosures mandated by accounting standards or regulatory bodies. Second, the rent-seeking behavior and the business interests of politically connected firms are protected by the monarchy (Mazaheri, 2013), which makes it less likely that management will resist the wishes of powerful ruling family directors (Jaggi et al., 2009). A setting in which there is no real separation between the monitoring and controlling functions is likely to have a negative effect on firm reporting and transparency. Third, ruling family board directors may not wish to attract negative market attention by disclosing information relating to their firms' risk exposures (Certo, 2003). Furthermore, politically connected firms could have lower disclosure levels, even in the face of higher risk levels or in times of distress, due to the protection that ruling family connections may offer these firms. Ruling family directors may consider that their connections with key stakeholders, such as other groups in the royal family or important government officials, will protect their firms in difficult times. Such ruling family directors are able to transfer wealth to themselves at the expense of other contracting parties and to make their risk-related disclosures in an opportunistic manner (Emanuel, Wong, & Wong, 2003).

However, several recent developments in the GCC region are likely to stimulate an increased demand for transparency and disclosure, particularly with respect to risk reporting (Al-Hadi, Hasan, & Habib, 2016; IFC & Hawkamah, 2008). Corporate governance codes[3] and regulations are now well established in all GCC countries, with some of these countries holding their firms accountable for non-compliance with business regulations (Al-Shammari et al., 2008). Some GCC countries have established corporate governance task forces to monitor the adherence of firms to codes of conduct and good governance (Al-Hadi et al., 2016; IFC & Hawkamah, 2008). Recently, regulation of GCC firms has made significant progress toward establishing more independent boards of directors. In all of the GCC countries, the corporate governance codes require that an audit committee must review a firm's risk management systems and policies, including their disclosure practices. Adoption of the International Accounting Standards (IAS) or the International Financial Reporting Standards (IFRS) is mandatory for all listed financial companies throughout the GCC (Al-Shammari et al., 2008; IFC & Hawkamah, 2008).[4] All GCC central banks have adopted Basel II, including Pillar III: *Disclosures*. Finally, although board risk management is voluntary in practice, about 39% of all the GCC financial firms have adopted risk management policies that require board oversight and disclosure of risk (Al-Hadi, Taylor, & Hossain, 2015).

The GCC region has also seen a marked increase in foreign direct investment (Mina, 2007). As a whole, the GCC has experienced unprecedented growth rates, and many of its companies trade with offshore partners or have subsidiaries incorporated in countries outside the GCC (Lagoarde-Segot & Lucey, 2007). This internationalization of GCC-listed firms makes them subject to greater scrutiny from stakeholders, regulators, and international institutional investors, who have recently been demanding greater transparency and accountability from those firms (Abu-Nassar & Rutherford, 1996).

Although ruling family membership on boards is relatively high in the GCC region, the ruling family ownership of financial firms is relatively low compared to such ownership of non-financial firms (Al-Hassan, Oulidi, & Khamis, 2010). Market risk

[3] For instance, the Capital Market Authority (CMA) of Oman mandated a code of corporate governance for listed firms starting from 2002. In 2005, the Qatar Financial Market Authority (QFMA) introduced a code of corporate governance based on the OECD's "comply or explain" requirements, which took effect in 2009 (Sharar, 2011). Similarly, in 2011, the Central Bank of Bahrain issued a code of corporate governance for listed firms based on nine governance principles that firms are required to address in their annual reports. In 2006, the CMA issued a code of corporate governance in the KSA, effective from 2009. In 2007, the Securities and Commodities Authority (SCA) released a code of corporate governance, closely followed by its Ministerial Resolution No. 518-2009. This code mandates standards of corporate governance for all listed firms in the UAE from 2009 forward. The code consists of 16 articles that are based on OECD corporate governance principles.

[4] Compliance with the IFRS is not required for non-financial firms in some GCC countries, such as the KSA.

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