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Strategy, Corporate Governance and the Future of the Arab Banking Industry

*By Farouk W. El-Kharouf**

I. INTRODUCTION

The Arab banking industry, as it is known nowadays, may be altered in the future. Its transformation will not only be the result of the looming external threats but also the product of inaction or unsuitable choices. With the new realities of the world order, the existence of some industries in the developing countries is not feasible. Certain industries may not be allowed. The convergence of the international financial markets into one underlines the importance of individual financial institutions. The international regulators cannot afford any mishap. This new reality will test the chances of Arab financial institutions to survive as active players, regionally and internationally. Furthermore, it places under examination the strategic choices available to Arab banks.

In September 1999, the Basle Committee on Banking Supervision (BCBS[1]) released its paper on "Enhancing Corporate Governance for Banking Organizations".[2] At a later stage, the recommendations of the Committee were adopted by several central banks in the Arab region. In the past most of the Arab regulators did not explicitly formulate specific rules to enhance their home country corporate governance.[3] One of the main requirements of the BCBS is the need to empower the board of directors of each bank, and hold it responsible for establishing strategic objectives in the bank, along with a set of corporate values that are communicated throughout the banking organization. Establishing strategic objectives goes beyond the concept of review or oversight of strategy, which was the normal practice among corporates before.[4] Actual implementation of the requirements of the BCBS by the Arab banking industry may require a cultural change and, consequently, a completely different orientation in the way Arab financial institutions are managed.[5] Most importantly, the new requirement comes when the Arab banking industry is facing significant strategic challenges that are endangering its very existence.

This article aims to discuss in one paper the three interrelated issues at hand, i.e. the concept of strategy, corporate governance and the strategic alternatives available to the Arab banking industry. Each of these topics may require an extensive presentation and research on its own. However, it may be beneficial here to highlight these three topics and their interrelation.

II. STRATEGY

What is corporate strategy, how should it be created, and who is responsible for formulating it are three basic questions that need to be answered by any corporate before starting the strategic planning process.

A. Strategy definition and framework

Corporate strategy may be defined as ".... a deliberate search for a plan of action that will develop the corporate's competitive advantage and compound it".[6] Here strategy is a deliberate plan to place the corporate in a unique position enabling it to outperform the competitors. Traditional strategists have identified five basic elements of strategic competition. These include 1. the ability to understand competitive behavior as a system in which competitors, customers, money, people and resources continually interact; 2. the ability to use this understanding to predict how a given strategic move will rebalance the competitive equilibrium; 3. resources that can be permanently committed to new uses even though the benefits will be deferred; 4. the ability to predict risk and return with enough accuracy and confidence to justify that commitment; and 5. willingness to act.

Michael E. Porter [8] emphasizes the need to distinguish between operational effectiveness and strategy. Operational effectiveness means performing similar activities better than rivals perform them. In contrast, strategic positioning means performing different activities from rivals or performing similar activities in different ways. A company can outperform rivals only if it is able to establish a difference that it can preserve.

Corporate strategy is about being different. It means the deliberate choice of a set of selected activities to produce for

its customers a unique mix of values by different means that will enable the corporate to attain a unique strategic position. Strategic position emerges from three distinct sources, which are not necessarily mutually exclusive. Strategic positioning can be based on producing a subset with an industry's product or service, which means the positioning is based on the choice of the product or service varieties rather than customer segments. A second basis for positioning is to serve most or all of the needs of a particular group of customers. This is called needs-based positioning. The third basis for positioning is that of segment customers who are accessible in different ways. Access-based positioning can be a function of customer geography, or customer scale, etc. Any one of these three bases of positioning requires a specifically tailored set of activities because it is always a function of differences on the supply side.

A sustainable strategic position entails trade-offs.[9] Trade-offs arise for three reasons. The first is consistency in image or reputation. More importantly, a trade-off arises from the activities themselves. Different positions require different product configuration, different employee behavior and different management systems. The third kind of trade-off may arise from limits in internal coordination and control which involve clearly choosing to compete in one way and not in others. Senior management makes the organizational priority clear. Companies that try to offer all things to all customers in contrast risk confusion, as employees attempt to make day-to-day operational decisions without a clear framework. It is important to note that trade-offs add a new dimension to the definition of strategy. Strategy can be defined as making trade-offs in competing. Thus, the essence of strategy is choosing what not to do.

Strategic positioning choices underline not only which activity a company will perform and how it will design individual activities, but also all its activities in relation to one another. In contrast to operational effectiveness, which is about achieving excellence in individual activities or functions, strategy is about combining activities or creating what may be called "fit". Fit locks out imitators by creating a change that is as strong as its strongest fit. Three types of fit have been identified. These are not necessarily mutually exclusive. Consistency between each activity or function and the overall strategy is the first order of fit. The second order of fit occurs when activities are reinforced. Optimization of efforts - representing the third order of fit - goes beyond activity reinforcement.

It is important to realize that strategic fit among activities is fundamental not only to competitive advantage but also to the sustainability of that advantage. In other words, strategic positions should have a long-term horizon, such as a decade or more, and not merely a single planning cycle. The success of a strategy depends on doing many things well and integrating them among themselves. If there is no fit among activities, there is no distinctive strategy and little sustainability.

B. Developing the strategy

One of the great challenges the corporate strategist faces is to know the organization's capabilities well enough to think deeply about its strategic direction.

Strategies can form of themselves as well as be formulated. A realized strategy can emerge in response to an evolving situation, or it can be brought about deliberately, through a process of formulation followed by implementation. But when these planned intentions do not produce the desired effects, organizations are left with unrealized strategies. It is important to grasp two things: 1. the problem often lies one step beyond, in the distinction we make between formulation and implementation; 2. smart strategists appreciate that they cannot always be smart enough to think through everything in advance. They allow their strategies to develop gradually through the organization's actions and experiences.[10]

The notion that strategy is something that should happen way up there, far removed from the details of running an organization on a daily basis, is one of the great fallacies of conventional strategic management. In reality the organization should be adapting all the time.

It has to be realized that organizations pursue strategies to determine direction, to lay out courses of action and to elicit cooperation from their members around commonly established guidelines.

A fundamental dilemma of strategy-making is the need to reconcile the forces for stability and the forces for change in order to focus the efforts made and gain in operating efficiencies on the one hand, yet to adapt and maintain continuous updating in a changing external environment on the other.[11]

Organizations adopt two distinctly different models of behavior at different times:

- Most of the time, they pursue a given strategic orientation. Change may seem continuous, but it occurs in the context of that orientation and usually amounts to doing more of the same, though perhaps better than before.
- When change takes place in dramatic shifts, the organization's strategic orientation moves out of harmony with its environment. In this case, a strategic revolution must take place. The organization will rapidly alter many of its established patterns, and will try to switch to a new stability quickly enough to reestablish a balanced position with a new set of strategies, structures and culture.

It is important to understand in this respect that strategic reorientations are basically cultural revolutions.

Whether through quantum revolutions or cycles of convergence and divergence, organizations seem to need to separate over time the basic forces for change and stability, reconciling them by attending to each in turn.

Many strategic failures can be attributed either to mixing the two, or to an obsession with one of these forces at the expense of the others.

During most of the corporates' life, strategy signifies managing stability. Strategic planning is a means, not to create a strategy but to program a strategy already created, to implement it and to work out its implications formally.

To conclude this part, it is important to differentiate between strategic planning and strategic creation. Strategic planning is analytical in nature based on decomposition, while strategy creation is essentially a process of synthesis. That is why trying to create strategies through formal planning very often leads to extrapolating existing strategies or copying those of competitors.

C. Responsibilities of the top manager

The top manager traditionally has three core responsibilities: (i) to be the corporation's chief strategist, (ii) its structural architect, and (iii) the developer of its information and control systems. Thus, corporate strategy is one of the principal tasks of the chief executive officer. However, recent years have witnessed several calls to involve other parts of the organization in the process of building corporate strategy.

In a study of twenty companies, S. Bartlett and S. Goshal [12] concluded that the hierarchical organization based on the strategy-structure-system doctrine of management no longer delivers competitive results. While a top-down structure of corporate division gives management tight control and allows compromise to grow, it also fragments resources, and creates a vertical organization that prevents small units from sharing their strength with one another. The authors predict that a managerial change will be witnessed shortly which will focus on horizontal processes rather than vertical structure. The role of the top manager will be transformed to promote three core organizational processes: frontline entrepreneurship, competence building and renewal.

M. Goold and A. Campbell,[13] in another study, identified three different styles for managing the strategic planning process. The first is strategic planning: In this type of planning, top management is deeply involved in strategy implementation in which unit managers formulate proposals but the top manager reserves the right to have the final say. The main advantages of the strategic plan style are in building checks and balances. It encourages strategists that are well integrated across business units and it forecasts the creation of ambitious business strategies. The main drawbacks of this style are motivational problems that may affect line managers, loss of autonomy at the business unit level and diminished flexibility.

The second type of strategic planning is what is known as financial control. Under financial control, responsibility for the development of strategic plans rests on the shoulders of business unit managers. The top management exerts influence through short-term budgetary control. Under this system the organization aims to get the business units to put forward tough but achievable targets. The greatest value of the system is the motivation it gives to managers. It frees the managers from ineffective plans, and it deals effectively with the complexities of highly diversified organization. However, this style suffers from long lead-time strategies and emphasizes short-term targets. It may also force the unit managers to take extensive risks that prevent healthy long-term business development. Another drawback is the difficulty that may be encountered in exploiting synergies between business units.

The last management style is what is known as "strategic control". A strategic control system attempts to accommodate both the need to build a business and the need to maximize financial performance. Responsibility for strategic planning rests with the business unit manager but top management must approve the strategies. For this purpose, there is an elaborate planning process in which the aim of the planning

review is usually to test the logic, to pinpoint weak arguments and to encourage the business units to raise the quality of their strategic thinking.

The authors concluded that all executives want strong leadership from the center, coordinated strategies that build-in a variety of viewpoints, careful analysis of decisions, long-term thinking and flexibility. But they also want autonomy for unit managers, clear accountability, and the freedom to respond entrepreneurially to opportunities, superior short-term results and tight controls.

To conclude this part, it is important to emphasize the difference between managing strategy and making strategy. No matter what are the positive arguments about the advantages of the participation of business units, the creation of strategy and the task of finding a strategic fit for the organization are and will remain the chief executive officer's responsibility. More than 5000 years ago, Sun Tzu[14] said that the commander is one of five constant factors that govern the art of war (strategy). The commander stands for the virtues of wisdom, sincerity, benevolence, courage and strictness.

III. CORPORATE GOVERNANCE AND CORPORATE STRATEGY IN BANKING ORGANIZATION

A. Definition

Policy makers and regulators have been paying corporate governance a great deal of attention. They recognize the positive role of a good corporate governance system in safeguarding the interests of a wide range of their constituencies and communities.[15] This part of the paper attempts to highlight the biological role of corporate strategy in maintaining a healthy corporate regime.

Governance can be defined as " ..... an exercise in assessing the efficacy of alternative modes (means) of organization. The subject is to effect good order through the mechanism of governance. A governance structure is the useful thought of an institutional framework in which the integrity of a transaction, or related set of transactions, is decided". [16]

B. The role of the board of directors

In practice, the role of the board of directors in setting the corporate strategy has been limited and confined to artificial oversight. Such involvement can be labeled at best as getting informed. Kenneth R. Andrews [17] outlined the main reasons for this lack of involvement. He said that many chief executive officers, rejecting the practicality of conscious strategy, preside over unstated, incremental, or intuitive strategies that have never been articulated or analyzed – and therefore could not be deliberated by the board. Others do not believe their outside directors know enough or have enough time to do more than assent to strategic recommendations. Still others may wish to keep discussions of strategy within management to prevent board transgression on to management turf and the consequent reduction of executives' power to shape by themselves the future of their companies. He later submitted four principal reasons justifying a deeper involvement of the board in the strategy setting. These are:

First, the board needs specific evidence that its management has a process for developing, considering and choosing among strategic alternatives operating within the company.

Second, independent directors need to understand the characteristics of their company's business, especially if they have no personal experience in the industry. Knowledge of strategy makes intelligent overview feasible.

Third, knowing the company's strategy can give the board a reference point for separate decisions that come before it and insight into what matters should be presented to it. If their approval is to be more than routine assent, board members must be allowed to assess the impact of proposals – whether for capital appropriation, a new R&D facility, or an acquisition in an exchange of stock – on their company's strategy.

The fourth reason for directors to insist not only that a company must have an explicit strategy, but also that it should present the strategy to them, is that evaluation of corporate strategy and of management's adherence to it allows continuous evaluation of management. The four reasons are positive signals for proper corporate governance.

In the past, the argument of the involvement of the board in strategy development did not go far enough. It stopped at the review process by which a management recommendation wins rather than coerces board approval, and begins only after full-scale presentation of strategy to the board. The review of strategic recommendations is designed to go beyond board satisfaction with the strategic process. It calls for a special full-scale strategy review, which requires the board members to be familiar with the issues involved. In order to enable the board to achieve such a goal, a call for the establishment of a corporate strategic committee must be enforced. The committee could be composed of carefully cho-

sen outside directors who have shown interest and talent in considering strategic questions brought to the board. This argument is a recommendation for acquiring new directors who are capable of performing this function.

C. Governance in banking organization

To the BCBS Committee, the concept of corporate governance in general evokes the set of relationships that exist between a bank's management, its board of directors, its shareholders and the other stakeholders. It provides the framework in which to establish the strategic objectives of the organization and the means to attain and monitor those objectives. Accordingly, for the Committee sound corporate governance involves the following seven practices:

1. Establishment of strategic objectives and a set of corporate values to be communicated throughout the banking industry.
2. Definition and enforcement of clear lines of responsibility and accountability throughout each bank and banking organization as a whole.
3. Assurance that board members are qualified for their positions, have a clear understanding of their role in corporate governance, and are not subject to undue influence from management or outside concerns.
4. Assurance that there is appropriate oversight by senior management.
5. Effective utilization of the work undertaken by internal and external auditors in recognition of the important control function they exercise.
6. Assurance that compensation approaches are consistent with the bank's ethical values, objectives, strategy and system of control.
7. Conduct of corporate governance in a transparent manner.

The BCBS Committee went beyond the existing practice in the banking industry. It demanded the board to establish the strategic objectives and to set corporate values. Accordingly, in the Committee's view, the board should create the strategies that will direct the ongoing activities of the bank in question. It should also take the lead in establishing the "tone at the top" and approving corporate values for itself, senior management and other employees. The values should recognize the critical importance of having timely and frank discussion of problems. Furthermore, processes should be established that allow the board to monitor compliance with these policies, and to ensure that deviations are reported to an appropriate level of management.

IV. SURVIVAL OF ARAB FINANCIAL INSTITUTIONS

The global banking industry has been transforming and reshaping itself at an accelerated rate, forcing all major financial institutions to revolutionalize their strategic setting process in order to cope with the new and different working conditions externally and internally. There are, however, certain common factors shared by Arab banks that may hinder their ability to meet the regulatory requirement to enhance corporate governance, as well as the forces acting on the financial services industry in general. Thus, the true and pressing question here is: How can the Arab banking industry prosper within the framework of the new realities?

The remainder of the presentation will deal with three specific issues: (a) the special characteristics of Arab financial institutions; (b) the threats and challenges facing them; and (c) the strategic alternatives available to them.

A. Common attributes of Arab financial institutions

It may not be completely accurate to assume that the attributes of Arab banks are homogeneous. Differences do exist as a result of the dissimilarities in their internal and external environments. The internal factors differentiating Arab banks include the history of the bank, the composition of its ownership and its geographical diversification.

However, the most significant factors causing the heterogeneity of the Arab banking industry are exogenous. External influences include banking and business laws. The laws in some countries tend to be socially focused. On the other hand, there are countries with almost completely open and unrestricted free market practices. The market economy in some countries, especially those that are important oil-producers, is restricted by the enforcement of protective practices. The disparity in economic conditions is also an important factor that is apt to disturb the harmony in the environment of Arab financial institutions.

In spite of their differences, however, in general Arab financial institutions share similar circumstances and have the following common characteristics:

1. Financial strength

Measured by the strength of the tier one capital, the largest Arab bank's equity does not exceed USD 2.2 billion. In terms of balance sheet size, total assets on balance sheet of the largest financial institution are limited to USD 25 billion. The maximum pre-tax profit of an Arab financial institution

achieved in 1999 was USD 412 million. In order to comprehend the magnitude of the marginality of the Arab financial institutions the following table depicts the picture to some extent:

A comparison between the sum of the 66 Arab banks listed in the Bankers Top 1000 of the World (18) and the three largest banks.

Amounts in USD million

	Tier one capital	On balance sheet assets	Pre-tax income	BIS capital ratio %	Income/ capital %	Income/ assets %
Arab banks:						
Total of the 66 banks	39,402	413,622	5,785	-	-	-
Largest	21,200	24,815	412	47.02	40.91	4.02
Smallest	138	733	0.0	NA	0.0	0.0
Mean	597	6,267	89	20.0	15.23	1.60
Medium	401	4,367	64	13.4	14.91	1.60
Citi Group	47,699	716,937	15,948	12.43	33.4	2.22
Bank of America	38,176	632,574	12,215	10.88	32.0	1.93
HSBC Holding	28,533	569,139	7,982	13.20	28.0	1.40

In addition to the sixty-six banks depicted, there are several hundred Arab banks with a tier one capital base smaller than USD 138 million.

The BIS ratio and profitability indicators underline some basic characteristics of the Arab financial institutions: they include excess unutilized capacity, a high percentage of risk free assets, mainly liquid, and consequently lower profitability.

2. Structure of ownership

Family and government ownership is a common phenomenon in the Arab banking industry. Both strategic orientation and the quality of implementation of corporate governance are influenced by this attribute. Setting a well-articulated strategy under such conditions is expected to be slow and to some extent superficial and untimely, and the simple response to this special challenge will not be in the favor of Arab banking institutions, considering that time is an important source of competitive advantage.

The structure of ownership does not affect the quality of management and control only; it also influences the financial position of the bank, and most importantly, its assets. For example, certain financial institutions in the oil-producing countries tend to invest most of their resources in funding the public sector and the state budget, depriving the private sector of badly needed support and limiting the expertise of the financial institution to a simple area of activities.

3. Limited product lines

The concentration of business activities in the area of trade limits the role of Arab financial institutions to their historically inherited function of export-import services, and to some extent working capital financing. Most of their activities are carried out in a limited area of retail banking services. Some Arab banks have only recently attempted to play an active role in project financing, fund management and investment. Unfortunately, all these new activities are timid, and are not based on deep-seated strategies. In conclusion, it may be said that the Arab financial institutions have yet to play the role of modern intermediaries.

4. Evolving working conditions

In general, the Arab financial banking industry is scattered in fifteen different small markets. This fragmentation limits the banks' ability to generate sufficient capital, genuine financial products and modern professional expertise.

Professional standards vary from one country to another. The social phenomena and the level of cultural evolution coupled with ad-hoc developments in business laws and regulations affect the harmony and the development of a common working environment. Some of the Arab countries are still bound by social laws that prevent the banking industry from providing simple banking services to the general public. Others are restricting access to their local markets, thus preventing non-native financial institutions from operating.

B. Threats and challenges

The threats and challenges that will face the Arab banking industry are serious, significant and closing in. They can be classified under five groups: (1) changing competition, (2) changing customers, (3) changing technology, (4) changing regulations, and (5) changing markets.

1. Changing competition

Most of the Arab states are members of the World Trade Organization and have signed the Uruguay Agreement and eventually its extension to the financial services. The actual implementation of the Agreement will ultimately lead to the opening of Arab markets to foreign competition without any restrictions or the need of a physical presence. It may be concluded that Arab banks will have a difficult time adjusting to the new competition, taking into consideration two elements:

the first is the operational ineffectiveness of the Arab financial institutions, and the second is to some extent the ease and costless possibility of entry to these markets. When customers will be offered their choice of a wider range of products and better services at much lower cost, the choice will be obvious.

The problems that will ensue from the failure of protectionism will be worsened by the declining level of political risks. In spite of the recent flare-ups, politically the Middle East with the passing of time is becoming less risky, and thus more attractive to the international banking industry. Large banks that hesitated to do business in the Middle East in the past now find the area very attractive in their search for growth and profitability. The international financial institutions that have timidly done some business in past years will solidify their presence and become more aggressive, The writing is on the wall: European and US banks have already taken their first step, and perhaps their second as well.

Accordingly, it may be concluded that the strategic advantages of the Arab banking industry, which were based on the safety afforded by state protection and/or the existence of political risks are disappearing by the minute.

2. Changing customers

To some Arab banks, customer loyalty has been an important element of strength providing them with a reasonable source of funding and accessible areas of business. Customer loyalty will not disappear suddenly, but it will erode gradually along with the ascent of the younger generation to the helm of business decision-making, besides the changes in their education and cultural orientation. The loyalty to Middle Eastern traditional banks will disappear in the search for better economic values and more comfortable services.

The importance of historically inherited trade-based business will decline in favor of other forms such as light export-based industry infrastructure and large agricultural projects. The change in the core of business in the Middle East will bring with it the need for new banking services, thus diminishing the importance of export/import financing.[19]

The impact of changing markets will intensify, forcing the Arab banks to introduce original and stronger lines of capital market instruments, reducing at the same time their reliance on money market products. Even in the area of money markets, customers will be demanding wider varieties and more sophisticated products than the commonly utilized time deposit accounts.

In retail banking, the Arab customers will demand services equivalent to those available to western customers. In the 1980s, the banking industry in the West went through a painful and devastating transformation.[20] Mergers with retailers and the reshaping of the banks' business into a completely different form were difficult and costly but necessary for survival. Such a transformation may be difficult to achieve by the Arab banking industry in view of its current small and insignificant size. Furthermore, retail banks will need to provide customers with expanded product lines and services in areas which they did not touch before, or which were restricted to specialized institutions such as leasing, insurance, and mortgaging.

3. Changing technology

Technological changes in financial services have been very rapid and deep. The speed of change in the financial services themselves has sometimes stimulated technological development.[21] Technological changes can be segmented into three areas. The first is related to customer needs and attributes and the related marketing issues. Most importantly, product developments have evolved to be a crucial factor in the development of technology. The second area of development is related to risk management: the need to control credit market and operational risk requires an instantaneous knowledge of all transactions that have been performed by the bank and their impact on its position, and the shareholders' net worth. The third area of development is related to communication: instantaneous knowledge of the financial position risks and speedy delivery of services require a technology which enables the organization to carry out these tasks successfully. Maintenance of state-of-the-art technology is costly, and entails a specific critical mass in order to justify the investment. Sadly, most of the Arab banks do not have a volume of business that generates sufficient revenues to withstand the high cost of technology. Investments in technological development, unfortunately, are not a one-time event but a continuous bleeding.

New technologies require qualified staff. The continuous upgrading of the professional qualifications of human resources entails continuous investment. Keeping qualified staff is usually a more challenging task than finding them. The Arab financial institutions that would like to be at the cutting edge of technology must have the stamina to invest in both technology and human resources simultaneously.

4. Changing regulations

In its efforts to strike a balance between regulations and control, the BCBS has introduced rules and regulations to safeguard the integrity of the international financial markets. Its aim is to build a framework of control and a well-managed risk environment. The capital adequacy rules have been introduced to enable banks to manage their credit and market risks more successfully. Capital requirements for operational and other risks are under consideration. Furthermore, several rules in other areas, such as corporate governance and internal control, have recently been introduced.

Changes towards stricter regulations in themselves do not represent a threat to the Arab banks. However, they do limit the banks' ability to operate in the international markets and to access and serve customers. The monetary authorities in the BIS Group of Ten do not allow any financial institution to operate within their jurisdiction if that financial institution, or its home country regulator, does not comply with those rules. A few years ago, several Arab financial institutions had to close their branches or subsidiaries operating in the United States and in Europe as a result of the strict and unyielding demands of the regulators in the host country for compliance.

The trend to induce all central banks to comply with the BIS rules will eventually succeed. All financial institutions, large and small, will consequently need to meet the BIS rules. Compliance will require core changes in the organizational structure of banks as well as in their concept of management. Most importantly, these changes are expensive, and may place a heavy burden on the smaller financial institutions, leading in some cases to their closure.

5. Changing markets

The change in markets is not directly related to the Arab banking industry. It affects the banking industry worldwide. The changes here include disintermediation, financial industry convergence, functional specialization, globalization of financial services, etc. The direct impact of these changes pressures down the profitability of the banks, forcing the unfit either to merge or to disappear. The most obvious impact on the Arab banking industry is the decline in intermediation interest margins. This trend will intensify, along with the growing international competition.

C. Strategic choices

The future of the Arab financial industry is vague and uncertain. The magnitude of the threats is enormous and indications of proper and timely responses are fuzzy. The remainder of this subpart addresses the following issues: (1) the need for a strategy, (2) the strategic choice of the niche players, and (3) a strategy for the top tier.

1. The need for a strategy

The previous parts of this paper demonstrated that the Arab banking industry is over-capitalized, offers limited products, operates below the efficient frontier of operational effectiveness, and achieves lower profitability than the norms of the global financial industry. Arab financial institutions are being asked to demonstrate proper corporate governance, and to compete with more efficient global financial institutions without the safety of sovereign protection. In other words, the Arab financial institutions have lost their strategic advantage. Moreover, they are in a difficult position to achieve operational effectiveness. Accordingly, it is possible to say with a reasonable degree of confidence that the Arab banks are facing a dramatic shift that will render their existing strategies obsolete.

The Arab banking industry requires a strategic reorientation or what may be called "cultural revolution" in the way they do business. A genuine strategy emerges out of a deep-seated philosophy. It addresses the fundamental object of the organization. The idea of a merchant establishing a bank to complement his business activities will definitely be a legend of the past. To base the strategy of a financial institution on the notion of enhancing the shareholders' interest is very narrow, and cannot be utilized as a basic strategic orientation for a leading financial institution.[22] The purpose of a regional Arab financial institution should be founded on the genuine role of intermediation and the provision of badly needed financial services in non-traditional areas such as capital markets. Its objective should go beyond advancing the interests of the shareholders and employees to the more general role of serving the regional economy. When the Arab financial institutions rise to this new height, the basic interests of the shareholders, employees and customers will automatically be raised to a higher level as well.

2. The strategic choice of niche players

Niche players are usually small banks that enjoy a specific strategic advantage in one or more segments related to customers, products or markets. To survive, the niche players need to do three things. The first is to redefine clearly their proper strategic position on the basis of their own characteristics. The second is to redesign their activities, concentrating on their profitable functions and eliminating the unprofitable activities or those that do not complement the prof-

itable ones. The third is to enforce their position by redesigning their activities, creating a proper fit which will prevent competitors from imitating them.

It is assumed that the survival of the niche players will not be undermined by the new realities. However, eliminating unprofitable activities may require the niche players to downsize and probably to distribute to the shareholders the unutilized part of their equities. Such refocusing actions are necessary in order to improve the performance ratios to the industry norms and ensure continuous survival.

3. A strategy for the top tier

The top tier banks in the Arab region, which try to provide financial services and products across the board and play an active role in the international markets, will suffer the most from the looming changes in the region's financial markets. With their USD 2 billion average equity and USD 15 billion average assets, they do not have the critical mass to compete and may not be small enough to be niche players. They are expected to face stagnant growth, declining profitability and increasing operating expenses. Their income will continue to be pressed down by the intensified cost of new technologies and more sophisticated requirements for risk management.

The most obvious strategic choice for the leading financial institution is to increase its business volume so as to generate sufficient revenues to justify the expenses required for survival. The financial institution in this case should aim to play a regional role that goes beyond its domestic market. This calls for better than normal growth, which can be achieved through an external injection of equity, mergers or acquisition. A new volume of business will justify the required investment in systems, organization, human resources and technology.

A strong Arab bank on the list of the first top 100 banks of the world will enjoy a unique strategic position. Its size will give it the fit that others may not be able to imitate. Its competitive advantages will be based on its deep knowledge of the regional markets, its old customer base and its mission and commitment towards the prosperity of the region. The leading bank would benefit from the opportunities to: a) accommodate the customers of other Arab financial institutions, b) be an active intermediator in funding large regional projects; c) play the role of the regional first choice of international banks that do not have actual and direct access to the Arab financial markets, and d) expand its operations into capital management and play a significant role in outside intermediation.

Performing all these functions as a major player in the Arab regional financial markets may not be possible for one organization. In order to have a perfect fit, the regional player should be able to separate its retail activities from its wholesale and capital management activities. This may require more than one organization within the same entity.

The concept of one or two leading financial institutions in the Middle East is an appealing one. When put into practical implementation, some difficulties are expected to arise. Dealing with the difficult and demanding requirements will depend on the leadership that chooses this strategic orientation.

V. SUMMARY

Corporate strategy is about being different. It means the deliberate choice of a set of selected activities to produce for the corporate customers a unique mix of values by different means that will enable it to attain a unique strategic position. When change takes place in dramatic shifts, the organization's strategic orientation moves out of harmony with its environment. In this respect, strategic reorientations are basically cultural revolutions. Policy makers recognize the positive role of a good corporate governance system in safeguarding the interests of a wide range of their constituencies and communities. The BCBS provides the framework in which to establish the strategic objectives of the organization and the means to attain and monitor those objectives. Accordingly, for the Committee sound corporate governance involves the establishment of strategic objectives and a set of corporate values to be communicated throughout the banking industry.

The global banking industry has been transforming and reshaping itself, forcing all major financial institutions to revolutionalize their strategic setting process in order to cope with the new and different working conditions externally and internally. Can the Arab banking industry prosper within the framework of the new realities? The threats and challenges that will face the Arab banking industry are serious, significant and closing in. They include changing competition, changing customers, changing technology, changing regulations and changing markets. The Arab banking industry is over-capitalized, offers limited products, operates below the efficient frontier of operational effectiveness, and achieves lower profitability than the norms of the global financial

industry. Furthermore, it is being asked to demonstrate proper corporate governance, and to compete with more efficient global financial institutions without the safety of sovereign protection.

The Arab banking industry requires a strategic reorientation or what may be called "cultural revolution". The top tier banks in the Arab region, which try to provide financial services and products across the board and play an active role in the international markets, will suffer the most from the looming changes in the region's financial markets. A strong Arab bank on the list of the first top 100 banks of the world will enjoy a unique strategic position. The Arab financial institutions will enhance their chances of success by ensuring that each one's board of directors has a clear understanding of its role in corporate governance and in the establishment of the organization's strategic objectives.

NOTES

1. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the Central Bank Governors of the Group of 10 countries in 1975. It consists of senior representatives of bank supervisory authorities and Central Banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.
2. For more details, see *Enhancing Corporate Governance for Banking Organizations*. September 1999. Basel: The Basel Committee on Banking Supervision.
3. The Central Bank of Jordan for example requested in August 2000 that all banks registered in Jordan should comply with the BCBS requirement on corporate governance.
4. K.R. Andrews in 1980 presented a strong argument for involving the board of directors in the development of corporate strategy, yet again his call did not go beyond the concept of oversight or review.
5. See El-Kharouf F.W. *Corporate Governance in Banking Organizations*. Arab Bank Review, Volume 2, Number 1: April 2000.
6. See Henderson B.D. *Origin of Strategy*. Harvard Business Review: November-December 1989.
7. Ibid.
8. See Porter M.E. *What is Strategy*. Harvard Business Review: November-December 1996.
9. Ibid., 68.
10. See Mintzberg H. *Drafting Strategy*. Harvard Business Review: July-August 1987.
11. Ibid.
12. See Bartlett C.A. and S. Ghoshal. *Tap Your Subsidiaries for Global Reach*. Harvard Business Review: November- December 1986.
13. Goold M. and A. Campbell elaborated on the ways to manage the relationship between corporate executives and business unit managers in their article, *Many Best Ways to Make Strategy*. Harvard Business Review: November-December 1987.
14. See *Roots of Strategy*. 1985. Thomas R. Phillips. Stockpole Books. London.
15. For more details see, *OECD Principles of Corporate Governance*. 1999. Paris: OECD.
16. See Williamson O.E. *The Mechanisms of Governance*. 1996. Oxford University Press, Inc., 11
17. Ibid., Andrews., K.R.
18. See *The Banker*, July 2000.
19. The September issue of Al-Iktissad-Wal-Aamal was dedicated to Arab Banking Prospects in the 21st Century.
20. Late in 1980, the retail banks in Europe faced significant challenges similar to those expected in the near future in the Middle East. There are countless number of articles written on the subject in newspapers, such as the Financial Times and the Wall Street Journal, especially during the years 1987-1988.
21. See Popescu M.M. *Data Warehousing – An Ultimate Solution for the Information Needs of a Bank*. Arab Bank Review: November 1999.
22. See Al-Iktissad Wal-Aamal: September 2000.

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* Farouk W. El-Kharouf, Ph.D., is the Director General at Finance, Accountancy, Mohassaba S.A., Geneva.