Cultivating Confidence Towards Attracting And Retaining FDIs

Unpacking The Impact Of Robust Governance, ICFR And ESG

WORLD GOVERNMENTS SUMMIT 2024

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Executive Summary

In a closely integrated world economy where successful governments thrive by elevating their national economies, privatization stands out as a modern and promising strategy to stimulate economic growth.

It can help strengthen the government's financial health, helping to attract and retain foreign direct investment (FDI).

Privatization serves as a strategic tool for distinctive and successful governments as it contributes towards creating an investor-friendly and transparent environment. Previously, investors considered their return on investment (ROI) as the key factor during their decision-making process, giving it greater weight than other considerations. However, the traditional investor mindset is evolving to embed other factors in making decisions.

In this paper, we will highlight three key principles that shape the path toward successful privatization: sound corporate governance; transparent and reliable financial reporting; and robust environmental, social, and governance (ESG) factors. These principles serve to enable and catalyze the development of a sustainable economy with solid foundations.

Governance

Privatization, corporatization, and initial public offerings (IPOs) have fundamentally transformed the global economy, and governments need to reimagine their governance frameworks to ensure the sustainability, agility, and resilience of their economies.

Reimagining governance frameworks requires introducing and refining multiple governmental regulations to cope with the evolving needs of investors, thus providing them with confidence that their interests are protected, and their invested capital is subject to effective governance.

One of the ultimate outcomes of this endeavor is to cultivate sustainable environments that facilitate FDI while avoiding bottlenecks.

Internal Controls Over Financial Reporting (ICFR)

Economies aiming for sustainable growth and prosperity have long grappled with the problem of achieving transparent and reliable financial reporting. As a response to this challenge, numerous governments have either implemented or are in the process of developing regulations to bolster this objective, with a particular emphasis on the crucial role of ICFR in advancing this agenda.

Beside other factors, international organizations such as the International Monetary Fund (IMF) and rating agencies play a vital role in incentivizing FDI inflow in the economy. To support this objective, the effective and efficient implementation of ICFR serves as a distinctive factor instilling investor confidence and distinguishing governments as active proponents of transparent and reliable financial reporting.

3

ESG

Evolving from a niche concern for a select group of investors, ESG has become a fundamental requirement for strengthening investors' confidence in governments, economies, and financial markets. Government and regulator commitments can establish clear and proactive ESG regulations to address relevant risks and investor requirements. The role of market participants lies in supporting government agendas and contributing toward shaping leading practices for implementing ESG measures. Furthermore, investors and other stakeholders can demonstrate their constructive impact is manifested by applying appropriate ESG principles both internally and through their investment decision-making process. Harmonizing ESG processes and expectations into a unified ecosystem comprising governments, market participants, and investors will naturally attract FDI, consequently stimulating the nations' GDP.

This paper sheds light on the multiplier effect achievable by incorporating the above-mentioned principles within government and public sector ecosystems. Governments can significantly strengthen stakeholder confidence, thereby becoming a more attractive destination for FDI.

The emphasis is on the return governments can expect by internalizing these principles, especially during the complex process of privatization. Through commitment to these principles and by connecting the dots, governments not only facilitate the privatization process but also create a favorable climate for sustained FDI, leading to long-term economic value creation.

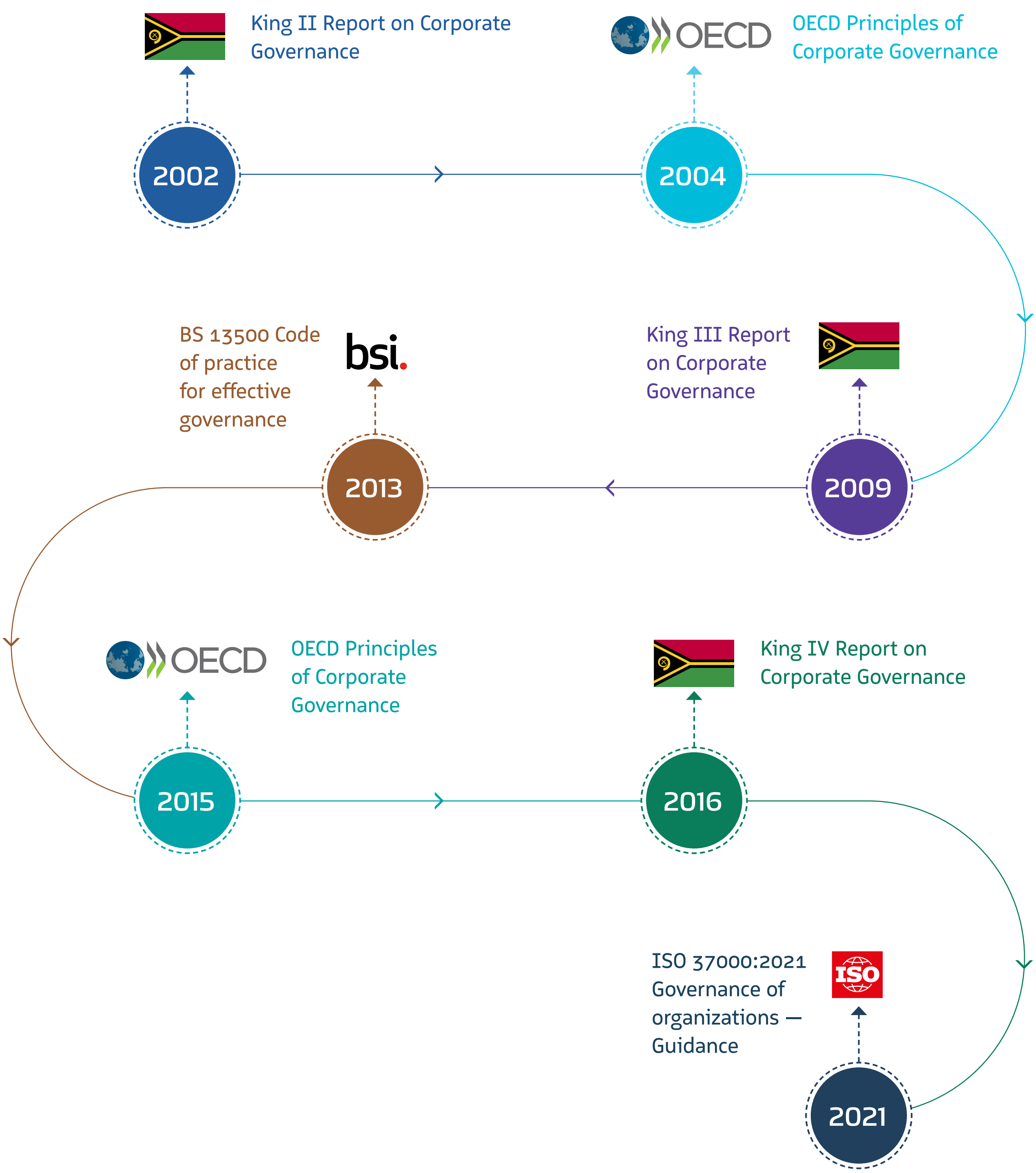
Section 1

Reimaging Governance As An Overall Umbrella For The Investment Landscape

The concept of corporate governance has evolved over centuries, balancing between the roles and responsibilities of boards, executive management, and shareholders, and aiming to prevent conflict and mitigate the risks associated with the principal-agent problem. In essence, corporate governance can be defined as a framework of principles that govern organizations, ensuring a consistent and disciplined relationship among the board, management, shareholders, and other stakeholders. In the early 2000s, a significant turning point in this evolution occurred when global accounting scandals prompted a thorough reassessment of corporate governance practices.

Investors and regulators joined forces in demanding the implementation of robust corporate governance frameworks that prioritize stakeholder inclusivity, sustainability, and ethical considerations, all with the aim of boosting stakeholders' trust.[1]

As a result, numerous corporate governance standards emerged in the past 20 years as detailed by the examples below:



This corporate governance evolution was not limited only to listed entities, but was also adopted by government entities. A live example is the 2020 UAE federal government issuance of the Guide to Board Governance in the UAE Federal Government covering all federal government entities in the UAE. This groundbreaking measure represents the first of its kind in the MENA region, aimed at organizing boards of directors activities in line with leading international standards and the strategic objectives of the UAE government. Such initiatives are crucial in boosting stakeholders trust in the government and public sector, providing a positive perception to investors, and serving as an indicator of governance maturity in these economies. Consequently, one of the goals to this initiative would be FDI promotion as a vehicle for economic growth. This goal is also a key pillar of the Dubai Economic Agenda D33 where the Dubai Government seeks to double FDI from an average of AED 32 billion (USD 8.7 billion) annually over the past decade to an average of AED 60 billion (USD 16.3 billion) annually across the next decade to reach a total of AED 650 billion (USD 177 billion) by 2033.[2]

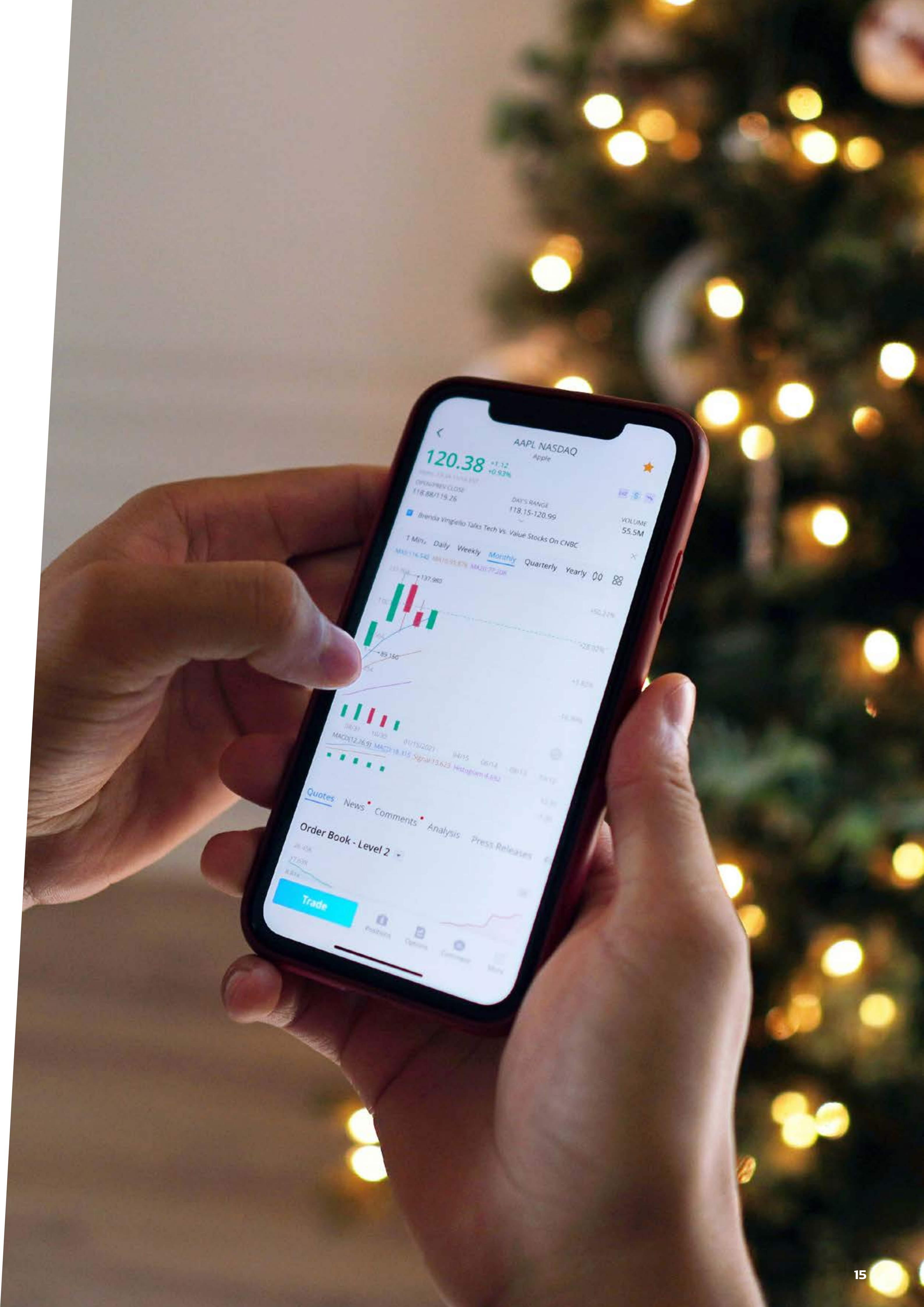
Such regulations, backed by leading standards as illustrated in the figure above, enhances government credibility in the eyes of investors and global rating agencies. One major regulatory development is the Worldwide Governance Indicators (WGI), which help investors and analysts evaluate the governance practices across countries globally. Its main aim is to assess the quality of governance in countries, covering dimensions like government effectiveness and control over corruption, with scores based on diverse data sources produced by over 30 organizations worldwide. It is published by the World Bank and provides country rankings based on assessed governance quality.[3] Such leading indicators serve as a valuable tool for investors to judge and compare the maturity of governance frameworks internationally. In addition, WGI scores help in identifying improvement areas and provide a systematic assessment of governance quality.

Investors often rely on these indicators to gauge the reliability and transparency of governments, with significant influence over their investment decisions. A consistently high WGI score can signal stability, sound governance, and government commitment, making a nation more appealing for investors and FDI.

An important element of a sound governance framework is incorporating resilient succession planning to provide a stable and sustainable foundation toward achieving the long-term strategic objectives of organizations. Ensuring this element is well embedded within the corporate governance operating model is crucial for all organizations, especially for the family-based businesses that contribute substantially to the MENA GDP. Recognition for effective governance indicates that a firm has successfully moved from a family culture toward a corporate culture. The continuous increase of family businesses listed in MENA stock markets demonstrates the scale of this phenomenon and the importance of creating a certification for progress in governance.

In conclusion, the evolution of corporate governance has been a dynamic and essential process, aimed at establishing equilibrium among the key players in organizations while mitigating the principal-agent problem.

Notably, governments have also embraced this evolution, exemplified by the MENA-OECD Initiative on Governance and Competitiveness for Development initiated and led within the region itself.[4] Such initiatives increase stakeholders' trust and encourage FDI, propelling economic growth. These regulations, aligned with leading international standards, enhance credibility and are key differentiators in assessments like the WGI, influencing investors' choices. Furthermore, effective governance includes robust succession planning, particularly vital for family businesses in the MENA region transitioning from a family to a corporate culture. As family businesses continue to play a significant role in the region's economies, their presence in stock markets is contributing significantly to the nations' GDP, underlining the enduring importance of addressing capital market expectations and requirements through the implementation of sound governance principles.


AAPL NASDAQ
Apple
120.38
+1.12
+0.93%
OPEN/PREV CLOSE
118.88/119.26
DAY'S RANGE
118.15-120.99
VOLUME
55.5M
Brenda Vingiello Talks Tech Vs. Value Stocks On CNBC
Daily
Weekly
Monthly
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News
Comments
Analysis
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Order Book - Level 2
Trade

Section 2

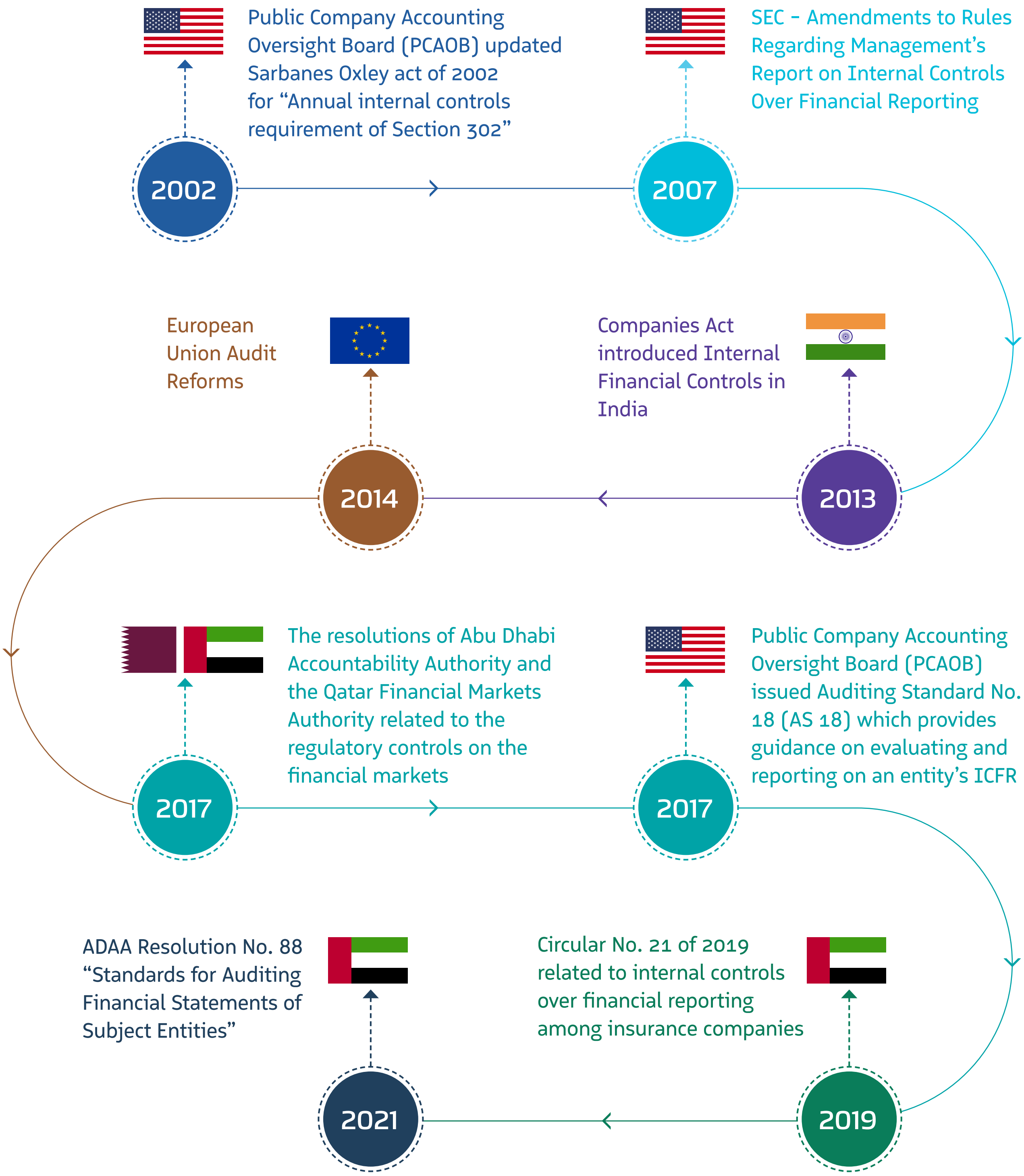
Solid Control Environment Fostering Transparency And Trust

As governments constantly undertake efforts to spur growth and innovation through FDI, they cannot neglect one crucial aspect: Implementation of a robust set of laws and regulations emphasizing transparent and reliable financial reporting.[5]

Reliable reporting establishes the blueprint for a trustworthy and credible local and global financial environment, providing assurance to investors seeking to invest their economic wealth across the globe.

The journey towards transparent and reliable financial reporting emerges through the evolution of accounting principles and the pursuit of openness in disclosing financial information. Originating from the double-entry bookkeeping system in the 15th century, the concept gained prominence with the 17th century rise of joint stock companies, which prompted the use of disclosure to attract investors. The early 20th century witnessed the introduction of securities regulations, such as the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934, establishing a legal framework for financial transparency.[6]

The Enron scandal in the early 2000s was a pivotal event which spurred the enactment of the Sarbanes-Oxley Act (SOX) in 2002, emphasizing internal controls and accountability. Recently, the focus has expanded to include sustainability reporting, reflecting a broader perspective on organizational transparency and accountability. The timeline below outlines the ICFR journey globally as a response to various scandals across the US, India, Europe and the Middle East. Those moments of crisis allowed regulators to issue various laws and resolutions pertaining to ICFR implementation.



Economic and financial turbulence calls for greater transparency from governments and policy-makers; in order to sustain this climate of transparency, governments are striving to implement regulations that promote accountability and effective decision making.

The introduction of ICFR in the US through the 2002 passage of SOX came in response to accounting scandals, such as those at Enron and WorldCom, which eroded public trust in internal corporate controls over financial reporting. An ineffective internal control ecosystem may prompt investors to shift their focus to countries with stronger regulatory frameworks and more transparent financial systems. ICFR stands out as a solid element of enhanced corporate accountability, transparency, and accuracy in financial reporting. It represents a significant regulatory measure to protect investors and restore confidence in the financial markets.

Consider the fact that Denmark, Finland, and New Zealand – recognized as the least corrupt countries in the world[7] – all established a set of robust laws and regulations to enforce ICFR implementation in public joint-stock companies. This reform of their financial systems ultimately led to a revolutionary transformation in the way transparency is practiced. These measures include Companies Acts in both Denmark[8] and Finland[9] as well as the Public Finance Act[10] in New Zealand, requiring companies, represented by their boards of directors, to establish and maintain proper internal control systems to safeguard their financial reporting processes as well as maintaining proactive initiatives to prevent fraud, errors, and irregularities in financial reporting.

The observed benefits of implementing such standards in Europe and New Zealand drove governments in the Middle East, especially in the UAE, to adopt similar acts such as Abu Dhabi Accountability Authority (ADAA) Resolution No.1 of 2017, which requires all subject entities' external auditors to issue a separate report including an assessment on the effectiveness of the internal control systems.[11] The adoption of the ADAA resolution was a milestone for many government entities in their privatization journey – including heavyweights such as ADNOC Drilling, ADNOC Distribution, and Abu Dhabi Ports – through an extensive transformation initiative to pave the way towards the ultimate privatization objective. Further, this was also reflected at a Federal level in the UAE through the establishment of the UAE Accountability Authority which is mandated to evaluate the efficiency and effectiveness of internal controls over financial reporting and operations, as well as information technology and communication systems within subject entities.[12]

Besides governments role in introducing regulations and driving this agenda, international organizations such as the IMF have been key players encouraging transparency in both government and the private sector to facilitate global FDI. Some examples of areas that the IMF looks at include fiscal transparency, anti-corruption, and rule of law, all of which contribute in providing investors access to accurate and reliable information about the country's economic conditions, risks, and potential opportunities.[13] This helps countries enhance their competitiveness in the global market.

Further, ICFR is a critical enabler for governments in their privatization initiatives. ICFR can help facilitate a smoother privatization journey by enhancing credibility and reliability, ensuring regulatory compliance, and creating a more attractive proposition for potential investors.

In summary, attracting FDI and nurturing economic growth and innovation hinges upon the establishment of robust regulatory frameworks that prioritize transparent and dependable financial reporting. This foundation underpins a trustworthy and credible financial environment, offering reassurance to investors who seek to expand their investment portfolio globally. Economic challenges underscore the need for governments and policymakers to enhance transparency, and the introduction of ICFR has revolutionized transparency standards.

The adoption of similar measures in the Middle East, exemplified by ADAA, marks a significant step towards privatization and accountability. International organizations play a vital role in fostering transparency and attracting FDI, thus promoting global economic resilience and competitiveness through adherence to international standards and best practices. Together, these efforts pave the way for a more secure and prosperous global economic landscape.

Section 3

The Evolution Of ESG and Its Influence On Governments And Communities

The genesis of the ESG investing concept came about in the 1960s through the principle of socially responsible investing. During that period, investors performed negative screening to exclude stocks or entire industries from their portfolios due to their involvement in activities such as tobacco production or ties to the South African apartheid system.

Recently, the importance of ESG has been emphasized for the first time by world leaders, shown by the Paris Agreement[14] and its revolutionary step of adopting a unified framework to combat climate change and adapt to its effects.

Further, this was also re-emphasized by the worlds' leadership during the COP28 which was recently held in the UAE. Since then, ESG has only gained in significance, with ESG components becoming fundamental criteria playing a pivotal role in reinforcing investors' confidence in governments, economies, and financial markets. This interconnectedness between ESG and investor confidence underscores the vital link between sustainable practices and overall economic stability.

This profound shift, underscored by several key factors, has seen governments and their regulatory bodies advancing the ESG agenda. Their commitment is manifested in the implementation of robust ESG regulations aimed explicitly at mitigating risks inherent in environmental challenges, societal dynamics, and governance frameworks. Many countries' capital market authorities have mandated sustainability reporting, emphasizing the importance of using international standards such as ISO 26000 (social responsibility) and the Global Reporting Initiative (GRI). These regulations or frameworks help governments and regulatory bodies foster an environment of standardized and dynamic ESG operating models, which is vital for wooing investors and setting clear guidelines and expectations for market players (i.e. corporations and financial institutions) in the economy.[15]

Market players have adjusted to these new governmental initiatives and regulations. To become effective partners in government efforts to achieve national ESG goals, market players must integrate sophisticated ESG practices into their financial and operational strategies. Be it through adopting sustainable business standards, reducing carbon footprints, becoming flag-bearers for diversity and inclusion, or by maintaining robust governance frameworks, market players have taken action to adopt these ESG practices.[16] By leaning forward, market players not only enhance the credibility of the ESG agenda but also may themselves become benchmarks for leading ESG practices.

Investors, along with other stakeholders, are instrumental in advancing ESG considerations, demanding that businesses embed ESG in their daily activities and uphold their corporate social responsibility (CSR) obligations where ESG acts as a key pillar for consideration before embarking into any investment, driving investors to meticulously assess how companies navigate the triad of environmental, social, and governance challenges and initiatives. Companies that don't measure up to these ESG standards often find themselves at risk of investor activism, ranging from pressure on corporate leadership to divestment to replacing senior management with a team willing to lead on ESG.

As proof of the ESG narrative's global resonance, multiple governments and sovereign wealth funds (SWFs) steering away from investments that are not aligned with the ESG agenda.

SWFs have more than one vital role within the ESG ecosystem, both as large investment vehicles influencing and making investment decisions in their own right and through the functional and personal links between national administrations, civil service staff, and SWFs.

One example is the Norwegian Government Pension Fund Global, known as the Norway Fund, which stands as an elite global investor, both the world's leading sovereign wealth fund and a beacon of rigorous ESG integration within investment strategies. This dual role is emblematic of the emphasis governments are placing on ESG, and it is in perfect alignment with the overarching global investment philosophy that leans heavily toward including ESG as a key factor in the investment decision making process. Practices by leading global players such as the Norway Fund set the benchmark and became an inspiration for countries and institutional investors globally, further underscoring the indelible mark ESG is making, as reflected in Portmann's 2021 observations.[17]

Underpinning these ESG dynamics is a formidable legal structure set and imposed by governments and regulators on market participants to govern the overall relationship among all involved stakeholders. This enabler is crucial to ensure the longevity and effectiveness of any ESG initiative. A national legal framework addressing the full spectrum of ESG considerations from environmental preservation to workers' rights and from corporate governance to ethical business practices, serves as a rigorous benchmark for corporate ESG adherence.[18] This is not just about setting the rules – a legal structure also offers investors reassurance on the security of their investments and preventing backsliding by corporate leadership. These may include instruments such as shareholder agreements, structured articles of association, transparent reporting standards, and legal frameworks mandating ESG disclosures to help foster accountability. For investors, especially those with an eye on FDI, this legal clarity is invaluable, offering them a predictable and consistent investment horizon.[19] This robust legal foundation should also be resilient enough to adapt with new emerging trends such as digital assets.

In short, the success of ESG initiatives relies on harmonious collaboration between governments, market players, and investors. Their collective endeavors create a magnetic pull for FDI, with both institutional and individual investors attracted to nations that exhibit a deep commitment to ESG tenets. The resulting investment inflow, in turn, has the power to boost national GDP and spur economic growth.

Conclusion

This report highlights three key strategies which governments can utilize to reimagine the future of their economies:

1. Promoting sound corporate governance
2. Enshrining transparent and reliable financial reporting
3. Embedding robust ESG practices

The return on this investment includes a favorable climate for investor confidence as well as maintaining and preserving the continuous inflow of FDI. By safeguarding these fundamentals for sustainable economic growth, governments can likewise secure an agile and promising future where privatization, corporatization, and IPOs propel national economies towards ever greater heights.

Forward-thinking governments willing to create and sustain an attractive environment not only introduce and impose the necessary regulations, but also lead and implement the following top three initiatives:

1. Pioneering consistent but dynamic governance, ICFR and ESG frameworks that reinforce concepts of responsibility, transparency, reliability, and accountability while minimizing bottlenecks for effective and informed decision-making.

2. Raising awareness and building capability around the interconnection of the three principles and the positive correlation between them and the nation's economic prosperity.

3. Sustaining distinctive ecosystems that foster a culture of creativity and innovation, drawing on yesterday's lessons to shape a brighter tomorrow for future generations.

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