Corporate Governance

Address by Cassandra C. Nottage, Manager, Bank Supervision Department - Central Bank of The Bahamas, to the BICA seminar 28th September, 2006, British Colonial Hilton

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Ladies and Gentlemen,

It is a pleasure for me to speak to you today on the subject of Corporate Governance. This topic is particularly relevant topic in today's world of business in light of the potential benefits that can be derived from a well maintained corporate governance structure by any business concern whether they are financial institutions or manufacturing firms.

My address today will, focus on the Central Bank's Corporate Governance Guidelines [CGG] which can be adapted to any business for improvements in managing and controlling their operations. I will endeavour to give you an overview of the Principles embodied in the Central Bank's CGG, the broader expectations of the Central Bank in relation to the sound corporate governance of our licensees and in so doing would hope that you would be able to garner ideas for testing adherence to CGG in your particular environment.

It is no secret that the banking sector is the major holder of the nation's financial assets, and presents the largest potential for risk for financial and reputation losses in the event of a corporate governance failure. Further, as these financial institutions are at the heart of the Bahamian economy facilitating the movement of capital, and funding the expansion in business operations, it is important for the Central Bank to continuously monitor licensees' corporate governance frameworks and also ensure that there is a structure in place for the maintenance of director responsibility and accountability.

Another often overlooked issue related to the importance of banks' Corporate Governance regimes is the effect of the banking sector on other parts of the economy. As the main providers of credit in an economy, banks with sound internal controls and prudent policies, induce and can impose good corporate governance on their borrowers – in particular their corporate borrowers. For example, Banks with sound credit risk policies often ensure that, in most cases, corporate borrowers produce audited financial statements. Banks with sound credit policies, in deciding whether to lend to corporate borrowers, review the borrower's operations, management and the ownership structures in order to determine whether the entity is a good risk. Therefore, as the governance and risk management structures of banks improve we would expect improved governance among the many corporate clients that utilizes their services.

Corporate Governance to the Central Bank is more than an international standard; it is a vital tool to ensuring the stability and viability of our Domestic financial system and the reputation of the offshore financial centre.

At the very heart of The Central Bank's CGG initiative was the issue of Director Responsibility and Accountability. The Bank's CGG mandates the submission of an annual certification from the Board, which is required to state that it has assessed and documented whether the licensee's corporate governance process is effective. The Board must report any material deficiencies and problems that are identified within the licensee, along with action plans and timetables for their correction.

This certification is an important companion to the Central Bank's onsite review of licensees' corporate governance processes. The Central Bank's assessment, at the time of onsite inspection, focuses on the overall effectiveness of the board and senior management in protecting the interest of depositors, shareholders and other creditors of the licensee. Our assessment of the structure and practices of the board of directors are key indicators of an effective corporate governance regime; that is, without a proper functioning board, the operation will not have the appropriate oversight required to ensure that proper processes are in place to manage risks, that internal controls and procedures are being followed, proper accounting of operations are on-going, etc.

The Board Certification

These Certifications aught to cover -

(a) **A Statement of Familiarity with the Guidelines: This is** a statement to the effect that the board is familiar with the contents of the *Guidelines for the Corporate Governance of Banks and Trust Companies Licensed to do Business Within and from Within The Bahamas*, issued by the Central Bank of The Bahamas on 13th December, 2001, and acknowledges its role and responsibilities under those guidelines;

(b) **Statement as to the board's performance under the Guidelines: This is** a statement indicating whether the board of directors is performing its functions and fulfilling its responsibilities under those guidelines;

(c) **Statement as to the effectiveness of senior management in the CG process:** A statement indicating whether the board of directors has carefully considered the reporting of senior management and other information relevant to forming an opinion as to whether the organization is following the corporate governance guideline (refer to page 4 of the Central Bank's corporate governance guidelines); and,

(d) **Statement as to the licensee's Compliance with the guidelines:** A statement setting out the board of directors' opinion as to whether the organization is following the Central bank's Corporate governance guidelines, paying particular attention to the annual review and annual certification sections of pages 5 and 6 of the Central

Bank's corporate governance guidelines. If the board of directors is of the opinion that the organization is not following the corporate governance guidelines or that the organization is following the corporate governance guidelines except for identified deficiencies, it should provide:

- An explanation of the reasons for the opinion that relate to deficiencies;
- A statement confirming that an action plan to correct those deficiencies has been prepared and is being implements; and,
- A statement confirming that a copy of the action plan has been or will be submitted to the Inspector of Banks and Trust Companies.

However, more importantly, in order to make these attestations, The Central Bank seeks to have directors ensure the following:-

1. That there are Clearly Defined Board Objectives.

- The board is required to have a clear mandate. Board members should demonstrate that there is a full understanding of their responsibilities, decision making authorities and accountability.
- There should be continual reviews to determine if the board is effective in achieving its objectives. For example, the Board is responsible for establishing business objectives and approving management's business strategies. Therefore, there should be evaluations of the company's actual performance against its targets. Where there are shortfalls, there should be reports to the board outlining where and why there were differences, including management's plan for corrective action.
- The board should ensure that there is ongoing re-evaluation of the business strategy to ensure that it is compatible with their approved objectives, given changing internal and external forces.
- Overall, the Central Bank wants to ensure that the board is meeting its objectives and where these are not being met, that there is a mechanism for identifying deficiencies and addressing them.

2. One of the most common governance deficiencies is in the structure of boards.

- Board members should be asking themselves, whether the current structure is effective for achieving board's objectives? For example, the Central Bank's guidelines outline a number of typical specialised committees which may be useful to meeting the objectives of any type of company. The Bank notes that instead of involving the full Board in every management matter, the board may chose to use these various specialised committees comprised of directors and senior management. The choice to create a specialized committee is entirely at the discretion of the board. For smaller banks / firms, for example, the entire board may find it appropriate to take part in credit policy decisions and there may not be the need for a separate audit committee. However, for larger more complex banks / firms, the decision to create specialized committees to address credit risk policies, liquidity risk management issues, or the bank / firm's internal and external audit functions is necessary. In assessing the structure of the board and the board committees, one should assess whether board structure is appropriate to the complexity of the licensee's operations. In particular, The Central Bank, when assessing licensees, would want to ensure that there is a clear understanding of the various roles and that these are properly documented. We would also want to ensure that where action is delegated to a committee, it is understood, that the board retains ultimate responsibility.

3. **Corporate governance weakness can also stem from the inappropriate composition of the boards that is in lacking the right mixture of skills.**

    - Each director and senior officer goes through a rigorous fit and proper assessment by the Central Bank. In like fashion, before appointments are made at other firms, either a regulator or the shareholders should assess the fitness or appropriateness of their directors / officers. In particular, we look for the experience and competence of the person seeking appointment as a director.

    - As companies become more complex, so too do their risk management needs. As the board is responsible for setting these policies, board members too must have an understanding of the organization's risks and the effectiveness of the risk management processes which have been put in place by management.

    - Admittedly, the Central Bank has not gone as far as the United States and the Sarbanes Oxley Act, which for example requires companies to disclose whether at least one member of the audit committee is a "financial expert" and if not, why not. However, the Central Bank expects that the appropriate skill sets will be present on the various board committees.

    - Finally, but importantly, Central Bank assessors look at the board's approach to the issue of succession planning. Far too often, the departure of a key executive can send an otherwise well performing organization into a tailspin. Effective boards should prepare for this.

4. **Board independence is another important issue which we hope to see addressed**.

    - The Central Bank's guidelines state that the board should have a sufficient number of independent, non-executive directors. This is especially the case where the board committees are used for particularly sensitive areas, where a potential conflict of interest may exist (i.e. audit committee, compensation committee, etc). The Central Bank requires that there be at least one (1) non-executive director. However, many licensees have determined that it is in their best interest to have more than one independent director. Just recently the Central Bank released its 'Independent Resident Non-executive Director Guidelines' to the industry for comments. We have tried to produce a workable operational definition of "independent" for a small country like The Bahamas, where there are many business and family links while trying to rule out recent ex-employees, recent ex-attorneys, etc., who don't strike us as "independent" . But this isn't an easy area and people should consider the issue closely NOW while it's still out for draft. We would be happy to receive all comments as we intend to finalise these guidelines before the end of the year and issue them to our licensees for their adherence.

- There are many competing theories when it comes to outside directors. Some put forth the position that there should be a distinction between the Chairman of the Board and the Chief Executive Officer – that these roles should never be held by the same person. Some feel that boards should be comprised of a majority of non-executive directors. While others feel that because of the smallness of some companies and the nature of their business, there is no need for an outside director.
- There is no absolute right or wrong approach here, **but** the board should demonstrate that it is sufficiently independent. Note is made here that there is no flexibility for public bank and trust company licensees on this issue as they are obligated to appoint an independent resident non-executive director.

5. **Another issue which we wish to see addressed is the ability of the board to make decisions.**

In this regard, we would want to assess whether, there is a timely flow of information to the board from the management and whether board decisions and strategies are effectively communicated to management. There should ideally be a two way flow of information between the board and senior management. While broad objectives are filtered down to management for translation into actionable strategies, there should also be a process for matters to escalate upwards to board from the management. This flow of information should be documented through board minutes and other board papers. There should be active involvement by the Board in requesting detailed information and specifications on tasks that are complex to ensure proper oversight in place for controlling risks that may be involved.

6. **We would also want to see that management follows through on the board's recommendations.**

This is very important and can be tested by our onsite examiners by reviewing the areas highlighted for action by the Board and response of management to rectifying any problems sited or addressing the areas of concern. Action plans with appropriate timeframes and progress reports should all be a part of the management's output in addressing Board directives, concerns and queries.

7. **The board should also demonstrate, through our review of board minutes and board papers, that it fulfils the specific responsibilities outlined under the Guidelines such as:**

- Ensuring competent management – in its annual assessment of management, any concerns should be listed and recommendations related thereto should be clearly and concisely spelt out;
- Approving objectives, strategies, plans, and operating policies, standards, and procedures – documented board papers on file and evidence of distribution to management as required;
- Ensuring that the organization's operations are conducted prudently and within the frameworks of laws, regulations and guidelines, as well as established policies and procedures – Reviews of same discussed and changes if any recommended, etc.;
- Ensuring and monitoring that the organization conducts its affairs with a high degree of integrity;
- Reviewing the organization's business and operating performance – internal audit reports, etc.;
- Ensuring that the organization is "in control" of itself.

8. **The Central Bank also wants the board to demonstrate that they meet the operational requirements set out in the Guidelines:**
   - Ensuring that there are regular meetings (monthly, quarterly, group wide etc);
   - Ensuring proper oversight of credit, liquidity, capital adequacy, compliance, control systems audit, etc.

9. **An important issue for the Central Bank, as a supervisor, is CAPITAL**. The board is ultimately responsible for ensuring that the licensee's capital, at all times, is adequate given the nature and risk profile of its operations. Where the board is not satisfied, then a plan to boost same should be devised and communicated to the Central Bank for review and comments. Pursuant to the governing legislation when warranted and in accordance with Supervisory Review Pillar II of BASEL II [the new capital adequacy standard], the Central Bank has the powers to direct licensees [independent of decisions of the board] to augment capital levels in line with current operating environments as warranted, taking into account such factors as management concerns, operations risk, and credit risk.

Conclusion

The Central Bank's Corporate Governance Guidelines have resulted in a change in the status quo in the banking and trust sector of the financial services industry. The securities sector has also been advised of similar guidelines as The Securities Commission issued its version based on The Central Bank's Corporate Governance Guidelines.

The important role and awesome responsibility of the board have been highlighted. However, the burden of good corporate governance is squarely placed on the shoulders of senior management of banks and other firms. These men and women are the banner bearers, eyes and ears of the board at ground zero. Internal audit departments are a must for banks and large firms in order for them to ensure that the controls and procedures that produces good corporate governance remains in place. The Internal Audit Department is a critical element in ensuring good governance is and remains in place. For this Department or Unit to be effective its function must be independent of senior and line management to avoid undue influence by those it may criticize. It should be directed by an independent Director or by the Audit Committee which reports solely to the Board and headed by an independent Director. And finally there has to be a strong culture of good governance from the top which would filter down to the lower ranking employees who are foot soldiers of any organisation. Training is key and most organisations, at times, place too few resources to develop and sensitize these foot soldiers who are the first line of defence in controlling risks such as fraud, money laundering and theft. Training and development of front line staff in any organisation can only result in huge dividends in retention of clients, maintenance of proper internal controls and procedures and prudent management of business operations.

A parting word on Sarbanes Oxley

In 2001, with the release of our Corporate Governance requirements, some may have thought that the Central Bank pushed the envelope, went too far, too quickly; but when one looks at the requirements of Sarbanes Oxley which came into force in 2002 we see that the United States went even further.

Sarbanes Oxley requires that an "issuer's principal executive and financial officers personally certify their company's public filings..... From 2005, management will also be required to report annually on the issuer's internal controls"[1] The act also imposes serious penalties for accounting errors. Under section 304 of the Act, *"if an issuer is required to restate its financials due to material non-compliance with financial reporting requirements, due to misconduct, the CEO and CFO must reimburse the issuer"*. These reimbursements include forfeiture of bonuses and incentive based or equity compensation. Should we in the Bahamas as regulators go this far?

Proper Corporate Governance systems would deter corruption, theft, fraud, money laundering, leakages, and other harmful elements that may be present in the society in which we find ourselves.

On the national front, if all of us were to see ourselves as the guardians in ensuring that Corporate Governance is progressed at every level throughout our entire economy, the Bahamas would become the envy of the world as it continues to emerge as the most efficient and progressive little nation this side of heaven.

[1] The Post Enron corporate governance revolution in the US: coping with the extraterritorial effect – David Sirignano and Howard Kenny or Morgan Lewis and Bockius.

Ladies and Gentlemen, thank you for your attention. I hope that I have sensitized you to the importance of Corporate Governance and its importance in the proper oversight of companies' operations.

Further, I would hope that you would have gleaned ideas for reviewing the extent of good governance that your clients practice with a view to recommending corrective action where necessary.

Thank you so kindly for inviting me to address this august body of professionals and I hope I did not make you happy twice – when I commenced my presentation and now that I am finished.