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ANALYZING THE CORPORATE GOVERNANCE REQUIREMENTS OF THE CENTRAL BANK OF THE BAHAMAS

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December 2003

The Central Bank of the Bahamas' (the "Central Bank") guidelines on corporate governance will crystallize at midnight, December 31, 2003, a mere fifteen days from today. On December 1, 2003, the Central Bank, in a letter to its licensees, notified them the elimination of the requirement for auditors to "certify" the assertion the Board will make as to the effectiveness of its corporate governance process. This move, on the face of it, presents, possibly, a less expensive alternative to financial institutions but have effectively eroded, from the point of view of these institutions, what the author considers to be a "safety net". The involvement of auditors would have been extremely beneficial especially for institutions with governance systems which are yet to be clearly defined and entrenched. Not, however, that the removal has in no way undermined the effectiveness of the guidelines.

Conversely, it has put the ball squarely in the court of financial institutions and has essentially heightened the level of vigilance required in the issuing of the certification to the Central Bank. Given a longer period time between the certification and the examiners onsite review it is more likely that "inaccuracies" in the assertions made will take longer to be discovered and therefore become more entrenched in the operation of the institution. This could have adverse implications, on "discovery" by the Central Bank. The auditor's review, which was envisioned to be very close to the Board's certification, had the potential of preventing this situation from occurring.

Some of the questions that have been asked a lot are: what needs to be in place to demonstrate effective corporate governance; what is it that will have to be done in order for the Board to make its assertions; and how one will test for effective corporate governance? The answers to these questions are not necessarily straight forward as it is extremely risky to take a vanilla approach to the issue of corporate governance. There are however some fundamental elements which are generally common across all organization that can be spoken to.

Before answering the questions above, it is useful to consider why the Central Bank has imposed this guideline on the industry. It is the author's position that corporate governance standards is one of the most effective means if one wishes to enhance the risk management structure of the industry. A solid corporate governance foundation will prepare any institution for the implementation of any risk focus guidelines. Why is this important? It is important simply because supervision worldwide has moved in general and in specific cases, like the Bahamas, is moving to a more risk focus approach.



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One only has to consider the new Basel Accord and its emphasis on regulatory capital being aligned to the certain risks faced by the organization to get an indication of the current trends in the banking and financial services industry.

Another trend is the growing recognition of the impact of local financial sectors on the stability of global financial systems. It has been estimated that at the end of 2002, assets resident in OFCs, claimable by onshore jurisdictions, stands at approximately \$2.8 trillion. This coupled with assets controlled by OFCs invested in onshore institutions makes them, collectively, a significant player in the global financial systems and therefore the ability to substantially impact its stability. Consequently, there have been many initiatives geared at ensuring that financial sectors, to include banks, insurance companies, securities companies and other specialized financial services organizations, worldwide are properly regulated.

For example the IMF is currently undertaking a review of Offshore Financial Centers (OFCs) with the view of confirming or otherwise the forgoing objective. Failure to meet the benchmark standards of these reviews could be detrimental to the industry as a whole. Most persons are aware of the past and continuous moves of bodies such as the FATF, FSF, OECD, The European Union and now the IMF. All these organizations are still there watching. As a jurisdiction the Bahamas cannot afford to provide any reason for them to suspend this state of relative inactivity. It is the view of the author that these organizations have yet to accomplish, in real terms, what they had initially set out to do but are still looking at creative means of doing so.

For example, here are a few stated position of the IMF, in providing background on its June 2000 initiative to review of OFCs (*report available at www.imf.org*). The IMF indicated in its report that:

- *The Fund embarked on an OFC program ... in response to concerns about potential risks posed to other financial systems by activities undertaken in offshore centers. Two broad concerns were to be addressed—adequacy of supervision and data availability. Inadequate supervision could encourage regulatory arbitrage and facilitate fraudulent activities, including money laundering. Moreover, weak supervision could impede effective consolidated supervision by the home countries of financial institutions with operations in those OFCs. Second, analysis of cross-border risks is hindered by the lack of information about the range and level of activities conducted in the OFCs.*
- *These concerns are material because the volume of financial transactions booked in OFCs is substantial.*
- *The major risks OFCs could pose for the international financial system are associated with prudential and financial integrity concerns.*



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- *Concerns about possible risks posed by OFCs are exacerbated by the lack of information about their operations. Lack of information on OFC activities restricts our ability to fully understand global financial flows and analyze their potential stability effects.*

What this means therefore is that the Bahamas and other OFCs have to ensure that they continue to be vigilant and implement and comply with internationally accepted principles and standards for the regulation and supervision of their respective financial services industry.

The current IMF review assesses, in part, compliance with the following international standards:

- International Association of Insurance Supervisors (IAIS) - Insurance Core Principles;
- International Organization of Securities Commissions (IOSCO) - Objectives and Principles of Securities Regulation; and
- Bank for International Settlements (BIS) - Basel Core Principles (BCP).

This should further highlight point and drive home the importance of having a financial sector which practices and adheres to proper governance and risk management principles. The benefit is not only to comply to the mandates of a regulator but more fundamentally that the regulators as a group and the country as a whole, can respond favorable when the effectiveness of the regulatory and supervisory regime is challenged by external, internationally significant bodies.

The need to create a solid foundation together with international trends are therefore two critical issues, separate but not independent, which would have motivated the Central Bank in the issuing of its governance guidelines. Another major factor is the Bank's acceptance of and desire to comply with the BIS Core Principles (CP) for banking supervision. For example the CP requires supervisors to ensure that banks, amongst other things:

- establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and adequacy of loan loss provision and reserves;
- have MIS that enable management to identify concentration risks and that it sets prudential restrictions on lending to a single borrower or group of related borrowers;



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- have in place systems to accurately measure, monitor and control market risk;
- have in place a comprehensive risk management process (*including appropriate board and senior management oversight*) to identify, measure, monitor and control all other material risks and where appropriate hold capital against these risks; and
- have in place internal controls that are adequate for the nature and scale of their business And appropriate independent internal and external audit and compliance functions to test adherence to the controls as well as applicable laws and regulations.

Additionally in September 1999, BIS issued a statement dealing specifically with corporate governance, the critical elements of which are encapsulated in the Central Bank's guidelines.

At this point it should be clear that the imposition of the governance guidelines by the Central Bank is intended to play a fundamental role in the successful supervision of its licensees. What better means is there of ensuring that there is effective risks management, within an institution, than explicitly placing the responsibility at the feet of the board of directors? Understanding these issues should dispel any uncertainty or nagging doubt as to the need or wisdom of promulgating the guidelines. The effective implementation and monitoring now takes center stage.

Let us now attempt to answer the questions that were asked earlier. The answer to the first questions holds a number of revelations for the others. It should be noted that entwined in the Central Bank's guidelines are many nuggets of information which provides broad answers for the questions posed. It requires a careful and diligent review, with the objective of isolating individual items in order to obtain a clearer picture of exactly what is required and what needs to be done.

Documentation of the Governance Process

Firstly the system of governance should be clearly documented. The Central bank guidelines clearly states that "the organization's corporate governance process should be effectively communicated to its appropriate internal and external stakeholders". From this one can reasonable infer that the best means of proving this communication is the ability to provide document together evidence that it has been made available across the organization. The document is not explicit on whether or not this ought to be written, but for practical purposes it would be difficult to fulfill the requirement for disclosure to external stakeholders, of which the Central Bank is one, otherwise.

A properly documented corporate governance framework will define, amongst other things, the: unambiguous role of management (day-to-day management and execution of



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strategic plans and programs) versus the functions of the board (responsible oversight); define independence of directors and outline the composition of the board; size of the board and the selection process; ethics and conflicts of interest; succession planning; board's access to senior management and independent advisors; mandate of the board and each committee; reporting relationships; and evaluation of the board, committees of the board, individual directors and senior management.

It may be possible to argue that there is a well communicated governance process within your institution. However, it may be extremely difficult to prove this if there is no documented evidence. Documentation does two things, it demonstrates a genuine commitment to the process and it provides a basis for analysis of the design effectiveness of the governance processes. This point is by no means proposing a "one book" approach. How an institution chooses to document its processes is totally up to management. The author would however, recommend that there is at least one high level document which is made available to each director of the board. Compliance ought not to be difficult; it lies largely in understanding what is required and then creating frameworks and systems within the organization to address the requirement.

Composition and Operation of the Board

One of the most straight forward elements, which can be gleaned from the document, is that the board must have non-executive directors (NED). This is maybe one area in which the Central Bank could provide further clarification. The guidelines fail to elaborate the extent to which these NEDs are required to be independent and whether executives of parent or affiliated entities would qualify as being independent. Given the extent of foreign ownership in a number of Central Bank licensees, an interpretive or clarifying note relative to this area could be useful. Despite this, however, it is clear that in order to be in compliance, the board should not be composed of only executive directors. Best practice governance principles recommend that the majority of board is composed of independent directors.

Independence is a critical issue. The institutions should be able to prove that it has the requisite mix of executive and independent non-executive directors. There is a school of thought that independence of mind is more important than the actual relationship. However, page sixteen of the guidelines gives an indication of the Central Bank's thinking when it outlines that "*members of committees are considered to be independent if they have no relationship to the organization that would interfere with the exercise of their autonomy from the organization and its management*". This closely mimics the definition used by the New York Stock Exchange (NYSE) to define independent directors. The NYSE listing requirements indicate that a director is independent where his only relationship with the company is that of him being a director. This is an extremely high standard and could prove onerous within the Bahamian context. While the author agrees with its application for certain committees such as say an audit or



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governance committee, a lesser standard, determined by the board and generally acceptable to the Central Bank, could be applied.

To a large extent the Board's and its committees "independent approach" to the business of the institution will be gleaned from minutes of meetings. It is therefore critical that the minutes of these meeting fully reflect discussions taking place and have the ability to demonstrate directors' focus on the critical risk facing the business, given its import to good governance. Minutes also serve to highlight the fact that the board is sufficiently challenging the representations of executive management. One other aspect that the minutes should capture is the confirmation of control functions to the Board by executive management and independent functions such as internal audit, compliance and should also documents discussions with external auditors.

The Central Bank guidelines mandate that the board meets a minimum of four times per year. Therefore there must be a minimum of four minutes to evidence this. The minutes together with Board papers and evidence of presentations by management, as required, will be pivotal to satisfying questions on the effectiveness of the board as the steward of the governance process.

Risk Management

Let us now turn our attention to what can be considered to be the most critical area of the guidelines. In order to be compliant the licensee must be able to provide evidence that it is able proactively identify and understand the significant risks that it faces in achieving its business objectives through its business strategy and plans, as well as to be able to demonstrate appropriate, effective and prudent management of those risks. The statement itself holds a number of clues as to how this can be demonstrated.

While insiders may know the business and are fully aware of the risks, the question here is how do you demonstrate this to an external party? The place to start is the strategic plan of the institution. The institution will need to firstly clearly document its individual business objectives as articulated by the strategic plan. For each of the identified business objectives, there should then be a careful analysis and documentation of the critical risks attached to the achievement of each. This presents a high level profile or risk matrix against which the control program of the institutions should be aligned. This process essentially covers risk identification. The institution should then measure the likelihood of a particular event (risk) happening together with the impact on the institution, financial or otherwise. The next step would then be to indicate what the control objectives are (for example, to prevent the institution being used for money laundering) and the control activities employed to manage these risk. The question maybe asked why it is important to state the control objective. The simple answer is - it must be firstly demonstrated that the control objectives are the right ones and that they are prudent and consistent with the risk profile of the institution. Therefore, the ability to



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demonstrate that the controls have fulfilled the noted objective puts an institution in a good position to demonstrate that its risk management process is effective.

One very effective means at of analyzing controls is to break them out into three broad categories, being: to ensure effective financial reporting; to ensure compliance with laws and regulations and thirdly to ensure operational effectiveness. By using these broad categories, which represents the end product of risk management and internal control systems, the institution should be able to gauge how relevant the control objectives are and also how effective it's internal control and by extension risk management framework is.

The framework described thus far is will be sufficient for most institutions. It however has to be augmented for others. This is especially true for clearing banks or other institutions which takes deposits and undertake lending activities. Liquidity risk, credit risk and interest rate risk (to a lesser extent in the Bahamas) must be dynamically assessed as there are a myriad of factors which can move the institution to an adverse position relative to these elements. The institution should therefore have in place tools, preferably information technology based, which is able track for example the attributes of its loan book; the maturity of its assets versus its liabilities; the risk sensitiveness of its balance sheet; and which have the ability to quickly assess the adequacy of regulatory capital or minimum capital requirement. The last factor is not only important from a risk management point of view but could be extremely useful to management as it analyzes scenarios in a bid to make more effective use of its assets.

Other risks categories, as outlined in the Guidelines, include market, compliance, reputation and legal risk. One risk area that oftentimes tends to get overlooked or down played is operational risk. The lack of attention to this area could render an otherwise sound system ineffective. People risks which deals mainly with the competency and performance of employees, is considered a sub-component of operational risk. It is an aspect that will be assessed both in determining the effectiveness risk management. This is critical as the ability of individuals to properly execute their tasks ultimately impact the effective operation of controls which is necessary to foster good corporate governance. Management of financial institutions must therefore ensure that they have the right persons in place that can properly carry out the day to day activities of the business.

On page eight (8) of the guidelines it is outlined that the institutions need to put in place "comprehensive contingency plans, addressing all significant risks identified in the organization, which should be and tested and regularly updated". The statement is very clear and speaks for itself. It however, refers to an aspect of risk management which frequently tends to go neglected. Management must ensure that where required there are adequate contingency arrangement is place in place. Contingency plans should be written and approved by the board



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Review and Monitoring

The guideline states that each licensee must implement an effective process to independently determine that risk management system is appropriate and ensure that its effectiveness is regularly assessed – This is a very important area. The guidelines is mandating that an independent function or party reviews, on a regular basis (not defined but should be read as at least annually), the accuracy and reliability of management information systems, timeliness and relevance of risk analysis and reporting and the thoroughness of control standards, processes and programs. The document goes on to indicate that where the size and nature of the business warrants it there should be independent and separate risk management and internal control functions. In cases where there is an internal audit function it would be expected that this would be the independent function which carries out these reviews as noted above.

What then of institutions that do not have such functions and it is not considered warranted to have them? It would be safe to assume that the institution may use an external party or it may chose, for practical reasons, to utilize its compliance function. The Financial Transaction Reporting Regulations requires all Central Bank licensees to have a compliance officer and as such all institution will have at least a compliance function. The critical issue here is independence. Therefore, as long as the requisite level of independence is maintained and the individual/function posses the requisite skills to adequately challenge and assess the systems the institution should be in a position to achieve compliance with this stated requirement.

The working papers and reports relative to this review process are very important in providing evidence of work done. A lack of documentation may be taken to mean that no work has been done. Improper documentation carries its own implications. It is safe to assume that a lot of emphasis will be placed on the effectiveness of the independent function, the competence of the employees in this area and the whether review function has the requisite skill set, having regard to the institutions business and risk profile, to adequately challenge the internal control system.

Other than the work of internal auditors or compliance personnel, the management of each functional area should be confirming the effective operation of the control in his area of responsibility. This communication, which can be obtain through control self assessments, should be carried out at regular intervals, agreed by the board and senior management, and communicated up the various levels of the organization and ultimately to the board. Obviously what gets to the board will be more high level than that which gets escalated at each tier of management

Text on page four (4) of the guidelines indicates how the board will keep itself informed about the various aspect of the governance process. This effectively lays the foundation for the annual certification that they will give to the Central Bank. The document clearly



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outlines that the advice of management will be relied on in making the determination. This position accurately captures the interaction between management and the board of any institution. Boards are not and should not be expected to delve into the micro aspects of the operations. Their role and responsibility is one of oversight and supervision to ensure that adequate systems are in place and working; to ensure that they are consistently kept abreast, by executive management, of the performance of these systems; and that management is taking the requisite steps in monitoring and identifying weaknesses and taking remedial actions as required.

Review and Testing

In broad terms we have answered the first two questions. We have analyzed what needs to be present to evidence the governance process and the fact that there should be an assessment, internally, to facilitate the Board's certification. Let's now look at the next question which contemplates how it will be tested. The step which follows represents the author's ideas and should not be taken as any methodology which will be employed by the Central Bank or a suggestion which covers all possibilities.

It is envisioned that the regulators could possibly employ some of the following procedures in carrying out its assessment of the effectiveness of institutions corporate governance:

- Determine whether the Board and its committees have established appropriate written charters and whether their mandates been effectively communicated to management and employees;
- Assess the composition of the Board (and its committees), including the independence of its members and size;
- Assess the process by which Board members are appointed, including succession planning for Board and committee members (this can be a very sensitive area but which must nonetheless be given due consideration);
- Assess the processes used by management to educate and keep the Board informed on business activities, the industry and important regulatory requirements/changes;
- Assess overall Board function including the process for determining priorities and setting agendas, the timeliness, relevance and quality of information provided to the Board;
- Assess the processes used by the board and its committees to obtain assurance as to compliance with laws, regulations and policies, the quality of discussion and debate at board and committee meetings;
- Assess the process for agreeing on the objectives for the managing director/president or chief executive officer and how the individual's performance is assessed;
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- Assess the process by which the Board assesses: the board as a whole; the committees of the board; and the contribution of individual directors; and
- Assess the process for reporting and discharging accountability of: management to the board and committees to the board.

Additionally, an assessment is likely to be made of the risk management systems in place. The issues discussed (see risk management section) will be look at critically to ensure that the measure up to the required accepted standards. It has been argued that there exist a high level of subjectivity with the governance process. While this is an accepted position as no two organization will implement its corporate governance in the same way the level of subjectivity can be addressed by focusing on the risk profile of the institution paying special attention to its critical risks. This is why it is critical that management has a clear analysis of its business objectives and the risk attaching to them.

It should be expected that the policies and procedures implemented by management will be reviewed and assessed for design effectiveness. The link here to earlier discussions is that these documents should encompass the control activities design to address identified risks. The examiners may then attempt to determine whether these procedures are operating properly. It is a combination of the design and operating effectiveness together with the effectiveness of the monitoring activities by management and any independent review function which will determine a pass or fail grade in this area. These steps assume that the examiner would have been already satisfied with the risk identification and assessment steps are adequate.

One also can expect a significant emphasis to be placed on the work of the audit committee. In the absence of the audit committee this should default to the entire board. Given the audit committee's importance to the financial reporting process and, normally, its oversight of the independent functions within an institution, it should be expected the examiners will seek to determine how well they execute their responsibilities. The effective performance of the role of the audit committee could have a direct and proportional impact on the effectiveness of the governance process.

A comprehensive analysis will entail a review ethical values and practices, and culture of the institution. The existence of a code of conduct will be useful to demonstrate how this issue has been addressed by management and the board.

Having made the forgoing points it is prudent to provide a cautionary note that in the same way that there is no one size fit all approach to corporate governance, so too will there be no one rigid approach to its testing or review.



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Conclusion

With literally only days to go before the end of the year, all institution should have already taken the necessary steps to prepare and if they have not already done so, start carrying out their assessment. It is highly recommended that the requirements of the guidelines are not taken for granted. The effective implementation thereof not only augers well for an effectively managed institutions but will provide a sound foundation for the implementation of other regulatory requirements which are currently in the pipe line. These include the new Basel capital Accord (Basel II) and minimum capital adequacy requirement; the Central Bank's proposed requirements for enhanced disclosure; enhanced requirements as it relates to management of credit risk and more specifically provisioning guidelines. Implementation of an effective governance system should not be only for the sake of complying with the requirements of the Central Bank but should be seen as fostering the discipline necessary to operate in a very risky sector together with fulfillment of an explicit obligation of the board to its shareholders and other stakeholders. If these factors are not sufficient motivation it will be useful to remember that a failing grade on review has both corporate and personal implications.

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