



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)



PRESENTATION BY

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**AT THE BAHAMAS ASSOCIATION OF COMPLIANCE OFFICERS
LUNCHEON**

**TOPIC: *"Achieving your Board's Certification in Compliance with
the Central Bank's Corporate Governance Guidelines"***

JULY 1, 2003

NASSAU BAHAMAS



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Madame President, fellow Excom members, ladies and gentlemen, it is indeed a pleasure to be invited to speak to you this afternoon on the issue of corporate governance. The topic is undoubtedly timely and discussion necessary as we draw increasingly closer to the end of the year. It is at this time that the requirement for certification as outlined in the Central Bank of the Bahamas Guidelines will crystallize. It is also at this time that the typical Bahamian boardroom will, in my mind, be forever changed.

Today I want to explore with you some of the issues that will be pertinent and critical in this certification process. First we will briefly explore some of the **concepts** of corporate governance. And then we will talk about some of what I consider to be the **practical steps** that the board and management must take in order to:

1. Make the assertion on the effectiveness of its governance process; and
2. Obtain a concurring statement from its external auditors.

We will then have a short discussion on the need for a framework and talk about one such framework which could assist institutions in **achieving effective governance through proper risk management**.

Before going further into the issue at hand let me advise you that fundamentally all I will say today hinges on one important pretext. That is – The Board of directors is ultimately responsible for every aspect of the financial institution and should at all times be comfortably “in control” of that financial institution. Additionally, it is my position that the Central Bank’s Guidelines are compliant with **internationally accepted principles** in all material respects.



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The **Cadbury** report from the UK, considered one of the hallmark reports on corporate governance, succinctly defines corporate governance as the *systems by which companies are directed and controlled*. There are many other more complex definitions. However, I choose this one because of its simplicity. Good governance it follows therefore is having *effective systems which facilitate control and direction of the institution*.

According to the **OECD Principles on Corporate Governance** – a corporate governance framework should, amongst other issues:

- Protect shareholders right;
- Ensure equitable treatment of all shareholders, including minority shareholders;
- Recognize the right of stakeholders as established by law; (make the link to CBB as a stakeholder)
- Ensure that timely and accurate disclosure is made of all material matters regarding the corporation; and
- Ensure that there is strategic guidance of the institution, effective monitoring of management by the board and that the board is accountable to its shareholders.

The systems of which I speak before can broadly be placed into three categories: **financial, operational and compliance**. It is along these lines that fundamentally the whole system of corporate governance is based. An entity should have adequate systems which ensure the **integrity of financial reporting**. There must be sufficient and **effective operational systems which manage the risks** associated with the operational aspects of the business. And finally there must be systems in place to ensure that the



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institution is complying with the relevant legislation and regulations together with internally imposed policies and procedures.

Some of the areas of risks, and these are clearly outlined in the Central Bank's document, are:

- Credit risk
- Liquidity risk
- Operational risk
- Technology risk
- Compliance risk

While the exacting nature of these risks differs from one institution to the next, there are elements of commonality across all financial institutions. More importantly it is this aspect of a business that at a rudimentary level, the principles of corporate governance speak to. The institution's ability to demonstrate effective control and effective adherence to the principles of corporate governance is intrinsically tied to its ability to demonstrate sound and proper management of the risks posed as a result of its business objectives.

We need now to necessarily make the linkages that exist with respect to:

- Governance, the overall means by which the organization is managed and directed;
- Risk Management, the essential anchorage of corporate governance; and
- Internal Controls, the building blocks of Risk Management.



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It is extremely important that this connectivity be clearly understood, because here in lies the roadmap which will enable you to get to the point of confidence necessary for making this very critical assertion to the Central Bank.

Its now time to turn our attention to the essential matter we are here to discuss today. How will your board of directors be in a position to provide the certification required by the Central Bank?

One of the first thing to recognized is that there are some minimum standards set by the guidelines which must me considered as being prescriptive in that regard. For example there must be a minimum **of four quarterly held board meetings per year**. Otherwise the guidelines are “principle based” and therefore it is compliance with the spirit as opposed to the letter of the guidelines which is most important. For example, it is not sufficient to have a written standard of ethics, when those ethics are not obvious throughout the institution.

In order to demonstrate that the **right control environment** is being fostered, ethical standards enforced, that there is **effective supervision of senior management**, and the existence of **adequate risk management systems**, the board and senior management must be able to comfortably answer some important questions.

- Does the Board have full and effective control over the bank through the monitoring of management and ensuring the implementation of its plans and strategies?



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- Has the Board defined its levels of materiality, reserving specific issues or items which it must be deal with?
- Has the Board identified, and does it monitor, the non-financial aspects relevant to the business of the institution?
- Has the Board implemented a “Standard of Business Conduct” and “Code of Ethics” as part of its governance process?
- Do we fully understand the broad strategic objective of our institution?
- To achieve the broad plan, what are the specific business objectives that must be achieved?
- What are the critical risks associated with the achievement of these objectives?
- Do we have control systems in place to address each of the identified risks attaching to these business objectives?
- Do we have a robust risk management and internal control systems?
- Does your Board take responsibility for the Risk Management process and its effectiveness?
- Does your Board set risk policy and strategy with executive directors and senior management, which is communicated to all employees and incorporated into the culture of the institution?
- Has the Board appointed either a specific committee or one of its other sub-committees, to assist in reviewing the risk management process and the significant risks facing the institution?



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- Does your Board ensure that a formal risk assessment is undertaken at least annually?
- What are the major risks to current business and how is each of the risks addressed/managed?
- What are the main business objectives at this point and the risks/impediments to achieving them?
- How are the common risks (credit, market, operational, liquidity, exposure concentration, capital adequacy, etc.) managed?
- Are there things that you are concerned about with regards to risks and management thereof?
- Is the monitoring mechanism effective in reviewing and challenging the systems of controls in place having due regard to the dynamic nature of the environment?
- Are there effective communication and information systems which would ensure that all critical issues are properly reported to the board on a timely basis?
- Do the directors have the pre-requisite background, knowledge and understanding of the conduct of business of the financial institution and the risks posed by its operations?
- Does the Board have an assessment process for board of directors individually, the Board as a whole and also very importantly, senior management?



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- Has the Board established comprehensive contingency plans addressing all significant risks identified in the financial institution?

This takes us therefore to two very fundamental issues.

1. How do you put your institution in a solid position to answer these questions?
2. What will be your benchmarks?

Here are a few suggestions which address the first issue:

- Design a plan which will enable you to make a full assessment of the systems within your institution. Both specifically and then in aggregate. It is important that an aggregate view be taken as this is essentially the difference between say a sound internal control system and good governance. They are not one and the same but essential parts of each other.
- Take time to “re-understand” your entity’s business;
- Assess each directors level of comfort with the current effectiveness of the corporate governance systems;
- Assess the availability of evidential material which will be used to corroborate the assertion [e.g. Minutes of meetings – do they show in sufficient details what is being discussed , directors handbooks, manuals, compliance/internal audit reports and plans – do they show an appreciation for risk and are driven by the business objectives. etc];
- Review policies and procedures to ensure that they are adequate to address the risk posed by your business;



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- **Review the design and operating effectiveness of internal controls;**
- Where applicable, the board should be speaking with internal audit and compliance to gauge their initial assessment; and
- Involve professional advisors to the extent you consider necessary.

Let us now turn our attention to the second issue at hand. While there has yet to be a finite standard or guidance which will assist in the assessment and evaluation of internal controls system and by extension risk management, I am sure in due course some organization representing the banking and/or accounting profession, with the blessing of the Central Bank will put forward some recommendations. Given that we are very close to the point of certification I suggest that any prudent board should be proactive in seeking out a framework that will assist it and its organization to “get ready” for that defining moment.

The framework I want to propose to you is the Committee of Sponsoring Organizations (COSO’s) Internal Control Framework. In 1992 the Treadway Commission was set up in response to a spate of financial reporting fraud in the US in early to mid eighties. This commission was sponsored by organization such as the IIA and AICPA among others. Hence the name Committee of Sponsoring Organizations.

This framework is adequate in my view simply because it is authoritative, widely accepted and is currently being used in the USA and wherever there are SEC registrant companies, as the workbench, to assess internal controls and corporate governance issues mandated by Sarbanes Oxley Act 2002. I am sure that all of you are acutely aware



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that the Sarbanes Oxley Act was penned, following some of the largest corporate scandals in history, to address the exact issues that we are facing today with the Central Bank's Guidelines. The COSO framework, while it may require some level of analysis to work with, provides the most viable benchmark, at this time, against which your internal control and risk management systems can be assessed. While I will not delve too much into it today, I wish to highlight and discuss briefly the main characteristics of COSO.

COSO defines internal controls as: *A process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives.*

COSO has outlined three stated objectives for a business. These are: *Effectiveness and efficiency of operations; Reliability of financial reporting; and Compliance with applicable laws and regulations.*

By analyzing these two aspects together you will undoubtedly see that the approach COSO takes makes it uniquely useful in corporate governance application.

COSO's framework is broken down into five components. They are:

- **Monitoring** - The purpose of monitoring is to determine whether internal control is adequately designed, executed, effective, and adaptive.
- **Information and Communication** - Information and communication requires that relevant external and internal information be identified, captured, processed, and communicated throughout the organization in a timely manner



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- **Control Activities** - Control activities are policies and procedures that help to ensure that actions identified to manage risks are executed and timely.
- **Risk Assessment** - Risk assessment starts with identifying risks associated with business objectives linked through all levels of the organization.
- **Control Environment** - The control environment is the control consciousness of an organization; it is the environment in which people conduct business activities and fulfill their control obligations.

Conclusion

In closing, the challenges posed as a result of the central Bank's Guidelines and specifically the need for certification can be numerous, but they are not insurmountable. Proper preparation coupled with the prudent processes which the board and senior management ought to have already in place, should ensure that every board of directors of financial institutions will be in a position to provide a positive certification.

However, be warned, nothing should be taken for granted. The fact that auditors will need to independently reaffirm the position taken by the board supplants a significant risk for there to be disagreements of opinion in the face of lack of sufficient evidence to support the position taken. How will any such disagreements, if any, be resolve is not yet clear but I anticipate that any such existence is going to create some serious anxieties among the institution, the auditors and the Central Bank.



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The new focus on corporate governance is a positive step. The Bahamas can not afford to have any significant shocks within its financial system caused by failing institutions. It means therefore that the emphasis is here to stay and each board of director and senior management has a vested interest to ensure that their institutions are properly managed. As outlined in the Central Bank's Guidelines, not only will inability to get a positive confirmation affect the institution, it will also bring into question the ability of those entrusted with its stewardship to continue to function in such positions. It therefore behooves you as compliance officers, senior management personnel or directors to ensure that you are in compliance with the regulations. Especially for the directors, the stakes are high and there is a significant downside to not getting it right.

I implore you, for the sake of yourselves, for the sake of your institutions and its shareholders, for the sake of the Bahamas and its fragile financial systems; let's endeavor to get it right.

Ladies and gentlemen, thank you for your attention.