



Lignum Vitae - "Tree of life"

The Risk & Regulatory Forum (TRRF)

CORPORATE GOVERNANCE AND THE BAHAMIAN FINANCIAL INSTITUTION

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Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board of directors, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. ***By doing this, it also provides the structure through which the company's objectives are set, and the means of attaining those objectives and monitoring performance.*** The board of directors provides the engine that drives the corporate governance process.

The regulatory framework in The Bahamas has gone through some dramatic changes. The obvious movement to "first world standards" coupled with the recent developments on the international scene, has made it evident that the current emphasis on corporate governance is here for the long term. The role of the director, especially independent directors, will be placed under more intense and closer examination by regulators and in due course by other stakeholders of the organization. Stakeholders are now becoming more aware of issues which are critical for the effective operation of the organization and have therefore started to challenge how effectively the board executes its responsibilities. This is evidenced by the recent response of minority shareholders to a recent corporate transaction and the subsequent flurry of commentary that the issue generated calling for legislative and regulatory amendments to protect the rights of those shareholders. In the final analysis, it is important to remain ever cognizant of the fact that one of the main responsibilities of the board is to ensure that the operation of the financial institution is properly organized so as to bring value to the shareholder. This must be counterbalanced against the need to comply with regulatory requirements. It is important also that effective, prudent and ethical management not be sacrificed for increased profits. Regulations, however, should not be an impediment to the ability of an institution to operate efficiently and profitably, thereby enhancing its ability to continue as a viable entity.

In December 2001, the Central Bank of the Bahamas (the Central Bank) issued its guidelines on corporate governance for its licensees. The promulgation of these guidelines has understandably caused a certain level of anxiety within the financial services industry and in some cases, the necessity of the guidelines has been questioned. From the point of view of the Central Bank fulfilling its mandate of ensuring that The Bahamas maintains a safe and sound financial system, the answer any questions is that it is absolutely required. The Central Bank, as a regulator is influenced to a large extent by the guidelines of the Basel Committee on Banking Supervision (Basel). In September 1999 Basel published its guideline "Enhancing Corporate Governance for Banking



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Organization". This document states that "supervisors should be aware of the importance of corporate governance and its impact on corporate performance. They should expect banks to implement organizational structures that include the appropriate checks and balances. Regulatory safeguards must emphasize accountability and transparency. Supervisors should determine that the boards and senior management of individual institutions have in place processes that ensure they are fulfilling all of their duties and responsibilities". Analysis of the Central Bank guidelines will show that it is consistent the general principles of the Basel document. Indeed the guidelines of the Central Bank is generally consistent, in principle, with international best practice requirements suggested by authoritative bodies such as the OECD, The Business Roundtable from the USA and listing requirements of various stock exchanges throughout the world.

Admittedly there is yet to be a clear consensus on issues such as what should be reported to the Central Bank and the format of those reports. This together with the perceived need for more specific guidance on some of the issues may have caused a level of apprehension and uncertainty. This though does not negate the importance of the requirements. It, however, clearly makes the case for the need to urgently address that particular aspect of the regulations. The emergence of such guidance will undoubtedly serve to clarify any doubts and remove any perceived disconnection between the concept of effective corporate governance, what the Central Bank guidelines sets out to achieve, and the fundamental elements necessary for prudently run business. Critically the point that needs to be accepted is that corporate governance is not an end in itself neither does the various aspect of corporate governance exist in an isolated or disjointed manner.

Examination of the opening paragraph provides an insight into exactly what the concept entails. While it can be argued that the point articulated there is significantly an academic definition, careful attention should be paid to area which speaks of the objectives of the organization. This is fundamentally what corporate governance is about. Remove all the peripheral issues and at the core of the various pronouncements, it is how the organization set its objectives, the means of attaining those objectives, the identification and management of the risks to achieving those objectives and the effective monitoring and reporting of the organizations performance in addition to the corporate culture engendered by the board and senior management. It is very easy to use the term "corporate culture" loosely as there is no one size fit all situations. In relation to effective corporate governance it speaks is to a corporate climate of sound business activities and procedures, consistent with those generally accepted within the industry of being "best practices", where integrity and ethical values are regarded with the utmost importance and the institution, by its actions, demonstrates the acceptance of its obligations as a good corporate citizen.

If the argument just put forward is true, then let us pose two questions. Is the promulgation of corporate governance guidelines an important and critical element in the supervision of the industry? And secondly, why would every financial institution not be in a position to easily fulfill the directive of the Central Bank? The answer to the former question is quite straight forward but for some very practical reason, the latter is not. The



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answer to the second question lies primarily, not in what is being done but the ability of the organization to provide sufficient evidence of these activities. The evidence will need to be in a structured, formal and articulate form and should have been formally communicated, representing the current practice and processes of the financial institution.

In 1992 the Committee of Sponsoring Organization (COSO) of the Treadway Commission, set up in response to a spate of financial reporting fraud in the US in early to mid eighties, published the document - "Internal Control – An Integrated Framework". This framework has become one of the most authoritative standards, not only in the USA, for the implementation of internal controls and the evaluation thereof. Analysis has shown that the COSO framework is very consistent with the recommendations of the United Kingdom's Cadbury Commission which is viewed as the *magna carte* of corporate governance. COSO defined internal controls as a *process designed to provide reasonable assurance regarding the achievement of business objectives*. It further noted that controls are designed to achieve three broad objectives, namely, to promote effectiveness and efficiency of operations, to ensure reliability of financial reporting and to maintain compliance with applicable laws and regulations. Essentially, internal control helps an entity get to where it wants to go and avoid the pitfalls and surprises (manage risk) that may occur along the way. The relationship is so profound that the US regulators have mandated that COSO [or in Canada a similar framework - Criteria on Control Committee (COCO)] be used as the basis for both management and auditors attestation (*confirmation*) requirement on the effectiveness of internal controls under section 404 of the Sarbanes Oxley Act.

These latest points when combined with the discussion, at the beginning, on the objectives of corporate governance, highlight the fact that the implementation of appropriate internal controls is the first bedrock of a governance system. Making the connection between the objectives of a business and the management of the risk of obtaining those objectives is very critical. This should be viewed against the back drop of the risk centricity of corporate governance and the importance of internal controls in the risks management. The argument further brings out the point that treating corporate governance as an issue in itself is both unwise and is very likely to lead to a suboptimal achievement of the fundamental principles of the Central Bank's guidelines. It is important that the associations are clearly seen and acknowledged.

With the framework of internal controls there are five widely accepted and important components. These components are the control environment, risk assessment, control activities, information and communication, and monitoring. These components can be easily linked or interchanged with, for example, the role of the board of directors and their responsibility together with senior management for setting the "tone at the top", risk management, annual reviews and reporting, internal processes and systems and organizational structure typically discussed relative to corporate governance.

It follows logically then that the presence on an effective internal controls system should be the first issue to be addressed by management of financial institutions in its bid to



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comply with the Central Bank's requirements. The application of the guidelines or any similar guidance document (any other document used should be at least as stringent as the Central Bank's, not less so) will then provide the road map which should ensure that overall governance process has the other critical ingredients necessary to be effective. It is difficult to perceive an effective governance process without robust system of internal controls and risk management. Unfortunately both of these elements could exist and yet an effective governance process is not achieved. Herein lays a serious dilemma for management. This is why it is important, as mentioned before, to analyze the systems individually while recognizing that they are a part of a larger puzzle and will require reevaluation, as a whole, before satisfaction can be gained and hence provide the basis for any attestation. The intricate interwoven links of these important elements necessary for the effective management of a financial institution dictates that this both a specific and a holistic approach be adopted in implementation, enhancements and evaluation. Recognition and acceptance of this reality will be central to the compliance with the Central Bank's regulation.

The board of directors is ultimately responsible for the performance of the financial institution. The fact that the Central Bank has now mandated an attestation from the board together with corroboration by auditors is a clear signal that the days of not "being fully involved" is over. The guidelines explicitly states that failure to adhere to the basic principles of the guidelines calls into question the satisfaction of criteria by the financial institution for continued licensing. It also states that this situation raises questions of the suitability of persons to continue serving in the capacity of director and senior management of a financial institution. The stakes have been raised significantly but not out of reach. It is imperative therefore, that the boards of directors and senior management of financial institutions put themselves in the best position, early, to be able to establish compliance with the guidelines.

By embracing the essential tenets of both effective internal controls and corporate governance principles, together with a viable and pragmatic plan, this can be achieved.

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