Central Bank Expectations and Corporate Governance

Address by Nicola Virgill-Rolle, Assistant Manager – Policy, Central Bank of The Bahamas, to the Bahamas Director's Forum on Corporate Governance
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Ladies and Gentlemen,

It is a pleasure for me to speak to you today on the subject of Corporate Governance and the Central Bank's expectations. This topic is particularly relevant to this audience as many of you serve as directors or senior executives of financial institutions or serve as external auditors of Central Bank licensees. As such I am sure that you are all eagerly looking forward to our April deadline for the submission of the board certifications.

My address today will, of course, focus on these important certifications; but I will also go deeper into the broader expectations of the Central Bank in relation to the sound corporate governance of our licensees.

The Governor indicated earlier today that the banking sector, as the major holder of the nation's financial assets, presented the largest potential for risk for financial and reputation losses in the event of a corporate governance failure. As such, it was important for the Central Bank to put in place a structure for the ongoing monitoring of licensees' corporate governance frameworks and also for ensuring 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 corporate borrowers produce financial statements, in some cases 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 to improved governance among the ordinary, unlisted firms, which make up the majority of firms in The Bahamas,.

Therefore, this issue of Corporate Governance is not just an international standard of little meaning, it is imperative that we continue our work in this area and that sound Corporate Governance continues to progress in our system at every level.

The Governor had also mentioned that at the heart of The Central Bank's Corporate Governance initiative was the issue of Director Responsibility and Accountability. The Bank's Corporate Governance Guidelines mandate the submission of an annual certification from the Board, 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 will be 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 deposits, 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.

The Board Certification

The Central Bank has provided licensees with a model text of the Board Certifications as follows,

(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 Central Bank wishes to ensure that the board has 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 deficiency 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, 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, the decision to create specialized committees to address credit risk policies, liquidity risk management issues, or the bank's internal and external audit functions is necessary. The Central Bank in its assessment of the structure of the board and the board committees will assess whether board structure is appropriate to the complexity of the licensee's operations. In particular, we 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.

- As the Governor mentioned earlier, each director and senior officer goes through a rigorous fit and proper assessment by the Central Bank. 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 Oxely 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 outside director.
   - There are many competing theories when it comes to outside directors. Some posit 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.

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. The Central Bank would like to see 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.

6. **We would also want to see that management follows through on the board's recommendations. [How will this be assessed?]**

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;
    - Approving objectives, strategies, plans, and operating policies, standards, and procedures;
    - 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;
    - Ensuring and monitoring that the organization conducts its affairs with a high degree of integrity;
    - Reviewing the organization's business and operating performance;
    - 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 should indicate that it has evaluated and is satisfied with the adequacy of the bank's capital given the nature and level of the risks in the operations. Where the board is not satisfied, then a capital augmentation strategy should be activated. I can recall at one meeting with a licensee, I was delighted to hear a board member discussing the proposed Basel II capital accord. It was reassuring, that our board members are keeping up to date with such an important issue and therefore could begin to prepare the organization for the required changes.

Conclusion

The Central Bank's Corporate Governance Guidelines and the upcoming board certifications and have resulted in a change in the status quo. The <u>important role</u> and <u>awesome responsibility</u> of the board have been highlighted This is the intention of the certifications – we wanted board members to state **and** to certify that they are satisfied with the state of governance in their respective organizations.

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 Oxely which can into force in 2002 we see that the United States went even further.

Sarbanes Oxely 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.

Ladies and Gentlemen, thank you for your attention. I hope that I have provided you with insight in to the rational for the Central Bank's board certification process and our expectations. We look forward to receiving them over the next few months.

Thank you.

[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.