

## **The Role of The Regulator in Corporate Governance**

Address by Julian W. Francis, Governor of the Central Bank of The Bahamas, to the Bahamas Director's Forum on Corporate Governance  
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Ladies and Gentlemen,

It is indeed a pleasure for me to address you today on the subject of Corporate Governance and the Role of The Regulator. Corporate Governance is also an issue which is at the forefront of the policy and examination work of the Central Bank, in its capacity as supervisory authority of the banking and trust sectors in The Bahamas. It is obviously of fundamental importance to this audience, given that many of you serve as senior officials and directors of Bahamian companies.

In the past, Corporate Governance used to be a loosely defined subject with elements scattered in Company Law, accounting standards and the fit and proper, internal controls and licensing guidelines of various financial sector regulators. However, since the late 1990s the concept of Corporate Governance as “the processes, structures and information used for directing and overseeing the management of an entity”, began to crystallize.

In 1998, for example, the Commonwealth Association for Corporate Governance was established to :-

- (a) promote best international standards on corporate governance through education, consultation and information throughout the Commonwealth as a

means to achieve global standards of business efficiency, commercial probity and effective economic and social development; and

- (b) To facilitate the development of institutional capacity that promotes good corporate governance by education, consultation and information in all Commonwealth countries.

The organization published its principles on Corporate Governance in 1999. In that same year, the OECD published its principles for corporate governance and the Basel Committee for Banking Supervision followed with specific recommendations for banks. In the years to follow, a plethora of academic papers on the importance of corporate governance were published.

Nevertheless, until the scandals and corporate failures of Enron, Tyco, and WorldCom, Corporate Governance did not receive much public attention and certainly no newspaper headlines. With these major scandals on every nightly news broadcast, the concept and importance of corporate governance became relevant to the everyday man on the street.

Indeed, the resulting civil lawsuits and criminal prosecutions of CEOs, CFOs, audit partners and directors certainly made those senior executives of corporations aware of their responsibilities and accountabilities. Additionally, the substantial losses to the affected economies, both in terms of financial assets and credibility, prompted those with responsibility policy makers – government and regulators to act swiftly and decisively.

The Brookings Institution (Policy Brief #106 “Cooking the Books: The Cost the Economy) has produced an interesting paper on the costs of corporate governance failures to the US economy. Their research indicates that the costs of Enron and WorldCom alone are estimated at \$35 billion or 0.34% of US Gross Domestic Product in 2002 alone. There were also other effects on foreign investment, the stock markets, consumer and investor confidence and regulator credibility.

The Corporate Governance failures of these few large US Companies provided the impetus for one of the most far reaching pieces of legislation in US commercial and financial law history – the Sarbanes- Oxley Act which came into force on 30<sup>th</sup> July, 2002.

My discussion of the US situation is not simply for the shock value, although the numbers are quite staggering. I wish to highlight the importance of good corporate governance for overall economic stability and national credibility. The collapse of relatively few companies due to poor corporate ethics, shoddy accounting practices and poor board oversight led to major financial disruption and resulted in thousands of job losses. Nevertheless, the US will and is recovering.

However, for a developing country and an offshore jurisdiction like The Bahamas, which is already under a powerful microscope of international observers, a lapse in corporate culture can be more devastating as reputation capital is not as easily or quickly repaired and replaced; and as the financial costs to the economy can not be as easily absorbed.

Therefore, the maintenance of sound corporate governance processes and structures at every level of our society - government, government parastatals, the Central Bank and the other regulators, financial institutions, and firms - is imperative for the continued well being of our economy.

Hence, there is an important role for the Regulator as an important standard setter in Corporate Governance. Indeed, the Central Bank of The Bahamas, recognising the importance of the good governance of the financial sector, was one of the first Central Banks to release comprehensive guidelines on Corporate Governance in December 2001. Licensee's were expected to be fully compliant with the guidelines by December 2003. The Guidelines were subjected to a lengthy period of wide consultation with the industry and a review of international best practices. The Central Bank has appreciated the input of BICA and other industry stakeholders which have helped to shape our requirements into a process which we feel will work in The Bahamas and will strengthen the Corporate Governance process of our licensees.

### **The Importance of Focusing on The Banking Sector**

Some may wonder why the Corporate Governance initiatives in The Bahamas appear to be driven by the banking sector. In the US and some other countries for example, the issue appears to have been led by the stock exchanges and the focus appeared to be on publicly traded companies.

The answer is, as I see it, that the initiative will come from where there is the largest potential for losses. In the Bahamas, capital and financial assets are allocated, to the major extent, through the banking system. Our capital markets are just now developing. Hence our banking system has the awesome task of the responsibility for the overwhelming percentage of our national savings – that is the capital of the Bahamian public.

Our banks in their role as financial intermediaries decide how best to allocate this capital and how to manage the risks associated with this task. Everyday banks face credit, liquidity, interest rate and market risk (although to a lesser extent in The Bahamas). Banks must deal effectively with fiduciary, reputation, operational, settlement, technology, outsourcing, compliance, legal and regulatory risks in order to remain a profitable going concern. How banks deal with these risks are directly related to their governance structures. The better the governance structure, the better the policies and procedures, the better the management of the organization, the better these risks are managed.

As for the offshore markets which make up the majority of licensed banks in the Bahamas, many may wonder why the Central Bank would be concerned with these entities as they have little direct financial impact on the Bahamas' financial sector. As you know the assets of the offshore market are separated from the onshore economy by the "Chinese Wall" of exchange control regulations. Nevertheless, the Central Bank, as regulator of 280 plus offshore banks, has a duty to ensure that the depositors, creditors

and shareholders of these institutions receive similar protections through the implementations of sound prudential standards. Additionally, collapses of these institutions, due to Corporate Governance failures impacts the credibility of the jurisdiction.

### **Central Bank Guidelines**

Our Guidelines, which I am sure you are all very familiar with by now, represent an additional element in the Central Bank's continuing programme to introduce and strengthen international best practices for the management and operation of banks and trust companies in The Bahamas and articulated the Central Bank's expectations for the corporate governance processes of licensees.

They also provided additional support to the corporate governance requirements related to shareholder rights, board structure and liability of directors contained in the Companies Act, 1992.

The Guidelines provided the framework around which additional guidance on specific aspects of the management and operations of licensees would be introduced. The Central Bank is already in the process of developing comprehensive risk management guidelines. On 16<sup>th</sup> October, 2003, the Central Bank released the first supplement entitled, "Guidelines for the Management of Credit Risk". Guidelines covering impaired assets, liquidity risk, large exposures, interest rate risk, compliance risk and operational risk are

scheduled to be released in 2004. Other guidelines on e-banking, outsourcing, capital adequacy and dormant accounts will be released shortly.

### **Director Responsibility**

The heart sound Corporate Governance lies in the boardroom. Therefore, at the heart of the Central Bank's guidelines is the issue of director responsibility and accountability.

The Central Bank required that management of every bank and trust company to provide the Guidelines to each board member. Directors and senior management were required to begin discussions and planning of the implementation, where necessary, of any additional corporate governance processes within their organizations, resulting from the issuance of the Guidelines. An important aspect of the Guidelines is that by April 2004 directors are required to certify that their organizations are in compliance with the Central Bank's Corporate Governance standards and where there are deficiencies, these should be identified and a plan of action developed to address them within a reasonable timeframe.

I cannot overemphasise the importance of the Board certifications to the Central Bank in our assessment of licensees' corporate governance structures. My colleague will go into this area in more details later in the day.

### **Licensing Process and Corporate Governance**

Interestingly, the Central Bank's Corporate Governance reviews actually begin well before onsite inspection process or the review of the board certifications. The process starts with the Central Bank's initial screening of an applicant for a bank directorship,

shareholder or senior officer. All senior officers, shareholders and members of the board are reviewed for their fitness and propriety to serve in a bank or trust company licensed in The Bahamas.

As anyone who has been through this process knows, the Bank Supervision Department reviews character and financial references, background checks are performed and through the use of the confidential questionnaire, assessments are made of the individual's capabilities, reputation in the market, integrity, and business history.

In addition to its current guidelines for licensing and the accompanying questionnaire for director and senior officer applicants, the Central Bank also released several guidelines in 2003 which codified existing licensing and operating requirements and/or introduced new standards. These included the *Guidelines for Assessing the Fitness and Propriety of Applicants for Regulated Functions*, *Minimum Standards for Character and Financial References*, *Guidelines for the Minimum Physical Presence requirements for Banks and Trust Companies Licensed in The Bahamas* and *Minimum Standards for Letters of Comfort*.

### **Disclosure Requirements, Accounting Standards and Corporate Governance**

Another important element of Corporate Governance is the issue of disclosure requirements and accounting standards. Once again, the debacles of Enron, Parmalat, WorldCom illustrated that these issues are as essential as the good ethics of directors.

The Central Bank wishes to have its licensees produce financial information in a way that is (a) useful to stakeholders, (b) which allows for comparability and (c) which is transparent and (d) discloses material information. We are intending to release guidelines on Minimum disclosure requirements, in line with International Accounting Statements, for consultation in the near future. These guidelines supplement, and do not replace any other disclosure requirements under the relevant legislation or accounting standards and we encourage licensees to develop a level of disclosure which exceed our minimum requirements. We seek to have a statement of compliance by the licensees' boards that the financial statements meet the minimum requirements of the guidelines.

Additionally, the Central Bank is also seeking to strengthen its relationship with the external auditors of our licensees. Our *Guidelines for External Auditors* of licensees outline the Central Bank requirements for and expectations of auditors of our licensees. The guidelines lay out the specific criteria used to assess the fitness of an auditing firm to serve as an auditor of a bank or trust company (i.e. Reputation, membership in BICA, experience, professional indemnity insurance). They also set out specific disclosures and undertakings which should be made by the external auditor to the Central Bank and a process for information sharing between the Central Bank and the external auditor in the case of material issues.

It is the Central Bank's expectation that the proposed strengthening in these areas together with the board certifications will support and encourage the overall corporate

governance of our institutions. We look forward to our continued work with BICA and the Auditors Advisory Committee in this regard.

### **Consolidated Supervision and Corporate Governance**

The Bahamas like many other countries finds its self with increasingly more multi-industry firms. Hence, there has been the recognition of the need for the regulator to respond to this innovation. In The Bahamas we have found that there is considerable overlap between licensees and registrants of the Central Bank and the Securities Commission of the Bahamas. Similarly, there is overlap with the Securities Commission and the Registrar of Insurance Companies. There are some financial firms which are regulated by all of the financial service regulators. Hence, the diversity of firms business activities have increased, but more importantly. Additionally, there has also been the increase of separately incorporated companies which form part of a related financial group.

This phenomenon poses new challenges for monitoring effective corporate governance as governance lapses in one part of the group can have negative effects on the operations of another company in the group. In these cases, Corporate Governance must be considered on a group-wide basis. Susan Bies of the Federal Reserve Board, in a recent speech, notes, “ *Too often firms are governed through silos by individual lines of business without a comprehensive risk review by executive officers and the appropriate committee of the board of directors. Financial institutions are being encouraged to establish enterprise wide risk management function to ensure that risks of all types, including conflicts*

*of interest, are identified; risk appetites are defined; appropriate mitigating controls are effective; and exceptions are rigorously reviewed at a high level within the organization.”*

In The Bahamas, the Central Bank, together with the other financial sector regulators has continued our efforts to provide effective consolidated supervision of licensees. The Regulators have signed and continue to progress towards the implementation of an MOU which is aimed at increasing co-ordination, co-operation and information sharing. The regulators have also undertaken to conduct joint onsite inspections and to steam-line the applications process as much as possible. These changes will not only add to regulatory efficiency but will also allow us to review licensees in their entirety, rather than as individual components.

Together with the other regulators we hope to establish standards and guidelines on the management and supervision of financial conglomerates.

### **Response of the Industry**

Key to the idea of promoting sound corporate governance is the development or maintenance of a business culture which is conducive and receptive to sound business principles. Two years into the process, we can say that the Industry has responded favourably to our Corporate Governance initiative and we are seeing the expansion of sound corporate culture.

The positive results come from the approach taken by the Central Bank to involve the industry in the development of the Corporate Governance Agenda from the beginning. Industry associations and other stakeholders were consulted in the development of the Guidelines and The Central Bank was able to attain the all important “*buy-in*” needed to achieve a successful implementation of the corporate new governance framework.

However, there were a small number of critics. Some stakeholders thought that the Guidelines were overly prescriptive in places, (e.g. the recommendation that board should meet monthly, but at least quarterly or minimum number of committees), while others thought that they were too not precise enough in their requirements. Some were concerned about the penalties for instances of non-compliance. Others felt that the required degree of involvement of the directors was too onerous and that because of differences in company law in their respective countries, for example, the functions of the board may be performed by specialist committees who were neither directors nor shareholders.

As the Bahamas is an offshore centre, many directors reside outside of The Bahamas and are not always directly accessible. To address this issue, the Central Bank mandates that at least one board member, the non-executive member, should be resident in The Bahamas. The Central Bank received some negative comments regarding this policy, however, the sector has settled into the requirement quite smoothly.

The Bahamas has also required its public licensees to establish a physical presence in the Bahamas by 30<sup>th</sup> June, 2004. Only a small number of restricted licensees and branches of foreign banks, which meet strict criteria will be permitted to continue under management arrangements with licensees with a physical presence. After an initial period of some transition, licensees have generally shown their commitment to remaining in the jurisdiction and establishing a meaningful physical presence.

However, for the most part we have seen extremely positive changes. Directors in The Bahamas, were already assessed for fitness by the Central Bank. However, the Central Bank increased its surveillance through the introduction of its “*confidential statement for directors*” which, among other things, looked at the number of directorships any one director held. We wanted to ensure that directors, especially the non-executive directors had the time to commit themselves to the proper governance of our institutions.

We have also seen, through our examinations of the board minutes as part of the process of control review, that directors are taking a more active role in the affairs of the institution. We are seeing that directors, and the established committees, are requesting, receiving and are reviewing more quantitative and qualitative information from management. We are seeing that matters are being followed through to their conclusions with greater zeal.

We have also seen more constructive and better run board meetings. The Minutes are reflecting that the Boards are discussing new legislation, guidelines and the possible effects on their organizations. These are good signs.

We have also seen the boards are concerned about the reputation of their institution, whether it is implementing “best practices” and their own compliance with our Corporate Governance standards. Over the last year, we have had many meetings with banks, and their boards, including their overseas directors to discuss the Central Bank’s requirements.

Of course we are seeing, in a small number of institutions, that while the governance structures have been put in place, they are not yet used in practice. In those cases, follow up examinations or meetings take place to ensure that the machinery is not just installed, but is also working..

The external auditors have also been actively involved in the process, as they will be required to assess the methodology of the board in the corporate governance review and provide an opinion as to the adequacy of that review. We have had several meetings with the auditors and their association to discuss what will be required of them.

## **Final Thoughts**

The next step will be to ensure that this awareness of corporate responsibility is maintained. To achieve this, the Central Bank plans to keep the issue at the forefront. As stated previously, Corporate Governance is a major component of the onsite examination process. There are also the certifications from the board and auditors which will be required on an annual basis. Additionally, the Central Bank meets annually with the principals to discuss, among other things, the governance of the institution.

Finally, The Bahamas, like many other common law jurisdictions, had a very solid base on which to build a corporate governance framework. Part IV of our Companies Act, 1992 lays out the requirements for the management of companies and the protection of creditors and investors, including the duties and responsibilities of directors. The Central Bank also has the authority to approve and disqualify a director. Additionally, in terms of the financial sector, The Central Bank and other financial sector regulators, have strict licensing and approval requirements and monitoring programmes which test the suitability of an individual to serve as a director or senior executive of a regulated company. Our primary goal, however, is to reinforce the awareness of all persons in positions of authority, that they are responsible for the good governance of their institutions. The board has to realize that the “buck” literally stops with them, and that that they have to live up to its duties. I think that we have seen this change in awareness.

Thank you.

