

Sound Corporate and Public Governance: A brief overview of the standards and best practices in the area of corporate and public governance as well as the possible ways forward from a Central Banker's perspective

Speech delivered by Mr. Prakash Mungra, Executive Director at the CBA, on the occasion of the seminar on sound governance organized by Ernst & Young on March 10, 2016 at the Surfside Marina in Aruba

1. Introduction

First of all, I would like to thank Mr. Garrick de Cuba of Ernst & Young Aruba for his kind invitation to speak on the important topic of sound governance in both the private and the public sector. During my speech I will also share with you my thoughts on possible ways forward, with due regard to the international standards and best practices in this area that have evolved quickly over the last 15 to 20 years. As specifically requested by Mr. De Cuba, I have also included the topic of sound public governance in my presentation. To this end, I have also conducted a very basic survey among Aruba's public entities to obtain a view on the current state of governance in the public sector. I will gladly share with you the aggregate results of this survey during the course of my presentation.

Let me briefly discuss the concept of sound corporate governance on the basis of the definitions used by some standard-setting bodies like the OECD and the Basel Committee on Banking Supervision.

The OECD applies the following definition: “Corporate governance involves the procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.”

According to the Basel Committee on Banking Supervision, Corporate governance involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structures through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

As can be derived from both definitions, corporate governance is about the way corporate entities are governed.

At this point already, I would like to note that, in my opinion, in essence the same principles for sound governance are also applicable to public entities. At the CBA, which is also a public entity (*sui generis*), much attention is given to implementing and maintaining a sound governance framework. Much emphasis is placed on the existence of sufficient checks and balances, as well as a proper documentation of all significant decision-making, including the arguments that led to the decisions made. The CBA’s internal audit department plays an important role in overseeing compliance with the internal policies and procedures. The manager of this department reports directly to the President and has the authority to

communicate directly to the Supervisory Board. Also, there are regular meetings between the Executive Committee and the Supervisory Board to inform or update the board on significant developments and also to respond to any issues or concerns that the board may have. An effective and open communication between the Executive Committee and the Supervisory Board is critically important. Without sufficient and timely information the Supervisory Board would not be able to properly carry out its oversight role. Also, in CBA's case and in conformity with best practices, the external auditor is appointed by the Supervisory Board and meets regularly with the Audit Committee to discuss the audit findings. The CBA is fully aware that, given its role as monetary and supervisory authority, it has to lead by example. Ethical behavior within all layers of the CBA organization is promoted via the CBA's code of conduct, which can be found on the CBA's website, and also through regular workshops in this area. Integrity is one of the CBA's core values. Finally, it is worth mentioning that the CBA strives to meet on an ongoing basis all international standards applicable to central banks.

Importance of a sound governance framework

It will not come as a surprise to you that the CBA attaches great importance to the existence of a sound and well-functioning corporate governance framework within the institutions it regulates and supervises. A sound governance framework is key for ensuring, among other things, a well-balanced decision-making process.

As you may know, in its capacity as regulator of the financial sector, the CBA has issued policy papers for credit institutions, insurance companies, and pension funds containing minimum high-level standards in the governance area to which all the institutions working in these sectors must adhere. These high-level standards leave institutions with sufficient room to design their own governance framework, taking into account the size of the organization, the products and services they deliver, the risks involved, and so on. It is important to note that no one size fits all. Having said that, the framework and practices chosen must be effective. In the CBA's policy paper "Sound Corporate Governance Practices for Credit Institutions" the following basic elements of sound governance practices are listed:

- Establishing clear objectives and corporate values that are communicated throughout the organization.
- Setting and enforcing clear lines of responsibility and accountability throughout the organization.
- Ensuring that board members and senior-management are qualified for their positions.
- Adequate risk management.
- Comprehensive internal controls.
- Full, accurate, and timely financial disclosure.

Also in the public sector the presence of sound governance practices is key to ensure that public entities are well-managed and supervised. Not having sound corporate governance practices in place may prove very costly, both to the institution itself as well as society at large. From a country perspective, it also is

important to have a sound governance framework in effect in order to be able to attract foreign investments. To that point, I would also like to quote the following from the pre-ambule of the OECD Principles of Corporate Governance (the Principles), which serve as the global standard and benchmark in this area.

“The Principles are intended to help policy makers evaluate and improve the legal, regulatory, and institutional framework to corporate governance, with a view to support economic efficiency, sustainable growth, and financial stability.”

2. International developments in the governance area

As you may know, many of the advanced economies have strengthened their corporate governance framework over the years, often as a result of corporate governance failures at some of their large institutions in the private sector, including the financial services industry. These failures can be attributed to, among other things, weak risk management systems, ineffective internal controls, lack of oversight by the board, mismanagement, management fraud including but not limited to false or misleading financial reporting, and last but certainly not least disfunctioning of external auditors. Unfortunately, it must be noted that the quality of audits performed at some of the failed or government-rescued institutions were below standards. The many high-publicity accounting scandals over the past few years have diminished the trust of the general public in the accounting profession. Much still needs to be done to regain this trust.

In some countries the principles of sound governance have been vested in law. A good example hereof is the Sarbanes-Oxley law in the United States that aims to strengthen governance practices, including proper internal controls and risk management systems, at companies listed on the stock exchanges in the US. This law, which was introduced by the US Government in response to some high-publicity financial scandals early this century (inter alia Enron, Worldcom, Tyco), pays particular attention to the roles of senior management, board, and external auditors. Also in other parts of the world high-publicity cases have occurred where investors suffered significant losses due to bad governance practices and fraudulent activities. In Aruba the media has also given ample attention to some domestic fraud cases that have occurred in both the public and private sector. These cases also appear to have had their origin in serious flaws in the governance of the institutions concerned, including their risk management and internal control systems.

With the global financial crisis that peaked in 2008 with the collapse of Lehman Brothers in September of that year, the topic of sound corporate governance received ample attention of governments and supervisory authorities around the world. The recent global financial crisis came with a huge price for investors and society at large in the form of, inter alia, increased government debts and tax increases as a result of the financial support that needed to be provided to the financial sector to prevent it from collapsing. It should be emphasized that governments in the advanced economies had no other choice than to provide significant financial support to the institutions considered systemic (too big to fail), to prevent a meltdown of the global financial system and herewith the

global economy. The financial crisis also led to significant economic output losses. The still slow and uneven economic recovery in many advanced countries is telling of the dire effects of a global financial crisis.

With an aim to prevent a future global financial crisis like the most recent one, with its prolonged negative effects on the global economy, supervisory authorities in most, if not all, of the advanced countries around the globe have strengthened the regulatory requirements in the area of corporate governance. Notwithstanding the fact that the financial sector in Aruba has weathered the global financial crisis quite well, the CBA also has intensified its oversight in this area. I will elaborate on this later in my presentation, but let me now discuss with you broadly the Corporate Governance Principles issued by the OECD, which form the global standard in this area for corporate entities.

3. The OECD principles on sound corporate governance

The OECD Principles were originally developed in 1999 and updated in 2004 and in 2015. These Principles have been adopted as one of the Financial Stability Board's key standards for Sound Financial Systems. They have also served as the basis for the Guidelines on corporate governance of banks issued by the Basel Committee on Banking Supervision and the OECD Guidelines on Insurer and Pension Fund Governance. Countries also use these principles as a benchmark to identify areas for improvement of their national governance frameworks.

The OECD Principles are presented in six chapters:

- I) Ensuring the basis for an effective corporate governance framework;
- II) The rights and equitable treatment of shareholders and key ownership functions;
- III) Institutional investors, stock markets and other intermediaries;
- IV) The role of stakeholders;
- V) Disclosure and transparency; and
- VI) The responsibilities of the board.

Each chapter is headed by a single principle and is followed by a number of supporting sub-principles. Let me highlight chapters I, V and VI of the Principles, which are of particular interest to Aruba and also to which the CBA, as the regulator and supervisor of the financial sector, attaches much value.

Before doing so, I would like to stress that the Principles are intended to apply to whatever board structure is charged with the functions governing the institution and monitoring management. Most continental law jurisdictions have two-tier boards that separate the supervisory function from the management function, while in most Anglo-Saxon countries the one-tier board model is applied, also known as “unitary” boards, which are composed of both executive and non-executive board members. The Aruban laws and regulations governing the financial sector require that a two-tier board model be applied for Aruban entities.

Chapter I : Ensuring the basis for an effective corporate governance framework

The main principle presented in this chapter is that the corporate governance framework should promote transparent and fair markets and an efficient allocation of resources. The framework should also be consistent with the rule of law and support effective supervision and enforcement. The mix between legislation, regulation, self-regulation, voluntary standards, and so on, will vary from country to country and is decided largely by cultural factors.

The legislative and regulatory elements of the corporate governance framework can usefully be complemented by soft law elements based on the “comply or explain” principle, such as corporate governance codes in order to allow for flexibility and address specifics of individual companies. However, it is very important that when codes or principles are used that their status, in terms of coverage, implementation, compliance and sanctions, is clearly specified and known to stakeholders.

Chapter V : Disclosure and Transparency

The main principle in this chapter is that the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including performance, ownership, and governance of the company. It is noted that a strong disclosure regime can help to attract funds on the capital markets and that, by contrast, weak disclosure and non-transparent practices can contribute to unethical behavior and a loss of market integrity. Along the same lines, insufficient or unclear information may hamper the ability

of markets to function, increase the cost of capital, and result in a poor allocation of resources.

Chapter VI : The responsibilities of the Board

The main principle in this chapter is that the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and its shareholders. At the same time, boards are expected to take due regard of, and deal fairly with, other stakeholders' interests including those of employees, creditors, customers, suppliers, and the communities in which they operate. For example, in the case of banks and insurance companies the interests of depositors and policyholders must be duly considered before taking decisions. Excessive risk-taking is not permitted as this is not in the interest of the company or its depositors or policyholders.

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance, while preventing conflicts of interest and balancing competing demands on the corporation. For boards to be able to effectively fulfill their responsibilities they must be able to exercise objective and independent judgement. Other important requirements are that board members should apply high ethical standards and also act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and, thus, in the long-term interest of shareholders and other stakeholders.

Some of the key functions that a board should fulfill are:

1. Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans, setting performance objectives and monitoring implementation, and overseeing major capital expenditures, acquisitions and divestures.
2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
5. Ensuring a formal and transparent board nomination and election process.
6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transaction.
7. Ensuring the integrity of the accounting and financial reporting systems.
8. Overseeing the process of disclosure and communication.

4. The Role of the CBA in promoting sound governance practices

Let me now touch briefly on the CBA's role in promoting sound governance practices within the Aruban financial sector.

The CBA has issued high-level minimum standards on sound governance for the banking, insurance and pension fund sectors. The elements of sound corporate governance just discussed can be found to a large extent in these standards.

Compliance with these standards is tested via surveys and regular onsite examinations in this area. Based on the findings, it can be concluded, in general, that there is a large variance in the degree of compliance and that particularly at companies held by individual shareholders there is ample room for improvement, especially in the area of managing conflict of interests. In this regard, it is important to note that within the Dutch but also Aruban context, the board is required to act at all times in the interest of the company. In cases where shareholders' interests conflict with the interests of the company, the board is required to act in the interest of the company. Therefore, it is essential that the board can act independently from the shareholder. It is also against this background that the CBA requires that the majority of the Supervisory Board consists of persons who are fully independent from the shareholder. It is noteworthy to mention that the CBA is planning to strengthen the governance requirements for banks, insurers, and pension funds soon.

5. Sound public governance

Let me now discuss briefly with you the concept of sound public governance and the outcome of a limited survey conducted among the larger public entities to obtain some basic information on their governance frameworks.

As you may know, In 2005 the OECD issued specific guidelines for good governance of state-owned enterprises (SOE's) as a complement to the OECD Principles of Corporate Governance. These guidelines have been updated quite recently. They contain recommendations on how to ensure that SOE's operate

efficiently, transparently, and in an accountable manner. Note that the rationale for state ownership of enterprises varies among countries and industries. It typically depends on a mix of social, economic and strategic interests. Examples include industrial policy, regional development, the supply of public goods, as well as the existence of so-called natural monopolies where competition is not deemed feasible. Globalization of markets, technological changes, and deregulation of previously monopolistic markets have led to readjustment and restructuring of the state-owned sector in many countries. In Aruba, for example, the telecom sector was opened up to new players in this market.

SOE's face some distinct governance challenges. On the one hand, SOE's may suffer from political interference, leading to unclear lines of responsibility, a lack of accountability, and efficiency losses. On the other hand, a lack of oversight due to distant or passive ownership by the state can weaken the incentives of SOE's to perform in the best interest of the enterprise and the general public who constitutes its ultimate shareholders, and can raise the likelihood of self-serving behavior by corporate insiders. The management may also be protected from two disciplining factors, i.e. the possibility of a takeover and that of a bankruptcy.

The guidelines are arranged in seven chapters and like the OECD corporate governance principles each chapter is headed by a single principle and is followed by a number of supporting sub-principles:

- I. Rationales for state ownership
- II. The state's role as an owner

- III. State-owned enterprises in the marketplace
- IV. Equitable treatment of shareholders and other investors
- V. Stakeholder relations and responsible business
- VI. Disclosure and transparency
- VII. The board responsibilities

Let me briefly discuss the guiding and supporting principles with respect to chapters II, V, VI and VII, which in my opinion are of particular importance to Aruba.

II. The state's role as an owner

The state should act as an informed and active owner, ensuring that the governance of SOE's is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness. However, the oversight role should, not lead to interference with the daily management of the company. On the other hand, this means that an SOE must be highly transparent and accountable regarding its policies and performance."

V. Stakeholder relations and responsible business

I would like to highlight the first part of sub-principle C, in which it is stated that the boards of SOE's should develop, implement, monitor, and communicate internal controls, ethics, and compliance programs or measures, including those

which contribute to preventing fraud and corruption. In my opinion, this sub-principle is key in ensuring a sound and safe business environment. It is also noteworthy to mention that the CBA has issued last year a directive on controlled business that requires all supervised financial institutions to have policies, procedures, and measures in place to promote and safeguard the integrity of their institutions. Article 8 of this directive stipulates that organizations must promote high ethical standards that are also embedded in their business processes.

VII. Disclosure and transparency

The principles laid down in this chapter are also highly relevant for Aruba. It is noted in this chapter that SOE's should report material financial and non-financial information on the enterprise in line with high quality internationally recognized standards of corporate disclosure.

In my opinion, the introduction of financial reporting requirements in the Civil Code of Aruba that are aligned to international standards and best practices would certainly contribute to the transparency objective, as well as to an increased level of standardization of the accounting principles applied for the preparation of financial statements.

VII. Board responsibilities

In this chapter it is noted that the board of an SOE should have the necessary authority, competencies and objectivity to carry out its functions of strategic guidance and monitoring of management. It should act with integrity and be held accountable for its actions.

Let me mention some of the supporting standards that are of particular importance in this regard.

- The board should be assigned a clear mandate.
- The boards should effectively carry out its functions of setting strategy and supervising management, based on broad mandates and objectives set by the government. It should have the power to appoint and remove the CEO. It should set executive remuneration levels that are in the long term interest of the enterprise.
- Board composition should allow the exercise of objective and independent judgement.
- Mechanisms should be implemented to avoid conflicts of interests.
- Particularly with respect to audit, risk management, and remuneration, the board should consider setting up specialized committees.
- Self-evaluations should be carried out on an annual basis
- Efficient internal audit procedures should be developed and an internal audit function should be established.

As can be concluded from the abovementioned bullet points, the boards of SOE's and private enterprises have very similar tasks and responsibilities.

Let me now move on to the outcome of a small survey conducted among the public enterprises in Aruba in which 6 out of the 10 companies approached by the the CBA participated. I must emphasize that the outcome of this survey can only be considered as indicative and that further research is necessary to draw firm conclusions.

The survey contained 15 questions, directed mainly towards obtaining a view on where the surveyed companies stand vis-a-vis chapters V, VI and VII of the OECD guidelines for SOE's. I will go very briefly through the responses received.

Question 1: Is there an adequate allocation of duties within the Executive Management.

Four respondents yes to this question, while two indicated "not applicable".

Question 2: Does your organization have function profiles in place for its Executive Management.

Three responded yes to this question, while two indicated "not applicable".

Question 3: Is there an Executive management charter.

Three responded yes to this question.

Question 4 : Is there a Supervisory Board.

All six responded yes to this question.

Question 5: Does your organization has function profiles for its Supervisory Board members.

Five responded yes to this question.

Question 6 : Is there a Supervisory Board Charter.

Four responded yes to this question.

Question 7: Did your Supervisory Board install an audit committee.

Two responded yes to this question.

Question 8 : Is there an audit Committee charter.

One responded yes to this question.

Question 9 : Is there an internal audit department.

Three responded yes to this question.

Question 10 : Is there an internal audit charter.

One responded yes to this question.

Question 11: Is there an adequate management information system in place.

All six responded yes to this question.

Question 12 : Is there an adequately functioning risk management system in place.

Three responded yes to this question.

Question 13: Does the external auditor issue a clean audit opinion on the financial statements.

Four responded yes to this question.

Question 14: Is there a code of conduct.

Two responded yes to this question.

Question 15 : Does the company provide regular performance reports to its stakeholders.

All six responded yes to this question.

From the responses received, it can be concluded that there is quite a lot of variance in meeting some of the elements that form part of a sound governance framework.

6. Conclusion and recommendations

The international standards and best practices in the governance area have evolved over time and are becoming more challenging to meet. Notwithstanding these challenges, it is of utmost importance that also smaller jurisdictions like Aruba with highly open economies and highly dependent on the inflow of foreign direct investments keep up with these standards.

It is highly recommended that an up-to-date governance code be introduced for public entities given their importance to the Aruban economy and the public services they offer. The OECD standards for state-owned companies could be used as a benchmark in this regard.

Thank you for your kind attention.

Aruba,

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