

A G Romero: Integrity and good governance - reputation risk in the public sector and financial institutions

Speech delivered by Drs A G Romero, Executive, President of the Bank of the Netherlands Antilles, on the occasion of the opening of the Sixth Biennial Regional Central Banks Legal Seminar, Willemstad, Curaçao, 12-14 May 2003.

* * *

OECD definition of corruption: *“The providing of grants or gifts to, the bribing of, or the offering of money to a receiving party (public servant) with the intention of influencing the receiving party to do a task that is not in accordance with his duty”.*

Introduction

We have seen drastic changes in the world in the areas of economics, finance, supervision, and legal matters. These changes have resulted from a number of factors. These factors include: the internationalization of economic activities fueled mainly by the increasing cooperation between nations through the formation of trade blocks in Europe, Asia, and the Americas; the easy access to information, making know-how cheaper and readily available; the intensification of financial cooperation in the region and global environment; and finally, the exchange of views and the alignment of policy actions between various international organizations, such as OECD, World Bank, IMF, Basle Committee on Banking Supervision, and the International Association of Insurance Supervisors.

Historically, since the mid-80s, we have noticed growing attention from the world community as well as governments to identifying and tracking the flow of financial funds proceeding from criminal activities. Concerns about the negative effects of these illegal activities on the welfare of the community have triggered international actions to combat criminality and corruption. Initially, the focus on combating criminal activities was concentrated mainly on business enterprises and financial institutions, which led to initiatives to develop various internal rules, best-practice guidelines, and national and international legislation. In the 90s, and specifically after the terrorist attacks of September 11, 2001, organized crime gained more international dimensions. At this point, the focus of governments, as well as financial sector supervisors, shifted to issues such as integrity, corruption, and the fight against organized international crime.

During the decade of the 90s we also witnessed a trend of increasing mergers and acquisitions in the European banking sector as a result of the closer economic and financial cooperation between the EU members. To a great extent, these mergers and acquisitions influenced not only supervision in the banking sector in Europe, but also supervision in general in our region because of the importance of the international (offshore) banking here. Moreover, we saw on the European continent a new bank assurance concept. Banks and insurance companies joined forces to form new global banking and insurance groups. The formation of these groups has added to the difficulties in risk management in the entire economy. They also present new challenges for national and international supervisors.

Around 1994, the Organization for Economic Cooperation and Development (OECD) launched a new international comparative research study on integrity in the public sector in the OECD countries. As a consequence of the findings of this study, in 1998 the Council of the OECD issued their first set of recommendations titled, “Improving Ethical Conduct in the Public Services”. In 1996, the United Nations also issued a “Code of Conduct for Public Officials” that provided guidelines on the acceptance of gifts, the handling of confidentiality, and the financing of political activities.

In 1997, the governments of the Netherlands Antilles and Aruba set up a joint committee to study the effects of corruption in the public sector. The committee was told to propose recommendations to improve ‘good governance’ and ‘integrity’ in the entire public sector. In 1997, the working group representing Aruba issued a first report titled, ‘Calidat’ (Quality) on good governance. This report was followed by the report, ‘Konfiansa’ (Confidence) in 1999 by the Netherlands Antilles working group. The main objectives of the working groups were to focus on the implications of the decision-making process in the public sector, where the activities of the governments and civil servants have important and sometimes long-lasting influence on the way the community behaves and on the democratic rights that must be respected.

Today I want to review with you some aspects of good governance, integrity, and market conduct from both a supervisory and a public-sector perspective. In the first part of my presentation, I will discuss the public sector / government responsibility for good governance and integrity. Here the main focus is to stress that only governments can initiate the process of creating a legal framework in which the society can function according to specific rules, and at the same time, set guidelines and acceptable norms and values for the community that respect the democratic principles of freedom. Next, I will highlight the new challenges for the supervisory authorities in the region. I will reveal some of the important issues related to the mitigation of reputation risk within financial institutions and their conduct of business in a changing environment. How can managing and supervisory directors promote a sound and safe business environment in which corruption and integrity risks are reduced to a minimum?

'Good governance' and 'integrity' in the public sector of the Netherlands Antilles

Concern for good governance and integrity in the public sector is a relatively new phenomenon. Considering that, as I indicated in my introduction, governments and international organizations began discussing issues related to corruption, good governance, and integrity in a global setting around 1994, one might be tempted to conclude that these are new issues! However, even though international attention on these issues is new, the concepts are not. Since the beginning of our parliamentary democracy, the focus of governments here and around the world has been to design policies and create instruments for good governance and integrity. One also could ask whether the situation related to these issues has worsened in recent decades, warranting the increased attention of the international community since the mid-90s. In my view, the worsening of the way the authorities and the community experience, perceive corruption and integrity have been the main driving force behind the increased focus on combating illegal activities.

In general, private-sector companies are operated with a predominant aim of promoting and safeguarding the profitability and earning capacity of the business. An objective derived from this main aim is to guarantee the continuity of the businesses, and by extension, job security for the employees. In the public sector, production and consumption are driven by other factors, such as power. Those in power must maximize the support of the electorate, which by nature has a shorter time horizon than private sector businesses.

Governments can be seen as monopolists when it comes to things like public tasks and services, such as defense of the country, police work within the community, the safeguarding and provision of good public health, education, the initiation/formulation of laws, and the transfer of income to those in need. Another group of stakeholders, i.e., the civil servants in their capacity as advisors to government and implementers of the plans and decisions of the governments, also are important elements in assessing, implementing, and guiding the process of good governance and integrity in a country. The community, on the other end, experiences the effects of actions undertaken by governments and the civil servants on their daily life. Good governance, therefore, has to do with efforts by all stakeholders aimed at striking a balance between the interest of government in initiating policies, the implementation of these decisions by civil servants, and the effects of these actions on the entire community.

In this crucial triangle of power between governments, civil servants, and the community, important instruments have been (or will have to be) developed to guide this process efficiently. One important tool that governments can use to improve good governance is communication between governments and civil servants, on the one hand, and the community, on the other hand, with respect to plans to be implemented. The community should be informed constantly concerning the government's actions, intentions, and directions with respect to their policies. Today in our community we experience daily at least one press conference of a minister and/or a commissioner to discuss plans and interact with the press and the community on public issues such as tax reforms, education, combat of illegal actions, and so forth. This is a very good way for governments to introduce and discuss their plans publicly.

Besides press conferences and public discussion with the community, other instruments have been developed and implemented here on the islands to deal with the issue of good governance and integrity. These instruments are, broadly, the acceptance of three important Ordinances: (1) the National Ordinance on Transparency in Government (Openbaarheid van Bestuur) in 1996, (2) the National Ordinance on Administrative Justice (LAR) in 2001, and (3) the Island Ordinance on the Institution of an 'Ombudsman' in Curacao. With these ordinances, the governments have improved further the transparency in the management of the public domain and property.

The National Ordinance on Transparency in Government of 1996 allows each member of this community to request and obtain information from the government and civil servants on all public issues, excepting only those issues regarded as national security or information on persons and individual industry-specific data. Through this Ordinance, the decisions taken by the authorities and the implementation of these decisions become more transparent for the community. If one member of our community wants assurance that a decision taken by the authorities to grant, for instance, a license to build a new hotel in a specific location was made in accordance with good governance rules, that individual has the right to request and receive all information on this project. He can then evaluate, based on the information received, whether the decision was made in accordance with the rules of good governance. I believe that this Ordinance on Transparency has far-reaching consequences, not only for the way the authorities function, but also for how the entire community will get accustomed to dealing with the objectives of this Ordinance. The National Ordinance on Transparency in Government has added to the transparency in the entire decision process. We as members of this community can at all times evaluate and critically follow actions of the authorities, particularly in the provision of public services and the granting of permissions and licenses. These areas are very vulnerable to corruption. A wrong decision can impact seriously the reputation risk in terms of how others perceive the functioning of our governments.

The second important instrument for good governance that our parliament has approved recently is the National Ordinance on Administrative Justice (LAR), which is linked closely to the previous Ordinance on Transparency in Government. This Ordinance on Administrative Justice allows the community (stakeholders) to raise objections or even appeal before a court of Justice, a decision taken by the authorities. The Bank, as supervisory authority of the financial sector, also is confronted with the effects of this Ordinance. In our daily work we have to be very careful with each decision that we make since the community can use this Ordinance to question or challenge our decisions. If we again use the example of the granting of a license to build a hotel, the community can not only raise objections against the granting of the license, but it also can even appeal this decision before a court of law (Judge) to have an impartial body evaluate whether the decision taken by the government respected the rules of good governance and integrity.

The third Island Ordinance on the Institution of an Ombudsman in Curacao is intended to allow the community to post a complaint about how the government or the civil servants handle requests and remarks from the community on issues like the granting of licenses, the reaction to requested public services, and the tariffs on certain public goods and services. This independent Ombudsman will channel the complaints of the community to the respective institution being criticized.

As you can appreciate, the government, the civil servants, and other public institutions are being transformed in the way they function because the community at all times publicly can challenge decisions of the authorities through objective and individual institutions aimed at assessing and evaluating these decisions.

There are at this moment two other areas of concern that will have to be addressed in the immediate future to complete the legal possibilities for the community to challenge the decisions taken by authorities. One of these risk areas is that of criminal liability of the ministers, commissioners, and public servants. A draft National Ordinance on the Criminal Responsibility for the Public Officers is awaiting parliamentary approval. The second risk area that the authorities will have to handle is improving the entire organization of the civil servants on the islands. The government apparatus will have to work further on the separation of duties to efficiently handle and react to requests for information and services from the community. Without good tools, no government apparatus can perform the task given to it by the legislative bodies. In recent years, many initiatives have been undertaken on the islands to scale down the government apparatus, reduce the red tape, and provide better training facilities for civil servants, but this process is taking longer than originally planned.

I understand that during this seminar, the issues I have discussed briefly will be dealt with in more detail. I'm convinced that since you all have a legal background, these discussions will lead to some useful recommendations that we can implement here and that you also can take back home as a positive experience.

Let me now turn to issues related to integrity and market conduct in the financial sector, but from a financial supervisory perspective. How are we as financial sector supervisors dealing with the issues of transparency, market conduct, and combating illegal activities?

Reputation risk and financial supervision

Integrity audit and testing, combating money laundering, and probity testing of (supervisory) directors have become integral parts of the supervision in our jurisdiction and around the world. Areas of attention and constant concern for the Bank van de Nederlandse Antillen, as supervisory authority for financial institutions, have been the assessing and testing of integrity and probity of directors of financial institutions. Since the mid-90s, we have been in the forefront of the discussion, the designing and setting of integrity rules, and the development of good conduct of business and best-practice guidelines for individuals who manage financial institutions in the Netherlands Antilles. Due to the increasing workload in the supervision departments of banking, insurance, and pension funds with regard to integrity audits and probity tests for directors, the management of the Bank agreed to concentrate the responsibility and coordination of integrity and good governance supervision in a separate department within the Bank. At the end of the year 2000, we officially agreed to incorporate in the Bank a department called the "Financial Sector Integrity Unit" as a tool to improve and concentrate the knowledge and efficiency in supervisory audits of financial institutions. Prior to 2000, the integrity audits and the compliance with corporate governance principles in financial institutions was done mainly as part of the normal supervisory audits that the Bank performed. These audits focused largely on prudential supervisory issues. The decision to concentrate integrity issues in one department was made not only because integrity audits had become a heavy burden in supervision in general, but also and mainly because we saw many sound and reputable financial institutions in the world go bankrupt in the 80s and 90s due to mismanagement and corruption. The major cases of fraud during these decades in the international financial sector (Banco Ambrosiano, Bank of Credit and Commerce International (BCCI), and Barings Bank) all were centered around unreliable and corrupt management. These scandals also triggered attention on integrity issues here and elsewhere in the world.

As we have seen, the concern about integrity in companies and financial institutions in particular has received a lot of attention here and in the world for various reasons: (1) developments within the public sector and the implications thereof for the public tendering of large projects, (2) the international legislation implemented during the 90s, which increased public awareness, (3) pressure from international and national stakeholders demanding more transparency in the decision-making process of the public sector, and, finally, (4) developments in the administration of justice in the areas of criminal, fiscal, and civil law¹.

Because of integrity audits and major scandals in accounting firms that certified inaccurate annual reports, we have expanded the focus of supervision to include the broader concept of market conduct and market discipline within the financial sector.

"Market discipline is about information and incentives. Market participants must have access to reliable and timely information on the financial conditions and prospects of banking firms and both the market participants and the firms must have incentives to respond to this information. With respect to information, we need to consider what additional disclosure would contribute to enhanced market discipline."²

Traditionally, supervision of financial institutions has centered more on prudential issues, such as liquidity, solvency, concentration of loans and funding to a limited group of customers, and the earning capacity in institutions, than on market conduct and reputation. As I indicated earlier in this presentation, supervision worldwide has shifted today to combine both prudential and integrity/market-conduct issues. The integrity and market-conduct issues have to do with the extent to which financial institutions allow market participants to have reliable information when doing business with these institutions. Integrity and market conduct also focus on the issues of transparency in institutions and the organization of financial markets. The major risk involved in supervising market conduct is determining to what extent the institutions assess and deal with operational, legal, concentration, and reputation risk.

Before discussing with you the tools that supervisors have developed to deal with market conduct and integrity in audits, let me first briefly define some concepts of risk that we deal with in financial

¹ Interview with Prof. C. Schaap of Ernst & Young Forensic Studies. "Eye on Finance: Information bulletin from Ernst & Young of February 2001

² "The roles of market discipline, regulation and supervision." Speech by Mr. L. H. Meyers, member of the Board of Governors of the US Federal Reserve System on the occasion of the 16th Annual Monetary Conference, Cato Institute, Washington DC, 1998.

institutions today. Supervisors will have to develop audit tools to assess these concepts within the financial sector.

Operational risk can be explained best as measuring the direct and indirect effects of an incomplete or deficient internal process resulting from human errors and technical failures in the IT system. This risk is related mostly to external circumstances, which the institutions may not control completely.

Legal risk can be defined as the risk of loss for an institution because a contract cannot be legally enforced. Legal risk includes risks arising from insufficient documentation and insufficient authority of the counter party. Bilateral agreements must be evaluated adequately for enforceability before any transactions take place.

Reputation risk has to do with negative publicity about the contractual and legal customers of an institution and is related mostly to cases of money laundering and insider trading using the institution's services. Reputation risk also has to do with the current and prospective impact on earnings and capital arising from negative public opinion. Such a risk affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk may expose the institution to litigation, financial loss, or a decline in its customer base. Reputation risk exposure is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with customers and the community.

Concentration risk has to do with the overdependence of an institution on one limited group of clients either on the asset side or the liability side of the balance sheet. This overdependence on a limited group of clients may make an institution very vulnerable if these customers abruptly stop doing business with the institution.

How has the Bank dealt with the increased attention on market conduct and integrity in financial institutions when undertaking our supervisory role?

Once again, we have developed a set of tools to assess and determine these specific risk areas within supervised institutions. Naturally, the first and by far the most important tools are the legislation enacted by the parliament and governments giving the Bank authority to supervise financial institutions and deal with other law enforcement bodies on specific issues regarding supervision and illegal activities. Here the authorities have enacted the following supervisory legal framework to facilitate the role of the supervisory authority to guarantee safe and sound operations of financial institutions. These laws are:

- The National Ordinance on the Supervision of Pension funds of 1985;
- The National Ordinance on the Supervision of Insurance Companies of 1990/91;
- The National Ordinance on Penalization of Money Laundering of 1993;
- The National Ordinance on Banking and Credit Institutions of 1994;
- The National Ordinance on Reporting of Unusual Transactions (MOT) of 1997;
- The National Ordinance on Identification of Financial Transactions (LIF) of 1997;
- The National Ordinance on the Supervision of Stock Exchange Markets of 1999;
- The National Ordinance on the confiscation and freezing of assets from illegal activities of 2001;
- The National Ordinance on the Registration of Transboundary movements of large sums of Cash (2002); and
- The National Ordinance on the Supervision of Investment Institutions (Mutual Funds) and Administrators of 2003.

Based upon this legislation, the Bank now is in a better position to use effective control tools to assess the integrity, money-laundering, and market-conduct issues within financial institutions. In recent months, our staff has been working on separate new guidelines on Money Laundering for banks and credit institutions, insurance companies, pension funds, money remitters, institutional investment companies, and administrators. According to our planning, these guidelines will become effective by June 1, 2003. These guidelines will replace the current guidelines on Money Laundering of 1996.

In October 2001, the Bank reissued a revised *Guidance Notes for Boards of Directors of Supervised Financial Institutions on Corporate Governance and Summary of Best Practice Guidelines on*

Corporate Governance. The guidance notes describe the general responsibilities of the Board, the legal obligations of directors, and the role of auditors. The best-practice guidelines contain a discussion and presentation of various systems, policies, and measures potentially effective in dealing with corporate governance issues in financial institutions. To encourage the practical implementation of the guidelines, the Bank requires the Board of Directors of all supervised financial institutions to report to the Bank on an annual basis a *Statement of Compliance* with the best-practice guidelines on corporate governance reviewed by an accounting firm.

Another important tool for supervision in financial institutions is the audit on the Know Your Customer (KYC) policies. Our supervisors have created an integrated audit tool to verify how financial institutions handle compliance with KYC policies. The main objective of this audit tool is to review and assess the customer's identification files and the source of funds in financial transactions.

Finally, the Integrity testing tool is used for (supervisory) directors and those who determine the daily state of affairs in financial institutions. My colleagues, Mr. S. Saab and Mr. S. Salesia, will discuss with you later during this seminar the details of this specific tool of supervision and management control over integrity issues, probity of the management, and ability to assess and mitigate all types of risks involved in the financial institutions under management or supervision.

Concluding remarks

Today I have reviewed important issues on good governance, integrity, and market conduct from both the public-sector and supervisory perspective. In the public sector, our parliament has passed various laws to enhance transparency in government and to enable the community to appeal important decisions of the authorities.

During the last ten years, the integrity and conduct of public officials have been at the center of discussion around the world. We specifically have dealt with these issues through the enactment of various laws and guidelines on good governance and market transparency. Since concern for these issues is recent, both authorities and the community will have to adapt to this new situation. This legislation was created to make the public-sector decision process more transparent, but use of the options created by lawmakers must be used with tact and care by the community, lest the government's flexibility to act rapidly becomes illusory. Experiences so far indicate that the community has handled responsibly their broadened acquired freedom to request information on and evaluate the process of good governance.

In the supervisory arena, we have used all the legal options created to develop new guidelines and revise existing ones to improve our efficiency in supervising financial institutions. One of the major achievements in recent years was the creation of a separate specialized unit within the Bank to deal with issues on integrity, corporate governance, and market conduct. This process now is being fine-tuned by our staff to better control risk areas on non-prudential matters. The cooperation between national and international authorities on these non-prudential matters in the form of exchange of information, provision of training facilities, and mutual assistance in supervision and combating of international crime and money laundering has helped us greatly understand and reduce operational, reputation, legal, and concentration risk.

Furthermore, the options being created to improve market discipline and transparency are intended to enhance the stability of the world financial markets and reduce inter(national) systemic risks. There is consensus among supervisors that this is the way to move ahead, and I have seen numerous initiatives in the region to improve cooperation among supervisors.

The future of adequate supervision can be strengthened only through more cooperation and appropriate training of supervisors. I'm convinced that the international supervisory institutions have acknowledged this problem and they are working increasingly toward more cooperation and assisting jurisdictions in our region to capitalize on their experiences.

Let me now end my presentation as I started it with a quote from former **US President Harry Truman on Good Governance and Integrity**: "*The only way free government works is if the men in charge of it have got the welfare of the people in mind at all times. If the man loses sight of that even for a minute, you don't have free governments anymore.*"

I thank you very much for your attention and wish you a fruitful conference and a happy stay on our island.