Arnold Schilder: Good governance

Speech by Professor Arnold Schilder, Chairman of the BCBS Accounting Task Force and Executive Director of the Governing Board of the Netherlands Bank, on the occasion of the leave-taking of Mr Jan Hommen, member of the Executive Board of Philips, Amsterdam, 11 April 2005.

* * *

This speech will highlight the role of public oversight concentrating on recent developments in the field of governance, accounting and supervision. Some concrete examples will be used from the practice as prudential supervisors and to show you how at DNB ´Sense and Simplicity´ are an objective as well.

Introduction

Ladies and gentlemen, it is a great pleasure to speak here on Good Governance. I will highlight the role of public oversight concentrating on recent developments in the field of governance, accounting and supervision. I will use some concrete examples from our practice as prudential supervisors and to show you how for us at DNB ´Sense and Simplicity´ are an objective as well. I am sure you are familiar with that slogan.

The main subjects of this speech

In the first part of my speech I will briefly discuss the way DNB has incorporated governance issues in its supervisory approach and how this compares with views held among the business community. I would like to emphasise here that as prudential supervisors for the financial sector we highly value Good Governance, especially such aspects as checks and balances - mainly in risk management structures - quality of management and accountability.

The second part of my speech is about how public overseers can help establish the rules of the game. In this capacity DNB uses its influence in the international regulatory environment. There we liaise with standard-setting bodies to ensure that new regulations and standards advance the public good. I will illustrate how we have played this role in practice, using recent developments of International Financial Reporting Standards as an example.

Governance as part of our supervisory approach

The widespread attention Good Governance receives nowadays could give the impression that this concept has only a brief history. On the contrary - looking back across the history of prudential financial supervision – we see that governance has been on our agenda for decades. Over time, the concept has been broadened and deepened, partly, of course due to the eruption of scandals. Undoubtedly, one of the milestones in the development of Good Governance is the 1997 Report of the so-called Peters Committee. This Report contained 40 recommendations to promote good governance. It appeared that these recommendations were not followed up satisfactorily. But the report set out important principles about a company´s risk management and necessary checks and balances. Its recommendations were based on the COSO-framework, an internal control framework of global standing. The Peters Report was, in fact, the first Dutch Code of Corporate Governance. It gave an impulse to the development of explicit requirements on good governance for banks. How? Well, in 1999 DNB issued its Regulation on Organisation and Control or ROC. In drafting the ROC, we used the governance framework of the Peters Report as its backbone. So in addition to risk management requirements, this Regulation includes checks and balances for the Managing and Supervisory Boards of banks. For example, the ROC requires all banks to establish an audit committee function involving knowledgeable and independent Supervisory Board Members. All banks, you may wonder? Yes, we require such an audit committee function for all, but we allow smaller institutions to meet this requirement within their limited capabilities. This is an example of a principle-based regulation which allows congruence with reality. It will come as no surprise that the second Dutch Code on Corporate Governance, the Tabaksblat Code, contains many of the same aspects as DNB´s ROC, since both are based on the same source. The same goes for some papers of the international Basel Committee on

Banking Supervision, in which we were again able to integrate the Peters Committee´s recommendations.

Oversight promotes a level playing field

This leads us to an important purpose of public oversight. I refer to the aspect of promoting a level playing field. Maintaining a level playing field requires not only adequate regulations but also transparent supervision. You will agree with me that supervising an organisation that applies Good Governance will differ strongly from supervising an organisation that applies Bad Governance. Supervisory action towards supervised organisations can have direct or indirect benefits for those who apply Good Governance. In that sense supervision is in the corporation´s as well as in the public interest.

Transparency

I have just mentioned transparency as an important aspect of supervision. It is beneficial for enforcement purposes. After all, it is important for supervised organisations to know what our enforcement instruments are and when we will use them. An important new development here results from the Revised European Directive on banking Capital Requirements. This Directive adopts the new Basel II capital framework for European legislative purposes. It also requires supervisory disclosures from all European competent authorities - a development which we support actively. So in future everybody will be able to compare the supervisory level playing field for banks through the websites of the European Banking Supervisors.

The view of Jan Hommen

Such supervisory objectives compare well with those of the business community. To illustrate this I will select some sound bites from a recent speech by Jan Hommen. Speaking before a financial reporting oversight seminar organised by VNO/NCW and AFM, Jan stressed the importance of oversight in preventing regulatory arbitrage, and of harmonised accounting standards. Such prevention is important, according to him, in order to guarantee a level playing field. He also said that public oversight of financial reporting contributes to the confidence in financial markets. And he went even further to say that the benefits of this type of public oversight may be diminished if not accompanied by good governance within the company itself. Indeed, congruence is important both ways. Rules and regulations should align with internal practices, and internal practices should be in line with formal governance structures. It is good to see that our views align to such a great extent.

Conclusion on the role of public oversight

In sum, only a balanced mix of sound governance structures and related practices together with transparent public oversight will give Europe a competitive Internal Market.

Public overseers´ efforts for ´Sense and Simplicity´; an example

I now come to the second part of my speech. The business community, including the financial sector, also needs legislation, standards, codes and guidance to be able to play the game. The rules of the game should, however, be conducive to the ´sense and simplicity´ in their appliance. As you know better than anybody, this is an important principle, but far from easy to apply. This is also an important aspect of the role of the public overseers. Allow me to illustrate this role by taking an example from recent experience. As you know, the International Accounting Standards Board has issued the revised Standard on Financial Instruments, IAS 39. The European Community faced the issue of endorsing this revised accounting standard by the end of last year. A key issue here was the so-called Fair Value Option. This option allows financial reporting entities to use fair values for the financial instruments in their accounts. The business community, amongst others banks and insurers, expressed concern about the revised Standard. Moreover the European Central Bank and the Basel Committee on Banking Supervision criticized in particular the risk of inappropriate use of the Fair Value Option.

The Fair Value Option

What was the problem? The International Accounting Standards Board, as a matter of policy, issues standards which can be applied by all relevant organisations, without specifics for individual sectors. For some sectors, such as the financial sector, these standards appear to be too broad. Regarding the Fair Value Option, the gap between the parties involved related mainly to the reliability, comparability and relevance of accounting figures in firms´ financial statements. There were fears that the unrestricted use of fair values could open the door to manipulation and the use of inaccurate valuation methods, which might hurt reliability. Moreover, different institutions could use the Fair Value Option in very different ways, which might hamper comparability. And finally, the use of fair values might not be in line with sound risk management practices within institutions, bringing into question the relevance of reported figures. Now, congruence between sensible standards and sound internal risk management practice is important. Jan Hommen said as much, in the speech I referred to earlier: for financial institutions, accounting requirements must align as much as possible with internal risk management policies.

And with time running short, the question how to bridge the gap became more and more urgent: between a broad standard on the one hand, and the restriction to a context of good governance and risk management on the other.

Searching for an acceptable outcome

It is important, in this kind of process, to listen carefully to each other and to search for common ground. IASB was strongly bent on an unrestricted option for reasons of principle and in order to maintain simplicity. Banks and insurers disagreed on the proposed restrictions. And regulators were concerned about the possible abuse of the option. We as banking regulators then engaged in very informal discussions with banking representatives. We drafted proposals that made sense to both banks and banking regulators. This was possible because we applied a simple principle: good governance banks want a level playing field based on sound risk management practices. Four months later, the now likely outcome is that IASB will have framed the Option within sensible boundaries – and will require comprehensive disclosures about underlying risk management practices, thereby serving transparency. Simple, in the end, and sensible – but after much perspiration. This outcome should strike the right balance between IASB on the one hand, and financial institutions and prudential regulators on the other. I trust this balance in outcome will receive the support of the European Commission as well.

Wrap up

Let me now wrap up my speech. I have given you DNB´s view on some elements of public oversight and how we contribute to transparency and to solutions that make sense. Both from a business and a supervisory perspective, one thing is of particular importance, and that is congruence. This means the congruence of sensible structures and regulations with sound internal practices and vice versa. And transparency can help achieve this. How gratifying it is, then, that Jan Hommen recently also marked these terms as overarching principles for the Philips corporate policy. He did so, not only for financial reporting, but also, if I understand correctly, for the governance structure in general. And as you will understand from my speech, I would like to congratulate Philips on these outstanding principles and Jan Hommen on his undoubtedly large contribution to their development. Ladies and gentlemen, thank you very much.