

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

Guidance notes for supervised financial institutions in Aruba issued on the basis of Section 15 of the SOSCS

I. Introduction

Financial institutions face special challenges, because these institutions differ from other corporations in that most of the funds they put at risk belong to others. Generating return to the shareholders with mainly third-party funding creates limits on the risks that a supervised institution can prudently undertake.

In general, to ensure that supervised financial institutions are safely and soundly managed, the Bank requires that these institutions avoid unsafe and unsound practices. Corporate governance involves the manner in which the business and affairs of individual institutions are governed by their senior-management and Supervisory Board (the Board). Therefore, supervisors of financial markets have a keen interest in determining that the institutions supervised have adopted sound corporate governance practices. With these guidance notes the Bank aims at promoting the adoption of sound corporate governance practices by financial institutions under its supervision.

II. Basic elements of sound corporate governance practices

Basic elements of sound corporate governance practices are:

- Establishing clear strategic 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.

In the following paragraphs these elements will be discussed more in length, especially in relation to the responsibilities of the Board.

III. Responsibilities of the Board and its members

The Board has dual responsibilities. The Board has its responsibilities as a whole, while each Supervisory Director has responsibilities as an individual member of the Board.

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

The responsibilities of the Board as a whole can be summarized as follows:

- Ensure competent management on an ongoing basis.
- Ensure appropriate plans and policies for the institution.
- Monitor operations to ensure compliance and adequate control.
- Oversee business performance.

III.1 Board responsibilities

a. To ensure competent management on an ongoing basis

Capable management is a critical element in the difference between success and failure of an institution. Integrity and suitability should be key considerations in the selection process of senior-management. Reference is made to paragraph 2 of the Directive on Sound Business Operations for further information on the integrity and suitability assessment conducted by the Bank. The appointment or dismissal of a member of senior-management should have the approval or at least the consent of the Board.

b. To ensure appropriate plans and policies for the institution

Planning

Rapid changes in the financial industry call for clear strategies and business planning. Long-term strategic planning is done in strong cooperation with the Board and forms the broad policy framework, containing the institution's philosophy and vision to the future.

Policies

All major activities must be covered by adequate policies and no such activity should be initiated before appropriate written policies and procedures are in place. Furthermore, policies should be communicated clearly through all levels, in order to promote consistency of interpretation throughout the organization as a whole. Reference is made to paragraph 3 of the Directive on Sound Business Operations.

c. To monitor operations to ensure compliance and adequate control

The Board needs to ensure that senior-management has put adequate internal controls in place to ensure that the institution's operations are properly controlled and that they comply with adopted policies, applicable laws and regulations.

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

d. To oversee business performance

The Board must receive timely all necessary information to evaluate management's performance (refer also to paragraph IV.3). The information provided should include at least:

- monthly balance sheet and profit and loss account;
- analysis of actual versus budgeted income and costs (also per division);
- analysis of key ratio's and trends (including prudential ratio's);
- information on accounting, policy and compliance matters;
- information on important external developments;
- internal audit reports (including management's comments);
- reports from and correspondence with the external auditor (including the so-called management-letter);
- on-site examination letter and other relevant correspondence with the supervisor; and,
- changes in relevant laws and regulations;

III.2 Supervisory Director's individual responsibilities

A Supervisory Director should:

- a) **be aware of the institution's operating environment.**
Each Supervisory Director should be generally informed of both the business environment and the legal and regulatory framework affecting the institution's activities.
- b) **be diligent in performing its duties.**
Supervisory Directors must devote adequate time and attention necessary to fulfill their duties in a proper manner and should be knowledgeable enough to contribute in a meaningful sense to the activities of the Board.
- c) **exercise independent judgment.**
If a Supervisory Director disagrees with a Board decision, he or she should say so and formally register and explain his or her disagreement. Objective judgement, with due observance of articles 9 and 10 of the Directive on Sound Business Operations, is critical to the Board's effectiveness.
- d) **be loyal to the institution's interests.**
Supervisors Directors are at all times responsible for protecting the institution's interests. Supervisory Directors must also ensure that neither they nor others abuse their position to benefit personally from the institution. They should structure their business with and personal ties to the institution so as to avoid even the appearance of a conflict

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

of interest. Reference is also made to articles 9 and 10 of the Directive on Sound Business Operations.

III.3 Required qualifications

Candidates for board positions in supervised institutions need at least some basic knowledge of the financial industry. However, the Board as a whole must possess sufficient knowledge and experience.

III.4 Separate Board Committees

The Board can form, for example, the following separate committees, in order to perform certain tasks that require detailed review or in-depth consideration.

Audit Committee: This committee serves to monitor compliance with Board's policies, applicable laws and regulations, and to review financial and auditing matters.

Risk Management Committee: This committee ensures that the institution maintains acceptable risk limits and that appropriate risk-control techniques are used to monitor and minimize losses to the institution.

Credit Committee: The credit committee ensures that an institution's lending policies are adequate and adhered to and comply with applicable laws and regulations regarding credit extension.

Investment/Asset-Liability Committee: This committee ensures that the institution's investment policies and assets/liabilities mix are adequate and that the institution's investments comply with Board policies, general principles of asset and liability management, principles of risk management, and applicable laws and regulations.

Remuneration Committee: Matters usually dealt with by this committee include CEO compensation arrangements, remuneration, recruitment and termination policies,

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

incentive schemes, and remuneration arrangements for Board members.

It should be stressed, however, that the Board as a whole remains fully responsible for a proper supervision of the institution. Therefore, these committees should report to the complete Board on all major issues discussed.

IV. Risk management

When evaluating the quality of risk management at financial institutions, the Bank considers primarily if the following conditions are met:

- active Board and senior-management oversight;
- adequate policies, procedures, and limits;
- adequate risk measurement, monitoring, and management information systems; and
- adequate and comprehensive internal controls.

IV.1 Active Board and senior-management oversight

The Board should be consulted on the overall business strategy and on significant policy matters, including those related to the managing and taking of risks.

Senior-management is, however, primarily responsible for implementing strategies in a manner that limits risks associated with each strategy and that ensures compliance with laws and regulations on both a long-term and a day-to-day basis.

IV.2 Adequate policies, procedures, and limits

The following guidelines are considered by the Bank in evaluating the adequacy of a supervised institution's policies, procedures, and limits:

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its activities.
- The policies, procedures, and limits are consistent with the institution's stated goals and objectives and the overall financial strength of the institution.
- Policies clearly delineate accountability and lines of authority across the institution's activities.
- Policies provide for the review of new activities of the financial institution to ensure that the infrastructure necessary to identify, monitor, and control risks associated with an activity is in place before the activity is initiated.

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

IV.3 Adequate risk measurement, monitoring, and management information systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by information-systems that provide senior-managers and Board with timely reports on the financial condition, operating performance, and risk exposure of the financial institution, as well as with regular and sufficiently detailed reports for line managers in the day-to-day management of the institution's activities.

In assessing the adequacy of a supervised institution's measurement and monitoring of risk and its management reports and information systems, the Bank will consider whether the following conditions exist:

- The institution's risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the institution's activities, structured to monitor exposures and compliance with established limits, goals, or objectives, and as appropriate, compare actual versus expected performance.
- Reports to the Board and management are accurate and timely and contain sufficient information to identify any adverse trend and to evaluate adequately the level of risk faced by the institution.

IV.4 Comprehensive internal controls

An institution's internal control environment is critical to the safe and sound functioning of the institution and, in particular, to its risk management system. Establishing and maintaining an effective system of controls, including appropriate separation of duties, is one of senior-management's primary responsibilities.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting. Moreover, the system safeguards assets and helps to ensure compliance with relevant laws, regulations, and institutional policies.

Internal controls should be tested regularly by an internal auditor. The results of audits or reviews should be adequately documented as should management's responses to them. In addition, communication channels

POLICY PAPER ON SOUND CORPORATE GOVERNANCE PRACTICES

should exist that allow negative or sensitive findings to be reported directly to the Board or to the relevant Committee of the Board.

In evaluating the adequacy of a supervised institution's internal controls and audit procedures, the Bank will consider whether the following conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and extent of the institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines provide sufficient independence of the control areas from the business lines and adequate separation of duties throughout the organization.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely; wherever applicable, exceptions are noted and promptly investigated.
- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other review related practice provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely attention.
- The Board, in consultation with senior-management, reviews on at least a yearly basis the effectiveness of internal audits and other review activities.

V. Financial disclosure

Stakeholders should receive sufficient information to evaluate management's performance. In this respect, all supervised institutions should at least comply with the disclosure requirements set out in the Aruban Code of Commerce.