Corporate Governance and Financial Stability in Trinidad & Tobago

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Abstract: This paper seeks to investigate the link between two of the major financial issues in the world today – Corporate Governance and Financial Stability. This is done within the context of Trinidad & Tobago, one of the major financial markets in the Caribbean region. This paper is relevant in light of the corporate governance issues that have arisen within this territory and the financial crisis experienced internationally. Corporate governance is important but not necessarily all parts of it are mandatory. However, its effect on financial stability is considered to be significant. Definitions of these two concepts will be explored within the context of a small economy, specifically, that of Trinidad & Tobago. Also, the use of an author-constructed corporate governance index as well as some financial stability ratios will aid in the analysis of the link between the two concepts – both before and after the crisis.

Keywords: Corporate Governance, Corporate Governance Index, Financial Stability, Financial Ratios

Section 1: Introduction

Corporate Governance and financial stability are both important concepts for firms operating in the modern financial arena. To find a linkage between them would indicate whether corporate governance and financial stability complement each other and perhaps, assist each other in the long run.

Corporate Governance refers to the firm's ability to govern itself properly within its local realm (internal governance) and within the national and international realm (external governance). Corporate Governance is a topic of great interest in today's financial world. This has been the case since the collapse of American energy company, Enron in 2001. Other major firms followed such as WorldCom, Xerox and Tyco. Trinidad & Tobago has not been immune to such financial disasters and in 2008 experienced distress when the Hindu Credit Union (HCU) collapsed and again in 2009 with the Colonial Life Insurance Company (CLICO) Trinidad Ltd. which experienced a bailout by the Trinidad & Tobago government. Till date Trinidad & Tobago does not have any formal legislation specifically related to Corporate Governance but the Central Bank of Trinidad & Tobago has issued a Corporate Governance guide which firms listed on the Trinidad & Tobago Stock Exchange (TTSE) are supposed to follow.

This paper constructs a Corporate Governance Index for companies listed on the TTSE in Trinidad & Tobago in order to facilitate easy measurement and assessment of the corporate governance situation of a particular company in this country. This index is divided into sub-indices, one of which will be used to indicate financial stability in the companies. In addition to this, a popular ratio, the return on equity will be used as another indicator of financial stability. Using these indicators financial stability and corporate governance will be tested for a possible relationship. The rest of the paper is organized as follows: Section 2 covers the literature in this area, Section 3 describes the data and methodology, Section 4 shows preliminary results and Section 5 concludes.

Section 2: Literature Review

2.1 Definitions of Corporate Governance

There are many definitions for corporate governance. Sir Adrian Cadbury in his 1992 Report on the Committee on Financial Aspects of Corporate Governance p.15 says "Corporate Governance is the system by which companies are directed and controlled." Another definition is, "corporate governance can be defined as the stewardship responsibility of corporate directors to provide oversight for the goals and strategies of a company and foster their implementation."(Cornelius 2005, p. 12). The OECD Glossary of Statistical Terms website (2010) states that corporate governance refers to "procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making." The Financial Times Lexicon website (2010) defines corporate governance as "How a company is managed, in terms of the institutional systems and protocols meant to ensure accountability and sound ethics. The concept encompasses a variety of issues, including disclosure of information to shareholders and board members, remuneration of senior executives, potential conflicts of interest among managers and directors, supervisory structures, etc." Brancato and Plath (2003) p.8 say "Corporate governance is defined in this report as a system of checks and balances between the board, management and investors to produce an efficiently functioning corporation, ideally geared to produce long-term value." Fahy et al (2004) p.163 say "Put in its simplest form, corporate governance is the systems and processes put in place to direct and control an organisation in order to increase performance and achieve sustainable shareholder value." Kaen (2003) pg 1: "Corporate Governance is about who controls corporations and why".
The definitions all have common features:
(1) Corporate Governance is concerned with monitoring the activities of the firm; (2) Corporate Governance must control the firm's activities while monitoring them (3) Corporate Governance must protect shareholders. Another important component in Corporate Governance that comes out of the definitions is the importance of board of directors and of monitoring this board.

2.2 Importance of Corporate Governance

Having a good legal framework is important for an economy and the firms operating in it. But it is also important for the firms to realize that their performance can be measured and reported to shareholders and to the public in general. The first group of firms that should be targeted therefore, will be those firms listed on the stock exchange/s in an economy. For Trinidad & Tobago such firms will be considered when preparing the Corporate Governance. This is because those firms are required by law to report certain aspects of their performance and daily activities to their shareholders. In Trinidad & Tobago the TTSE rules state that firms must disclose: their Balance Sheet, Profit & Loss Account, full name & description, registered address, registrar's address, names and addresses of all the company directors, date of incorporation and a brief history of operations, structure of authorized and issued capital, recent capital history, dividend history, special conditions related to company share transfers (Trinidad and Tobago Stock Exchange Rules 2004, Trinidad and Tobago Central Depository Rules 2002).

In the USA the prevailing Corporate Governance legislation is the Sarbanes-Oxley (SOX) Act of 2002. This piece of legislation clearly states the number of directors a firm should have – and states how many should be independent, their terms of service, remuneration elements and many other stipulations ensuring that the firms will function in a proper Corporate Governance environment. The SOX Act is heavily criticized (Wade 2002) on the basis that it is too stringent to allow complete compliance. Other important corporate governance guidelines include the OECD Principles of Corporate Governance (2004), the Corporate Governance Guide published by the London Stock Exchange (August 2004) and the guide produced by the New York Stock Exchange (November 2004). Locally, the Central Bank of Trinidad & Tobago has issued a Corporate Governance Guideline, first in May 2006 and then a revised version in May 2007. Even though the Corporate Governance guideline is meant to be just a guide for Corporate Governance procedures, firms are required to satisfy the criteria of having at least two independent directors. The other elements, though strongly recommended, are not mandatory. Firms listing on the TTSE are required to disclose enough information to allow the public to make a proper judgement about their state of affairs before making an investment.

The legislation and guides listed above all outline the responsibilities of the board, the structure of the board – including the number of independent directors, shareholder rights, the level of required disclosure, what is expected of the audit committee and the audit process. Therefore, these can be considered to be the main aspect of Corporate Governance.

2.3 Corporate Governance indices

Corporate Governance indices have been developed by many companies and researchers. However, the majority of these are relevant only to developed economies. This is a flaw that is quickly being corrected since developing economies also need to have proper Corporate Governance measures. Of the notable Corporate Governance indices that have been formulated are the following: the Corporate Governance index developed by Ananchotikul (2008), the index developed by Black, Jang and Kim (2003a and 2003b), the FTSE-ISS Corporate Governance index (2005), the Gompers, Ishii and Metrick (2003) index, the Corporate Governance Index developed by Khanna et al (2001), and by Klapper and Love (2002). Of these, only the index developed by Ananchotikul (2008) was specifically formulated for developing countries.

According to Cornelius (2005) the FTSE and ISS have partnered to create a Corporate Governance Index. According to their publication there are five major aspects of Corporate Governance that a firm should prepare for: (1) Compensation systems for Executive & Non Executive directors (2) Executive and non executive stock ownership (3) Equity structure (4) Structure and independence of the board (5) Independence and integrity of the audit process. Although the FTSE ISS index is very well thought out and relevant, it is only constructed for developed economies and this is a major flaw in the index.

Gompers et al (2003) construct an index by adding one point for every firm for every provision by the firm that restricts shareholder rights and by extension, increases managers' power. Sub indices are also created: delay, protection, voting, other, state. The index totals 28 provisions in all, 24 of these are exclusive to them.

Black et al (2003a, 2003b) constructed a Corporate Governance based on a survey carried out by the Korea Stock Exchange. They have six sub indices: shareholder rights, board of directors, outside directors, audit committee, internal auditor, disclosure to investors, ownership parity. They allow each sub index to carry a maximum value of 20 with the overall Corporate Governance having a maximum value of 100. If a firm does not report on a particular question it is not considered as a part of the value, in this manner this index differs from others, particularly from Ananchotikul (2008) who uses the zero value to indicate that there is a lack of a corporate governance measure that should have been included by the firm. The authors excluded subjective questions from the construction of the index (these were taken to be questions where the managers were asked to offer an opinion). The authors had 38 survey elements which were usable for constructing the Corporate Governance after they eliminated certain aspects of the survey which would not have contributed to the index such as subjective questions, questions not directly related to Corporate Governance, questions with ambiguous answers, with high overlap, minimal variation between firms, few responses.

According to Ananchotikul (2008) the major aspects of Corporate Governance are: board structure, board responsibility, conflict of interest, shareholder rights, disclosure & transparency. She constructs a firm Corporate Governance index for firms in Thailand which uses only information available from public sources such as company disclosure reports, annual reports, company websites, stock exchange of Thailand databases. Up to 87 criteria are analyzed. The values for Ananchotikul (2008)'s index range from 0 to 100 with 100 being the perfect Corporate Governance score and 0, the worst. The interesting part about this index is the fact that it uses only publicly available information. This, the author states, is favourable to using the survey collection method for Corporate Governance data since firms instantly believe that they are being judged on the appropriateness of their Corporate Governance structures. This may lead to inaccurate reporting or self selection where only firms with good Corporate Governance structures will be likely to report values. Ananchotikul (2008) uses a weighted average of the sub indices to create a composite Corporate Governance Index. The weights assigned are as follows: board structure – 20%, conflict of interest – 25%, board responsibility – 20%, shareholder rights – 10%, disclosure & transparency – 25%.

The Heidrick and Struggles biennial study (2001 – 2009) first rated firm in ten European countries: Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain, Sweden, Switzerland, the UK and then expanded to include Austria, Denmark and Finland. These countries are rated on Corporate Governance with a maximum rating of 16 being allowed. The company ratings are used to produce a country average, and the country averages are used to create an overall European rating. The study uses only published information and especially, the annual reports of the companies. The working style of the board, board composition and the disclosure of the firm were considered to be the three driving forces in Corporate Governance in a firm.

Khanna et al (2001) report on several Corporate Governance Indices. In particular they mention the Credit Lyonnais Securities Asia (CLSA) Corporate Governance Index. The index was constructed using a 57 question survey of which 70% was based on facts while 30% required the analyst's opinion. The questions were all answered in the yes/no form and where Corporate Governance information was not available the answer 'no' was used since a lack of information about governance indicates poor governance and should be treated as such. The questionnaire used to formulate the index was broken up into seven parts: fiscal discipline, accounting transparency/disclosure, board independence, board accountability, responsibility, equitable treatment of shareholders, social awareness. One of the limitations of this questionnaire is its reliance on analyst opinion.

Klapper and Love (2002) developed a Corporate Governance Index using the CLSA questionnaire data as well as Worldscope data and use six components of the index: management discipline, transparency, independence, accountability, responsibility, fairness. The components are not studied as sub indices since they each have overlapping parts. This index has a maximum value of 100 and a minimum value of zero.

Overall the Corporate Governance Indices have some common themes: Shareholder Rights are important in all cases and almost all the authors (Khanna et al 2001, Black et al 2003, Ananchotikul 2008, Gompers et al 2003) have a sub index devoted to Shareholder Rights. Another major focus is that of the board of directors of a firm. This is shown in two ways – the emphasis on responsibilities of the board of directors (Ananchotikul 2008, Black et al 2003, Cornelius 2005, Khanna et al 2001, Klapper and Love 2002) and the emphasis on the structure of the board (Ananchotikul 2008, Black et al 2003, Cornelius 2005, Khanna et al 2001). Transparency is also very important to a good Corporate Governance system since transparency inspires shareholder confidence in the firm Ananchotikul (2008), Black et al (2003), Khanna et al (2001), Klapper and Love (2002). Another major element of Corporate Governance is that of the audit committee’s performance. After the crash of the Arthur Andersen accounting firm, the audit process has been under strict scrutiny. The index constructed by Black et al (2003) includes a sub index on the audit committee and the FTSE ISS Index also includes a sub index on the audit committee (Cornelius 2005) while Klapper and Love (2002) have a component titled ‘accountability’. The literature points to these aspects of governance as the most important to the proper functioning of a firm. These components were also important in the construction of the Corporate Governance Index for Trinidad & Tobago.

2.4 Financial Stability Defined

There is no international financial stability definition. The lack of concurrence on this matter is discussed by several authors and regulatory institutions (Schinasi 2004, European Central Bank 2005, Central Bank of Trinidad and Tobago (CBTT) 2008,). Instead, several authors have attempted to construct a proper definition of a phrase that clearly encompasses many elements of the financial system. Schinasi(2004) agreed that financial stability is a difficult concept to define and he proposed four major aspects that must be considered: (1) The broadness of financial stability must be considered and this includes its effects on the various aspects such as the types of institutions, market structures. (2) The efficiency of the payment system is imperative to a financially stable economy (3) Financial stability ensures not only an absence of financial crisis, but an ability of the system to repair crises as they begin to occur. (4) Financial stability affects the workings of the economy in general and has far-reaching consequences that extend beyond the activity of the firm. The European Central Bank (2005) added that financial stability should incorporate the ability of the financial system to adapt to the changes occurring in the financial markets over time – the creation of new instruments and new rules for example should be easily incorporated.

The CBTT uses a definition by Andrew Crockett (2005) “Financial stability requires that (i) the key institutions in the financial system are stable, in that there is a high degree of confidence that they can continue to meet their contractual obligations without interruption or outside assistance, and (ii) the key markets are stable, in that participants can confidently transact in them at prices that reflect fundamental forces and that do not vary substantially over short periods when there have been no changes in fundamentals."

2.5 Indicators of financial stability

Financial stability is usually assessed using financial ratios (IMF 2003, Nelson and Perli 2004). Since the concept of financial stability is itself so broad, a variety of financial ratios are used to assess the stability of firms in various aspects – profitability, liquidity, openness to risk and others. Different ratios are used for different types of firms as well since deposit-taking institutions and non deposit-taking institutions have different rules, as well as firms operating in different sectors.

This definition comes from the IMF "FSIs are indicators of the current financial health and soundness of the financial institutions in a country, and of their corporate and household counterparts. They include both aggregated individual institution data and indicators that are representative of the markets in which the financial institutions operate." (IMF 2004).

The IMF produced several pieces of literature surrounding financial stability indicators of the different classes. The IMF has issued a paper which covers the core set of financial stability indicators and the encouraged set. The indicators, usually ratios, are also categorized according to the type of institution to be assessed. The indicators are too numerous to list here, but these indicators suggested by the IMF have been used by several authors as the basis for financial stability assessment – both in a research setting and in a practical implementation setting, especially in Central Banks worldwide (European Central Bank, Indonesian Central Bank, Central Bank of Trinidad and Tobago).

2.6 Corporate Governance and Financial Stability

Authors who have studied corporate governance and financial stability and their relationship have shown that sometimes the corporate governance stipulations interfere with the financial stability of the firm (Wymeersch 2008). In particular reference was made to the incentive aspect of internal governance that allows incentives to be earned when governance goals are met. In the long run, excess incentives have proven to be toxic to firms as was seen in the case of the subprime mortgage crisis in the USA. The European Commission (2010) in their report on corporate governance and remuneration practices in financial institutions mentioned that

However, in general the view is that corporate governance and financial stability should go hand in hand and that regulators should make an attempt to promote corporate governance rules that also ensure financial stability of the firms operating in an economy (Basel Committee 2010, European Commission 2010, Heremans 2007, Mavrommati 2005, Sauzerzpof 2005). Financial stability and corporate governance were both acknowledged to be important concepts to any well-performing firm. The likelihood that they could be tailored to complement each other is a strong one and therefore very appealing to researchers and regulators since it offers the opportunity of promoting financial health of the firm in two ways at once.

Section 3: Data & Methodology

To measure Corporate Governance I constructed a corporate governance index for firms listed on the Trinidad and Tobago Stock Exchange (TTSE). The full index includes 135 questions which cover the following areas: Audit Committee, Board Responsibility, Board Structure, Shareholder Rights, Transparency & Disclosure.

In this case, two financial stability indicators are used: one constructed using the transparency and disclosure components of the full CGITT indicator, since all the above definitions of financial stability stress the importance of transparency and this indicator shows that as well and the other uses the return on equity financial ratio.

The CGITT, its sub-index the Transparency Index (TI) and the Return on Shareholders' Equity (ROSE) are all calculated for the firms listed on the TTSE for the year 2008. The information for the CGITT is gathered using company annual reports, information on the TTSE website, the company websites and other public sources (including the newspaper). The ratio is calculated using the financial information provided by each firm in their audited financial statements produced at the end of their business years.

At this stage only simple correlation analysis is done to establish whether a relationship may exist between financial stability and corporate governance and to individually assess financial stability and corporate governance in the companies and for the TTSE as a whole.

Section 4: Results

No major econometric analysis was done at this stage because of the limited number of firms listed on the Trinidad and Tobago Stock Exchange, there was not much room for reliable statistical analysis. However, a correlation analysis is included and attempts to determine if any relationship exists between the measure of corporate governance, the CGITT, and a measure of financial stability. The ratio indicating the return on equity was chosen since this was a generally accepted indicator for firms in all sectors. Some of the firms also had very limited disclosure and the return on equity ratio was the only one that could have been found using the information available.

As an alternate measure of financial stability I extracted the transparency and disclosure component of the CGITT since financial stability rests mainly on the firm's transparency. However, in extracting the transparency and disclosure sub-index, the value for each firm was weighted in relation to the total for that sub-index. The purpose of this was to indicate how transparent the firms are, and by extension, how financially stable.

Correlations are not shown between the Transparency sub-index and the CGITT because these values are likely to be high since the TI is itself a part of the CGITT.

Table 1 – Correlations

Sector	Companies	ROSE	CGITT	TI	Correlation ROSE CGITT	Correlation ROSE TI
	BCB Holdings	20.94313	37	51.11111		
	First Caribbean International Bank	15.12006	135	64.44444		
	National Commercial Bank of Jamaica	0.34494	87	66.66667		
	Republic	29.83642	80	60.00000		
Banking	Scotiabank	30.42912	75	55.55556	-0.28180	-0.66235
	Ansa Mc AL	28.96318	67	62.22222		
	Barbados Shipping and Trading	7.63608	43	48.88889		
	Grace Kennedy	11.30000	78	60.00000		
Conglomerate	Neal and Massy Holdings	27.52743	49	48.88889	0.05674	0.21713
Property	Point Lisas Industrial Port Development Corporation	0.28250	44	57.77778	n/a	n/a
	National Flour Mills	-0.77431	50	53.33333		
	One Caribbean Media	16.21679	57	57.77778		
Manufacturing 1	Unilever	45.25378	59	57.77778	0.89590	0.78161
	Flavorite	16.37851	43	26.66667		
	Readymix WI	51.14637	41	53.33333		
Manufacturing 2	Trinidad Cement Limited	15.50000	71	57.77778	-0.56865	0.36118
Trading	Agostini	20.29305	63	53.33333	0.85540	0.81409

	Prestige	7.93342	8	2.22222		
	Supreme	37.60372	68	53.33333		
Non-banking financial	Ansa Merchant Bank	8.13624	31	48.88889	0.14674	0.07673
	Capital and Credit Financial Group	9.55855	57	42.22222		
	Guardian Holdings	0.11646	81	55.55556		
	JMMB	18.88657	80	57.77778		
	National Enterprises Ltd	32.44468	27	22.22222		
	Sagicor	33.69808	96	73.33333		
	Scotia DBG	2.47752	40	37.77778		
Non-sector preference	Capital and Credit Merchant Bank	11.16457	56	46.66667		
TOTAL					0.06163	0.13941

The correlations indicate that the relationship between the financial stability indicator and corporate governance is stronger in some sectors. However, overall the relationship seems to be a very weak one and overall, the two financial stability indicators chosen do not appear to be correlated with each other. This is not a real problem since financial stability does encompass many aspects, as listed in the definition above.

Section 5: Conclusions

It appears that there is no significant link between financial stability and corporate governance for the TTSE overall. However, the individual sectors do have differing values. In some sectors there seems to be greater evidence of a relationship and there also seems to be a greater transparency focus in some sectors of the economy.

Overall the correlation value between the indicator for stability and that for governance is quite low at 0.06 indicating that there is almost no relationship between the two. Further analysis may indicate if this is true and what relationship is present – positive or negative. For the manufacturing 1 sector and the trading sector the correlations are very high between the financial stability indicator and the corporate governance indicator. This means that in these two sectors there may be a stronger level of interaction between these two concepts than in the others. Interestingly, in those two sectors, there was also strong evidence of correlation between the two financial stability indicators chosen. Perhaps then, financial stability and corporate governance are related within sector constraints instead of for the economy in general. There is a definite need for further analysis in this area.

When considering the level of transparency in the firms, it must be said that the firms in general seem to have a low level of transparency since none of them disclose more than 67% of what is required. This points to the need for stricter laws requiring that firms disclose what is stipulated by law.

Overall, there does not seem to be much evidence of a relationship between corporate governance and financial stability in Trinidad and Tobago. However, there is a need for further research to be done in this area.

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