



Improving internal checks and balances in semi-public organisations

SYNOPSIS OF WRR-REPORT NO. 91

WRR

*Improving internal checks and
balances in semi-public organisations*

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Background

This publication is a summary of WRR report no. 91, *Improving internal checks and balances in semi-public organisations* [Van tweeluik naar driehoeken] by the Netherlands Scientific Council for Government Policy (WRR). The conclusions and recommendations presented here are based on an in-depth analysis that can be found in the full report.

The Council presented the report *Improving internal checks and balances in semi-public organisations* (ISBN 978 90 8964 821 1) to the Dutch Government on 27 May 2014. It is commercially available and can be ordered from Amsterdam University Press. A PDF of the report can also be downloaded from www.wrr.nl.

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I INTRODUCTION

The managing directors of semi-public organisations in the Netherlands have a great deal of decision-making authority, but the system of checks and balances within those organisations is negligible. That is the impression left by enquiries into recent incidents at Dutch housing associations, educational establishments and health care institutions. It is not – or not only – the unscrupulous behaviour of managing directors that is to blame for many of these incidents, but also the fact that, in many cases, no one opposed those who acted too rashly. The financial and societal consequences of undisciplined management and faulty internal supervision can be significant.

In response to these incidents, researchers and policymakers have argued in favour of more stringent regulation on the one hand (stricter external oversight, liability, ministerial powers) and more professionalism on the other (training, codes of conduct and consultation). The Netherlands Scientific Council for Government Policy (WRR) has already examined the concept of external oversight in previous reports, for example *Toezen op publieke belangen* [Supervising public interests] (2013) and *Publieke zaken in de marktsamenleving* [Public interests in a market society] (2012).

What is missing from the current policy debate, however, is a focus on improving the internal checks and balances *within* semi-public institutions. If organisations have a faulty system of internal accountability, then confidence in the professionalism of individual managing directors will quickly turn into blind trust. And if the internal system of checks and balances does not function properly, external oversight bodies will soon be asked to do the impossible. Or, to put it otherwise: what is not properly regulated internally cannot be repaired through external measures. In the report *Improving internal checks and balances in semi-public organisations*, the Council explores a number of ways that internal checks and balances can be improved in semi-public organisations in the housing, education and health care sectors.

II INTERNAL CHECKS AND BALANCES

In the past few decades, many semi-public institutions in the Netherlands have evolved from small-scale private initiatives into large, professional organisations with tens of thousands of employees and users. Associations were replaced by foundations, causing their members to fade from view. Now that these institutions have grown in scale, their clients – patients, pupils, and tenants – have forfeited their role as the managing directors’ regular consultation partners. The semi-public sector has adopted the private-sector governance model, with management and supervisory boards, but the ‘public shareholders’ have been left by the wayside. These transformations have increased the financial interests and risks just as the number of parties monitoring the institutions internally has declined. On top of this, it is not always clear who the ‘public shareholders’ are with authority to decide the organisation’s strategic targets.

The absence of counterbalancing influences sometimes means that impassioned managing directors can pursue their objectives unchecked, and that financial irregularities or management debacles long go unnoticed. In the current governance model, counter-power should reside mainly with the supervisory board, but supervisory directors are not always informed, practised or vigorous enough to provide sufficient counterbalance. In its report *Improving internal checks and balances in semi-public organisations*, the Council advocates a more extensive system of internal checks and balances in which third parties will once again play a role.

By internal checks and balances, the Council means forms of monitoring and counterbalancing influence organised within an institution. ‘Checks’ are the options open to internal accountability forums to monitor and correct managing directors. ‘Balances’ refer to an even division of authority internally, so that power is not concentrated in the hands of any one person or group. Internal checks and balances force decision-makers to move more cautiously, and therefore more sluggishly. They are explicitly designed to rein in rash, unrestrained forms of entrepreneurship. Semi-public organisations are not commercial enterprises, after all; they are rarely, if ever, subject to the mechanisms that provide for balance in the private sector, i.e. rejection by customers, plummeting profit margins, critical banks, angry shareholders, or looming business failure. In its report *Improving internal checks and balances in semi-public organisations*, the Council discusses three ‘lines of defence’ that can organise or deliver the necessary system of checks and balances: the management board, the supervisory board, and third parties.

III FIRST LINE OF DEFENCE: COLLECTIVE MANAGEMENT

The first line of defence that provides checks and balances consists of the institution's own managing directors. No institution can prosper without good directors. The mounting scale at which semi-public institutions now operate means they face major challenges. They must tackle complex tasks, shoulder a heavy burden of responsibility, and cope with enormous pressure from politicians and the public. Great strides have been made towards professionalising the management boards of hospitals, health care institutions and universities in recent years. Recent malpractices have further led to various proposals aimed at fostering responsible behaviour among managing directors.

Some of these measures focus on *prevention*. Their aim is to improve the level of professional and moral competence among directors through better selection and training, and by developing normative frameworks. Codes of conduct and professional oaths for directors have become popular in recent years, for example. Not every solution will prevent every form of managerial misconduct, however. Codes of conduct will do nothing to deter those directors – admittedly a small group – who knowingly and willingly misbehave. Neither will a code offer a remedy against managerial impotence.

Other measures focus on *repression*, i.e. external regulation and oversight of directors. This includes proposals to extend and tighten up financial oversight, directors' liability and ministerial powers of dismissal. There are a number of crucial disadvantages to repression, however. They may lead to high transaction costs, a heavy administrative burden, and defensive behaviour. External oversight often comes too late in the day to avert specific incidents. And while making managing and supervisory directors liable allows for redress after excesses have already been committed, it may also scare off good candidates and raise insurance rates.

Besides greater professionalism and more *external* oversight, the Council therefore advises looking at *internal* checks and balances and *internal* regulation. This would include monitoring an institution's articles of association and identity, internal financial control, internal liability, and joint strategic planning. Such internal checks and balances can help prevent various forms of undesirable conduct – but certainly not all. In the end, the best remedy against directors who lack a moral compass or professional competence is to improve the selection process. It is essential to continue looking at proper selection, training, monitoring and evaluation of directors.

When it comes to internal checks and balances, a managing director's most important day-to-day sparring partners are his or her fellow directors. Introducing forms of collective rather than unilateral management within semi-public organisations creates a built-in system of checks and balances. Collective management is by no means the standard at all semi-public institutions, however. Fellow directors can offer an effective form of counter-power because they have access to almost the same information, have worked together for a long time, and operate at the same level of authority. Board members also cannot dismiss one another, preventing any abuse of power if internal criticisms grow too pointed.

Collective management is not without its risks, however. Forceful personalities can end up driving each other away. Collective management requires managing directors to give one another enough room for manoeuvre and to put the interests of the organisation first. That is why directors must agree on specific tasks and powers, for example by making the chairperson responsible for coordinating the management process. Having an odd number of managing directors – three or five – can also help avert stalemates and conflict. Because they work together every day, directors can become blind to one another's failings, and they can also fail as a group. The Council therefore believes that internal supervision is still needed to guarantee counterbalancing influence to management boards.

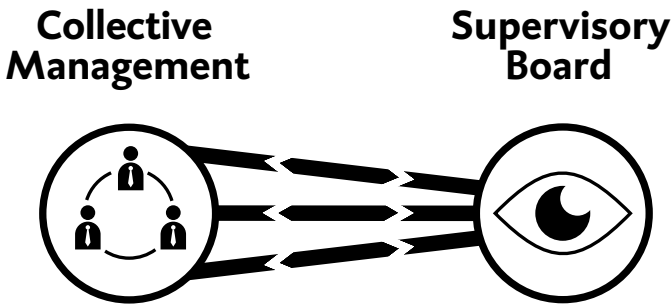


Figure 1 Collective management

IV SECOND LINE OF DEFENCE: THE DIPTYCH

The second line of defence is the supervisory board. This is a key internal body because it forces the management board to reflect on its actions and to account for its conduct. Nevertheless, the supervisory board is not always capable of counterbalancing the management board sufficiently, for various reasons. The Council believes it could use some assistance in that regard.

The supervisory board model applied in the semi-public sector is based on the model used by Dutch listed companies. In the private-sector version, the management board and supervisory board are separate entities, with the supervisory board monitoring the management board from the outside. Another model common in the Netherlands is the board/executive model. Here, volunteer board members exercise oversight while one or more executive directors assume responsibility for day-to-day decision-making. Both of these models are based on a *governance diptych*. Acting alongside and, at times, in opposition to the managing or executive directors are, respectively, the supervisory directors or volunteer board members, who are charged with internal accountability and control, on a part-time basis. The statutory position and authority of internal supervisory boards are significant, properly regulated, and further confirmed in governance codes drawn up by industry associations in virtually every sector.

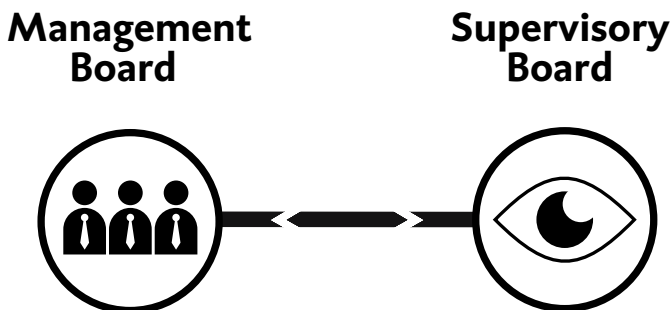


Figure 2 Diptych model

The diptych model is by far the most important system of internal checks and balances. The supervisory board monitors everything that might affect the organisation. It should be guided by the organisation's long-term interests and by the interests of society in general. However, the supervisory board can only offer the management board proper checks and balances if it has timely, accurate information, if it is capable of forming an opinion based on that information, and if it has both the opportunity and the courage to intervene

when necessary. To what extent this description reflects actual practice is open to question, according to the Council. In addition, in years to come it may prove difficult for the many institutions in education, health care and public housing to find an adequate number of supervisory directors with enough time and enough relevant expertise and experience to provide the necessary internal checks and balances for professional managing directors.

It is the Council's observation that the powers of supervisory boards are both underutilised and overestimated as an effective counterbalancing influence for managing directors. They are *underutilised* because supervisory boards themselves make less than optimal use of the statutory powers bestowed on them (for example to request information, to form an opinion based on arguments, and to intervene where necessary). They are *overestimated* because politicians and the public have very high expectations of what supervisory boards can actually achieve. The nature of the supervisory board's position and role means that it cannot, on its own, provide the social moorings lost to economies of scale and greater professionalism. In addition, because the supervisory board depends on the management board for most of its information about internal processes, that information may come too late, or be one-sided in nature.

V THIRD LINE OF DEFENCE: THIRD PARTIES

In the Council's view, both the managing and the supervisory directors of large semi-public organisations should be 'kept on their toes' but also informed by third parties. Third parties can help both groups of directors remain alert. They can also supply additional information. Where necessary, they can sound the alarm or act as internal whistleblowers. Because they work with the organisation every day, they can improve on the information that reaches the supervisory board, allowing it to exercise more effective oversight. Third parties can also improve the public legitimacy of the organisation's service provision and hold managing and supervisory directors accountable for social value that they are required to deliver.

The idea is not to create more or new regulatory bodies, but to reinforce triangular relationships so that all the parties can do a better job. To begin with, the management board can improve the public legitimacy of the organisation's service provision by involving third parties in its long-term strategy, alongside the supervisory board. The supervisory board can receive more effective information by going beyond the management board as its only source and consulting third parties that can provide timely, direct signals from the organisation itself. Finally, third parties may themselves benefit from a triangular relationship because it allows them to turn to the supervisory board when they feel that managing directors are not taking adequate account of their views.

There are a number of existing actors and various new structures that fit the bill of third party in internal governance triangles. Depending on the financial or strategic matters at issue, institutions can call in various categories of third parties in this capacity. The type of cooperation with third parties would differ from one category of institution to the next, in other words. Another possibility is that multiple triangular relationships would co-exist.

- The first step might be to call in *internal* controllers and other risk management and quality assurance officers as third parties. They could be assigned a key role as sources of information and advice for both the management and supervisory boards, provided either voluntarily or on request.
- In addition to internal oversight of finances, security and quality, there are other parties that monitor employee and organisational interests. On paper, *the works council* provides the most important internal check of whether the management board is acting in the organisation's interest. One way of improving this triangular relationship is to reinforce the alliance

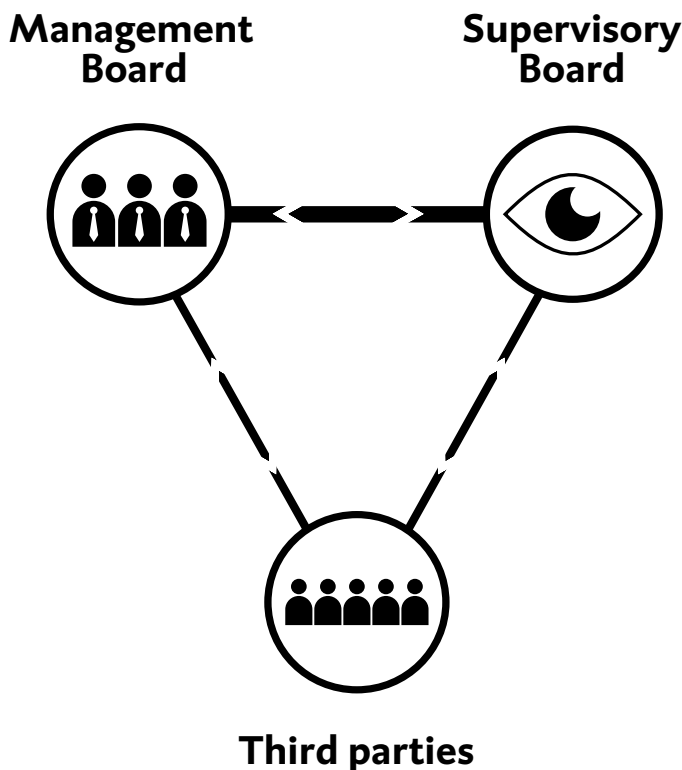


Figure 3 Third parties in the triangle

between the works council and the supervisory board, which is often weak or non-existent. After all, the supervisory board can use the works council as an important source of information about matters on the shop floor.

- To improve the value to society and public legitimacy of the organisation, it might be useful to involve *civil society stakeholders*. They can play an important role as a critical sounding board when identifying the organisation's strategic targets and when accounting for the course it has followed. They can also act as a 'third eye' that guards against the directors' own blind spots. A more conservative approach would be to serve in an advisory capacity only, but more radical methods are also imaginable, with civil society stakeholders exerting real influence. The more radical the chosen approach, however, the greater the risk of 'sluggishness'. Civil society advisory boards are compatible with the existing statutory framework for foundations and can be introduced without amending the relevant legislation.
- One special category of stakeholder consists of the institutions' clients, i.e. their tenants, pupils, and patients with their families. Many health care institutions have a *client panel* or *patient council*, for example. They usually

play only a limited role as accountability forums, often serving merely as a sounding board. They are also mainly interested in the day-to-day level of service provided institution-wide. When it comes to the quality of the specific service provision, however, they can offer the management board an important counterbalancing influence.

- An option that goes a step further involves installing a *stakeholder council* that liaises with the management board and has the right of approval in some matters. The latter can be arranged by giving the council the right to approve or endorse specific decisions or accountability documents, for example annual reports and strategic policy plans. The advantage of this model is that ‘outsiders’ help monitor both the management and supervisory boards and moor governance more securely in civil society than existing models do. The disadvantage is that the council may represent differing, and conflicting, interests.
- Alongside the existing options described above, all of which leave the pre-eminence of the supervisory board entirely intact, alternative structures can also be imagined. These clearly go much further in that they aim to install a third body as the managing directors’ counterpart. Going well beyond the stakeholder council is the *council of interested parties*, whose purpose would be to identify the targets that the organisation is obliged to attain. Interested parties are those parties directly affected by the institution’s ability or inability to function properly. The council of interested parties would prescribe the social performance that the institution’s managing directors are expected to deliver. In reality, then, the managing directors would be responsible for navigating the course charted by the council of interested parties, with a financial controller providing oversight.
- Even more radical would be the introduction of a *council of civil society shareholders*. This would closely resemble structures used in the private sector, with the beneficial owners coming into play. Instead of a foundation, the institution would be converted into a limited liability company, with shares in the organisation being issued. In this structure, the shares are held by a number of relevant civil society parties or public financing bodies such as the pension funds, the state, and the municipal and provincial authorities, which then organise themselves into a general council of civil society shareholders. The organisation would be authorised under its articles of association to decide which interests and parties should be represented on the council of civil society shareholders. Once again, this would be different for each organisation. As in private enterprises, the civil society shareholders would have a number of powers, for example the power to appoint and dismiss managing directors at the supervisory board’s recommendation, the power to appoint and dismiss supervisory directors, and the power to approve the annual accounts, budgets, strategic

policy plans and long-term investment decisions. This structure is high-risk, however, because a shareholder model can also open the door of the semi-public sector to economic interests and motives. In product markets that are devoid of competition, privatisation of this kind might be at the expense of public interests.

As we have seen, various third parties can mount a third line of defence in addition to those of the management and supervisory boards. The parties can be differentiated by the object being monitored, or the functions that they fulfil. On the one hand, their purpose is to monitor financial stability, organisational integrity, and the quality of the primary process; on the other, it is to improve the value to society and public legitimacy of the organisation. These structures can also be differentiated by the nature of their powers, which may be more conservative or more radical in nature. Managing and supervisory directors can achieve an evenly balanced triangular relationship by working with different third parties. In the Council's view, it would be advisable to combine multiple options, for example improving the position of the controller while simultaneously introducing a council of civil society stakeholders. 'Evenly balanced' also implies that the triangular relationships must be workable for both managing and supervisory directors. Powers should not be cumulative or overlap when assigned to third parties.

VI CONCLUSION

There are thousands of institutions active in the Netherlands' semi-public sector. Some of them are small, many are medium-sized, and a growing number are very large. Some manage voluminous property portfolios, others mainly render services to vulnerable groups. Some have short-lived relationships with clients, while others work with their clients for virtually their entire lifespan. In each case, the public interests involved are considerable, as are the public finances. To ensure that these important institutions stay on track, a properly functioning system of internal checks and balances is indispensable. The internal checks and balances of semi-public organisations can be improved along three lines of defence: the management board, the supervisory board, and third parties (stakeholders and interested parties).

On a day-to-day basis, fellow managing directors are important sparring partners for one another. Introducing forms of collective instead of unilateral management creates a built-in system of checks and balances within semi-public organisations. Collective management is by no means the standard at all semi-public institutions. In the current diptych model, the supervisory board is the primary counterpart for professional managing directors. Because it has an equal status to that of the management board, the supervisory board can demand that managing directors account for their actions, and it can intervene when problems arise. But the supervisory board can also use help, on the one hand to monitor financial stability, organisational integrity, and the quality of the primary process, and on the other to monitor the institution's basis of support in civil society. That is why it would be sensible to call in 'third parties' that keep both the managing and supervisory directors on their toes.

The Council recommends introducing a graduated model of (conditional) self-regulation to improve the system of internal checks and balances. To begin with, the management board and, in particular, the supervisory board should consult and assume responsibility for organising the internal checks and balances so that they contribute as much as possible to financial stability and public legitimacy.

Industry or professional organisations can include criteria for effective and appropriate internal checks and balances in their industry-wide codes and use them when auditing their members. Associations of internal supervisory directors are advised to work together to develop standards and working methods, to experiment with best practices, and to share their knowledge. It may be useful to set up a forerunner or 'breakaway' group, similar to the Public Accountability Charter Group for the autonomous public bodies.

Until now, the formal regulatory frameworks of external oversight bodies and inspectorates have paid little or no attention to institutions' internal checks and balances. In addition to performance, adherence to standards and financial risk, inspectorates should require institutions to account for the quality of their internal checks and balances. They can do so by identifying criteria within the regulatory framework for effective and appropriate internal checks and balances and by auditing or evaluating institutions against these criteria. In addition, oversight bodies could address the quality of internal checks and balances when analysing problems in their annual review of the sector or in their theme-based studies.

Self-regulation does not, in the Council's view, offer sectors *carte blanche* to do as they please, however. In its capacity as lawmaker, government must provide for situations in which sectors are incapable of designing an adequate system of internal checks and balances. In that case, government could consider developing a 'good governance' framework incorporating a number of basic standards and principles for internal governance that the semi-public sector must satisfy. In the first instance, this can take the form of a Government Opinion. A framework of this kind would play a number of useful roles. It provides a benchmark for the Council of State and Parliament when evaluating sector-specific regulations. It provides an assessment framework for the Government and individual ministers when exercising their authority vis-à-vis semi-public institutions, for example – in unusual cases – when dismissing managing directors or awarding or withdrawing funding. It also provides a benchmark for inspectorates when assessing individual institutions and when developing their own regulatory framework.

VII RECOMMENDATIONS

Recommendation for management and supervisory boards

Ensure that the system of internal checks and balances is robust and account for that system publicly in the organisation's annual report and other communications.

Recommendation for associations of internal supervisory directors

Encourage the development of best practices by establishing a 'Charter Group for Internal Checks and Balances'.

Recommendation for industry organisations

Include criteria for effective and appropriate internal checks and balances in industry-wide codes and use them when auditing members.

Recommendations for external oversight bodies

Monitor the progress that institutions and sectors are making in improving their internal checks and balances. If progress is inadequate, consider incorporating criteria for effective and appropriate internal checks and balances into the regulatory framework and evaluating institutions against these criteria.

Recommendation for the Government

If self-regulation proves ineffective, consider developing a 'good governance' framework incorporating a number of basic standards and principles for internal governance that the semi-public sector must satisfy.

VIII HOW TO ORDER

The report *Van tweeluik naar driehoeken* (ISBN 978 90 8964 821 1) is commercially available in Dutch and can be ordered from Amsterdam University Press. A PDF of the report can also be downloaded from www.wrr.nl.



Van tweeluik naar driehoeken,
ISBN 978 90 8964 821 1



Amsterdam University Press

This report describes various options for improving the system of internal checks and balances in housing corporations, health care organisations and educational institutions. In the semi-public sector, the governance model consists of a diptych, with the supervisory board acting as the most important sparring partner for the management board.

The report recommends making more frequent use of third parties in this context, such as internal controllers, civil-society stakeholders, and members. They can keep the supervisory board on its toes as it monitors the organisation's financial stability and value to society. The Council discusses a number of ways that such parties can exercise a greater counterbalancing influence.

The internal supervisory directors and managing directors should be the first to make improvements to the system of internal checks and balances. They can be assisted in this by industry and professional organisations and encouraged to do so by external regulators and the state.

The Netherlands Scientific Council for Government Policy (WRR) is an independent think-tank for the Dutch Government. It provides the government with advice, both on request and of its own accord, from a long-term perspective. The topics are cross-sectoral and cover social issues with which the government may need to deal with in the future.

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