Corporate Governance of Banks in Hong Kong

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Introduction

• Corporate governance is the system by which companies are directed and controlled

• It is a key issue for listed companies because of:
  – the separation between ownership and management
  – the need to protect minority shareholders
Why is corporate governance important for banks?

- Sound corporate governance is particularly important for banks because of:
  - Banks are looking after depositors’ money, but risk-taking is central to their activities.
  - Increasing risk as a result of globalisation, deregulation, and technology advancement.
  - There are potentially huge systemic problems if banks get into difficulties.
The role of bad corporate governance in the Asian crisis

• Weak corporate governance in Asian banks was one of the key factors in the Asian crisis
  – many banks were controlled by owner-managers and the board of directors played a little role
  – banks were often parts of wider conglomerates and were used to fund other parts of the group or the owners (i.e. connected lending)
  – management was not professional and lacked self-responsibility
  – growth was more important than return on capital
  – risk management was poor
The role of regulation

• The potential for banking crisis explains why banks are regulated

• Traditionally this has been a top-down process
  – regulators lay down rules and try to enforce them

• Increasingly, however, the trend is towards supervision rather than regulation

• This places the main emphasis on the key role of the directors and senior management in ensuring that banks are prudently managed
The role of supervision

• The above trend brings corporate governance to the fore
  – recognises that banking is too complex to be run by regulators
  – tries to encourage self-responsibility in banks and to avoid moral hazard

• Role of the supervisor is to put in place certain minimum standards, to monitor the performance of management and to take action if management is not doing its job properly
How can good corporate governance be promoted by supervisors?

- Issue of guidelines on corporate governance
- Approval of directors and chief executives of banks and removal of those that are not fit and proper
- Measures to encourage market discipline through disclosure and transparency
Contents of the HKMA Guideline

• Major responsibilities of the board
  – ensure competent management
  – approve objectives, strategies and business plans
  – ensure that the bank’s operations are conducted prudently and within the framework of laws and board policies
  – ensure that the bank’s affairs are conducted with a high degree of integrity

• Legal obligations of directors

• The use of auditors, including internal audit

• Specific requirements
Specific Requirements (1)

- The board should ensure that the bank establishes policies, procedures and controls to manage the various types of risk with which it is faced
  - 8 types of risk specified by HKMA (i.e. credit, interest rate, market, liquidity, operational, reputation, legal and strategic risk)
  - board should approve relevant policies to manage these risks while senior management should put them into effect
Specific Requirements (2)

• The board should ensure that the bank fully understands the provisions of section 83 of the Banking Ordinance on connected lending and establishes a policy on such lending
  – section 83 of the Ordinance limits the unsecured advances of banks to connected parties (e.g. directors and their relatives)
  – board should ensure that the bank fully understands its legal obligations and establishes a policy on connected lending according to the minimum standards specified in the Guideline
Specific Requirements (3)

• The board should ensure that it receives the management letter from the external auditor without undue delay, together with the comments of management
  – management letter should normally be received within 4 months from the financial year-end
  – board and/or audit committee should ensure appropriate action is taken to address any weaknesses identified in the management letter
  – copy of the management letter should be given to the HKMA
Specific Requirements (4)

- The board should maintain appropriate checks and balances against the influence of management and/or shareholder controllers, in order to ensure that decisions are taken with the bank’s best interests in mind
  - board should have at least 3 independent directors to provide the necessary checks and balances and bring in outside experience
  - the role of the chairman and the chief executive of a bank are distinct. If the chairman is also the chief executive, there should be a strong independent element on the board (i.e. more than 3 independent directors)
Specific Requirements (5)

- The board should establish an audit committee with written terms of reference specifying its authorities and duties
  - audit committee should be made up of non-executive directors, the majority of whom should be independent

- Board meetings of a bank should be held preferably on a monthly basis but in any event no less than once every quarter
  - banks should keep full minutes of board meetings
  - HKMA will require banks to provide it with a record of the number of board meetings held each year
Specific Requirements (6)

• Individual directors should attend at least half of board meetings held in each financial year
  – participation of directors in board meetings can be facilitated by video or telephone conferencing
  – HKMA will monitor the attendance records of individual directors

• The HKMA will meet the full board of directors of each bank every year
  – HKMA’s intention is not to participate in board meetings but to strengthen communication between the HKMA and the banks at the highest level
Industry concerns

• Is too much burden being placed upon the board and non-executive directors, in terms of establishing policies and controls?

• Should there be a distinction between listed and non-listed banks?

• Is it a level playing field between locally incorporated banks and overseas banks?

• Is it going to be possible to find sufficient independent directors of the right quality?
Too much burdens on directors?

• Banks are exposed to special risks and the board needs to ensure that policies are in place to manage these risks. This does not mean that the directors should themselves formulate policies but should certainly approve such policies.

• Being a director of a bank does involve heavy responsibilities.

• The criminal sanctions in the Banking Ordinance apply to all directors, whether they are executive or non-executive.
A distinction between listed and non-listed banks?

- Banks are different from other companies because they are looking after other people’s money.
- It does not matter whether the bank is listed or non-listed.
A level playing field between local and foreign banks?

• This is an interesting question.
• Is sound corporate governance a bad thing?
• Some foreign banks are a role model
• International standards and principles:
  – OECD Principles of Corporate Governance
  – Basel Committee Paper on “Enhancing Corporate Governance on Banking Organisations”
Sufficient independent directors?

• “Independent directors” means non-executive directors who are independent of management and free from any business or other relationship that could materially affect their independent judgement

• In assessing the independence of such directors, the HKMA will take account of various factors such as their direct or indirect financial or other interest in the business of the bank and their relationship, if any, with significant shareholders of the bank
Sufficient independent directors?

• We acknowledge that it may not be easy to find independent directors with the right skills and degree of independence.

• Flexibility:
  – This requirement does not apply in full to deposit-taking companies and restricted licence banks.
  – A 12-month transitional period is allowed.
Compliance indicators (1) - 23 locally incorporated banks

- Percentage of independent directors to the full board in average: almost 1/3
- All local banks have established audit committee (except one which relies on the parent bank’s audit committee)
- Frequency of board meeting:
  - 17 (Quarterly)
  - 3 (Monthly)
  - 3 (5 - 8 per annum)
Compliance indicators (2) - 23 locally incorporated banks

• All directors have attended more than 50% of the board meetings

• Roles of Chairman and Chief Executive:
  – 17 (Segregating these two roles)
  – 6 (No segregation but with more independent or non-executive directors)
Quality of people (1)

- Key to good corporate governance is the quality and integrity of the people at the helm

- The appointment of directors and chief executives of banks is subject to approval by the HKMA

- Relevant criteria include:
  - probity, reputation and character
  - knowledge, experience, competence, soundness of judgement
  - compliance record
  - business record and other business interests
Quality of people (2)

• Senior management of a bank, under the supervision of its directors and chief executives, plays a pivotal role in ensuring the financial soundness and efficient operation of the bank.

• In 2002, a new authorization criterion was added to require banks to have adequate systems to ensure that only fit and proper persons can be appointed as their senior managerial positions.

• Notification of the appointment of senior executives is required.
Public disclosure (1)

- Transparency or market discipline can play an important part in promoting a high standard of corporate governance.
- This helps a bank’s stakeholders and public depositors to judge the effectiveness of their board and management.
Public disclosure (2)

• Banks in Hong Kong are required/encouraged to disclose the following additional information in their annual reports:
  – transactions with group companies
  – a statement of compliance with the HKMA’s guideline on corporate governance
  – qualitative and quantitative information on risk management
  – segmental information
Conclusion

Internal discipline

External discipline (Supervisor)

External discipline (Market)