GUIDELINE ON CORPORATE GOVERNANCE OF LOCALLY INCORPORATED AUTHORISED INSTITUTIONS

Following consultation with the banking industry, the new Guideline on Corporate Governance of Locally Incorporated Authorised Institutions was formally issued by the Monetary Authority under section 7(3) of the Banking Ordinance on 19 May 2000. This Guideline, which superseded the Best Practices Guide issued by the Monetary Authority in 1991 on the duties and responsibilities of directors of authorised institutions, sets out the minimum standards that locally incorporated institutions are expected to follow in respect of corporate governance. This article explains the importance of corporate governance for the banking industry, summarises the role and responsibilities of the board of directors and other key points of the Guideline, and describes the Monetary Authority's approach in monitoring authorised institutions' compliance with the Guideline.

Introduction

Following consultation with the banking industry, the new Guideline on Corporate Governance of Locally Incorporated Authorised Institutions ("Guideline") was formally issued by the Monetary Authority (MA) under section 7(3) of the Banking Ordinance on 19 May 2000. This Guideline, which superseded the Best Practices Guide issued by the MA in 1991 on the duties and responsibilities of directors of authorised institutions, sets out the minimum standards that locally incorporated institutions are expected to follow in respect of corporate governance. A copy of the Guideline can be found at the Hong Kong Monetary Authority website (http://www.info.gov.hk/hkma).

The Importance of Corporate Governance

Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. As far as the banking industry is concerned, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the structure through which the objectives of the institution are set, the strategy of attaining those objectives is determined and the performance of the institution is monitored.

The MA believes that sound corporate governance is particularly important for banks. The rapid changes brought about by globalisation, liberalisation of financial markets, innovations in financial products and technological advances have the effect of increasing risks in the banking sector. Unlike other companies, most of the funds used by banks to conduct their businesses belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank not only affects its own stakeholders but may have a systemic impact on the stability of other banks. As such, the quality of corporate governance expected of banks is high, and there is a strong reason for ensuring that banks are properly managed.

It is true to say that banks in Hong Kong are already well managed by international and regional standards. The fact that they survived the financial crisis in generally good shape is a testament to this. However, the recent crisis has reinforced the point that leadership and control by the board of directors is vital if authorised institutions are to steer their way safely through difficult conditions. In fact, a few individual cases have shown up during the financial crisis where the board of directors did not perform as well as expected. This, coupled with the challenges that lie ahead, has led the MA to look at ways in which corporate governance among authorised institutions might be further enhanced.

Key Points of the Guideline

The important role played by the board of directors in ensuring sound corporate governance is reiterated in the Guideline. While the day-to-day running of an authorised institution should certainly be left in the hands of the management, the board must play a leadership role in approving the objectives, strategy and business plans of the institution, monitoring the performance of management and ensuring that the internal control and risk management systems of the institution are effective. The board must also make sure that the institution conducts its affairs with integrity and in accordance with high ethical standards. Moreover, individual directors (including non-executive directors) must fulfil the many legal obligations imposed on them by common law or statutes, and are ultimately responsible for ensuring that their institution complies with all laws and regulations.

In addition to the responsibilities and obligations of the board of directors as outlined above, the MA expects the boards of all locally incorporated authorised institutions to adhere to a number of specific requirements. These include:

(a) The board should ensure that the institution establishes policies, procedures and controls to manage the various types of risk with which it is faced;

(b) The board should ensure that the institution fully understands the provisions of section 83 of the Banking Ordinance on connected lending and establishes a policy on such lending;

(c) The board should ensure that it receives the management letter from the external auditor without undue delay, together with the comments of management;

(d) The board should maintain an appropriate level of checks and balances against the influence of the management and/or the shareholder controllers, in order to ensure that decisions are taken with the institution's best interests in mind;

(e) The board should establish an audit committee with written terms of reference specifying its authorities and duties;

(f) Board meetings should be held preferably on a monthly basis but in any event no less than once every quarter;

(g) Individual directors of an institution should attend at least half of board meetings held in each financial year; and

(h) The MA will meet the full board of directors of each local bank every year.

In finalising the above requirements of the Guideline, the MA has carefully considered the comments received from the banking industry as well as the particular circumstances of Hong Kong. For example, acknowledging that it may not be an easy task to find sufficient non-executive directors with the right skills and degree of independence, the MA has relaxed the requirement on the number of independent directors in relation to restricted licence banks and deposit-taking companies. More details of the above requirements can be found in the Guideline itself.

Enforcement of the Guideline

The Guideline does not itself have the force of law, but failure to adhere to the standards may call into question whether the institution continues to satisfy the minimum criteria for authorisation laid down in the Banking Ordinance. Such failure may also cast doubt on the fitness and propriety of individual directors and shareholder controllers of the institution. Where the standards set out in the Guideline are not met, it may nonetheless be acceptable for the institution to demonstrate that it has put in place alternative measures that have the equivalent effect of ensuring sound corporate governance. The MA will monitor institutions' compliance with the Guideline through regular off-site reviews and on-site examinations.

- Prepared by the Banking Policy Division