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Empowerment of Independent Non-Executive Directors in the Banking Industry in Hong Kong

In relation to the captioned Consultation Paper, The Hong Kong Institute of Directors is pleased to present its views and comments.

General Comments

Better quality directors means better corporate governance

Company directors are ultimately responsible for corporate governance. Better quality company directors should mean better corporate governance. That principle would hold true for banks.

Prudential regulations and its effect on corporate governance

Prudential regulation of banks is not new. Traditionally, prudential regulation is mostly about the safety and soundness of banks. In the wake of the financial crisis, there is the impetus to add an extra layer to guard the well-being and stability of the financial system.

Prudential regulation has evolved, but its effect on AI's corporate governance remains. The major recommendations included in the Consultation Paper can be viewed as a reflection of the perceived need for special governance measures as part of an effective prudential regulatory system, and such would translate into a demand on INEDs at AIs that are different from what they would normally expect at ordinary corporate entities.

Board oversight at AIs – what differences?

Many directors and observers will be familiar with those corporate governance principles and practices widely-practised or expected from listed companies. Because of certain attributes of financial markets and prudential regulations, however, simply following generally applicable principles and practices may not be adequate for banks. There are several reasons for it.

For one, the capital market discipline assumed in much corporate governance theory and practices is dampened. The very existence of deposit insurance (not without good reason for protection of the general public) actually creates a moral hazard wherein AIs (those deposit-reliant ones at least) are sheltered from the need to fully price risks. Even creditors of banks may slack off from capital market discipline because they feel the government will be there to bail out banks that run into difficulties. And to the extent that prudential regulations put constraints on an AI's corporate merger or consolidation activities, weeding out transactions that may present a notionally unacceptable increase in risks (to an AI individually or to the financial system), the discipline from the market of corporate control is also mollified.

Next, while all corporate firms bear some risks on what they do, risk-taking is in fact the very central activity of a financial intermediary. And with many more bank groups having combined traditional banking with other capital market businesses, runs on funding can escalate and migrate with such pace that can very quickly put the survival of the institution in doubt. Thus, there is a stronger need to get involved in how AI boards approach risk management. This in turn would require AI boards to have information and monitoring processes that are more extensive than ordinary firms.

Prudential regulation therefore is to influence the risk-taking of AIs. Prudential regulations of course have been there to put constraints on operation of business and discretion of the board. Certain activities are prohibited. For activities that are otherwise permitted, there may well be restraints (e.g., capital requirements) to influence the extent of risk-taking. Risk, however, is not easy to quantify. And therefore regulatory requirements are also being instituted to influence the *processes* of risk-taking (e.g., by way of requiring a risk committee at AIs to oversee risk management and internal control).

Prudential regulation of the governance processes

There, nonetheless, remains a divergence of the private assessments of the risk-reward calculus from that of the public. The interest of shareholders and the public may well overlap, but they are not coincident. That divergence comes not in the institutional requirements of risk management but the substantive judgement of how much risk (risk appetite). The risks that shareholders of an AI (and especially for those shareholders who are well-diversified) would want to take may not be the same as what the regulators would want the AI's board to elect to take.

To apply regulatory supervisory requirements to corporate processes is to ask boards/directors to resolve that divergence. To ensure the soundness of an AI and the stability of the financial system each have obvious social benefits, but prudential requirements constrain the discretion of AI boards versus their counterparts in ordinary industries. Directors at all types of corporate entities would have to meet certain duty established by law and rules, but ordinarily they are to protect shareholders from the loss in value due to a violation. Banking, in comparison, is one of the few industries where regulation operates to impose specific and on-going oversight over corporate decision-making and risk management processes. To have to include risk considerations flowing from prudential regulatory objectives will necessarily put strain on AI directors' performance of their fiduciary duties. To ask AI directors to further regulatory objectives will surely alter the landscape of fiduciary duty as we know it.

Formal expansion of fiduciary duties to include regulatory objectives is not the purpose of the Consultation Paper. We are, however, aware of debates and thought experiments around the globe that might someday gather steam to become regulatory initiatives somewhere. Short of a formal expansion of fiduciary duties, regulatory expectations on the roles of the boards and directors conveyed through supervisory practices will certainly call for heightened sensitivity among AI directors and have implications on their potential liabilities.

Tools to perform, shields to protect

The recommendations embodied in the Consultation Paper will inevitably mean greater demand in time and effort from AI directors, especially the NEDs and INEDs. It is essential that we find individuals who have the skills, knowledge and qualities to meet corporate governance demands of today to fill INED positions at AIs, not just to make up the numbers.

If we are to make directors more accountable and to have higher expectation or how directors are to perform, there should also be in place complementary measures and mechanisms to work in tandem. Directors need rules that will protect them when they make good faith business judgment and decisions. They need adequate risk coverage to shield their exposure. They should be required to have a proper level of qualification before taking office. They should be expected to continually upgrade and improve their skills and knowledge. There should also be widely-accepted and recognized reference guides to their conduct and behavior. And they should be adequately remunerated for their skill and their time and effort.

HKIoD does maintain a roster of members who have positively indicated their willingness and who have conscientiously equipped themselves to become INEDs. And HKIoD will have pleasure in being a part of the on-going effort to enhance the supply of quality INEDs, through training or otherwise.

Potential liabilities and the attenuating punishment and stigma will inevitably be on the mind of sitting and prospective directors when it comes to deciding whether to join a board or to stay on. If the need for AI directors to incorporate prudential regulatory objectives is taken down the path of a broadening of liabilities without the corresponding emphasis and reinforcement of the shields available for exculpation, such could drive away talents and limit the supply of quality INEDs for AIs.

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Consultation Questions

Subject to our general comments above, we state our responses to specific questions as set out in the Consultation Paper as follows:-

1. Do you agree with the recommendations set out in this paper with regard to INEDs?

HKIoD response:

- HKIoD generally agrees with the direction taken in the Consultation Paper, but have concerns or observations as stated elsewhere in this response.

2. Are there any recommendations with which you do not agree, and if so, what are your reasons or concerns?

HKIoD response:

- HKIoD generally agrees with the direction taken in the Consultation Paper, but have concerns or observations as stated elsewhere in this response.

3. Do you have other suggestions regarding the areas considered by the Study Group, in particular measures to ensure that a sufficient and ongoing supply of suitable persons to take up INED roles in the banking sector is maintained?

HKIoD response:

- HKIoD generally agrees with the direction taken in the Consultation Paper, but have concerns or observations as stated elsewhere in this response.

4. If the recommendations in this paper are adopted, do you foresee any implementation issues and what are your suggestions in dealing with such?

HKIoD response:

- The difficulty will likely be in whether AIs can source and find suitable persons to be appointed as INEDs.

5. If the recommendations in this paper are adopted, how long would it take for full implementation? Are there specific recommendations that require more time for implementation so that a phased approach is preferred? Please provide details of the

proposed timeline and preparatory work as required for full implementation of the recommendations.

HKIoD response:

- The difficulty will likely be in whether AIs can source and find suitable persons to be appointed as INEDs. Sufficient time should be given to the AIs. It may take one or two board nomination and election cycles (9 months or longer), depending on the board election or constitutional process of the individual AI.

Comments on the major recommendations:

Subject to our general comments and the responses to specific questions above, we include some comments on the major recommendations:-

I. Constituting the Board and its Committees (Para 1-7)

What committees?

The Consultation Paper included a recommendation that all boards of AIs establish an audit committee. The Consultation Paper also included a recommendation that licensed banks additionally establish other committees that are normally found in a typical corporate governance lineup: risk management committee; remuneration committee and nomination committee. For other AIs (restricted licence banks and deposit-taking companies), the Consultation Paper states that it would be “good practice” to do the same. Para 1.

The Consultation Paper does not mention the “corporate governance committee” function that would normally be found in a typical corporate governance lineup. It is not rare for such to be made part of the portfolio of the nomination committee, however.

A major principle remains, that ultimate responsibility rests with the full board despite the formal existence of various committees. For instance, the Consultation Paper contemplates that an AI may have chosen not to have a nomination committee, and in that case the function may have to be performed by the full board. Para 20. This principle may deserve a more prominent mention.

Committee membership

The Consultation Paper would recommend the audit committee to have at least one INED from an accounting or financial background, to have all members as NEDs with a majority being INEDs, and to be chaired by an INED. Para 2-3. We concur.

The Consultation Paper would also recommend the risk management committee to have all members as NEDs with a majority being INEDs, and to be chaired by an INED with an accounting or financial background and expertise in risk management. Para 4. We concur.

The Consultation Paper included a recommendation that the audit committee and the risk management committee to be chaired by two different INEDs. Para 5. This recommendation stems from the BCBS Guideline. We concur.

The Consultation Paper included a recommendation that all or a majority of the members of the remuneration committee be INEDs. Para 6. We concur.

The Consultation Paper included a recommendation that the nomination committee be chaired by an INED (who could happen to be the chairman of the board if he or she is an

INED). Para 7. We concur. See also the comments pertaining to “Pathway towards “non-executive chairs” or “lead directors””.

Constituting the board – INEDs with accounting or financial background

The Consultation Paper included a recommendation that the boards of all AIs should have at least one INED from an accounting or financial background, and larger AIs are likely to require more. Para 2. We note also that a minimum of one INED is required under the recommendation as to audit committee chairmanship under Para 3.

Constituting the board – pathway towards majority INEDs?

The Consultation Paper notes that currently, licensed banks are required to have one-third or three INEDs on their board (whichever is higher). Restricted licence banks and deposit-taking companies are encouraged to do the same. Note 3. Some thoughts could be given to foster a pathway towards introducing “majority INED” as a recommended practice. We are aware of the well-versed arguments made on its practicality or suitability for the Hong Kong market, but we are also aware of well-founded postulation that it could make INEDs collectively better able to play their director roles. With INEDs comprising the majority, their active involvement in board matters becomes more necessary and their time commitment to do so better valued.

II. INEDs of AIs

Roles (Para 8-11)

The Consultation Paper included recommendations that would require AI directors to incorporate prudential regulatory objectives and wider public interests in their role and duties. Para 8 and 10. Prudential regulation in the governance process will have effect on AI directors’ potential liabilities.

The Consultation Paper included a general expectation that INEDs be members of and are to chair the major committees in the corporate governance lineup (with audit, risk management, remuneration and nomination specifically mentioned in the Consultation Paper.) Para 9. We concur.

The Consultation Paper included a requirement for dealing with connected transactions. For listed AIs, the practice adopted in the Listing Rules are to be followed. The Consultation Paper would recommend non-listed AIs to follow similar procedures. Para 11. We concur.

Qualities and background (Para 12-15)

Constituting the board – qualities and background

The Consultation Paper included recommendations on the qualities and background of INEDs for AI boards. Para 12-14. We concur.

The Consultation Paper included recommendations that speak to the duty of care, skill and diligence of AI directors in performing their duties with professionalism and honour. Para 15. We concur.

The recommendations are consistent with the values embodied in the HKIoD Guidelines for Directors (now in its 4th edition) and the HKIoD Guide for Independent Non-Executive Directors (now in its 5th edition). We at HKIoD consider the two guides to be essential reference tools for directors, and they will give directors useful guidance on how to meet their duties in practice. The recommendations are also consistent with the HKIoD Code of

Conduct (available on the HKIoD website at <http://www.hkiod.com/accreditation.html>). We recommend the HKMA to consider stipulating the HKIoD Code of Conduct as one element of the framework of common reference for the conduct of directors in fulfilling their duties.

Time commitment (Para 16-17)

The Consultation Paper included recommendations pertaining to a director's time commitment, including time commitment for training. Para 16-17. We concur. HKIoD believes all directors must devote sufficient time and attention to the affairs of the AI. See, e.g., HKIoD Guidelines for Directors; HKIoD Guide for Independent Non-Executive Directors; and HKIoD Code of Conduct.

The Consultation Paper included a recommendation for the establishment of a nomination committee. Para 1. The nomination committee's term of reference should include a duty to regularly review the time required from a director to perform responsibilities to the AI, and whether the individual director is meeting that requirement. It would also be reasonable to require NEDs (including INEDs) to confirm annually to the nomination committee that he has spent sufficient time on the AI's business. EDs are already subject to employment control.

III. Independence and tenure (Para 18-21)

The Consultation Paper included recommendations that speak to the characteristics and factors for considering whether a director is considered "independent" Para 18-19. And when an AI is also a listed company, requirements under the Listing Rules will also have to be satisfied. Para 21. We generally concur with those characteristics and factors and requirements. We also concur that the nomination committee (or another committee serving that function) should have within its duty to assess the appropriateness of whether an INED is or remains "independent" in situations where the individual has served more than 9 years (Para 19(h) and Para 29) or has cross-directorships that may bring conflict or implicate the ability to commit time to the AI (Para 19(g)).

IV. Remuneration of INEDs (Para 22-25)

The Consultation Paper included a recommendation that INED fees should (only) be in the form of cash payments and that INEDS should not receive remuneration based on any measure of the performance of the AI. Para 22-23. As we noted elsewhere, prudential regulatory objectives may lean towards compensation arrangements that are more conducive to the stability of the AI, but there would also be another legitimate purpose of having incentive compensation to better align the interests of managers and directors with shareholders in creating long-term value of the AI. AIs must have much leeway to make the assessment based on their own circumstances as to what is appropriate. That would not be inconsistent with the recommendation to review the compensation mechanism regularly to maintain competitiveness. Para 24.

The Consultation Paper included a recommendation that a basic fee of at least HK\$400,000 per year (with additional payments for membership/chairmanship duties of board committees) for INEDs. Para 25. AIs must make the assessment based on their own circumstances as to what amount is appropriate. One undesirable outcome would be for the amount so stated in the Consultation Paper (or any future guidance) to at once operate as a floor and a cap. Prospective candidates must have the necessary qualities and should have conscientiously equipped themselves to become NEDs/INEDs., but they must, as the Consultation Paper mentioned, also be adequately remunerated for their skills and their time and effort. Para 22.

V. Board practices in relation to INEDs (Para 26-39)

Appropriate insurance coverage (Para 26)

The Consultation Paper included a recommendation that AIs arrange appropriate insurance cover for their directors. Para 26. We concur. HKIoD has long advocated that, while directors must act with diligence to discharge duties, they must also be properly shielded from liability. While it is the AI to arrange the insurance for directors, the AI's board should have key authority in determining the scope and coverage. Wherever possible, the insurance should have "supplemental" coverage that covers only directors (and officers). We also believe that the terms of the insurance coverage should be reviewed on a regular basis and no less than once a year, in order to better match the changing scale and type of the AI's business activities and the associated risks they bring.

Insurance, however, may not be always permissible for certain types of breach. Indemnity from AIs, likewise, may also not be permissible (or if permissible, rendered useless in a bankruptcy situation). AI directors must be assured that they are protected and have good grounds available to them for exculpation. Even considering the need to incorporate prudential regulatory objectives, banking laws and rules should not be taken to require *extraordinary* efforts on the part of AI directors to uncover or prevent non-compliance. AI directors should be protected when they have made good faith attempts to put in place a risk management process and internal control systems.

To facilitate attendance by INEDs at meetings (Para 27-28)

The Consultation Paper included recommendations that AIs should facilitate attendance by INEDs at board or committee meetings. While physical meetings are to be encouraged, AIs should facilitate participation via remote means. Para 27-28. We concur. Participation by remote means, however, should only include such communication modes wherein each participant can hear each other. Telephonic or video conferencing should meet that requirement.

Determining an INED's "independence" (Para 29)

The Consultation Paper included recommendations on board practices relevant to the determination of whether an INED is or remains independent. In particular, service on the board for longer than 9 years is considered a factor for assessing "continued independence". Para 19(h) and 29. For listed AIs, the requirements under the Listing Rules are to be followed (i.e., separate resolution to be approved by shareholders.) For non-listed AIs, the nomination committee should assess and make a recommendation to the board. Para 29. We concur. See also the comments pertaining to "III. Independence and tenure".

Alternate directors; shadow directors (Para 30)

The Consultation Paper included a recommendation to discourage the appointment of alternates for directors, and in particular, not for INEDs. Para 30. We concur.

Board papers and minutes; pre-meeting briefings; access to advice (Para 31-34)

We concur. The recommendations should help AI directors meet the duty of care, skill and diligence.

Communications to facilitate functional integration (Para 35)

The Consultation Paper included a recommendation for committees to brief the rest of the board members not on their committee membership. Para 35. We concur. This would be necessary to ensure that various matters that may each have risk implications on the AI are not just being discussed or decided upon in silos. This may be particularly important for large complex organisations.

It would not be enough for board members to brief among themselves. The board and management will have to divide responsibilities as to risk management, and together determine the nature and scope of risk information that the board should receive. Information asymmetry will only make the risk management task that much more difficult, if not impossible, for NEDs and INEDs at AIs. This may also be particularly important for large complex organisations.

Approach to risk management at AIs may well call for an augmented mode of board-management interaction, but care must be taken to avoid drawing directors (NEDs and INEDs especially) into too much specific detail that detracts from their strategy and oversight role.

Separate meetings with or among NEDs/INEDs (Para 36-37)

The Consultation Paper included recommendations that the board chair hold separate meetings with INEDs, and where the board chair is not an INED, for the INEDs to meet among themselves without the presence of executives at least once a year. Para 36. We concur. Para 36 contemplates the very possibility of the board chair being an INED.

The Consultation Paper included a recommendation that INEDs meet separately with the auditor and the internal audit function. Para 37. We concur.

Pathway towards “non-executive chairs” or “lead directors”?

Some thoughts could be given to separately highlight the practice of having a “non-executive chair” or a “lead director” in the eventual guidance circular. It would be for AIs to assess and decide according to their circumstances, but it is certainly in congruence with the purpose of empowering INEDs.

Interaction with regulators (Para 38), and board-shareholder engagement

The Consultation Paper included a recommendation that there should continue to be held meetings between the HKMA and INEDs. Para 38. We concur. On-going supervisory practices can indeed give regulators an informed, outside perspective of the AI’s operation that could help the board in strategy refinement and risk oversight. The AI directors actually owe fiduciary duty to shareholders, however. It will be for the board to effectively communicate with and engage shareholders to assure them that there is proper adherence to and performance of that fiduciary duty.

Performance evaluation (Para 39)

The Consultation Paper included recommendations that AI boards and individual directors be evaluated for their performance at least once a year. Para 39. We concur.

VI. Training and development requirements for INEDs (Para 40-46)

The Consultation Paper included recommendations that speak to the induction and continuing training for INEDs in order that they have sufficient and up-to-date knowledge of the AI's business and the banking sector in general to fulfil their role. Para 40-44. We concur.

The Consultation Paper mentioned the possible development of an accreditation scheme. Para 46. HKIoD will have pleasure to be a part of such scheme.

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