

Mr Carse: The importance of corporate governance in banks

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at The Year 2000 Millennium Dinner of The Association of International Accountants - Hong Kong Branch, Hong Kong Bankers Club, Hong Kong, on 17 March 2000.

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Ladies and gentlemen,

I am very pleased to be here this evening to speak to the Association on the subject of corporate governance in banks. I have chosen this as my theme both because it is highly topical for reasons that I will explain later and because it should be of particular interest to this audience. The Association plays an important role in the training and promotion of the accounting profession; and accountants are a vital component in corporate governance not simply in their specific role as auditors but also as a source of highly trained directors and managers.

I will begin by giving you a brief situation report on the banking sector because this is relevant to the governance issue. Clearly, the situation is looking a lot better than it has done for the last two years. As the 1999 results released so far have shown, the performance of individual banks is by no means uniform. Some have done a lot better than others, depending on such factors as the mix of their business and where they are in the provisioning cycle. But the figures collected by the HKMA for the local banks' Hong Kong offices show that, in aggregate, their pre-tax operating profits rose by about 15% in 1999. This compares with the decline of 33% that we saw in 1998. This improvement has been supported by renewed growth in net interest income. Moreover, the aggregate bad debt charge of the local banks showed little change in 1999, having increased by 335% in the previous year. It is true that some banks were obliged to increase their provisions against Mainland related companies during the course of the year. But the general trend in the latter part of 1999 was that the growth in new problem loans began to slow down as the economy improved. This is supported by the figures for problem loans in the final quarter of 1999 which we published recently. These show that the ratio of loans classified as "substandard", "doubtful" or "loss" to total loans fell to 9.8% at the end of December, compared with the 1999 peak of 10.3% at the end of September. At the risk of tempting fate it does seem that the worst of the bad debt problems for Hong Kong banks is over. Certainly all the local banks are expecting a significant reduction in the bad debt charge in 2000, which will give a boost to profitability.

Can we say therefore that life for the local banks is getting back to where it was prior to the crisis? The answer unfortunately has to be "no". We are certainly moving into calmer waters for the banks but there are strong currents, and a few sharp rocks, underneath the surface. The fact is that the competitive environment for banks in Hong Kong is changing radically as it is for all banks around the world. The current competition in mortgage lending is a case in point. Banks are increasingly prepared to lend at margins well below prime. We are getting to the point where it is becoming difficult to earn an economic return from this business once funding costs and other expenses are taken into account. It can be argued that this in part reflects the current excess liquidity in the market and that margins will start to move up again as loan demand and the property market recover in line with the economy. There is some truth in this, but it is difficult to see margins on mortgage business recovering too far. Certainly they will not get back to where they were in the boom years before the crisis. There are too many active players in the market, both domestic and foreign, to allow this to happen.

What this means is that the banks are going to have to work harder to earn a profit than they have done in the past. They will have to do this at a time when the last stages of interest rate deregulation in Hong Kong are taking place, starting in the middle of this year and finishing in the middle of 2001. The impact of deregulation cannot be predicted with certainty but the likely impact will be to increase funding costs and thus squeeze the net interest margin. The banks will therefore have to find ways to generate income through new products and through new charging policies. You can expect fees for the

various banking services to rise in the deregulated environment. The banks will also be under greater pressure to reduce costs through exploiting new delivery systems, re-engineering their processes and better managing their risks.

Technology is at the heart of these issues. It is one of the main forces which is driving increased competition and one of the main weapons that the banks are using to respond to competition. How to harness the power of technology, and how to finance the necessary investment, constitute the main strategic challenge facing banks in the world today.

This brings me to the main theme of the importance of corporate governance in banks. It will be the responsibility of the board of directors and senior managers of banks to navigate the way through the strategic challenges that I have described, and they must ensure that they have the capacity to do so.

Corporate governance is of course not just important for banks. It is something that needs to be addressed in relation to all companies. The Financial Secretary recognized this by announcing in his Budget speech that he had asked the Secretary for Financial Services with the assistance of the Standing Committee on Company Law Reform to conduct a comprehensive study on corporate governance in Hong Kong this year. The objective will be to plug any gaps in the corporate governance regime and to become a benchmark in the region. Market bodies, professional organizations and regulators will be asked to help in this task. Your own Association may be able to contribute.

I do however believe that sound corporate governance is particularly important for banks. The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.

It is true to say that banks in Hong Kong are already well managed by international and certainly by regional standards. The fact that they survived the financial crisis in generally good shape is a testament to this. However, during the financial crisis, the HKMA came across a few individual cases where the board of directors did not perform as well as might be expected. And this, coupled with the challenges that lie ahead, has led us to look at ways in which corporate governance among the banks might be further enhanced.

If I could sum up our objective, it would be to try to reassert the role of the board of directors in banks. While the day-to-day running of banks 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 bank, monitoring the performance of management and ensuring that the internal control and risk management systems of the bank are effective. The board must also make sure that the bank conducts its affairs with integrity and in accordance with high ethical standards. The board is part of the system of checks and balances that ensures that neither large shareholders nor management abuse their power and that decisions are taken with the bank's best interests in mind. If the board does not play its full part, a vacuum in leadership will be created. This vacuum may be filled by the shareholders becoming directly involved in running the bank's affairs, or by the executive management acting more or less in isolation. In either case, the board of directors is bypassed and checks and balances are lost.

The HKMA has recently issued for consultation a draft guideline for banks and other authorized institutions which sets out what the HKMA expects of them in relation to corporate governance. The guideline aims to establish minimum standards. It does not itself have the force of law, but failure to adhere to the standards may call into question whether the bank continues to satisfy the criteria for authorization laid down in the Banking Ordinance.

The draft guideline describes the general responsibilities of the board, the legal obligations of directors and the use of auditors. It then goes on to specify detailed guidelines to which locally incorporated authorized institutions are expected to adhere. Let me summarise these for you. While I will refer to

the guidelines in relation to banks, most of them are also applicable to restricted licence banks and deposit taking companies.

- First, the board should ensure that the bank establishes policies, procedures and controls to manage the various types of risk with which it is faced.

Altogether the HKMA has identified eight types of risk for the purposes of its supervision. These are credit, interest rate, market, liquidity, operational, reputation, legal and strategic risk. The board should approve the relevant policies while management should put them into effect. It is important that the policies should not exist merely for form's sake - in other words, just to keep the HKMA happy - but should dictate how the institution is actually run in practice.

- Second, 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.

While there are no indications that banks in Hong Kong are abusing the rules on connected lending, there seems to be uncertainty among some banks as to how the rules work. We have therefore recommended that the board should ensure that the bank fully understands its legal obligations under the Banking Ordinance and establishes a detailed policy on connected lending.

- Third, the board should ensure that it receives the management letter from the external auditor without delay together with the comments of management.

We have specified that the management letter should normally be received within four months from the year-end. Of course, this is not something that is totally within the control of the bank. I would therefore put in a plea to any bank auditors in the audience to submit the management letter without delay.

- Fourth, the board should maintain an appropriate level of checks and balances against the influence of management and/or the shareholder controllers in order to ensure that decisions are taken with the bank's best interests in mind.

The key issue here is the number of independent non-executive directors there should be on the board of banks. We recommend a minimum of three to ensure that there is a sufficient pool of independent directors to sit on the various committees of the board and to cover absences.

- Fifth, the board should establish an audit committee with written terms of reference specifying its authorities and duties.

We recommend that the audit committee should be made up of non-executive directors, the majority of whom should be independent.

- Sixth, board meetings should be held preferably on a monthly basis, but in any event no less than once every quarter.

The board can only fulfil its leadership role if it meets frequently enough and receives sufficient information from management to be able to monitor the financial position and performance of the bank.

- Seventh, individual directors should attend at least half of the board meetings held in each financial year.

We fully recognize that the effectiveness of a director cannot be measured simply by attendance at board meetings. But equally it is difficult for even the most competent individual to make a contribution if he or she does not turn up for meetings in the first place.

- Finally, the HKMA will meet the full board of directors of each bank every year.

It is not the intention that the HKMA should participate in board meetings. Rather, we will meet with the board with the aim of strengthening communication between the HKMA and

the board at the highest level. Among other things, this will give us the opportunity to give the board first hand information on the major findings about the bank that emerged from our onsite examinations and offsite reviews. It will also give the board the opportunity to convey its views directly to us, for example on whether we are imposing too much of a regulatory burden.

As a result of the consultation exercise, we have received a number of supportive comments. It is difficult, after all, to argue against the principle that banks should be encouraged to raise their governance standards. However, a number of concerns have also been voiced. I will not go into these in detail, but some of the questions that have been raised are as follows: Is the HKMA interfering too much in the way in which banks choose to manage themselves? Is too much burden being placed upon the board, and upon non-executive directors in particular, in terms of establishing policies and controls? Should there be a distinction between listed and non-listed banks? Is it right to place more onerous requirements on banks compared with other companies, for example as regards the required number of independent directors? And is it going to be possible to find sufficient independent directors of the right quality?

I have answered some of these questions already in this speech. We do believe that banks are different from other companies because they are looking after other people's money. From this point of view, it does not matter whether the bank is listed or non-listed. We also believe that banks are exposed to special risks compared with other companies, and that the board needs to ensure that policies are in place to manage these risks. This is not to say that the board should actually formulate these policies itself. That can be left to management. But the policies should certainly be *approved* by the board. As to whether we are placing too much burden on the non-executive directors, it should be recognized that being a director of a bank does involve heavy responsibilities. Moreover, the criminal sanctions in the Banking Ordinance apply to *all* directors, whether they are executive or non-executive. We acknowledge that it may not be an easy task to find non-executive directors with the right skills and degree of independence. We have therefore reconsidered our original recommendations on the number of independent directors to some extent, particularly in relation to restricted licence banks and deposit-taking companies, and we are prepared to give institutions which do not already comply more time to do so if necessary.

Finally, on the complaint that we are perhaps being too intrusive, I would point to our statutory responsibilities under the Banking Ordinance to ensure that institutions operate with integrity, prudence and competence and that individual directors are fit and proper. Concern about corporate governance falls squarely within these responsibilities. However, let me stress that this is not an area where we would want to take a narrow legalistic position. We are anxious to work closely with the banking industry to arrive at a mutually acceptable approach to corporate governance which is appropriate to the particular circumstances of Hong Kong. We will be aiming to ensure that the final version of our guideline embodies this approach.