Jessica Chew Cheng Lian: Corporate governance at the Central Bank of Malaysia

Opening speech by Ms Jessica Chew Cheng Lian, Assistant Governor of the Central Bank of Malaysia, at the Third Institute of Chartered Accountants in Australia-The Malaysian Institute of Certified Public Accountants (ICAA-MICPA) Audit Forum, Kuala Lumpur, 27 September 2012.

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It gives me great pleasure to be here this morning at the *3rd ICAA-MICPA Audit Forum*. The theme for the Forum this year is the role of the audit committee within the context of corporate governance in insurance companies. It has been said that an audit committee is like a good insurance policy - it is better to have it and not need it, than to need it and not have it. I am certainly happy to know that we have established strong audit committee practice within our financial industry, and while admittedly, some institutions have moved further than others in improving the effectiveness of the audit committee, it represents without exception a core pillar of governance systems in our financial sector. I say this because as we speak, there are countries that are now debating the requirement for financial institutions to establish separate audit committees.

There are a number of reasons why the theme chosen for this forum is particularly relevant in current times. Corporate governance problems have once again come under intense global scrutiny since the outbreak of the global financial crisis. It is however worth noting that quite aside from the crisis, recent episodes of compliance and market misconduct issues surrounding financial institutions have had very little to do with the crisis, but nevertheless have their roots in corporate governance problems. Poor governance allowed, and in some cases, likely encouraged, internal control failures leading to large-scale fraud, excessive risk-taking, market manipulations, and an endemic disregard for compliance with laws and regulations.

While such issues have not plagued our domestic financial industry to nearly the same extent as they have in some other parts of the world, there are other reasons why we need to continue to pay close attention to corporate governance in Malaysia.

For one, global economic and financial conditions have become considerably more uncertain. In the last Monetary Policy Statement, the Bank Negara Malaysia observed that economic activity is slower in most major advanced economies. There is considerable policy uncertainty in these economies, while conditions in the international financial markets continue to be volatile. In this environment, effective leadership reinforced by a robust framework within financial institutions for directing strategy and for regulating behaviour will be especially important.

Domestically, the financial industry also faces greater competition as a result of the progressive liberalisation of the financial sector. Within the general insurance industry, the course has been set for greater price competition with the gradual removal of tariffs. A review of the operating cost controls which also regulate incentives for insurance sales is also in train. As we know from this recent crisis, incentives and a disproportionate focus on short term gains played a central role. This does not mean that we should put on hold initiatives that would promote a more competitive, efficient and sustainable insurance sector. But it does mean that we need to ensure that we have sufficient confidence in the system of checks and balances that exist to safeguard the interests of financial consumers and the long term viability of the industry. Corporate governance is clearly an essential part of that system of checks and balances.

As the Government embarks on the Economic Transformation Programme, demand will increase for new and innovative solutions for investment, protection and risk diversification. As presented in the Bank's Financial Sector Blueprint, expectations are for the insurance industry to be able to deliver a wider range of insurance products that include medical and health insurance, risk protection offerings for small and medium businesses as well as products supporting the global expansion of Malaysian businesses. Stronger insurance companies are also expected to expand beyond our domestic shores. These developments present tremendous opportunities, but also new risks that must be managed. As individual insurers chart their own paths in this landscape, strong governance systems will assume greater importance to keep business standards in check and to guard against actions that would put the long term interests of the company at risk.

Bank Negara Malaysia is also particularly focused on corporate governance in the light of regulatory changes that are being pursued for the insurance industry. I am referring to the transition from a rules-based system which regulates a number of aspects of insurance operations, to a more principles-based system. This process has already started with the newer guidelines that we have introduced lately, but there continue to be a number of rules applied to the insurance sector which may have outlived their purpose. We are reviewing these. A precondition for this transition is a significant emphasis on a strong system of corporate governance, and one that is actually working effectively within financial institutions.

Ultimately, corporate governance reforms are about improving accountability and control, especially where interests and incentives of stakeholders are not fully aligned. We believe that in Malaysia, we have laid strong foundations for sound governance practices within financial institutions. For the insurance industry, the prudential framework on corporate governance for insurance companies and various other guidelines that have been issued by the Bank establish standards that we expect insurers to operate against to ensure the sound and prudent management of insurers. Our supervisory approach has contributed to promoting better governance in practice. And in the last four years, we have focused on providing important support to directors in performing their roles through education initiatives. Forums such as this contribute to that effort.

Our continuing work on corporate governance builds on and strengthens this foundation. This morning, I would like to take the opportunity to briefly address some of the issues and priorities that are currently directing the Bank's work in this area.

We have substantially completed a review of the existing corporate governance frameworks for the banking and insurance industries and expect to be able to consult with industry on our specific proposals to update and harmonise the frameworks later this year. As part of this review, the insurance industry can expect that what is currently described as "best practice" in the prudential framework on corporate governance will be elevated to principles or minimum expectations to be met by all institutions. We do not expect this to substantially alter current practice in the industry given that for some time now, the Bank already holds insurers to higher standards that reflect the maturity of the industry and the more sophisticated nature of the business over time.

But we also set out in the review to take a fresh and critical look at some key elements of the governance framework to ensure that our requirements remain fit for purpose in the context of the changing financial landscape. Independence, board size and composition, and expectations of subsidiary boards are among some themes addressed in our proposals. We have drawn extensively on our supervisory observations and thematic reviews of governance practices over the course of the past two years in informing our review. In many areas, positive changes can be observed in the governance practices of insurers. In some other areas, we have found that practices of institutions have fallen substantially short of our expectations as enumerated in existing corporate governance principles that institutions must observe. An example relates to the effectiveness of nomination committees and attention to remuneration practices. In such areas, we find merit in providing more specific guidance to institutions in order to achieve greater progress towards the desired state.

I alluded earlier to the particular importance of effective governance as we move towards the adoption of more principle-based regulations for the insurance industry. A common misperception that we find in the industry has been the notion that principles-based regulation equals deregulation or less regulation. It is in fact neither. The move is mainly motivated by two key considerations: first, a recognition that in an environment of fast-paced innovations, attempts to regulate prudent behaviour through detailed and prescriptive rules is just not sustainable as they risk becoming outdated almost as soon as they are written. Second, common rules often do not adequately capture the risks of larger and more complex institutions, or when they do, they are disproportionately onerous for smaller institutions and this can choke off innovation. The adoption of more principles-based regulation is therefore about *re-regulating* the industry in a manner that better reflects the risks which an insurer faces.

There is a third consideration. With greater focus on principles of sound practice, it is left to insurers to design appropriate internal rules that will govern their activities. This has the intended effect of encouraging firms to shift from a compliance focus to developing a deeper understanding of the risk drivers in their business. In turn, conversations between management and the board, and between insurers and supervisors, have moved to focus on how key risks are being controlled rather than on whether particular rules have been breached. This reflects our expectation that boards, supported by the audit and risk committees, must monitor changes to their risk profiles and actively review risk strategies and internal controls in the light of those changes.

An area in which Bank Negara Malaysia is currently seeking to better understand industry practice is with respect to the interactions between the audit and risk committees of the board. Audit committees have a clear interest in risk management within their organisations. Most internal audits adopt a risk-based approach to auditing which requires an understanding of material risks within the organisation. Audit committees also obtain independent assurance from internal audit on the effectiveness of risk management processes within the organisation and this requires a reasonably deep knowledge of risk management. Conversely, risk committees must consider the quality of internal controls, including financial reporting practices, which are an important part of any risk management framework.

The Walker Review of corporate governance in the financial industry acknowledged an important link between these two functions. In Malaysia, we have moved ahead of many countries in requiring an organisational separation of the audit and risk committees in order to encourage an enhanced focus on audit and risk. This move is now validated by similar directions in other countries including Canada, Australia and the UK to require separation. Moreover, the enormous challenges of implementing new financial reporting standards, have substantially increased the demands on the audit committee, which further affirms the separation of these committees as best practice in order to maintain a clear focus on both risk management and controls.

Within existing structures in the insurance industry, we observe common overlaps in membership between audit and risk committee members. We also observe varying degrees in which firms explicitly refer to coordination between the audit and risk committees in their respective charters. There is even greater variance in the actual practice of how the two committees interact with one another. These observations lead us to believe that there is room for greater clarity and improved coordination in responsibilities between these committees.

Bank Negara Malaysia is mindful of concerns expressed by the industry that we are adding too much responsibility to the board's plate, and requiring boards to approve numerous policies and management actions may be distracting boards from being effective in performing their core oversight functions. The addition of new responsibilities to the board has also raised some questions within institutions on whether the separation between management and oversight is being appropriately preserved. In revising the existing framework on corporate governance, we intend to take the opportunity to address this issue by improving how we capture board roles and responsibilities at the organisational level, taking into account all the things that we currently ask boards to do. This will reduce the need for the Bank to direct matters that boards must approve in specific business areas. It does not however, obviate the need for boards to be fully engaged in approving core policies such as risk and capital management strategies. In other areas, the board should determine matters that are reserved for its decision, and the Bank will look to the quality of engagement with management, escalation of issues to the board and the means by which boards obtain assurance on matters that it does not specifically approve. This will be reflected in our assessment of the quality of oversight and risk control functions of the insurer.

I hope that these insights to some of the Bank's current policy considerations will provoke reflections of your own on how your organisations are currently organised and positioned to cope with an environment that will only become more challenging on various fronts. We have much work still to do and over the course of the coming months, we will be seeking industry feedback on these issues. We also have our own expectations of the industry. A key expectation continues to be that the board collectively ensures that it has the requisite knowledge and competencies represented on the board to discharge its role effectively. Our demands of insurers will increase in this respect. Given its responsibility for financial statements, and for ensuring a sound system of internal controls, the audit committee will be a point of some focus as financial reporting standards as well as insurers' operations become more complex.

This Forum and your participation provide great encouragement to the Bank that continuously raising the level of board competence is an important priority that is shared by those who have primary charge of ensuring that insurers operate in a prudent and responsible manner.