

New Corporate Governance Standards for Authorised Insurers to Ring in the New Year

2017 brings a new and modernised set of corporate governance standards to authorised insurers in Hong Kong. The revised edition of the Office of the Commissioner of Insurance (OCI)'s Guidance Note on the Corporate Governance of Authorised Insurers ("Revised GN10"), which sets out the minimum standards of corporate governance expected of authorised insurers, came into effect on 1 January 2017, retiring the original Guidance Note.

Modelled upon the Insurance Core Principles of the International Association of Insurance Supervisors, the Revised GN10 seeks to raise corporate governance standards of insurers in Hong Kong. It requires insurers to more clearly define responsibilities within senior management and control functions as well as the implementation effective risk management and internal controls ensuring stronger checks and balances.

What's New?

The following highlights some key changes:

THE BOARD AND ITS COMPOSITION

The Board must comprise of a suitable number of directors that enables it to carry out its functions effectively and efficiently. The Revised GN10 provides that there should be a minimum of five directors (for small authorised insurers, the minimum number of directors should be three). It is also mandated that the Board should have sufficient knowledge and relevant experience of insurance business to guide the authorised insurer and oversee its activities effectively. As such, the Revised GN10 provides that at least one-third of the directors should possess such knowledge and experience.

Further, the Revised GN10 provides that more rigorous standards are now expected of individuals filling the role of independent non-executive directors

(INED). Where previously only the insurer's controllers or associates of the insurer's controller or director were considered to be not sufficiently independent to become an INED, directors or controllers of a corporation having significant financial interests with the insurer are now unlikely to meet the criteria under the Revised GN10. Nor is an individual who has been an employee with the insurer within the last three years likely to be accepted as an INED (whereas previously only current employees were excluded).

To maintain checks and balances against the influence of management and controllers, the Revised GN10 also sets out the requirement that a minimum of one-third of the Board should be made up of INEDs, up from the previous one-fifth ratio required. However, one INED would be sufficient for small insurers with a smaller board of less than five directors.

Other than expertise in finance and investment, the Revised GN10 advises that the Board be made up of a greater diversity of expertise that may also include areas such as underwriting, claims and actuarial as well.

ROLES AND RESPONSIBILITIES OF THE BOARD

The roles and responsibilities of the Board have been fleshed out in the Revised GN10. It specifies that the pivotal role of the Board in setting the strategic plan and policy of the insurer requires the Board to take into account the long term financial soundness of the insurer, the legitimate interests of its stakeholders and fair treatment of policy holders.

Furthermore, greater accountability is now expected of the Board, which is tasked with the express responsibilities of managing risks appropriately and establish clear and transparent internal policies. They include:

- setting an appropriate risk appetite and strategy for the insurer;
- providing appropriate risk management and internal control systems;
- providing a reliable and transparent financial reporting system;
- establishing adequate policies and procedures for the appointment of external auditors; and
- promoting transparency on governance overall with timely disclosure of accurate and useful information to the public and within the company.

COMMITTEES

While ultimate responsibility lies with the Board as a whole, activities or tasks can be delegated to designated committees within the Board, provided it is done in a clear and well-defined manner, with appropriate allocation of powers and effective monitoring from the Board. To avoid undue concentration of powers in a director, the Revised GN10 suggests rotation of membership.

The Revised GN10 requires that save for small insurers, a Risk Committee be set up in addition to the mandatory Audit Committee and any other optional specialised committees that are established to assist in its work. Guidance on how each optional committee, including committees for investment, nomination, remuneration, underwriting, claims settlement, and reinsurance, should operate is also set out in the Revised GN10. Insurers may set up committees with combined functions as long as it does not compromise the integrity or effectiveness of the functions.

The remuneration committee should include INEDs and should be chaired by an INED; while the nomination committee should comprise of at least one INED.

An insurer that is part of a group of companies may rely on group committees, including a group risk committee and a group audit committee, so long as they abide by the principles set out in the Revised GN10 and take into account of the insurer's matters.

BOARD MEETINGS

The Revised GN10 confirms that the minimum of four board meetings expected to be held annually as set out in the Old GN10, should be held at approximately quarterly intervals. At least two of

these meetings should be participated by the directors.

Where required, the Revised GN10 allows board meetings to be held over electronic means such as telephone or video conferencing.

FIDUCIARY AND GENERAL DUTIES OF INDIVIDUAL DIRECTORS

The Revised GN10 deems it important for directors to avoid actual, potential and perceived conflicts of interest. If such conflict is inevitable, there should be clear and well-defined procedures in place to effectively manage them, through for example, disclosure to the Board, abstention and prior approval of the Board or shareholders.

Specific provisions on the fiduciary duties and general duties of care and skill each individual director owes to the insurer have been set out to include:

- to act in good faith, honestly and reasonably;
- to exercise due care and diligence;
- to act in the best interests of both the insurer and policy holders;
- to exercise independent judgment and maintain objectivity in the decision making; and
- to not use his position to gain undue personal advantage or cause any detriment to the insurer.

Directors, particularly those with other directorships, are expected to dedicate sufficient time and attention in carrying out their duties, including attending Board meetings.

SENIOR MANAGEMENT

The Revised GN 10 sets out a new section of provisions regarding senior management which includes the chief executive.

Senior management is expressed to be held accountable for the carrying out of the insurer's day-to-day operations and implementation of systems and controls in accordance to the business strategies, policies and procedures set out by the Board.

Individuals appointed to senior management should be authorised by the Board, with their roles and responsibilities clearly set out and formally documented. An appropriate reporting line between senior management and the Board should also be established, with adequate controls systems in place

to allow the Board to assess their performance against the objectives set out.

The two roles of chief executive and the chairman would not be assumed by the same person, and an appointed actuary cannot assume either role.

KEY PERSONS IN CONTROL FUNCTIONS

The Revised GN10 also introduces the concept of “key persons in control functions”, who are defined by Insurance Companies (Amendment) Ordinance (Amendment Ordinance) and the Revised GN10, as individuals responsible for control functions, namely in the areas of actuarial, financial control, internal audit, compliance, risk management and intermediary management (and other functions the Financial Secretary specifies by notice). Appointment of such key persons are mandated by the Amendment Ordinance to require approved by the Independent Insurance Authority, the insurance industry regulator set to replace the OCI this year.

Strengthening of risk management and internal controls system of insurers is a core area of amendment in the Revised GN10, and control functions play a big role in providing additional checks and balances and supporting the Board with its oversight duties. Appropriate authority and independence are therefore to be given to each control function, with adequate reporting lines to the Board set up appropriately to prevent conflict of interests.

REMUNERATION

The Revised GN10 introduces a new section of provisions requiring a prudent and effective written remuneration policy to be established for not only general directors and senior management, but also INEDs, key persons in control functions and employees authorised to make decisions on material risks (such as those authorised to decide on underwriting or investment activities). The policy should not induce them to take inappropriate or excessive risks and should demonstrate a clear relationship between performance and remuneration. For INEDs in particular, remuneration should be set at a level that does not compromise their independence.

Best practices for remuneration, including setting up a remuneration structure comprising of both fixed and variable components, measuring performance and making severance payments, are also detailed.

EVALUATION OF THE BOARD AND BOARD COMMITTEES

Directors are expected to review the performance of the Board at least once a year to address any inadequacies and implement appropriate measures for improvement. They should also review its committees annually to ensure that the delegated responsibilities are being carried out effectively.

SERVICING OF CUSTOMERS

The Revised GN10 highlights fair treatment of customers as an important concept to incorporate into the insurer’s business culture, strategies and internal controls, and for which the board is ultimately responsible. It provides more elaborate guidance on providing policy information to customers and handling their complaints.

OTHER CHANGES

The Revised GN10 also incorporates new sections on:

- *Proper Books and Records* – insurers should properly record all of its transactions such that they can be sufficiently exhibited and explained to the insurance regulator and implement adequate documentation to demonstrate compliance of regulations and guidelines.
- *Cyber Security* – insurers should put in place policies and procedures to fend against cyber security threats, including designing response plans and mitigation measure should there be a breach.
- *Business Continuity Planning* – insurers are required to plan against plausible disruptions to its business by taking precautionary measures or designing and maintaining business continuity plans (BCP) that allow it to continue and restore business activities when disruptive events take place. If an insurer needs to activate its BCP, it must notify the regulator promptly with detailed information of the identified disruptions, actions taken, potential impacts and the recovery target timeline, and is expected to continue submitting progress reports until business resumes to normal.

Certain Provisions To Take Effect on a Later Date

To allow time for transition, the more substantive changes requiring a minimum number of INED on the Board, establishment of a Risk Committee, as well as requirements on remuneration matters will not take effect until 1 January 2018.

Insurers are also given more time to establish clear and adequate policies concerning key persons in control functions, as the requirements of the Revised GN10 will only take place when s13AE of the Amendment Ordinance comes into operation upon further notice from the Financial Services and the Treasury Bureau.

Takeaway

With the rising of the bar for corporate standards, insurers will have to put corporate governance as a key priority. The crux of the changes in the newly enforced GN10 requires new systems and policies to be established and existing ones closely reviewed to ascertain if they meet the more stringent criteria. The legal and compliance divisions of insurers are likely to be heavily involved in designing and implementing their business strategies and operations. The changes will as such increase the compliance burden for insurers in Hong Kong and this will result in recruitment of more resources and engagement of external service providers.

While there will be some pain for insurers, the introduction of Revised GN10 is a step in the right

direction. It will bring Hong Kong in line with standards of corporate governance already expected of insurers internationally and it clearly sets out what exactly is expected of insurers doing business in Hong Kong. The increase regulatory requirements on insurers is similar to what the banking industry is experiencing and there is more change on the horizon for insurers in Hong Kong.

Interestingly, the Revised GN10 also seeks to introduce the concept of fair treatment of customers into the insurer's business philosophy. This gives rise to questions whether insurers should reconsider the application of stringent policy terms and conditions (for example, breach of warranty and conditions precedent to liability clauses) that exists in certain policies.

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