

## New corporate governance guidance set to increase compliance burden for HK insurers

Dec 12 2016 Ajay Shamdasani, Regulatory Intelligence

Recently introduced corporate governance standards from Hong Kong's insurance regulator will increase compliance costs and requirements, industry officials said.

In October, the Office of the Commissioner of Insurance (OCI) issued a revised version of its Guidance Note on the Corporate Governance of Authorised Insurers (GN 10), with the aim of bringing corporate governance standards in Hong Kong into line with those observed internationally, including enhanced requirements for independent non-executive directors.



"There will be increased pressure on the compliance function as GN10 has new prescriptive requirements [such as] increasing [the] proportion of independent directors on the board," said Greg Crichton, a consultant with law firm Oldham, Li & Nie in Hong Kong. An enhanced role framework for persons responsible for oversight and management, including boards of directors, senior management and key persons in control functions, would also pose compliance challenges, he said.

Crichton said new requirements for remuneration policies and practices to avoid excessive risk-taking and to align compensation with insurers' long-term risks would be enforced in early 2017 by the territory's long-anticipated independent regulator, the Independent Insurance Authority (IIA), which would have greater resources and powers than its predecessor, the OCI.

"As a result, insurers will either have to reallocate existing resources or, more likely, hire new resources with experience in the right disciplines and control areas, like risk management and compliance. Also, the new corporate governance requirements make it clear that boards have to exercise effective oversight, and in an increasingly complex regulatory environment, all directors of insurance companies should receive regular training on relevant new laws, regulations and the changing risk environment," he said.

The OCI's revised GN10 becomes effective on January 1, 2017. Some requirements, such as those concerning compensation, the establishment of risk committees and the minimum number of independent non-executive directors (INEDs), take effect from January 1, 2018.

Under the new guidance note, at least one-third of the boards of locally-based insurers must be INEDs, and the roles of chairperson and chief executive must be separated. The new GN10 also affects key individuals to be appointed for control functions, such as compliance, internal audit, risk, financial control, actuarial and intermediary management.

The revised note also requires that insurance company boards form separate audit and risk committees where necessary, and that remuneration, nomination, underwriting, investment, reinsurance and claims settlement committees also be set up.

The note also contains new requirements for compensation policies and practices covering all directors and employees at authorised insurers, with specific attention paid to directors, senior management, and key persons in control functions and material risk-taking staff.

### **Compliance implications**

Hong Kong's insurance providers may face challenges in adapting to the changing regulatory landscape, as compliance costs are expected to rise. Many local insurers may find it hard to meet the stringent new governance and conduct mandates, most notably, the enhanced requirements for INEDs, sources said.

"The new requirements will require close scrutiny by management and legal advisors to ensure compliance. There is considerable work to be done in terms of setting up systems and processes along with the implementation of committees, role descriptions of members, determining areas of responsibility, recruitment, engagement procedures and processes of INEDs, reporting lines and requirements, rules and procedures to be scoped out and settled by management," said Michael Turnbull, a senior consultant with law firm DLA Piper in Hong Kong.

Those charged with ensuring compliance with the revised GN10 had little time to get the bulk of the requirements in place. "An early appreciation of the implications needs to be undertaken, if not already done," he said.

In any case, more will be expected of in-house compliance and legal teams as GN10 addresses the structure of senior management and is designed to set up "clear lines of reporting" and "division of responsibilities within the organisational structure of an authorised insurer".

Generally, it will result in more work, said TL Lim, a partner with law firm Mayer Brown JSM in Hong Kong. "The compliance and legal divisions will be more involved now because of the nature of what is required [by GN10] as well as the need for their input to develop internal policies going forward," he said.

Compliance officers and in-house legal counsel will probably have to review the composition of the board of directors with regard to numbers, knowledge and relevant experience, said Declan McDaid, partner at Norton Rose Fulbright in Hong

Kong.

"Boards of directors, when properly constituted, will also have to ensure that there are proper internal controls, policies and procedures in place, and invariably these tasks and many others expressly set out in GN10 will be delegated to compliance officers and in-house counsel to review and implement. Finally, the board ... will be responsible for ensuring compliance with all relevant ordinances, regulations, guidance notes and industry standards," McDaid said.

Such a task involves compliance with the relevant industry-specific legislation and regulations, but also legislation and regulations that may not immediately spring to mind, such as the Sex Discrimination Ordinance, the Disability Discrimination Ordinance and the Code of Best Practice within the Listing Rules issued by the Stock Exchange of Hong Kong (SEHK).

McDaid said these could be carried out by in-house compliance officers and counsel, or by external service providers. Outside consultants and specialists, however, would still need to be managed by internal compliance and legal staff.

Additionally, GN10 mandates that INEDs play a full and active role in the decision-making process and, where they possess specialised expertise, they may be required to assist boards in the interests of an authorised insurer. This requirement ensures that compliance will be involved in both vetting and monitoring such INEDs.

"Non-executive directors playing a full and active role will be required to check and ensure that the high standards of corporate governance required by the IIA have been introduced ... maintained and reviewed on an ongoing basis. As a consequence, we believe the compliance officers and in-house legal counsel will be required to report to ... boards of directors on compliance issues on a more regular basis than they possibly have done in the past," McDaid said.

The drudgery of greater work for insurance-sector compliance officers and lawyers notwithstanding, some suggest there might be a silver lining in that they can now rely on a source of authority to get the insurance firms they serve to take corporate governance seriously.

"Compliance officers and in-house legal people will welcome this. With the minimum standards for corporate governance proposed by GN10, it is easier for compliance officers to do their job because they can now point to specific requirements and directives to ensure that the insurer concerned is looking seriously at corporate governance," Mayer Brown's Lim said.

The revised guidance note also places a significant emphasis on risks and controls.

Insurers that have previously implemented more comprehensive risk management and compliance practices would have fewer changes to make, said David Wu, Hong Kong insurance sector leader for Deloitte China. "For other insurers, this could require new policies, committees, controls and other practices to be implemented to facilitate compliance," he said.

There is also a cyber security requirement in the amended guidance note, with which legal and compliance will need to be involved. Specifically, directors will need to show they have a response plan for cyber attacks, and that they have considered cyber security a serious risk and can ensure they have mitigation measures in place should a breach occur.

"The implementation of policies and procedures on cyber security and business continuity planning have been explicitly called out in the revised GN10, recognising the significance of the risks underlying these areas for insurers," Wu said. Compliance officers and in-house counsel would, he said, needed to be fully involved in interpreting the requirements, completing gap analyses against current practices and making the required changes.

### **Too few INEDs**

Crichton said the enhanced INED requirements would increase compliance burdens because the new rule that INEDs should make up at least one-third of the board of a local insurer — up from one-fifth — was a significant change. Tougher still will be the requirement that even small, authorised insurers have a minimum of one INED on the board.

It may also prove difficult to find suitable candidates. "Not many have the relevant industry experience, particularly in the underwriting and actuarial areas. Also, qualified INEDs may have a conflict in taking on new appointments if they are already on the board of one or more insurance companies," OLN's Crichton said.

Turnbull said, quite apart from the additional expenditure involved in meeting annual fees, travel expenses and perhaps the cost of training, insurers might also face further difficulties, both in terms of physically accommodating INEDs at board meetings and also in providing them with the information necessary to carry out their functions.

"To this extent compliance burdens will increase. One difficulty that may arise is for an authorised insurer to locate and engage suitable candidates for the role of the INED, as [the number of] available industry personnel in Hong Kong is finite and recruitment into the mainstream insurance business is already a challenge. Even in other leading international insurance markets like London, which have a larger insurance talent pool, it is difficult for insurers to find suitable INEDs," he said.

### **Keeping up with the times**

The revision of GN10 will coincide with the IIA coming into being next year, and is aimed at ensuring the local insurance sector complies with international standards.

"GN10 really just brings Hong Kong in line with the standard of corporate governance already expected of insurers under international standards," Crichton said.

For example, Singapore has required that INEDs should form at least one-third of the board at incorporated insurance

companies since 2013.

The GN10 provisions for remuneration, which require the deferral of a major part of variable compensation for senior management and material risk-taking employees, for example, come straight from the International Association of Insurance Supervisors (IAIS) Insurance Core Principle 7.6 and follow the lead taken by the European Union and the UK under the Solvency II directive which have stricter requirements.

"The approach set out in GN10 is in line with the higher global risk, capital and governance standards brought in by the implementation of the Solvency II directive in the European Union at the beginning of 2016 and the ... ongoing work of the IAIS. A key element of the Prudential Regulation Authorities (PRAs) implementation of systematically important institutions (SII) in the UK has been the Senior Insurance Managers Regime (SIMR), which codifies the regulators expectations around the governance arrangements for UK insurers and reinsurers," said Ben Blackett-Ord, chief executive of regulatory consultancy Bovill in London. "These requirements are all in line with expectations of other regulators such as the UK's FCA (Financial Conduct Authority) and PRA," he said.

The explosion in sales of insurance products to mainland Chinese buyers over the past decade may also help to explain the need for reform.

"The recent changes in the rules underlying the sales of insurance products to mainland Chinese customers, increased presence of Chinese investors in Hong Kong insurance businesses and increased compliance requirements around conduct and sales practices further accelerate and amplify the need for enhanced corporate governance and risk management practices across the sector," Deloitte's Wu said.

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