

# **A Comparison of Board Governance Practices of Selected Philippine and Hong Kong Banks**

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This paper compares the board governance practices between Philippine and Hong Kong banks using the Walker Review recommendations. The governance “gaps” between the two countries are identified. Propose areas for improvement are also discussed so that the Philippine financial system will remain safe and sound.

*Keywords:* corporate governance, board governance, Walker Review

## **1 Introduction**

The 2008 global financial turmoil, which triggered widespread bank and financial institutions failures in developed countries, has again elevated corporate governance in the center stage. While the series of corporate failures in the United States at the turn of the century was primarily due to the lack independence of external auditors and the lack of adequate accounting disclosures and transparency, the Organization for Economic Cooperation and Development (OECD), the leading authority on corporate governance based in Europe, in 2009 issued a report entitled “Corporate Governance and the Financial Crisis: Key Findings and Main Messages”. The report identified four major corporate governance weaknesses—in the areas of board governance, risk management, remuneration scheme—and the role of shareholder as contributory to the global financial crisis.

The banks and financial institutions in developed economies were the worst hit in 2008. Thus, British Prime Minister, Gordon Brown, commissioned Sir David Alan Walker, formerly chairman and current senior advisor of Morgan Stanley International, to review the governance of banks and financial institutions in the United Kingdom (UK). In mid-2009, the Walker Review came up with 39 recommendations encompassing the four key areas identified by OECD. Both the United Kingdom and Hong Kong Code of Corporate Governance have adopted some of these best governance practices in their codes and in their supervisory policy manuals.

The Philippine financial system was not badly hurt by the crisis. However, it ranked last among the 11 Asian countries in the CG Watch 2010 Report<sup>1</sup>, which merits that a study of the Philippine corporate governance on publicly-listed banks be done, particularly on board governance. A BusinessWorld news article<sup>2</sup>, which provided a synopsis of the CG Watch 2010 Report, reported that the Philippines fared poorly in all corporate governance indicators in said report except in the adoption of tougher accounting rules. It landed at the bottom in three of the five categories, namely, corporate governance rules and practices, enforcement and corporate governance culture. Hong Kong, in contrast, was one of the best performers in the same report and has started to adopt some of the recommendations in the Walker Review.

## **2 Objective, Methodology and Limitation of the Study**

The main objective of this study is to identify gaps between the Philippine corporate governance of banks, specifically in board governance and structure, with that in Hong Kong and to discuss the refinements in corporate governance of banks adopted in both the UK and Hong Kong. Hong Kong is chosen as a benchmark because it has been a top performer in the CG Watch 2010. Given that Hong Kong draws most of its laws and regulations from UK, it is inevitable not to delve into the UK Code. It

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<sup>1</sup> The CG Watch 2010 Report is prepared by Credit Lyonnais Securities Asia (CLSA) Asia-Pacific Markets in collaboration with Asian Corporate Governance Association (ACGA), an independent, non-profit organization based in Hong Kong.

<sup>2</sup> Business World Online, “Corporate Governance Faulted” dated September 23, 2010 by N.J.C. Morales.

is, however, not the objective of the study to render a judgment whether the *Bangko Sentral ng Pilipinas* (BSP), the Philippine Central Bank, is effective in its banking supervision.

To achieve the above stated objective, the following activities were undertaken: (a) a review and comparison of the Code of Corporate Governance adopted in the Philippines, Hong Kong and UK; (b) a review and comparison of the corporate governance standards as issued by the BSP and Hong Kong Monetary Authority (HKMA), specifically the Manual of Regulations for Banks and the Supervisory Policy Manual, respectively; (c) a review of the 2009 annual report and the Securities and Exchange Commission (SEC) Form 17-A of the top five Philippine banks, particularly those sections that deal with "Corporate Governance" and "Control and Compensation"; (d) a review of the 2009 annual report of the five selected Hong Kong banks, specifically the Corporate Governance Report; and (e) a comparison and identification of the "gaps" in board governance and structure in the selected Philippine and Hong Kong banks.

Three of the five Philippine listed banks selected for this study, namely, Banco de Oro (BDO), Bank of the Philippine Islands (BPI) and Metropolitan Banking and Trust Company (MBTC), are the top three banks in the country. Philippine National Bank (PNB) and Rizal Commercial Banking Corporation (RCBC) were chosen by virtue of being one of the older banks in the industry. The combined total assets of these five selected Philippine banks represent at least 50% of the banking industry's total assets of Php 6.2 trillion.

The five Hong Kong banks reviewed were randomly selected. Two banks-- Bank of China (BOC) and Industrial and Commercial Bank of China (Asia) Ltd (ICBC)-- are banks based in the People's Republic of China. The other two, Bank of East Asia Ltd (BEA) and Hang Seng Bank (HSB), are Hong Kong-based banks, with one UK-based bank, Hong Kong Shanghai Bank Corporation (HSBC) to complete the selection.

### **3 Review of Literature**

The first version of the UK Code of Corporate Governance succinctly defined corporate governance as the system by which companies are directed and controlled and then went on to elaborate the duties and responsibilities of the various actors - directors, shareholders, auditors and managers. Echanis (2006) simply defined it as the structure and process by which public corporations control agency problems. Indeed, the agency theory provides the main theoretical framework in the development of corporate governance literature. Jensen and Meckling (1976) pointed out that due to the separation of ownership (shareholders) and control (management), the agency problem is created. Eisenhardt (1989) elaborated that in a principal-agent relationship between owners and managers, especially of large public corporations, conflict of interests or goals exist. To limit the agent's self-serving behavior, certain governance mechanisms should be in place to protect the rights of all shareholders. Fama and Jensen (1983b) observed that a single individual agent, usually the CEO, dominated some corporations. This dominating figure leads to the lack of separation of the management and control functions, making the expropriation of the interests of shareholders quite easy. La Porta et al. (2000) further refined the classification of the principal-agent into insiders (managers and controlling shareholders) and outsiders (minority shareholders and creditors), recognizing that minority shareholders and creditors need to be protected through the legal system. Shleifer and Vishny (1997) claimed that the interests of large, controlling investors do not necessarily coincide with the interests of minority shareholders, employees, creditors and managers. Claessens et al. (2000) found that concentrated control structure that dominates the East Asian corporate landscape could lead to suppression of minority rights.

While previously mentioned authors called for the protection of shareholders and minority investors, Macey and O'Hara (2001) argued for the adoption of a broader view of corporate governance in the case of banking institutions due to its peculiar contractual form. The authors propose that corporate governance mechanism for banks should encompass the protection of both shareholders and depositors (creditors).

## 4 Corporate Governance of Banks

### 4.1 Agency problems in banks

What makes banks distinct from other entities? What are the peculiarities that Macey and O'Hara are referring to? Banks face unique agency conflicts not common to other enterprises. The risk profile of bank portfolio of financial assets changes much faster than that of firms belonging to other industries. Moreover, the complexities of bank's balance sheet makes outside monitoring by shareholders, depositors and other creditors difficult, if not outright impossible. The obscurity of the bank's balance sheet also makes incentive contracts with managers less effective in aligning the interests of the managers and shareholders. Management's remuneration scheme may further encourage focus on myopic or short-term results at the expense of long-term sustainability of the bank. Prudential regulation imposed by regulatory agencies (i.e., minimum capital requirements) increases the cost of banks, which may consequently prompt banks to adopt riskier business strategy to compensate for the higher cost of doing business. Safety nets (e.g., deposit insurance) provided by regulatory agencies, not only weaken the incentive for outside (depositor) monitoring, but also it encourages banks to pursue riskier business strategy. Bailouts by central banks also distort the incentives of all players— banks, depositors, creditors, shareholders, supervisors, and so on. While the monetary losses from aggressive business strategy are borne by the banks and shareholders with the guilty employee/s spared, bailout schemes shift the ultimate losses to taxpayers.

More importantly, bank's assets, particularly loans and receivables, are financed primarily by its liabilities (e.g., deposits) rather than its equity capital. It can be argued that bank depositors, who supply most of the working or operating capital of banks, can be rightfully considered as "shareholders" rather than mere creditors. This is the main reason why Macey and O'Hara advocate that the rights of the depositors should also be protected in a bank setup.

Due to the peculiar agency conflicts faced by banks, corporate governance of banks is definitely important as failures of banks could result not only in monetary loss for depositors and taxpayers but could destabilize the financial system and wreak significant havoc to the economy.

### 4.2 Characteristics of Asian banks

To compound the agency conflicts faced by banks, Asian banks are predominantly family-owned with interlocking networks and subsidiaries. Claessens et al. (2000) noted that a few families effectively control most of East Asian companies and the banks are no exception. Since principal investors are usually family members and close friends, incentive to adopt good governance is quite weak. Echanis (2006) noted that ownership in banks is concentrated in few individuals and families, and few banks controlling 71.2% of system-wide assets as of 2005 dominate the banking industry. Moreover, corporate insiders constitute the governing elite, leading to information asymmetry and weak minority shareholder and stakeholders' position (Arun & Turner, 2002). Other factors such as poor investor protection laws, weak information disclosure requirements particularly on board governance and functions, as well as weak prudential supervision in Asia, require focus on board effectiveness. Cayanan's (2007) finding states that the monitoring systems of Philippine regulatory agencies— such as the SEC, the BSP and the PSE— are weak.

Appendix A presents the various events or milestones that led to the enhancements and refinements of corporate governance practices.

## 5 The Walker Review

The Walker Review proposed 39 recommendations. These were broadly categorized into five major areas, namely: (a) board size, composition and qualification; (b) functioning of the board and evaluation of performance; (c) role of institutional shareholders; (d) governance of risk; and (e) remuneration. Since the focus of the study is on board governance, the discussion in the next section will concentrate on the first two areas.

### 5.1 Recommendations on board size, composition and qualification

- **Formal and tailor induction and continuous professional development of Non-Executive Directors (NEDs).** It is recommended that companies should “provide thematic business awareness sessions on a regular basis so that non-executive directors (NEDs) individually can contribute effectively to the board functions” (Walker Review p. 43). Moreover, “each non-executive director should be provided with a personalized approach to induction, training and development to be reviewed annually with the chairman” (Walker Review p. 43). While companies are encouraged to arrange and fund a suitable development program for their directors, more importantly, they are required to disclose these induction and continuing development programs for directors in their annual report.
- **Support for NEDs.** The board should provide dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process. Though external perspective should be sought, internal support is equally or more important.
- **Time commitment of NEDs.** NEDs should give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in major banks should clearly be indicated in the letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere. It aims to ensure that NEDs will devote sufficient time and attention to board matters and will not over-saddle themselves with other commitments, consequently, undermining their capacity to diligently perform their duties and responsibilities as directors. Implicitly, the time commitment requirement dictates that a NED should only hold a maximum of seven to eight directorships.
- **Supervisory assessment of NEDs continuing qualifications.** The fourth recommendation requires that the supervisory process should give closer attention not only to the relevant experience and other qualities of individual directors, but also to their access to an induction and development program, thereby equipping them to engage proactively in board deliberation. Supervisory assessment of directors does not stop at the possession of relevant experience and qualities at the time of their appointments. Equally or more important is the availability of ongoing training and development provided to these directors given the changing business environment and product innovation in the finance world as well as the specialized and technical nature of the banking and finance industry. An effective board hinges on two key factors– the continuous training and development program given to directors, as well as having directors possessing the highest ethical standards in executing their fiduciary duties.
- **Selection of NEDs.** The interview process for NEDs by bank supervisory agency should involve one or more external senior advisers with relevant experience at or close to board level of a similarly large and complex entity. This adviser can be engaged on a part-time panel basis. Where a proposed NED does not possess the relevant financial industry experience, an interview process by the bank supervisory agency should become the norm rather than the exception and more importantly this interview should involve one or more senior advisers with relevant industry experience. This recommendation addresses the fact that the bank supervisory agency may lack the expertise required to assess or evaluate the appointed director’s experience and qualifications.
- **Establishing the “independence” criteria of NEDs.** The “independence” criteria is not only affected by family ties, previous employment or material business relationships but also by the number of years served by each director. In the UK Code, board members who served for more than six years are subject to more rigorous scrutiny by the regulatory agency and the nomination committee. In fact, the board should state in the annual report its reasons for considering a director to be independent despite the existence of relationships or circumstances to the contrary. The setting of “cooling-off period” also forms part of establishing the “independence” criteria of NEDs.

## 5.2 Recommendations on the functioning of the board and evaluation of performance

- **True role of NEDs.** It is recommended that “NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive” (Walker Review p. 51). They should “satisfy themselves that board discussion and decision taking on risk matters is based on accurate and appropriately comprehensive information and draws on external analysis and input” (Walker Review p. 51). This puts into proper perspective the true role and value of NEDs in the board, which are their independent judgment and other relevant experiences. NEDs lose their true utility in the board if they are not truly independent.
- **Time commitment of chairman.** The chairman is expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the chairmanship role would have priority over any other business time commitment. Further, it also requires that the chairman’s “other significant commitments” should be disclosed to the board before or upon appointment. Moreover, it is recommended that one individual should not exercise the roles of the chairman and CEO, and that there should be a clear division of responsibilities between the chairman and the CEO. The UK Code further provides that the chairman should on appointment meet the independence criteria. If, exceptionally, a board decides that a CEO should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of appointment and in the next annual report. Refer to Appendix B for the list of responsibilities of the chairman as indicated in the Philippine, Hong Kong and UK Codes.
- **Over-riding quality of a chairman.** It is recommended that “the chairman should bring a combination of relevant financial industry experience and a track record of successful leadership capacity and that the board should give more weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice” (Walker Review p. 54).
- **Responsibilities of the chairman.** The Walker Review specifies broadly the main duties and responsibilities of a chairman, which include leadership of the board, ensuring board effectiveness in all aspects of its role and setting its agenda, facilitating and encouraging informed and critical contributions of the directors, promotion of effective communication between executive and NEDs and ensuring that all directors receive all information on time.
- **Annual re-election of the chairman.** The chairman should be proposed for election on an annual basis. Just as NEDs should be appointed for a specific term and subject to re-election, the chairman being a director is also subject to the same conditions.
- **Role of senior independent director.** Another recommendation speaks about the roles of the senior independent director, which is to provide a sounding board for the chairman, to evaluate the chairman, and to serve as a trusted intermediary for the NEDs and accessible to shareholders.
- **External facilitation of board performance evaluation.** It is recommended that there should be external facilitation of the board performance evaluation every second or third year. Moreover, a statement on board evaluation should be disclosed in a separate section of the annual report. Where external facilitator is used, an indication of its “independence” in terms of business relationship with the entity should be disclosed.
- **Performance evaluation statement in the annual report.** Not only should board performance be evaluated by external consultants, it requires that the evaluation statement should include information necessary to assist shareholders in the understanding of the main features of the evaluation process. Moreover, ongoing process of identifying skills and experience required in the board as well as indication of the nature and extent of communication by the chairman with major shareholders should be disclosed.

## 6 Comparison of the UK, Hong Kong and Philippine Codes of Corporate Governance

After the passage of the Sarbanes-Oxley Act of 2002 in the United States and the issuance of the OECD Principles of Corporate Governance (2004), many countries worldwide have adopted a code of corporate governance to ensure that business entities, especially publicly-listed ones, are properly managed, and that transparency and accountability to the public investors are established. However, due to the changing business landscape, corporate governance best practices have been continuously evolving. Thus, there is a need to regularly enhance and improve existing adopted codes of corporate governance. However, each country differs in their degree of refinements and improvements of the various corporate governance codes. Table 1 shows the extent of adoption by the three countries, namely, UK, Hong Kong and Philippines, of the Walker Review recommendations on board size, composition and qualification, and on the functioning of the board and evaluation of performance.

**Table 1. Adoption of Walker Review**

<b>Recommendations on Board Size, Composition and Qualification</b>	<b>United Kingdom</b>	<b>Hong Kong</b>	<b>Philippines</b>
Personalized induction, training and development of NEDs	Yes	Yes	No
Dedicated support to NEDs	Yes	Yes	Yes
Greater time commitment from NEDs	Yes	Yes	Yes
Ongoing induction and development program for NEDs	Yes	Yes	No
Bank supervisory interview of NEDs, particularly those without relevant financial experience	Yes	Yes	No
<b>Recommendations on the Functioning of the Board and Evaluation of Performance</b>	<b>United Kingdom</b>	<b>Hong Kong</b>	<b>Philippines</b>
NEDs to challenge and test proposals forwarded to board	Yes	Yes	Yes
Time commitment of the chairman	Yes	Yes	No
Leadership skills of the chairman over financial expertise	Yes	Yes	No
Duties and roles of the chairman	Yes (detailed)	Yes (detailed)	Yes (broadly)
Annual re-election of the chairman	No	No	No
Role of the senior independent director	Yes	No	No
Board evaluation and external facilitation	Yes	Yes & No	Yes & No
Evaluation statement in the annual report	Yes	No	No

In June 2010, the Financial Reporting Council, UK's independent regulator responsible for promoting high quality corporate governance and reporting, issued the latest version of the UK Code. The UK Code has been updated to include almost all recommendations found in the Walker Review. To maintain its status as world's premier financial center, Hong Kong has strived to adopt as many of the Walker Review recommendations. The HKMA has, in fact, started upgrading its supervisory policy manual in 2010 to include some of the best practices proposed in both the Walker Review and the latest version of the UK Code. The Philippine Code, although recently revised in 2009, remains very "backward" compared to the two other codes. There are still many areas for improvement.

## 7 Comparison of Selected Philippine and Hong Kong Listed Banks

Table 2 shows a tabulation of the board structure and governance findings:

**Table 2. Comparison of Board Composition, Size and Qualifications**

	Hong Kong	Philippines
Total Number of Directors	9 to 21	11 to 15
Number of INEDs / Total Number of Directors	33% to 67%	18% to 33%
Number of Banks where Chairman/Vice Chair = CEO	2 out of 5	1 out of 5
Age Profile of Chairman	51 to 70 years old	59 to 65 years old (excluding honorary or emeritus chairman)
Age Profile of CEO	51 to 70 years old	43 to 63 years old
Age Profile of Directors (excluding Chairman and CEO)	45 to 83 years old	41 to 88 years old
Number of Banks with Directors over 70 years old	2 out of 5	5 out of 5
Gender	Predominantly Male	Predominantly Male
Number of Chairman with Doctorate Degree	1 out of 5	None
Number of Chairman with Masters Degree	2 out of 5	3 out of 5
Number of CEO with Doctorate Degree	1 out of 5	None
Number of CEO with Masters Degree	2 out of 5	4 out of 5
Number of Board Meetings During the Year	4 to 9	4 to 12
Attendance Rate	57% to 100%	54% to 100% (only BPI provides this information)
Chairman's Remuneration Per Annum	HK\$90k to 360k	Not specified
Director's Remuneration Per Annum	HK\$90k to 280k	Not specified
Number of Committees Established	3 to 5	2 to 7
Committee Chair's Remuneration Per Annum	HK\$50k to 100k	Not specified
Committee Member's Remuneration Per Annum	HK\$30k to 50k	Not specified
Number of Meetings Held by the Audit Committee Per Annum	3 to 9	13 (only BPI provides this information)
Number of Banks with Risk Management Committee	2 out of 5	3 out of 5
Number of Concurrent Directorships	Minimum of 0 Maximum of 16 Average of 2 to 10	Minimum of 0 Maximum of 22 Average of 3 to 11

Sources: 2009 Annual Reports.

### 7.1 Number of independent directors

One significant difference between the Hong Kong and Philippine banks is the number of independent directors on the board. The number of independent directors becomes more meaningful if considered as a percentage of total directors. It shows that though the Hong Kong Code requires only three independent directors, some banks appoint a higher number of independent directors equivalent to at least one-third of the board. On the other hand, four of the top five Philippine banks have more than two independent directors with the exception of Banco de Oro Unibank, Inc. (BDO) with only two independent directors. Since the Philippine Code requires only two independent directors and the BSP Manual of Regulations for Banks requires that the board committees should be composed of three members, two of whom should be independent directors, the workload of independent directors in the Philippines can be quite heavy. This may lead to independent directors spreading themselves too thin and not being able to perform their roles and responsibilities well, consequently leading to ineffective board oversight and monitoring.

## **7.2 Age profile and term**

Though the age profile of chairman and CEO in both countries are within the retiring age of 70, the age profile of directors, other than the chairman and CEO, is another matter altogether and merit some attention. There are quite a number of directors, excluding the chairman and CEO, who are beyond 70 years old in both countries. However, this situation is worse in the Philippines with all five banks having directors beyond 70 years old. Though it cannot be denied that with age comes experience and knowledge, a plan of orderly succession should be in place to avoid vacuum in the board especially when qualified directors are quite limited in the market. Related to age is the term of the director, particularly independent non-executive directors. It is found in this study that many directors in the sample Philippine banks have been on the board for quite a number of years already. While both the UK and Hong Kong consider a term beyond six- to nine-years a ground for stricter and more rigorous review, there is no such requirement in the Philippines. Serving as director for more than a period of time makes it difficult for the director, especially independent non-executive director, to be truly independent and objective. Many and a majority of the directors in Philippine banks have been serving their respective bank for more than ten-years.

## **7.3 Gender**

Both Hong Kong and Philippine banks' directors are predominantly male. Only Bank of the Philippine Islands (BPI) has more women directors – a ratio of nine males to six females.

## **7.4 Educational attainment**

Though there is no chairman or CEO in the Philippine banks that attained a doctorate degree, it should be noted that majority of these Philippine banks' chairmen and CEOs have Masters degrees. In the Hong Kong banks reviewed, there is one chairman and one CEO with doctorate degree.

## **7.5 Disclosures on frequency of meetings, attendance and remuneration of directors**

In terms of number of board and committee meetings, attendance report and remuneration of directors, only Hong Kong banks have these disclosures. In the Philippines, with the exception of BPI, all publicly-listed banks do not disclose these information either in their annual report or in their SEC Form 17-A. As mentioned previously, the UK and HK Codes require that these items should be disclosed in the annual report. Refer to Appendix C for other governance disclosures required by the HK Code. In the Philippines, attendance report is submitted to the SEC on or before January 31 of the following year. This disclosure is not required in the annual reports. In terms of remuneration of directors and officers, the UK and HK Codes require that directors' fees and any other reimbursement or emolument payable to a director must be disclosed in full in the annual report and accounts on an individual and named basis. In the Philippine Code, disclosure of all fixed and variable compensation that may be paid to its directors and top four management officers are done in aggregate only.

## **7.6 Concurrent directorships**

Though the BSP Manual of Regulations for Banks is quite clear that there should be no concurrent directorships and officerships between banks, Philippine directors have more concurrent directorships in subsidiaries of their bank and/or other companies compared to their Hong Kong counterparts. Except for Bank of East Asia and Hang Seng Bank, all the selected Hong Kong banks' directors handle a maximum of seven concurrent directorships only. One serious implication of holding many directorships is that the directors will not be able to give sufficient attention and time to the affairs of the companies they are serving, thereby, resulting in ineffective board monitoring and oversight function. This requires the disclosure of time devoted by each independent director to ensure that each is performing his/her role as independent director properly. Table 3 shows the number of directorships held by the selected Hong Kong and Philippine banks.



**Table 3. Number of Directorships Held by Directors**

<b>Hong Kong Banks</b>	<b>Lowest</b>	<b>Average</b>	<b>Highest</b>
Bank of China Hong Kong (Holdings) Ltd (BOC)	0	4	7
Bank of East Asia Ltd (BEA)	1	7	16
Hang Seng Bank (HSB)	3	10	16
HSBC Holdings Plc (HSBC)	0	4	7
Industrial and Commercial Bank of China (Asia) Ltd (ICBC)	1	2	4
<b>Summary for Hong Kong Banks</b>	<b>0</b>	<b>2 to 10</b>	<b>16</b>
Note: Memberships and public offices are not included in the computation of directorships held.			
<b>Philippine Banks</b>			
Banco de Oro Unibank, Inc. (BDO)	0	7	22
Metropolitan Bank and Trust Corporation (MBTC)	0	3	4
Bank of the Philippine Islands (BPI)	1	11	21
Rizal Commercial Banking Corporation (RCBC)	5	8	17
Philippine National Bank (PNB)	1	8	13
<b>Summary for Philippine Banks</b>	<b>0</b>	<b>3 to 11</b>	<b>22</b>
Average = Number of directorships held (excluding memberships and public offices) by all directors of said bank divided by the total number of directors in the said bank			

Sources: 2009 Annual Reports.

## 7.7 Codes

While the focus of the three Codes is on board governance, both UK and HK Codes include more disclosure requirements compared to the Philippine Code. Furthermore, many mandatory disclosure requirements related to corporate governance are summarized in the UK and HK Codes with reference to other authoritative laws or regulations. This makes the governance of the entities more transparent, enabling shareholder to make proper and informed decisions. The corporate governance section in the annual report of Philippine banks varies in their contents, making comparison between and among banks difficult.

## 8 Other Issues

One major difference noted is that in the Philippines it is management who is responsible for the preparation of the financial statements and any representations made to the auditor. On the other hand, in both UK and Hong Kong, it is the board or specifically the directors that are responsible for the preparation of the annual report and accounts. Moreover, UK and Hong Kong directors should report in the annual and half-yearly financial statements whether the business is a going concern, providing supporting assumptions or qualifications as necessary.

Another issue worthy of mention is the whistle-blowing mechanism. The audit committee should establish and maintain mechanisms by which officers and staff may raise concerns about possible improprieties or malpractices. Though all the three Codes have this provision, there is no whistle-blower protection law yet in the Philippines. On the other hand, the HKMA has enlisted the help of the Independent Commission on Corruption<sup>3</sup> (ICAC) in fighting corruption in the system. Given the powers and success rates of the ICAC, there is no doubt about HKMA's serious stance against bribery and corruption. There is no such agency in the Philippines to regulate and police the graft and corruptions in the corporate world.

<sup>3</sup> The ICAC was established by Governor Murray MacLehose on 15 February 1974, when Hong Kong was under British rule. Its main aim was to clean up endemic corruption in the many departments of the Hong Kong Government through law enforcement, prevention, and community education.

## 9 Summary and Conclusions

The study has identified the gaps in the best practices of Hong Kong and Philippines in the following areas: (1) the minimum number of independent directors required; (2) the screening of non-executive directors; (3) concurrent directorships; (4) roles and responsibilities of the chairman and the board; (5) responsibility for preparing the financial statements; (6) mandatory governance disclosures specified in the Code; (7) disclosure of induction and development programs for directors; and (8) formal and rigorous annual evaluation of board performance and that of its committees and individual directors.

From these findings, further reforms and refinements in corporate governance practices in the Philippines should be undertaken by the appropriate organizations in the Philippines for effective governance and transparency. The SEC of the Philippines is proposing amendments to the Securities Regulation Code, particularly on increasing the number of independent directors, imposing the maximum number of years a person may serve as independent director, the maximum number of independent directorships one person can hold, just to name a few. The current SEC chair also acknowledges that the selection of directors, including independent directors, remains the weakest area as indicated in the corporate governance report<sup>4</sup>.

However, appropriate regulatory agencies should also seriously consider some of the possible impediments to reforms such as: (a) Philippine banks are predominantly family-owned; (b) weak legal framework which makes it quite impossible for minority shareholders to form enough clout to impose better transparency and governance practices on companies; and (c) the scarcity of non-executive directors with financial expertise. Furthermore, before SEC and BSP can implement any amendments in any laws and regulations to improve corporate governance practices in the country, the scarcity or shortage of non-executive directors with financial expertise should first be addressed.

The BSP Monetary Board should also collaborate with the Institute of Corporate Directors or other relevant organizations to ensure that directors appointed to bank boards are truly qualified to handle the statutory and fiduciary responsibilities entrusted to them.

Finally, the SEC and BSP should come up with a list of minimum disclosure requirements so that all listed banks will show the same information in their annual reports to facilitate comparison among and between them. It is important that critical governance issues should be transparent to shareholders, the investing public and the regulatory bodies in order that proper investment decisions and monitoring can be achieved.

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<sup>4</sup> Philippine SEC Chairperson Teresita Herbosa discussed at the launch of a corporate governance report issued by the Hills Program on Governance and the Ramon V. del Rosario Sr. – C.V. Starr Center for Corporate Governance in July 2011.

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## APPENDIX A

### History of Bank's Corporate Governance

Event/Year	Lead To
East Asian financial crisis in 1997 and the signing of the Sarbanes-Oxley Act in 2002	<ul style="list-style-type: none"> <li>• Adoption codes of best practices in corporate governance.</li> <li>• Major changes in laws and regulations as well as new stock market listing rules on disclosures and financial reporting.</li> <li>• Appointment of independent directors.</li> <li>• Establishment of audit committee.</li> </ul>
Macey and O'Hara publication in 2001	Calls for the protection of depositors.
OECD issued the "White Paper on Corporate Governance in Asia" in 2003	<p>Some of the recommended actions:</p> <ul style="list-style-type: none"> <li>• the adoption of adequate banking laws and regulations and supervision of bank operations;</li> <li>• the disclosure of ownership and financial relationships;</li> <li>• the restriction of self-dealing and related party transactions;</li> <li>• the "fit and proper" test for bank directors; and</li> <li>• the establishment of better insolvency system to protect creditors' rights.</li> </ul>
OECD issued the "Policy Brief on Corporate Governance of Banks in Asia" in 2006	<p>Two major items of recommendation – on board governance and on bank supervision.</p> <p>There are six recommended actions on board governance:</p> <ul style="list-style-type: none"> <li>• the boards of banks should act in line with their fiduciary duties;</li> <li>• boards should set the right tone at the top;</li> <li>• competence, integrity and qualifications are prerequisites for an effective board;</li> <li>• board should be able to exercise objective and independent judgment;</li> <li>• bank boards should establish certain specialized committees; and</li> <li>• the boards should manage related party transactions using independent directors.</li> </ul> <p>Other recommendations:</p> <ul style="list-style-type: none"> <li>• improve corporate governance structure of banks' corporate borrowers;</li> <li>• bank supervisors to draft a code of corporate governance;</li> <li>• bank supervisors to provide incentives for banks to improve their corporate governance through a rating mechanism and adoption of differentiated deposit insurance premiums.</li> </ul>
After the sub-prime crisis in late 2008	<ul style="list-style-type: none"> <li>• The OECD Steering Group on Corporate Governance issued a three-part report penned by Grant Kirkpatrick in 2009 analyzing the corporate dimension of the said financial fiasco.</li> <li>• British Prime Minister, Gordon Brown, commissioned Sir David Walker to do an independent investigation and review corporate governance in UK banks and other financial institutions. This is the Walker Review.</li> <li>• Both the OECD three-part report and Walker Review identified four weaknesses that led to the crisis: <ul style="list-style-type: none"> <li>○ Ineffective board oversight;</li> <li>○ Deficiencies in risk management;</li> <li>○ Distorted incentive schemes; and</li> <li>○ Gap between existing standards and actual implementation.</li> </ul> </li> </ul>

Sources: Walker Review and OECD and Asian Corporate Governance Association (ACGA) archives

## APPENDIX B

### Roles and Responsibilities of the Board Chairman

Philippine Code	HK and UK Codes
<ul style="list-style-type: none"> <li>Ensures that the meetings of the board are held in accordance with the by-laws or as the chairman may deem necessary.</li> </ul>	<ul style="list-style-type: none"> <li>Responsible for leadership of the board and ensuring its effectiveness on all aspects of its role. (This is only a recommended best practice in the HK Code.)</li> </ul>
<ul style="list-style-type: none"> <li>Supervises the preparation of the agenda of the meeting in coordination with the Corporate Secretary.</li> </ul>	<ul style="list-style-type: none"> <li>Responsible for the board's agenda and ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues.</li> </ul>
<ul style="list-style-type: none"> <li>Maintains qualitative and timely lines of communication and information between the board and management.</li> </ul>	<ul style="list-style-type: none"> <li>Promotes a culture of openness and debate by facilitating the effective contribution of NEDs in particular and ensuring constructive relations between executive and non-executive directors. (This is only a recommended best practice in the HK Code.)</li> </ul>
	<ul style="list-style-type: none"> <li>Responsible for ensuring that the directors receive accurate, timely and clear information.</li> </ul>
	<ul style="list-style-type: none"> <li>Ensures effective communication with shareholders. (This is only a recommended best practice in the HK Code.)</li> </ul>
	<ul style="list-style-type: none"> <li>Ensures that the directors continually update their skills and the knowledge and familiarity with the company required to fulfill their role both on the board and on the board committees. (In the HK Code, this task is assigned to the nomination committee.)</li> </ul>
	<ul style="list-style-type: none"> <li>Ensures that new directors receive a full, formal and tailored induction on joining the board. (In the HK Code, this task is assigned to the nomination committee.)</li> </ul>
	<ul style="list-style-type: none"> <li>Regularly reviews and agrees with each director their training and development needs. (In the HK Code, this task is assigned to the nomination committee.)</li> </ul>
	<ul style="list-style-type: none"> <li>Acts on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors. (Only in the UK Code.)</li> </ul>
	<ul style="list-style-type: none"> <li>Ensures that the views of the shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. (This is only a recommended best practice in the HK Code.)</li> </ul>
	<ul style="list-style-type: none"> <li>Arranges for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the annual general meeting and for all directors to attend.</li> </ul>

*Sources: Philippine Revised Code of Corporate Governance, UK Corporate Governance Code and HK Code on Corporate Governance Practices*

## **APPENDIX C**

### **Mandatory Disclosure Requirements (Hong Kong Exchange Listing Rules)**

1. Corporate governance practices. This includes how the company has applied the Code Principles and whether it meets all the Code provisions. Since Hong Kong follow the “comply or explain” approach, in case of deviation from any Code Principles or provisions, the company has to give the reason or reasons why.
2. Securities transactions of directors. The company must explain how it has complied with the Model Code as set out in Appendix 10 of the HK Exchange Listing Rule).
3. Board of directors. The following information should be provided under this section:
  - a. Composition and category of directors.
  - b. Number of meetings held during the year and attendance of each director on a named basis.
  - c. How the board operates, the types of decisions taken by the board and those delegated to management.
  - d. Number of independent non-executive directors (INEDs).
  - e. Reasons for independence where the INED fail to meet one or more criteria as set forth in Rule 3.13 of the Hong Kong Exchange Listing Rules.
  - f. Relations among directors, in particular between chairman and CEO.
4. Chairman and CEO. Identify the identity of each and whether the roles are segregated or not.
5. Non-executive directors. In a named basis, indicate the term of appointment of each director.
6. Remuneration of directors. The following should be disclosed:
  - a. Role and functions of the remuneration committee.
  - b. Composition of the remuneration committee with names and corresponding position.
  - c. Number of meetings held during the year and attendance report.
  - d. Summary of work done in the year.
  - e. General description of emolument policy and long-term incentive schemes as well as the basis of determining emolument payable to directors.
  - f. Emolument to directors on a named basis.
7. Nomination of directors. The following should be disclosed:
  - a. Role and functions of nomination committee.
  - b. Composition of the nomination committee with names and corresponding position.
  - c. Number of meetings held during the year and attendance report.
  - d. Summary of work done in the year.
  - e. Nomination procedures and the process and criteria adopted.
8. Auditor’s remuneration. This section requires an analysis of remuneration of the audit and non-audit services as well as the details of the nature of services and fees paid.
9. Audit committee. The following should be disclosed:
  - a. Role and functions of the audit committee.
  - b. Composition of the audit committee with names and corresponding position.
  - c. Number of meetings held during the year and attendance report.
  - d. Summary of work done in the year.
  - e. Others which include acknowledgement from directors of their responsibility for preparing the accounts; report on material uncertainties that may bear on going-concern; statement that the board has conducted a review of the effectiveness of the internal control system; statement from the audit committee explaining its recommendation regarding the selection, appointment, resignation or dismissal of the external auditors and reason/s why the board has taken a different view.

*Source: Appendix 23 of the Hong Kong Exchange Listing Rules*