

GUIDELINES ON CORPORATE GOVERNANCE FOR LABUAN BANKS

1.0 Introduction

- 1.1 Good corporate governance practice improves safety and soundness through effective risk management and creates the ability to execute strategy and achieve business objectives in a manner that promotes confidence and protects the interest of stakeholders.
- 1.2 The adoption of the fundamental concepts of responsibility, accountability and transparency in corporate governance standards and practices plays an essential role in ensuring that Labuan banks are managed in a safe and sound manner with appropriate balance between risk-taking activities and business prudence.
- 1.3 The Guidelines set out regulatory expectations on the Labuan banks. In implementing practices for governance and risk management, the Labuan banks must adopt the standards relevant and appropriate to their activities. In this regard, Labuan banks are encouraged to observe higher regulatory and prudential standards and ensure that the observed standards are in line with internationally accepted standards and best practices.

2.0 Applicability

- 2.1 These Guidelines are applicable to all Labuan banks and Labuan investment banks licensed under Labuan Financial Services and Securities Act 2010 (LFSSA).
- 2.2 For the purpose of exercising these Guidelines, the term “Labuan bank” covers all Labuan banks and Labuan investment banks licensed under LFSSA both incorporated as subsidiaries and branches including banks undertaking Islamic financial services activities in Labuan.

3.0 Board of Directors ¹

- 3.1 The Board should have adequate and appropriately skilled, experienced and qualified directors that commensurate with the complexity, size, scope and operations of the Labuan bank, including adequate independent directors.
- 3.2 The composition of the Board should be effective with strong independence element where decision making is not dominated by any individuals or group of individuals.
- 3.3 For the purpose of section 173 of LFSSA, all Labuan banks are expected to have an Audit Committee (AC) who is independent from the management and responsible to provide independent oversight of the Labuan bank's internal and external audit functions, internal controls and ensuring checks and balances within the Labuan bank. As the effectiveness, independence and how influential the AC is, would to a great extent, depend upon the professional competent of its members, Labuan FSA therefore allows only non-executive directors to be appointed in the AC. The Guidelines on Minimum Audit Standards for Internal Auditors of Labuan Banks issued on 8 April 1997 are to be observed with regard to the composition and responsibility of AC.
- 3.4 If it is considered appropriate, the Board should establish other Board committees such as Risk Management Committee, Compensation Committee, Nominating Committee, Compliance Committee or other committees responsible for other specified aspects of business to ensure the effectiveness in executing its functions. The Board retains ultimate responsibility and all the Board committees must report to the Board.

¹ For Bank established as a branch, Board of Directors means the Board of Directors of the Head Office.

4.0 Responsibilities of the Board

The Board has the ultimate responsibility for proper stewardship of the Labuan bank. It should collectively acquire sound and sufficient knowledge and expertise to enable effective governance and oversight. The Board should, amongst others:

- 4.1 Understand its responsibilities including the business activities of the Labuan bank and evaluate objectively, on a regular basis, its effectiveness in fulfilling those responsibilities.
- 4.2 Review and approve the objectives, strategic plan, operating policies, standard and procedures for the Labuan bank.
- 4.3 Ensure that the operations of the Labuan bank are conducted prudently and in compliance with the laws, regulations and guidelines issued by Labuan FSA from time to time, as well as established internal policies and procedures.
- 4.4 Establish the responsibilities and balance of power and authority of committees of the Board and of the Senior Management, as well as accountability requirements for them so that no individual has unfettered powers of decision.
- 4.5 Appoint individuals who are suitably qualified and capable of managing the operations of the Labuan bank effectively to Senior Management positions and plan for their succession.
- 4.6 Evaluate the effectiveness and competency of Senior Management in managing the operations of the Labuan bank and the risks to which the Labuan bank is exposed.
- 4.7 Ensure that the Labuan bank establishes comprehensive risk management policies, process and infrastructure and implementation of appropriate system to manage these risks.
- 4.8 Establish standards of business conduct and ethical behaviour for the Directors, Senior Management and other personnel, and obtain on a regular basis, reasonable assurance that the Labuan bank has an ongoing, appropriate and effective process for ensuring adherence to those standards.

- 4.9 Review the adequacy and the integrity of the Labuan bank's internal control systems and management information systems including the system for compliance with applicable laws, regulations, rules, directives and guidelines.
- 4.10 Ensure that the Senior Management provides adequate and timely information relating to the activities of the Labuan bank.
- 4.11 Set the risk appetite or tolerance levels in relation to the Labuan bank's business strategy.

5.0 Responsibilities of the Senior Management

The Senior Management must undertake and report to the Board, for its consideration and approval, the following areas but not limited to:

- 5.1 Establishment of business objectives, plans and strategies development of the Labuan bank which then be endorsed by the Board.
- 5.2 Reports on the implementation of the Labuan bank's business strategies and business plans for significant operations and on its actual operating and financial results as against forecast results in a timely manner and also ensure that the decision and direction of the Board are implemented and adhered to.
- 5.3 Identification of the principle of risks to which the Labuan bank is or will be exposed, whether on- or off-balance sheet in conducting its current and planned operations and measuring those risks on an aggregate basis.
- 5.4 Development of appropriate and prudent risk management policies including policies on aggregate exposure limits and ensures that the day-to-day business affairs of the Labuan bank are effectively managed.
- 5.5 Regular review of the Labuan bank's risk management and internal control policies to ensure that they remain appropriate, relevant and prudent.
- 5.6 Timely updates on all important and critical aspects of the Labuan bank's operations including risk management activities and ensure sufficient information is distributed to the Board members.
- 5.7 Reports on the implementation of overall corporate governance practice.

6.0 Risk Management and Internal Control

It is sound business and financial practice for the Labuan banks to establish effective risk management and internal control tools and mechanisms to ensure appropriate mitigants are in place for any risk they are exposed to, and Labuan FSA therefore encourages Labuan banks to employ various risk management practises outlined under the Basel Core Principles. The Board should provide guidance to the Senior Management and ensure that a comprehensive risk management and internal control system incorporating continuous identification, measurement, monitoring and controlling risk appropriate to the size and complexity of such risk and its business are developed, implemented and reviewed for effectiveness. The Board (through the Senior Management) should ensure that the Labuan bank has ongoing, appropriate and effective/prudent, the following critical matters but not limited to:

6.1 *Credit Risk*

- 6.1.1 Establishment of an appropriate credit risk management environment, robust credit assessment process and implementing the approved credit risk strategy to ensure that the Labuan bank is operating under a sound credit-granting process, maintain an appropriate credit administration, measurement and monitoring process and ensure adequate control over credit risk.
- 6.1.2 Policies on the areas and types of credit, both on- and off-balance sheet, in which the Labuan bank is willing to engage and exposure limit for a single counterparty, for groups of associated counterparties, for industries or economic sectors, for geographic regions and for other credit exposures warranting aggregation, that take into account all other risks, both on- and off-balance sheet, to which the Labuan bank is exposed. This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investment, the ongoing management of the loan and investment portfolios as well as provision policies.

6.2 **Market Risk**

- 6.2.1 Policies, procedures and controls for managing market risks that include the types of instruments and other investments (both on- and off-balance sheet) in which the Labuan bank is willing to trade or take position and exposure limits for a single issuer, for groups of associated issuers, for types of financial instruments and other investments or assets, for industries or economic sectors, for geographic regions and for other market exposures warranting aggregation that take into account all other risks to which the Labuan bank is exposed.
- 6.2.2 Procedures and controls for foreign exchange rate risks that comprise defined and prudent levels of decision-making authority and techniques for measuring the Labuan bank's foreign exchange rate risk position and for evaluating the impact on those positions of changes in underlying factors under current and reasonably foreseeable scenarios.
- 6.2.3 Establishment of risk measurement, monitoring and controlling functions with clearly defined duties that are sufficiently independent from position-taking functions and the risk measurement systems that assess the effect of market changes. The assumptions underlying the measurement system should be clearly understood by risk managers and Labuan bank management.
- 6.2.4 Strategies, policies and systems in place to identify, monitor and control interest rate risk in the banking book appropriate to the size and complexity of such risk. The structure of the Labuan bank business and the level of interest rate it assumes should be mitigated by appropriate limits on risk taking, adequate system and standards for measuring risk, standards for valuing positions and measuring performance, comprehensive interest rate risk reporting and interest rate risk management review process and effective internal control.
- 6.2.5 Analysis and risk management activities related to interest rate risk as to ensure that they are conducted by competent staff with technical

knowledge and experience consistent with the nature and scope of the Labuan bank's activities.

6.3 ***Operational Risk***

- 6.3.1 Policies, procedures and controls for managing operational risk that is inherent in the operations of the Labuan bank. This includes human resource management programme, documentation of the Labuan bank's significant processes and control, accounting and valuation methods, accurate and complete records of financial and key information and management information system that facilitates the day-to-day management of the Labuan bank's operations and of the risk to which it is exposed. Operational risk management processes should also be integrated within other risk management processes and that those involved in the process are aware of the inherent risk and have taken steps to mitigate it.
- 6.3.2 Development of an appropriate risk management environment where the Board must be aware of the major aspects of the Labuan bank's operational risks and to provide a bank-wide definition of operational risk and lay down the principles of how operational risk is to be identified, assessed, monitored, controlled and mitigated.
- 6.3.3 Technology development and maintenance processes, security procedure and controls for safeguarding of the Labuan bank's record of financial and other key information and appropriate and effective business continuity plans including backup and recovery process for dealing with the loss of the destruction of critical information or critical technology.
- 6.3.4 Appropriate policies and procedures involved in reviewing legal documentations have been established to ensure that the desired effects of contracts are enforceable and to mitigate risk of miss-selling or misrepresentation.

6.4 ***Liquidity Risk***

- 6.4.1 Liquidity and funding management strategy that takes into account the Labuan bank's risk profile and prudent policies and procedures to identify measure, monitor and control liquidity risk and to manage liquidity on a day to day basis. This should include policies on the source, types and levels of liquidity that are to be maintained by the Labuan bank and policies that are designed to prevent the Labuan bank's funding from becoming unduly concentrated with respect to source, type, term to maturity or currency of denomination.
- 6.4.2 A robust liquidity risk management framework should be established to ensure that the Labuan bank maintains sufficient liquidity and high quality liquid assets to withstand a range of stress events.
- 6.4.3 Establishment of a formal contingency funding plan that clearly sets out the strategies for addressing liquidity problems.

6.5 ***Control Environment and Business Conduct***

- 6.5.1 Control environment that supports the management of the Labuan bank's operations and of the risks to which it is exposed and procedure to ensure the Board is provided with timely, relevant, accurate and complete reports that will enable it to assess whether the Labuan bank has such a control environment and that it is operating effectively.
- 6.5.2 Procedures to ensure adherence to the Labuan bank's standards of business conduct and ethical behaviour.
- 6.5.3 Description of the methods used to identify, measure, control and monitor each risk (for example, avoidance of undue concentration of risk, requirement for collateral to mitigate credit risk, hedging of risk exposures), in particular, whether and how derivatives are used to manage risk.
- 6.5.4 Comprehensive business contingency plans addressing all significant risks identified in the organisation are in place, tested and updated regularly.

6.6 ***Internal Control***

- 6.6.1 Review of the effectiveness of the key internal control policies and procedures established for managing daily activities and the changes made to the policies and procedures during the year to ensure that they remain relevant.
- 6.6.2 Review and assessment conducted in respect of the Labuan bank's risk management system, including a statement on whether the reviews and assessment referred to were conducted by an independent party to the Labuan bank, as well as outlining the key recommendation of the review.
- 6.6.3 Review of internal audit functions put in place to provide an independent assessment of the adequacy of, and compliance with established policies and procedures, the line of reporting of the internal audit division as well as the scope and nature of audit work.
- 6.6.4 Procedures used to report internal control deficiencies or breaches, any potential trends identified on the control issues and any preventive actions that were taken.

7.0 Islamic Financial Services

In addition to the above requirements, those Labuan banks undertaking Islamic Financial Services (IFIs) are to ensure compliance with Shariah rules and principles and develop robust Shariah governance framework to strengthen decision making process. In this regards, IFIs must observe the following requirements:

7.1 Compliance with Shariah rules and principles

The Board should be responsible to ensure that the IFIs have internal procedures to obtain Shariah endorsement on its offering of Islamic financial products and services. The governance framework should have proper systems and controls to ensure Shariah principles are not compromised and the scope of internal audit function must cover Shariah

Audit. This includes the Audit Committee's roles to regularly check with those responsible for the Shariah compliance function of the IFIs.

7.2 Transparency of reporting

The Board of IFIs are to ensure that the financial and non-financial information are reported in a timely and adequate manner and in compliance with Shariah rules and principles. The reporting should be in accordance with the internationally recognised accounting standards taking into consideration the specificities of different Islamic transactions involved.

7.3 Rights of investment account holder

The Board of IFIs should be responsible to ensure that the IFIs have internal guidelines and mechanism to protect the interest and rights of both the shareholders and other stakeholders that bear the same risks of losing their investments similar to the shareholders. This includes all relevant and material disclosures covering contractual rights, mode and manner of investments undertaken by the IFIs and the basis of profit allocations.

8.0 Implementation Date

- 8.1 All Labuan banks and Labuan investment banks are required to comply with these Guidelines effective 1 January 2009.

Labuan Financial Services Authority
3 November 2008