COMMISSIONER OF BANKING
HONG KONG

香港
銀行業監理處

Our Ref : CB/POL/3/28 II

Tel : 867 2661

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Directors
All Locally Incorporated Authorised Institutions

Chief Executives
All Authorised Institutions

Dear Sir/Madam,

The Duties and Responsibilities of Directors of Authorised Institutions

--- The enclosed paper is a best practices guide concerning certain duties and responsibilities of directors of banks and deposit-taking companies.

Effective self-regulation starts with an institution's board of directors. They have a first line responsibility for many matters crucial to the continued profitability and soundness of their institution. It is in recognition of this that persons wishing to be directors are required to obtain the Commissioner of Banking's consent for their appointment.

In view of the importance of their role, we have thought it sensible to prepare a paper describing how the boards and directors of authorised institution are expected to discharge their responsibilities.

The paper does not set out to be an exhaustive guide to the legal responsibilities and duties of directors, nor is it intended that it should impose any additional legal obligations on directors. Rather it is a guideline addressing issues important for the prudent management of banking institutions.

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The paper will be issued to new directors of locally incorporated authorised institutions upon the granting of approval by the Commissioner for them to become directors. Copies are also issued to existing directors and their institutions for reference. Hong Kong branches of overseas banks do not have to work under a local board; but many of the principles for prudent management of banking activities in the paper will be of useful reference. The paper is therefore being issued to these institutions as well.

I should emphasize that issuing a paper on the topic is not meant to imply that directors of local institutions do not already take their responsibilities seriously. The main purpose is to ensure some consistency in the approach which such directors take towards their responsibilities, and an awareness of the expectations which the Commissioner has of them.

The paper has been developed in consultation with the Hong Kong Association of Banks and the Hong Kong Deposit-taking Companies Association.

Yours faithfully,

(D. T. R. Carse)
Commissioner of Banking

c.c. Chairman, Hong Kong Association of Banks

Chairman, Hong Kong Deposit-taking Companies Association

Duties and Responsibilities of Directors of Authorised Institutions

A Best Practices Guide issued by the Commissioner of Banking

Introduction

The directors of banks and deposit-taking companies carry important responsibilities for the direction and management of their institutions. Although authorised institutions, like other companies, use their capital to support their activities, most of the funds put at risk belong to their creditors, in particular to their depositors. High standards of integrity and business behaviour must be maintained by an institution if its financial strength is to be preserved and confidence sustained. This in turn means that the qualities required and standards expected of directors of banks and deposit-taking companies are high.

2. In recognition of this, persons wishing to be directors of authorised institutions are required to obtain the Commissioner of Banking's consent for their appointment. This consent may subsequently be withdrawn. Directors are also subject to a statutory requirement to disclose information to the Commissioner to assist him in assessing whether they are fit and proper to hold their positions.

3. Directors, as members of the board, share responsibility for the proper direction and management of their institution. Operational functions will be delegated to management, but the directors remain accountable for ensuring that these functions are discharged prudently, which includes conformity with the law.

4. Some directors are executive, that is they are contracted to provide management services over and above their functions as directors. Non-executive directors may look to their fellow executive directors to guide them on those areas of special responsibility and expertise which they possess, and of which they may have no direct knowledge and experience. But the non-executive directors cannot absolve themselves of responsibility for those matters which fall to the board collectively to review and decide by permitting such matters to be handled exclusively by management - including the executive directors.

5. This guideline is intended -

(a) to set out key responsibilities of the board and of individual directors, and the manner in which they are expected to discharge their responsibilities; and

(b) to remind directors of certain of their legal obligations, in particular those under the Banking Ordinance.

It is not intended that the guideline should impose any additional obligations under common law or any statute. However, neither is it intended as a comprehensive guide to all of the responsibilities and duties of a company director under Hong Kong law and best practice.

The Board's Responsibilities

6. In meeting its overall responsibilities to its shareholders, depositors and other creditors, employees and others, such as the banking supervisor, the board of a bank or deposit-taking institution is expected -

(a) to ensure competent management;

(b) to establish or approve strategies, policies and controls for the sound and profitable operation of the business;

(c) to ensure that the operations of the institution are conducted prudently, and within the framework of established policies and laws; and

(d) to ensure and monitor that the institution conducts its affairs with a high degree of integrity.

A. Competent management

7. Skilled management is perhaps the single most important element for ensuring a profitable and soundly run institution. The board's main responsibilities are -

(a) to appoint a Chief Executive with integrity, technical competence, and experience in banking business, able to administer the institution's affairs effectively and prudently;

(b) to oversee the appointment of other senior executives;

(c) to approve the management succession policy of the institution; and

(d) to supervise management's performance.

B. <u>Strategy, policies and controls</u>

8. The institution must set its goals, and draw up a business strategy for reaching them. Annual budgeting is a key ingredient in the short-term planning process. The board must approve these plans, and ensure that performance against plan is regularly reviewed, with corrective action taken as needed.

9. Policies and internal controls governing all key areas of business and risk are major operational requirements. These must extend to new activities, before they are undertaken. The board should assure itself that the policies and controls are appropriate and practicable, and are tailored to the institution's business strategies, systems, expertise, and resources.

10. The board should review policies regularly to ensure that they remain adequate and consistent with the institution's operating environment. The directors should also ensure that proper systems are in place to ensure that all those responsible for the implementation of board policies and procedures are fully aware of them.

11. Major functional areas for which policies must be established include -

(a) balance sheet management, including capital adequacy;

(b) lending; and

(c) investments.

12. The management of the institution's balance sheet is critical to its well-being. Policies need to be drawn up, and approved by the board, relating, for example, to -

(a) the composition of assets and liabilities, including those off-balance sheet;

(b) maintaining an appropriate minimum capital adequacy ratio;

(c) maintaining adequate liquidity to meet predicted and unexpected cash needs;

(d) limiting exposure to maturity transformation, and to interest rate and foreign exchange rate risk; and

(e) limiting concentrations of assets, both to individual borrowers, and to economic sectors.

13. Limits for many of these risks are prescribed in the Banking Ordinance (see Annex B). Directors should be fully aware of these. A prudently managed institution will set norms below these statutory levels, and require exceptional justification before they are breached. Special reference must be made to controlling exposures to parties connected with the institution, its controllers, directors and management, not least to require that they are subject to scrutiny as if they were made at arms-length. Excesses should be reported to the board, with reasons.

14. Investments in assets other than in the ordinary course of banking business, such as property, subsidiaries and affiliates, must be sanctioned by the board, where these exceed predetermined minima. (Similarly proposals to open branches overseas should be agreed by the board.) Management should provide appropriate justification to enable these decisions to be properly taken by the board. Again the board should be familiar with the limits set in the Banking Ordinance.

15. Where the institution is also a holding company, many of the areas set out above must be directed by the holding company board on a group basis. A bank is likely to have to support its subsidiaries over and above its direct legal liability. The institution's capital adequacy, liquidity and risk exposures should all be considered with this in mind.

16. The board should regularly review the development of the balance sheet, against performance and risk targets set.

C. The Monitoring of operations

17. Internal control : While the board may depend on the management to run the institution day-to-day, it remains responsible for taking reasonable steps to ensure that its operations are properly controlled and comply with board policies, and with laws and regulations.

18. Supervision of major functional areas may be handled by committees. The full board, however, remains responsible for its decisions. Typical committees are described in Annex A. This is not to suggest that every board should establish such committees. The best committee structure for an institution depends on its size and business, the board's composition and individual directors' expertise. It is, however, important that all committees should be established with clearly defined objectives, authorities, responsibilities and tenure. The committees should report regularly to the full board.

19. The board should make good use of external and internal auditors in reviewing the adequacy of its internal control systems.

20. External auditors can provide the board with third party opinion on the adequacy of management systems and accounting controls and the accuracy of financial information. In addition to the auditor's statutory opinion of the financial statements, the board should expect to receive a management letter highlighting control or other weaknesses identified in the course of the audit.

21. Internal auditors also have an important role to play. They should review proposed operating procedures to ensure that they incorporate adequate controls and comply with board policies. They should review and test

operations to ensure internal controls are functioning properly, and help management develop appropriate solutions to problems. For institutions which are part of a larger banking group, it may be acceptable to make use of internal auditors from the parent institution.

22. It is important that the board, not management, control the selection of the external auditors. The board should also approve the appointment of the head of internal audit. The internal auditors must have independence of management and have unfettered access to the board or its audit committee so that they can directly report their findings. The board should review carefully the auditors' findings; where the review is carried out by an audit committee, key issues should be brought to the full board's attention. Management should be required to report periodically on its progress in resolving problems raised by the audits, internal and external.

23. Compliance : the directors are held personally responsible for the institution's compliance with many of the requirements under the Banking Ordinance (see paragraphs 39 - 41 and Annex B). To discharge this responsibility, consideration should be given to appointing a compliance officer or committee to develop, with management, systems and controls to ensure compliance with the requirements under the Banking Ordinance, assess the impact of new laws and regulations on bank operations and procedures, and provide guidance on compliance issues as new products are developed.

24. It is recognized that for many smaller institutions members of the board also constitute the key personnel of the management. This means, for example, that where an audit committee exists it may be composed mainly, or even wholly, of executive directors. However, this does not alter the basic principle that the internal audit and compliance functions should be independent of the operational management of the institutions and should have reporting lines to the board as a whole, or to the audit committee, rather than to management. Where members of management are acting in their capacity as directors, they have a responsibility for ensuring the prudent and sound management of the institution as a whole, and their particular areas of responsibility should be subject to scrutiny by other members of the board.

D. Ethics

25. A financial institution is entrusted with the public's monies. It has, as a matter of self-interest, a responsibility to ensure that in its dealings with the public it observes a high standard of integrity. This means, for example, that particular care is taken to avoid the disclosure of customers' affairs without proper authority, and that there are controls to limit the possibility of the directors or the employees benefitting from the improper use of confidential information, or otherwise from advantages offered them.

26. The board has a responsibility to ensure that policies are developed to regulate these matters, including those set out in the Commissioner's Banking (Code of Conduct) Guidelines. It should also adopt a policy on insider trading no less comprehensive than that provided for in the model code for listed companies issued by the Stock Exchange of Hong Kong (see Annex C).

27. The board also has a wider social responsibility to help prevent its institution from being used for the laundering of money from illegal activities or for any other criminal purpose. Policies and adequate internal controls should be established in accordance with the Commissioner's guidelines on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering. There should be regular reports to the board from either the internal or external auditors on the operation of these policies.

The board and the parent holding company

28. The board of an institution that is a part of a larger group may operate in a very different environment from the board of an independent institution. Key bank functions and policies may be centralised at the holding company level. But as the institution is a separate legal entity, its directors are not absolved of responsibility for actions that are directed by the holding company.

29. The board of the subsidiary institution should review holding company policies that apply to the institution. If the board is not satisfied with the policies, it should notify the holding company and discuss appropriate modifications. Final approval and responsibility to monitor implementation and effectiveness rest with the board of the local institution.

30. The board's primary duty is to protect the interests of the institution which it serves, which interests includes those of its creditors. Therefore, if the holding company is engaging in practices that the directors fear may harm the institution, or the holding company does not respond adequately to the concerns raised by the board, the directors should dissent on record and consider action to protect the institution. In such a situation, the board may consider seeking independent professional advice and/or raising the issue with the Office of the Commissioner of Banking.

Frequency of board meetings

31. Meetings should be held sufficiently frequently so as to ensure that -

(a) the board is kept sufficiently in touch with the business of the institution; and

(b) the operations of the institution are not adversely affected because of the need to secure board approval for policies and decisions.

The Director's Individual Responsibilities

32. In broad terms, a director's individual responsibilities are to -

(a) be aware of the institution's operating environment;

(b) be diligent in undertaking his duties;

(c) exercise independent judgement; and

(d) be loyal to the institution's interests.

33. To meet these responsibilities, individual directors are expected to contribute actively to the work of the board. Having regard to the range of issues which are the board's collective responsibility, each director must ensure that all relevant issues are brought to the board for collective review, approval and decision, as appropriate. Directors should attend meetings, stay informed of the institution's condition, and exercise independent judgment in board decision-making. Moreover, non-executive directors should ensure that they have at

least a basic understanding of banking, the industry, the risks involved and the supervisory requirements affecting their activities. They should also put the institution's interests before their own in business dealings affecting the institution.

34. Arrangements should be made to enable individual directors to review personally major reports and comments from OCB on the condition of the institution, as noted earlier in regard to external audit findings. These supervisory and other third-party reports may constitute effective notice to board members of problems in the institution. It is likely that directors will be held responsible for any failure to be aware of their content and for not ensuring that corrective action is taken.

Legal Obligations

35. This section reminds the directors of their legal obligations under -

(a) common law and the Companies Ordinance; and

(b) the Banking Ordinance.

A. Common law and the Companies Ordinance

36. Basically, the common law imposes two main duties on a director : **fiduciary duty and duty of care.** The fiduciary duty, in practical terms, means -

(a) A director shall act honestly and in good faith for the benefit of the institution;

(b) A director must not act beyond the power conferred by the institution;

(c) A director must guard against any conflict of interest in dealing with the institution; and

(d) A director shall not use the property of the institution or relevant information or opportunity (by virtue of his/her position) for his/her advantage.

37. In terms of duty of care, directors are expected to administer the affairs of the institution diligently.

38. Under the Companies Ordinance, a director is, inter alia, required -

(a) to disclose in the directors' report any arrangements to which the company is a party to enable him/her to acquire benefits by means of the acquisition of shares in or debentures of the company, and the nature of his/her interest in material contracts with the company (section 129D(3)); and

(b) to disclose the nature of his/her interest in a contract or proposed contract with the company. (Sections 155B and 162).

B. The Banking Ordinance

39. Directors are responsible for ensuring that their institution complies with the Banking Ordinance. Areas that merit special attention include -

(a) limitations on loans by and interests of the institution;

(b) capital and liquidity ratios;

(c) unsafe and unsound banking practices; and

(d) reporting requirements.

40. Related to (a), directors' attention is drawn specifically to section 83 of the Ordinance which limits unsecured connected lending to directors and their relatives. The prudential reason for putting statutory limits on connected lending is that such transactions tend, or are often seen, to be not at arms-length.

41. The Ordinance is so worded that directors are personally held accountable for non-compliance with many of its requirements. Breaches may lead to prosecution and to penalties of imprisonment or fine. Annex B lists these obligations. Section 126(1) of the Ordinance provides that in proceedings for an offence under the Ordinance it shall be a defence for the person charged to prove that he took all reasonable precautions and exercised all due diligence to avoid the commission of such an offence by himself or any person under his control. It should however be noted that this defence is not available in relation to all offences provided for in the Ordinance. Section 126(2) contains a list of those offences in respect of which the defence is not available. A number of those offences could be committed by directors.

Typical Committees

Instead of involving the full board in handling every matter, committees can be established to address matters which require detailed review or in-depth consideration. Some typical committees are described below, but as made clear in paragraph 18, the number and nature of committees in an individual institution will depend on its size, and other characteristics.

1. Executive Committee

This committee usually handles matters that require board review, but arise between full board meetings. Executive Committees are used most commonly in large institutions. They can relieve the full board of detailed reviews of information and operational activities. Generally, all major functions of the institution will be subject to review and approval by the executive committee, and the work of the other board committees will be coordinated by the executive committee.

2. Audit Committee

An audit committee is one of the most important committees. It serves as the board's "eyes and ears" in monitoring compliance with board policies, and internal and statutory regulations. As it evaluates the institution's operations, an audit committee should, preferably, be made up of a majority of non-executive directors. The audit committee works with the internal and external auditors in order to ensure comprehensive audit coverage. To ensure the independence and objectively of auditors, the audit committee should supervise the audit function directly. This includes the hiring of fully qualified staff to audit the kinds of activities in which the institution engages, and evaluating their performance. The audit committee should also ensure that it sees all communications between the institution and its supervisory authorities, and should monitor management's efforts to correct deficiencies discovered in audits or supervisory examinations.

3. Credit Committee

A credit committee ensures that the institution's lending policies are adequate and lending activities are conducted in accordance with laid down policies, and relevant laws and regulations. It also serves the vital role of monitoring loan portfolio quality. It ensures that management follows adequate procedures to identify problems early, recognize adverse trends, take appropriate corrective actions, and maintain adequate provisions for loan losses. The committee should pay particular attention to the procedures for monitoring compliance with statutory lending limits. In some institutions, this committee also participates in evaluating credit applications and making credit decisions.