

## **CG-1 “Corporate Governance of Locally Incorporated Authorized Institutions”**

### **A Guideline issued by Monetary Authority under Section 7(3) of the Banking Ordinance**

#### **Purpose**

To set out the minimum standards which the HKMA expects locally incorporated AIs to adopt in respect of their corporate governance.

#### **Classification**

A statutory guideline issued by the MA under the Banking Ordinance, §7(3).

#### **Previous guidelines superseded**

Guideline 3.1.1 "Appointment of Alternate directors" dated 16.11.95; Guideline on "Corporate Governance of Locally Incorporated Authorized Institutions" dated 19.05.00, V.1 dated 21.09.01 and V.2 dated 03.08.12.

#### **Application**

To all locally incorporated AIs.

#### **Structure**

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# 1. Introduction

## 1.1 Background

- 1.1.1 Corporate governance, as far as the banking industry is concerned, signifies the manner in which the business and affairs of individual AIs are directed and managed by their board of directors and senior management. It also provides the structure through which the strategic objectives of an AI are set, the business plan for attaining those objectives is determined and the performance of the AI is monitored.
- 1.1.2 Given the important financial intermediation role of banks within the economy and the consequences of bank failures to depositors as well as to the financial system and markets in which they operate, effective corporate governance within banks is of crucial importance not only to individual banking institutions but also to the financial system and the economy as a whole.
- 1.1.3 The increasingly complex business environment resulting from globalisation, innovation in financial products and technological advances has intensified risk in the banking sector. Against this background, effective corporate governance is critically important to ensure that the business of AIs continues to be managed in a controlled, prudent manner.

## 1.2 Application

- 1.2.1 This module sets out the HKMA's supervisory expectations in respect of the corporate governance policies and practices of locally incorporated AIs. It covers the roles and responsibilities of the board of directors ("the board") of an AI and its senior management, and sets out a range of sound governance principles and practices. Some key components of effective corporate governance frameworks are also contained in other relevant modules of the Supervisory Policy Manual, including:
  - Systems of Control for the Appointment of Managers ([CG-2](#))
  - Code of Conduct ([CG-3](#))
  - Establishment of Overseas Banking Subsidiaries: §51A ([CG-4](#))
  - Guideline on a Sound Remuneration System ([CG-5](#))
  - Competence and Ethical Behaviour ([CG-6](#))

- Risk Management Framework (IC-1)
- Internal Audit Function (IC-2)
- Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance (IC-3)
- Exposures to Connected Parties (CR-G-9)
- Reputation Risk Management (RR-1)
- Strategic Risk Management (SR-1)

This module should therefore be read in conjunction with those listed above, as well as any applicable guidance issued and updated by the HKMA from time to time.

- 1.2.2 All AIs are expected to maintain a level of corporate governance reflective of the standards set out in this module (and those listed above) in a manner commensurate with the nature, scale and complexity of their operations. Moreover, AIs designated by the MA under §3S or §3U of the Banking (Capital) Rules as global systemically important AIs (“G-SIBs”) or domestic systemically important AIs (“D-SIBs”) are expected to have corporate governance structures that are commensurate with their potential impact on financial stability in Hong Kong, and in the case of G-SIBs, globally.
- 1.2.3 Failure to adhere to the standards set out in this module may call into question whether an AI continues to satisfy the minimum criteria for authorization in the Banking Ordinance and may cast doubt on the fitness and propriety of individual directors and shareholder controllers of the AI.
- 1.2.4 Nevertheless, in cases where the standards set out in this module are not met, it may be acceptable for the AI concerned to demonstrate to the reasonable satisfaction of the HKMA that the AI has in place alternative measures which have the equivalent effect of ensuring sound corporate governance. In other words, the HKMA will adopt a principles-based approach to assessing the adequacy of the AI’s corporate governance arrangements and AIs should notify the HKMA promptly of, and provide justifications to support, their adoption of measures which they consider equivalent to those set out in this module.

### **1.3 Implementation**

- 1.3.1 AIs are generally expected to implement this revised module starting from 1 January 2018.

## **2. Responsibilities of the board**

### **2.1 General**

- 2.1.1 The board of an AI has the ultimate responsibility for the operations and financial soundness of the AI. In discharging its responsibilities, the board should be actively engaged in the affairs of the AI and cognizant of material changes in the AI's business and the external environment in which the AI operates. Decisions of the board should be taken in a timely manner, having regard to the legitimate interests of shareholders, depositors and other relevant stakeholders.
- 2.1.2 Individual members of the board should act bona fide in the interest of the AI, and on an informed and prudent basis, in accordance with applicable laws, regulations and supervisory standards.

### **2.2 Responsibilities**

- 2.2.1 The key responsibilities of the board of an AI include:
- (i) setting and overseeing the objectives of the AI and the strategies for achieving those objectives (see subsection 2.3);
  - (ii) establishing and overseeing risk governance (see subsection 2.4);
  - (iii) appointment and oversight of senior management (subsection 2.5);
  - (iv) setting corporate values and standards (see subsection 2.6);
  - (v) overseeing the remuneration policy (see subsection 2.7);
  - (vi) ensuring a suitable and transparent corporate structure (see subsection 2.8);
  - (vii) ensuring effective audit functions (see subsection 2.9); and
  - (viii) ensuring an appropriate degree of transparency in respect of the structure, operation and risk management of the institution (see subsection 2.10).
- 2.2.2 In establishing an AI's organisational structure, the board should clearly define in a written document the key responsibilities and authorities of the board, senior management and internal control functions in general. The board should also clearly define appropriate internal

governance practices and procedures for the conduct of its own work and have in place the means to ensure that such practices are followed and periodically reviewed.

- 2.2.3 The board should establish and maintain a robust finance function responsible for accounting and financial data to ensure that the AI's business performance is accurately captured and reported to the board, senior management and business lines.

## **2.3 Setting and overseeing objectives and strategies**

- 2.3.1 The board should set and oversee<sup>1</sup> the objectives and overall strategy of an AI within the applicable legal and regulatory framework, taking account of the institution's long-term financial interests, its financial and human resources, its exposures to risk, and its ability to manage risk effectively. The board should also approve business plans for achieving the AI's objectives and ensure that performance against plans is regularly reviewed, with prompt corrective action taken as needed.
- 2.3.2 Among other things, the board should set out its strategic plan for an AI and oversee the AI's capital adequacy assessment process, its capital and liquidity planning and the management of the institution (including compliance policies and internal control systems) so as to ensure that there is adequate capital and sufficient liquidity to cover the risk exposures and liquidity needs of the institution.
- 2.3.3 The annual budgeting exercise is an integral part of the short-term planning and performance monitoring process. The board should approve annual budgets and review performance against these budgets.

## **2.4 Risk governance**

- 2.4.1 Risk-taking is an integral part of banking business. The board should have a sound understanding of an AI's business activities and their associated risks, and ensure that these risks are properly managed. To ensure sound risk management, the AI should have an effective risk management framework containing a set of robust risk governance arrangements and an effective risk appetite framework (see [IC-1](#)). In particular, the AI should have an independent risk management function, under the direction of a Chief Risk Officer<sup>2</sup>, to oversee risk-taking activities.

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<sup>1</sup> In the context of board responsibilities, the term "oversee" should be understood to mean "oversee and be satisfied with".

<sup>2</sup> Chief Risk Officer refers to the person responsible for the risk management function.

Procedures should also be in place to outline the actions to be taken by management when risk limits are breached, including escalation procedures and board notification, and disciplinary actions for excessive risk-taking by individual staff.<sup>3</sup>

2.4.2 In fulfilling its responsibility to ensure sound risk management as described above, the board should:

- set an AI's risk appetite framework and ensure that it is consistent with the AI's strategy, business, capital and financial plans, as well as risk-taking capacity and remuneration systems ;
- approve the AI's risk appetite statement and oversee the AI's adherence to the risk appetite statement;
- oversee the development and implementation of risk management policies and procedures to ensure that the AI's risks can be identified, monitored and controlled, and that the financial and management information is reliable, timely and complete; and
- ensure that the AI's internal control functions (including risk management function, internal audit function and compliance function) are properly positioned, staffed and resourced and carry out their responsibilities independently, objectively and effectively.

2.4.3 Fostering a strong risk culture within an AI is important for effective risk governance. Risk culture reflects an AI's attitude and behaviour with respect to its risk awareness, risk-taking and risk management, and controls that shape decisions on risks. In addition to overseeing senior management in maintaining sound risk culture, the board should promote risk awareness and a strong culture of adhering to risk limits and managing risk exposures. The board should convey the expectation that it does not support excessive risk-taking under any circumstances and that all staff are responsible for helping the AI to operate within the established risk appetite and risk limits. The board should also encourage open communication and challenge about risk-taking across the AI as well as vertically to and from the board and senior management.

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<sup>3</sup> AIs are also required to have adequate internal systems for assessing capital adequacy in relation to the risks they assume (see [CA-G-5](#)).

2.4.4 These risk governance arrangements should be subject to regular review by the board to ensure that they remain adequate and consistent with an AI's operating environment, and are able to support business expansion. The board (or its audit committee) should consider to periodically obtain an independent assessment (from the internal audit function, or an external consultant as appropriate) of the design and effectiveness of the risk governance arrangements of the AI.

## **2.5 Appointment and oversight of senior management**

2.5.1 Whilst the board is ultimately responsible for the conduct and financial soundness of an AI, the appointment of competent management is key to achieving the objective of a soundly and efficiently run AI. The board works with senior management to achieve this and senior management remains accountable to the board.

2.5.2 Senior management are responsible and accountable for running an AI on a day-to-day basis, and should ensure that the AI's activities are consistent with the business strategy, risk appetite and policies approved by the board. In particular, they are responsible for:

- implementing the business and risk strategies approved by the board, and the risk management systems, processes and controls for managing both the financial and non-financial risks to which the AI is exposed, and cultivating the risk culture promoted by the board;
- providing the board with regular, adequate and comprehensible information in relation to material matters<sup>4</sup>;
- ensuring that the risk appetite is appropriately translated into risk limits for business lines and legal entities, and that those limits are consistent with the AI's overall risk appetite, even under stressed conditions;
- putting in place processes for reviewing the AI's risk exposures and ensuring that they are kept within the risk limits set;

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<sup>4</sup> Matters which depending upon their significance (in terms for e.g. size, potential impact, repetition or recurrence) could be material include implementation of business strategy, risk strategy or risk appetite approved by the board; performance and financial conditions; breaches of risk limits or compliance rules; internal control failures; legal or regulatory concerns; as well as any issues raised through the AI's internal communication (or whistleblowing) procedure (see paragraph 2.6.7).



- ensuring that the risk management, compliance and internal audit functions work as intended and independently;
- establishing a compliance policy that contains the basic principles to be approved by the board and explains the main processes by which compliance risks are to be identified and managed through all levels of the organisation;
- actively communicating and consulting with the control functions on management's major plans and activities;
- establishing an effective management information system to report to the board and senior management, in a comprehensible format fit for their respective use, on a timely basis;
- establishing a management structure that promotes accountability and transparency throughout the organisation, and facilitates delegation of duties to staff, and oversight of those they manage; and
- ensuring the competence of the managers and staff responsible for the business and internal control functions of the AI, with appropriate programmes to recruit, train and retain employees with suitable skills and expertise.

2.5.3 The board should adopt a formal document setting out clearly the role, responsibilities, accountability and reporting lines of senior management. Delegations of authority from the board to senior management should be formal and clear.

2.5.4 The board is ultimately responsible for the appointment and removal of the senior management of an AI. Senior management should have the necessary experience, competencies and integrity to manage the business and staff under their supervision. Senior management should be selected through an appropriate promotion or recruitment process which takes into account the qualifications for the position in question. In particular, the board should:

- appoint a chief executive (including an alternate chief executive) with integrity, technical competence and experience in banking business which enables him to administer the AI's affairs effectively and prudently;

- oversee the appointment of other senior executives<sup>5</sup> (see CG-2) and ensure that they are fit and proper to manage and supervise the AI's key business and internal control functions;
- ensure that appropriate succession plans are in place for senior management; and
- actively engage in succession plans for the chief executive and other key senior executives as appropriate.

2.5.5 The board should review and approve performance objectives for, and written standards (within the context of an AI's remuneration policy<sup>6</sup>) governing the remuneration of, key members of senior management (which should include at least the chief executive and alternate chief executive, and preferably also those senior executives who report directly to them), and should likewise ensure that performance objectives and remuneration standards are set for all other senior management, which in each case are consistent with the long-term objectives, strategy and financial soundness of an AI. The board should put in place effective systems of control to monitor senior management's performance against the performance objectives and assessment criteria within the remuneration standards on a continuing basis.

2.5.6 The board should oversee senior management's implementation of the overall risk governance arrangements of an AI. The board should monitor the consistency of senior management's actions with the strategy and policies approved by the board, and enumerate the possible consequences if the actions of senior management are not aligned with the board's performance expectations, including adherence to the AI's values, risk appetite and risk culture. In doing so, the board should assess whether senior management's collective knowledge and expertise remain appropriate given the nature of the business and the AI's risk profile.

2.5.7 The board should meet regularly with senior management and internal control functions (including those responsible for internal audit, risk management and compliance) to review policies and controls in order to identify areas that need improvement and address significant risks and issues. In its

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<sup>5</sup> Such as the chief financial officer, chief risk officer, division or department heads and the head of internal audit function and the head of compliance.

<sup>6</sup> See CG-5 section 2.1.

dialogue with senior management, the board should question and review critically explanations and information provided by senior management.

- 2.5.8 The board should ensure that senior management has access to regular training to maintain and enhance their competencies and to keep themselves updated on industry and regulatory developments relevant to their areas of responsibility.

## **2.6 Setting corporate values and standards**

- 2.6.1 The board and senior management should demonstrate consistently through their own actions and behaviour that they have a strong commitment to high ethical and professional standards.
- 2.6.2 The board should set and adhere to professional standards and corporate values that promote ethical and responsible professional behaviour amongst an AI's staff (including senior management and members of the board). The board should oversee senior management's role in fostering and maintaining sound corporate culture and confirm that appropriate steps are taken to communicate throughout the AI the professional standards and corporate values it sets.
- 2.6.3 Such professional standards and corporate values should be reflected in the code of conduct issued by an AI and should articulate acceptable and unacceptable behaviour, clearly disallow behaviour that could result in the AI engaging in any improper or illegal activity and require that business be conducted in accordance with applicable laws, regulations, standards and guidelines issued by the HKMA and other relevant regulatory authorities. The code should make clear that employees are expected to conduct themselves and their activities in an ethical manner and perform their duties with due skill, care and diligence. See [CG-3](#).
- 2.6.4 To address the risk of misconduct, which may arise from a variety of sources including the mis-selling of financial products to retail or business customers, the violation of national rules or international standards (e.g. tax, anti-money laundering or sanctions regulations) or the manipulation or attempted manipulation of markets, the board and senior management should define conduct risk and standards of behaviour to protect the interests of customers and stakeholders within the context of, and by reference to, an AI's own business profile.
- 2.6.5 Satisfactory levels of ethical and professional behaviour amongst staff are key to ensuring that an AI's business is

carried on with integrity and prudence and in a manner which is not detrimental to the interests of depositors. Therefore, the board should act to ensure that a culture of ethical and professional behaviour is embedded within the AI at both the institution and individual staff levels. Staff recruitment and appraisal systems should be designed to include ethics, professionalism and integrity as key assessment factors. Ethical and corporate values as well as professional behaviour should form part of any induction course provided for newly recruited staff and AIs are encouraged to regularly provide specific training on ethical issues for all of their staff. See CG-6.

- 2.6.6 An AI should take all reasonable steps to ensure that every staff member fully understands the ethical and corporate values of the AI and the behaviour expected of them in the discharge of their duties in the day to day operations of the AI, and is aware that appropriate disciplinary or other actions will follow unacceptable behaviour and transgression.
- 2.6.7 In maintaining and supporting an AI's corporate values and ethical standards, the critical importance of timely and frank discussion and escalation of problems should be recognized. In this regard, AIs should have a well communicated policy setting out procedures for their staff to communicate, in confidence and without the risk of reprisal, material and bona fide concerns or observations of any violations. Communication should be allowed to be channelled to the board – directly or indirectly (e.g. through an independent audit or compliance process) – independent of the internal “chain of command”. The board should have oversight of any such “whistleblower” policy mechanism and ensure that senior management address legitimate issues that are raised. The board should oversee and approve how and by whom legitimate material concerns are to be investigated and addressed whether by an independent internal or external body, senior management and/or the board itself.

### ***Conflicts of interest***

- 2.6.8 The board should establish and oversee the implementation and operation of effective policies to identify actual and potential conflicts of interest so that they can be prevented or, if this is not possible, at least appropriately managed.
- 2.6.9 There should be a written policy that identifies the relationships, services, activities or transactions of an institution in respect of which conflicts of interest may arise

and sets out measures for prevention or management of these conflicts.

2.6.10 There should be controls to prevent directors and employees from benefiting from the improper use of confidential information or otherwise from advantages offered to them which may lead to unfair, improper or, in the extreme, illegal behaviour. AIs which are listed should 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 Limited ("SEHK"), and should have adequate procedures and systems in place to ensure compliance and report any deviations that are identified.

2.6.11 Relationships and transactions which may create conflicts of interest include those between different customers or clients of an institution and those between an institution and:

- its customers (as a result of the business model and/or the various services and activities provided by the institution);
- its shareholders;
- the members of its board;
- its staff; and
- other related institutions (e.g. its parent company or subsidiaries).

2.6.12 The measures to be adopted to prevent or manage conflicts of interest include:

- adequate segregation of duties;
- establishing information barriers such as physical separation of certain departments; and
- preventing directors, senior management and other staff members of an AI who are also active outside the institution (e.g. acting as a director of another commercial entity) from having inappropriate influence within the institution in respect of matters which have some connection with, or touch upon, their outside activities. This could include lending to a company of which one of the directors is also a director or a member of the senior management of the AI.

2.6.13 For managing any conflicts of interest of its members, the board should have a formal board-level conflicts of interest policy (in addition to that referred to in paragraph 2.6.9) and

an objective compliance process for implementing the policy. The policy should cover:

- a member's duty to avoid, to the extent possible, activities that could create conflicts of interest or the appearance of conflicts of interest;
- examples of where conflicts can arise when serving as a board member;
- a rigorous review or approval process for members to follow before they engage in certain activities (such as serving on another board) so as to ensure that such activity will not create a conflict of interest;
- a member's duty to promptly disclose any matter that may result, or has already resulted, in a conflict of interest;
- a member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfil his duties to the AI may be otherwise compromised; and
- the board's approach to dealing with any non-compliance with the policy.

2.6.14 In cases where board members are appointed by a controlling shareholder or other stakeholders, the board should consider setting out specific procedures or regularly conduct reviews to ensure that the board members concerned are qualified and have appropriately discharged their responsibilities in the best interest of the AI regardless of who appoints them.

### ***Connected lending***

2.6.15 There is a potential conflict of interest when an AI lends to a connected party. Therefore, connected lending should be monitored with particular care, and appropriate steps taken to control or mitigate the risks of such transactions. For example, the terms and conditions of loans granted to connected parties should not be more favourable than loans granted to non-related borrowers under similar circumstances. The board should ensure that the AI establishes a policy on such lending. Senior management, under the oversight of the board, should establish control mechanisms to ensure that such policy is adhered to. The policy, and any changes to it, should be reviewed and approved by the board. See [CR-G-9](#).

- 2.6.16 §83 of the Banking Ordinance limits unsecured advances of locally incorporated AIs to connected parties. This is to reduce the risk of improper and excessive lending to connected parties which may jeopardise an AI's interests or be detrimental to its financial position. A breach of §83 is a serious offence which may result in fines and/or imprisonment.
- 2.6.17 The board and senior management should fully understand the AI's legal obligations under the Banking Ordinance in relation to connected lending. Although §83 of the Banking Ordinance only applies to unsecured lending, care should also be taken by AIs when granting secured credit facilities to connected parties.

## **2.7 Remuneration**

- 2.7.1 A sound remuneration system forms a key component of an AI's governance structure. The board (or its remuneration committee) should oversee senior management's implementation of the AI's remuneration system, including monitoring and reviewing the remuneration of senior management and assessing whether the AI's overall remuneration policy is in line with its risk appetite, risk culture and long-term interests. The board should approve the remuneration packages of the chief executive (including the alternate chief executive), heads of control functions and other key positions<sup>7</sup>. The board should also ensure that remuneration and performance measures for staff in the internal control functions (including risk management and compliance) are determined independently from the business overseen so that the independence of these staff members is not compromised.
- 2.7.2 SPM module CG-5 provides guidance on the key elements of a sound remuneration system and the approach of the HKMA in supervising AIs' remuneration systems. In particular, the module provides that the board of an AI should establish and maintain a written remuneration policy to ensure that the AI's overall approach to risk management is supported, and not undermined, by the remuneration arrangements for employees whose activities during the course of their employment (individually or collectively) could have a material impact on the AI's risk profile and financial soundness.

## **2.8 Suitable and transparent corporate structure**

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<sup>7</sup> Including those referred to in paragraph 2.1.7 of CG-5.

- 2.8.1 Where an AI creates structures for legal, regulatory, fiscal or product-offering purposes in the form of units, branches, subsidiaries or other legal entities, their number and, particularly, the interconnections and transactions between them, may pose challenges for the design of the AI's corporate governance structure and for the management and oversight of the risks of the AI or the AI group as a whole (where the AI has subsidiaries).
- 2.8.2 The board and senior management of an AI should understand and guide the institution's structure and organisation and ensure that organisational complexity does not prevent effective control of the institution's or the AI group's activity in its entirety. For this purpose, the board should set clear strategies and approve policies for the establishment of new units, branches, subsidiaries or other legal entities within the AI's or the AI group's organisational structure and should ensure that they are consistent with the policies and interests of the AI and the group. New structures should be approved only if the material risks associated with the structures can be properly identified, assessed and managed. If the risk management process is not adequate to monitor and control the structure, then such structure should be delayed until the risks can be appropriately addressed. There should also be a process to assess risk and performance relative to initial projections and to adapt the risk management treatment accordingly as the business matures.
- 2.8.3 The board should assess whether there are effective systems in place to facilitate the exchange of information among the various units, branches, subsidiaries or other legal entities within the organisational structure to manage the risks of individual entities as well as the group as a whole, and to ensure effective oversight of the group. The board should ensure that it keeps itself informed about the risks posed by the group structure.
- 2.8.4 In accordance with the strategy and policies set by the board, senior management (and the board as appropriate) should, among other things:
- avoid setting up unnecessarily complicated structures (e.g. structures that lack economic substance or business purpose);
  - have a centralised process for approving the creation of new legal entities based on established criteria, including the ability to monitor and fulfil, on an ongoing basis, the requirements applicable to



each entity (e.g. regulatory, tax, financial reporting, and governance);

- continually maintain and review the appropriate policies, procedures and processes governing the approval and maintenance of new structures; and
- ensure that the approved structures and the activities conducted within them are subject to regular internal and external audit reviews.

2.8.5 Prior to setting up new structures or initiating new activities, an AI should make an assessment of the structures or activities, which would include:

- a full vetting of the purpose of the structures or activities;
- identifying and assessing the associated risks of setting up the structures or activities, e.g. lack of management transparency, operational risk introduced by interconnected and complex funding structures, intragroup exposures, trapped collateral and counterparty risk;
- assessing the AI's ability to manage the risks when the structures or activities are established.

2.8.6 For the purpose of enhancing the sound governance of an AI's banking group, internal audits conducted on individual entities could be complemented with regular assessments of the risks posed by the group's structure. Periodic reports that assess the AI's overall structure and individual entities' activities, confirm compliance with the strategy previously approved by the board, and disclose any possible discrepancies could be useful for the audit and risk committees, senior management and the board of the parent company.

## **2.9 Internal and external audit**

### ***General***

2.9.1 The board should recognise the importance of the audit process and communicate this throughout the AI. It should review carefully, and make use in a timely and effective manner of, the findings of both internal and external auditors. The deliberations of the board on whether or not the auditors' recommendations are accepted should be documented so that auditors' recommendations are properly dealt with. Where the review is carried out by an audit

committee, key issues should be brought to the full board's attention.

### ***Internal audit***

- 2.9.2 An effective internal audit function is essential to the sound corporate governance of an AI as it provides independent assurance to the board and senior management with respect to the quality and effectiveness of the AI's internal control systems and risk governance arrangements. To ensure its effectiveness, the internal audit function should be independent from the business units and other internal control functions.
- 2.9.3 The internal audit function should have a clear mandate and sufficient standing, skills, resources and authority within the AI. It should have a direct reporting line and unfettered access to the board and/or the audit committee in order to ensure both its operational independence and the prompt and direct reporting of its findings. In order to discharge its functions, the internal audit function should have full and unconditional access to any records, file data, meeting minutes and physical properties of the AI. See [IC-2](#) for the detailed role and responsibilities of the internal audit function.
- 2.9.4 The board should approve the appointment or dismissal of the head of internal audit, and in case of resignation, the board should be notified promptly of the resignation and any reasons given therefor (see also paragraph 2.10.3). The board may, where appropriate, delegate such authority to its designated audit committee.

### ***External audit***

- 2.9.5 External auditors play an important role in relation to an AI's corporate governance structure as they provide the board with an independent opinion on the adequacy and effectiveness of the AI's financial reporting, including the reasonableness of the judgements, estimates and presentation used in the accounts.
- 2.9.6 Apart from fulfilling the legal obligation (see [IC-3](#)) to give a statutory opinion on financial statements, external auditors will normally draw the attention of the board to other significant matters identified during the course of their audit work by way of a management letter and provide recommendations for improvement as appropriate (e.g. material weaknesses identified in the AI's internal control system).

- 2.9.7 Given the importance of external audit in the context of an AI's corporate governance process, the audit committee should establish a robust process for approving the appointment (or recommending full board approval of the appointment), reappointment, removal and remuneration of the external auditors. The selection criteria for external auditors should ensure that the external auditors appointed, whether for financial or prudential audit purposes, are competent with the appropriate skills, knowledge, experience and resources to perform the tasks required of them, and are independent of the AI and capable of forming an objective and impartial judgement in relation to the work undertaken for the AI.
- 2.9.8 To reinforce the independence of external auditors, the board should, as good practice, rotate its external auditors (either the audit firm or individuals within the firm) from time to time.

## **2.10 Transparency for sound and effective governance**

- 2.10.1 Transparency is essential for sound and effective corporate governance. Public disclosure with respect to key areas of corporate governance by AIs can help shareholders, depositors and market participants to assess and monitor the effectiveness of the board and senior management and properly hold them accountable. Therefore, AIs are expected to disclose relevant and useful information in this area commensurate with their size, complexity, structure, economic significance and risk profile. The disclosure should be in compliance with any legal and regulatory disclosure requirements, clear, accurate, timely and accessible.
- 2.10.2 Disclosure by an AI should be made whenever relevant but at least annually and include, but not be limited to,
- material information on the AI's objectives, organisational and governance structures and policies (in particular the content of any code of conduct or other corporate governance code or policy and the process by which it is implemented);
  - key points concerning its risk appetite, including the process for defining it, the nature of the risks it covers and which the AI is therefore prepared to assume, the scenario, metrics (qualitative and quantitative) and time horizons the AI uses to articulate its risk appetite and the measures it

uses to ensure risks are controlled within the appetite (without disclosing commercially sensitive information). A description of board involvement in the process should also be provided;

- information about board members, including their qualifications, directorships of other companies, other executive positions held, and whether they are independent non-executive directors (“INEDs”)<sup>8</sup>;
- the approach for recruitment and selection of members of the board (in so far as the sensitivity of the information will not be disadvantageous to the AI) and for ensuring an appropriate diversity of skills, backgrounds, and viewpoints;
- the committees established by the board, their roles, functions, composition (including members who are INEDs), and number of times these committees have met;
- remuneration information as set out in CG-5;
- major share ownership and voting rights and related party transactions; and
- adequate information regarding the purpose, strategies, structures, risks and controls around material and complex or non-transparent structures<sup>9</sup>.

2.10.3 Whenever a person is appointed or ceases to act in the capacity of head of internal audit function or chief risk officer, the AI concerned should inform the HKMA in a timely manner with relevant information (e.g. qualification of the new appointee and the circumstances appertaining to the change in personnel), and make public disclosure. The HKMA may consider meeting with the outgoing head of

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<sup>8</sup> See paragraph 4.2.3.

<sup>9</sup> For the purpose of this module, a “complex or non-transparent structure” would generally refer to a structure that involves a number or layers of legal entities, and chains of activities, services, operations and products that create extensive interconnections and intra-group transactions among the entities such that it is difficult for supervisors and stakeholders of the AI concerned to reasonably assess the risks to which the AI as a whole is exposed. This would include, for instance, transactions involving the creation of special purpose vehicles to accommodate or facilitate transfer of credit risk, particularly where the AI remains potentially exposed to any residual risk, not immediately apparent or transparent in terms of nature or amount.

internal audit function or chief risk officer after he has been relieved of his duties.

- 2.10.4 The Banking (Disclosure) Rules (“BDR”) made by the MA under section 60A of the Banking Ordinance prescribe information to be disclosed by AIs (“section 60A disclosure”), and the manner in which, times at which and periods during which such information shall be so disclosed. Section 5 of the BDR provides that a locally incorporated AI must have a formal disclosure policy approved by the board that addresses the AI’s approach for determining the content, appropriateness and frequency of the section 60A disclosure it makes and the internal controls over the disclosure process.
- 2.10.5 The objective of the BDR is to set out the minimum standards for the public disclosure which an AI must make, so as to allow market participants to assess the risk exposure of the AI and how the risks are managed by the AI. It is important that AIs convey, through their public disclosure, their actual risk profile to market participants and other stakeholders and if the fulfilment of this objective requires disclosure beyond the minimum standards in the BDR, AIs should provide such additional disclosure. As market discipline can contribute to a safe and sound banking environment, the HKMA as a general principle encourages AIs to make more extensive voluntary disclosures where relevant and practical for them to do so.

### **3. Organisation and functioning of the board**

#### **3.1 Charter**

- 3.1.1 The board should maintain and periodically update organisational rules, by-laws, or other similar documents setting out the board’s organisation, authorities, responsibilities and key activities.
- 3.1.2 The board should define and document appropriate governance practices and procedures for its own work in line with the provisions of an AI’s constitutional documents. The practices and procedures should include the size, frequency, and working procedures of meetings, the format of the minutes of meetings, the role of the chair and the use of committees. These practices and procedures should support the efficacy of the board’s work, particularly with regard to facilitating and ensuring a sufficiently in-depth review of the matters to be considered, and robust, critical challenge and discussion of issues. The board should

periodically review its governance procedures and practices, determine where improvements may be needed, and make any necessary changes.

## **3.2 Meetings**

- 3.2.1 The board can only fulfil its responsibilities effectively if it meets sufficiently frequently, and receives sufficient information from management to enable it, to monitor the financial condition and performance of the AI. In the absence of an active, engaged board, a leadership vacuum will likely be created and this vacuum may be filled either by major shareholders becoming directly involved in the running of an AI's affairs or by the executive management. In either case, the board would be bypassed and checks and balances lost, in particular through the inability of INEDs to play an oversight role.
- 3.2.2 Meetings of the board of an AI should preferably therefore be held on a monthly basis but in any event no less than once every quarter. The board should ensure that it receives sufficient information from management, board committees and those responsible for internal control functions to enable its members to fulfil their responsibilities. Such information should be provided in a suitable format to facilitate board members' comprehension and should be accurate and delivered to members in a timely manner to enable them to prepare in advance for board meetings and other relevant discussions. In addition, the board should have timely access to any other information which its members may request.
- 3.2.3 To document the fulfilment of their respective responsibilities, the board and its specialized committees should keep full minutes of all their meetings. Such minutes should cover matters reviewed, discussions on key deliberations, decisions taken and dissenting opinions.

## **4. Board structure**

### **4.1 Role of the chair**

- 4.1.1 The chair should provide leadership to the board and be responsible for the overall effective functioning of the board. The chair should possess the requisite experience, competencies and personal qualities to fulfil his responsibilities.

4.1.2 The chair should ensure that board decisions are taken on a sound and well-informed basis and in the best interest of the AI. To this end, the chair should, among other things:

- set the agenda for board meetings and ensure that all directors are given an opportunity to include matters on the agenda;
- ensure that directors receive accurate, timely, complete and clear information sufficiently in advance of board meetings;
- encourage and promote open and critical discussion;
- ensure that any concerns and dissenting views can be freely expressed and discussed within the decision making process;
- encourage constructive relations and effective communication between the board and management, and among executive directors, non-executive directors and INEDs;
- ensure that directors, especially non-executive directors and INEDs, have access to independent professional advice at the AI's expense where they judge it necessary to discharge their responsibilities; and
- dedicate sufficient time to the exercise of his responsibilities.

4.1.3 To achieve appropriate checks and balances, increased accountability and greater independence in board decision-making, the chair should be an INED or non-executive director. In very exceptional cases where an AI intends to appoint an executive director to be the chair of the board, it should promptly discuss with the HKMA the reason for such proposed appointment and demonstrate to the HKMA's satisfaction that the AI has alternative measures to mitigate any adverse impact on the working of the board.

## **4.2 Board composition**

4.2.1 The board should have an adequate number and appropriate composition of members to ensure sufficient independence (in the sense described below) and collective expertise for effective, objective decision-making. The size and composition of the board will vary from institution to institution depending upon the size, complexity and risk profile of an AI and the nature and scope of its activities. In

assessing the collective suitability of board members, the following should be taken into account:

- the board members should possess a range of knowledge and experience in relevant areas and varied backgrounds to promote diversity of views;
- the board collectively should have a reasonable understanding of local, regional and global economic and market forces and of the legal and regulatory environment. In this context, international experience, where relevant, should be considered; and
- individual board members' attitudes should facilitate communication, collaboration and critical debate in the decision-making process.

4.2.2 The board of an AI should maintain an appropriate level of checks and balances to counter the influence of management or of shareholder controllers in order to ensure that decisions are taken with the AI's best interests in mind.

4.2.3 The key characteristic of "independence" in relation to directors is the ability to exercise objective, independent judgement after fair consideration of all relevant information and views, without undue influence from executives or from external parties. An INED means a director who does not perform any executive functions within the AI and is not under any other undue influence, internal or external, political or arising through the incidents of ownership or otherwise, that would impede his exercise of independent and objective judgement. Some non-executive directors may represent the interests of an AI's shareholders or have some other form of connection with the AI, which means that they cannot be considered as independent.

4.2.4 INEDs play an important role in providing the necessary checks and balances to ensure that an AI operates in a safe and sound manner and that its interests are protected. INEDs can also assist by bringing in outside experience and providing objective judgement. They are particularly useful in a monitoring role, e.g. as members of the audit committee.

4.2.5 In order to ensure sufficient independence of the board of licensed banks or of any other AI which may be designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important, either one-third or three of their board members, whichever is higher, should be INEDs and at least two of these INEDs should possess a background in accounting, banking or other relevant financial industry.



- 4.2.6 Restricted licence banks and deposit-taking companies (other than any designated by the MA as systemically important) are strongly encouraged to appoint at least three INEDs to their boards. There may however be cases where a restricted licence bank or deposit-taking company considers this impracticable in the light of its small size or generally narrow scope of operations. In such circumstances, the HKMA will nevertheless expect the restricted licence bank or deposit-taking company to include an appropriate number of INEDs (or at least non-executive directors) on its board. While the appropriate number will vary on a case-by-case basis (depending on a number of factors including the size of the AI, the total number of directors on the board and whether the AI is majority-owned by a bank incorporated in or outside Hong Kong), there should at least be one INED with background in accounting, banking or other relevant financial industry.
- 4.2.7 AIs should notify the HKMA of the names of the directors who are considered to be independent (i.e. INEDs) and the criteria supporting this judgement. In assessing the independence of such directors, the HKMA will take account of various factors such as their direct or indirect financial or other interest in the business of the AI<sup>10</sup>, their relationship, if any, with significant shareholders of the AI, and the length of their service on the board, in particular whether they have served for a significantly long period of time under the same chair or chief executive which could potentially undermine their objectivity and independence.
- 4.2.8 The HKMA may require an AI to appoint additional directors who can be regarded as more fully independent if it is not entirely satisfied that there is an adequate independent element on the board.

## **5. Specialized committees**

### **5.1 Objectives and practices**

- 5.1.1 Although the board is ultimately responsible for the conduct of an AI's affairs, it may be beneficial for the oversight of certain major functional areas to be delegated to specialized committees of the board (specialized committees). All such

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<sup>10</sup> Any banking relationship between an AI and a director of the AI (or company connected with that director) should be on an arm's length basis and on normal commercial terms. Where such a relationship is significant to either the AI or the director (or company connected with that director), the AI should consider whether that may prevent the director from being considered independent.

specialized committees should be established with formal and clear delegation of authority by the board and be provided with sufficient resources to perform their duties. Each specialized committee's objective and terms of reference should include authorities, responsibilities, membership, meeting frequency and working procedures (including how the committee will report to the board and tenure limit for members serving on the committee). The objective and terms of reference of the committee should be set out clearly in a written document, regularly reviewed and updated appropriately.

5.1.2 The board should appoint members to specialized committees with the goal of achieving an optimal mix of skills and experience that, in combination, allows the committees to fully understand, and objectively evaluate the relevant issues which they will need to consider and address. In order to achieve the needed objectivity, the committees should have in their membership a sufficient number of INEDs and be chaired by an INED.<sup>11</sup> There should be a regular and transparent communication mechanism between the board and its specialized committees to ensure continuous and robust dialogue and information sharing. The committees should also interact with each other as appropriate to ensure consistency and compatibility in their actions and minimise any potential for gaps (e.g. information gaps) in risk management oversight. For instance, there should be effective communication and coordination between the audit committee and the risk committee to facilitate the exchange of information and effective coverage of all risks, including emerging risks, and any needed adjustments to the risk governance arrangements of an AI. To avoid undue concentration of power, the board should consider occasional rotation of members and of the chairs of specialized committees.

5.1.3 Each specialized committee should maintain appropriate records of its deliberations and decisions. Each committee should report regularly to the board on its decisions and recommendations. However, the board remains ultimately responsible for the decisions taken. Where necessary, each specialized committee should be able to seek independent expert advice at the AI's expense.

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<sup>11</sup> For restricted licence banks and deposit-taking companies which are not designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important and which may have a limited number of INEDs to meet the INED membership requirement for specialized committees, non-executive directors should be appointed in such cases.

5.1.4 It is generally expected that a locally incorporated AI will establish a nomination committee, audit committee, risk committee and remuneration committee (see also subsections 5.2 to 5.5). In addition, the board of an AI should establish other specialized committees as necessary to manage different areas of an AI's business operations and risk management. For instance, the board should either establish a standalone culture committee, which should be chaired by an INED, or charge one of its existing committees (for example the remuneration committee) with the responsibility for reviewing regularly the effectiveness of the AI's measures to promote a sound corporate culture and supporting the board on culture-related matters (see subsection 2.6).

5.1.5 For a restricted licence bank and deposit-taking company (other than one designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important) with a relatively small and simple business operation and low risk profile, it may be acceptable for its board:

- to rely on the audit committee of the AI's holding company; and
- to rely on other specialized committees of the AI's holding company<sup>12</sup>, or not to establish such specialized committees so long as the board can dedicate sufficient time and resources to carrying out its responsibilities in the relevant specific area(s).

Als wishing to adopt such or similar practices should consult the HKMA and be prepared to justify the merits of their proposed approach in their specific circumstances.

5.1.6 Where the relevant board committee(s) of the holding company of a restricted licence bank or deposit-taking company is relied upon, it should be satisfied that:

- (i) the AI is wholly-owned by that holding company;
- (ii) the holding company is regulated as a bank under a recognised banking supervisory authority;
- (iii) the board committee has attributes consistent with the requirements set out in this module and any other relevant modules as appropriate<sup>13</sup>;

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<sup>12</sup> In this context, holding company could be the intermediate holding company or the ultimate holding company of the AI.

<sup>13</sup> CG-5, IC-1 and IC-2 among others in the case of remuneration committee, risk committee and audit committee respectively.

- (iv) the composition of the board committee at the holding company level is consistent with section 5; and
- (v) the board committee oversees the relevant functional area(s) in respect of the AI.

It should be noted that reliance on board committees at the holding company level should not relieve the board of an AI of its own governance and oversight responsibilities (see also subsection 9.2).

### ***Specific requirements***

## **5.2 Nomination committee**

- 5.2.1 The majority of the nomination committee members (including the chair) should be INEDs.
- 5.2.2 The key objectives of the nomination committee include the following:
  - identifying individuals suitably qualified to become members of the board or of senior management, and selecting, or making recommendations to the board on the selection of, individuals nominated for directorships and senior management positions (based on the role and its responsibilities and the knowledge, experience and competence which the role requires); and
  - making recommendations to the board on the appointment or re-appointment of directors and succession planning for directors, in particular the chair and the chief executive.
- 5.2.3 The nomination committee may also undertake board performance evaluation to assist the board in reviewing the efficiency and effectiveness of the functioning of the board (see section 7).
- 5.2.4 The nomination committee should ensure objectivity and independence in the selection process for board members and senior management. The committee should also strive to ensure that the board is not dominated by one individual or small group of individuals in a manner that is detrimental to the interests of the AI as a whole.

## **5.3 Audit committee**

- 5.3.1 The audit committee should be distinct from any other committee and made up of non-executive directors, the majority of whom should be independent. The chair should

be an INED with a background in accounting, banking or other relevant financial industry. To ensure independence, the chair of the audit committee should not also be the chair of the board or of any other committee.

- 5.3.2 The audit committee as a whole should have adequate experience in audit practices, financial reporting and accounting and should possess a collective balance of skills and expertise which is commensurate with the complexity of an AI and its business and risk profile in order to ensure it is in a position to discharge its responsibilities effectively. Where necessary, it should have access to external expert advice at the AI's expense. See IC-2 for the responsibilities of the audit committee.

#### **5.4 Risk committee**

- 5.4.1 The risk committee should be distinct from the audit committee. See IC-1 for the responsibilities of the risk committee.
- 5.4.2 The risk committee should be chaired by an INED with a background in accounting, banking or other relevant financial industry or expertise in risk management. The chair of the risk committee should not be the same person as the chair of the board or of any other committee. The majority of the members of the risk committee should be INEDs. The members of the committee should collectively possess relevant technical expertise and experience in risk disciplines that are adequate to enable them to discharge their responsibilities effectively.
- 5.4.3 The risk committee should interact regularly with, and oversee, the chief risk officer. The committee should also receive regular risk reports from the AI's risk management function and chief risk officer.

#### **5.5 Remuneration committee**

- 5.5.1 The remuneration committee should be chaired by an INED. The other committee members should be INEDs or, where executive directors are to be members of the committee, the committee should comprise a majority of INEDs.
- 5.5.2 The remuneration committee should assist the board in discharging its responsibility for the design and operation of the AI's remuneration system, and make recommendations in respect of remuneration policy and practices to the board (see CG-5). In particular, the committee should (i) make recommendations to the board in respect of the remuneration packages for the bank's senior management

and Key Personnel (see the definition of Key Personnel in [CG-5](#)) in cases where the approval authority for such remuneration packages rests solely with the board; (ii) ensure that remuneration is appropriate and consistent with the AI's culture, long-term business and risk appetite, performance and control environment as well as with any legal or regulatory requirements; and (iii) work closely with other relevant committees of the AI's board, such as the risk committee and the audit committee, and consult with the AI's compliance function in evaluating incentives created by the remuneration system.

## **6. Appointment of directors**

### **6.1 Fit and proper**

- 6.1.1 The board, or its nomination committee (see subsection 5.2), should identify, assess and select qualified and experienced candidates for appointment as director. For this purpose, the board should have formal policies with clear and rigorous procedures on the selection and appointment/re-appointment of directors. The policies for selection should include a description of the necessary competencies and skills required to ensure sufficient expertise.
- 6.1.2 The board should satisfy itself that a candidate for appointment is a fit and proper person for such appointment, taking account of his experience, knowledge, skills, track record, independence of mind (particularly in the case of non-executive directors and INEDs) and other relevant factors as may be determined by the board (e.g. the candidate's record of integrity and good repute and the candidate's ability to promote a smooth interaction between board members).
- 6.1.3 Board candidates should not have any conflict of interest that may impede their ability to perform their duties independently and objectively or subject them to undue influence from:
- personal, professional or other economic relationships with other members of the board or management (or with other entities within the group);
  - other persons including shareholders; or
  - relationship arising from or connected to past or present positions held.

- 6.1.4 After appointment, the board should regularly review whether each existing director remains qualified for his post. If a board member ceases to be qualified or fails to fulfil his responsibilities, the board should take appropriate action, including notifying the HKMA.
- 6.1.5 Under §71 of the Banking Ordinance, the MA has the power to approve directors. The fitness and propriety of directors is also an authorization criterion under the Seventh Schedule to the Ordinance. Thus if a director fails to satisfy the MA that he is fit and proper for the position:
- the consent granted under §71 may be withdrawn; and
  - the power to revoke an AI's authorization may become exercisable.

See also subsection 11.3 on the HKMA's fit and proper test.

- 6.1.6 Occasionally, a person may act as an alternate to a director. However, alternates should only be appointed for directors (whether executive and non-executive) on a strictly temporary basis, for example where a director is unable to attend meetings due to ill health. In any event, alternates should not be appointed for INEDs. The HKMA is of the view that "alternate directors" have all the obligations imposed on the primary directors. In particular, if an alternate director attends a board meeting at which decisions are taken, that alternate director would share the responsibility for such decisions. The HKMA accordingly considers that the definition of "director" in the Banking Ordinance includes alternate directors and that they are therefore subject to the approval requirement under §71 of the Ordinance.

## **6.2 Commitment**

- 6.2.1 Directors, including non-executive directors and INEDs, are expected to contribute actively to the work of the board in order to discharge their responsibilities. Therefore, when considering an appointment/re-appointment, the board should satisfy itself that the candidate is able to commit sufficient time, attention and effort to fulfil their responsibilities effectively, particularly if the candidate has a seat on more than one board or undertakes other professional or commercial activities. Given the important role and responsibility of the chair of the board, a greater time commitment should be expected of the person appointed to the chair.

6.2.2 Individual directors should make every effort to attend all meetings of the board and any committees on which they sit especially where major issues are to be discussed. If necessary and where permitted under law, regulation and the constitutional documents of the AI, the participation of directors in board meetings can be facilitated by means of video or telephone conferencing.<sup>14</sup>

### **6.3 Succession**

6.3.1 The board should have plans for orderly succession in respect of appointments to the board, so as to maintain an appropriate balance of skills and experience on the board.

## **7. Board qualification and training**

7.1 The board should possess, both as individual board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and integrity, to discharge its responsibilities adequately and effectively. Members of the board should have up-to-date understanding of the nature of an AI's business and its associated risks commensurate with their responsibilities. The board collectively should have adequate knowledge and expertise relevant to each of the material business activities the AI pursues (or intends to pursue) and the associated risks in order to ensure effective governance and oversight.

7.2 Board members should be and remain qualified for their position. To help board members acquire, maintain and enhance their knowledge and skills in order to fulfil their responsibilities, the board should ensure that its members participate in induction programmes and have access to ongoing training covering relevant issues (drawing on external expertise where necessary). Induction programmes for new members of the board aim to familiarise them with their role and responsibilities, and the AI's business strategy and operations, corporate values, governance and internal control system.

7.3 The board should identify and meet the training needs of individual members and of the board collectively. More extensive efforts should be made to train and keep updated those board members with more limited financial, regulatory or risk-related experience. As part of this process, the board should take into account developments in areas such as products and markets, business operations, risk profile, and the risk management tools and models used by the institution; as well as changes in laws, regulations and

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<sup>14</sup> Participation in board meetings by means of video or telephone conferencing is regarded as attendance and should be recorded as such.



supervisory standards relevant to the AI's activities. Processes should be in place to regularly evaluate the effectiveness of training provided to individual members of the board and the board as a whole.

- 7.4 The board should provide sufficient time, budget and other resources for developing and updating its members' knowledge and capabilities as necessary to enable them to fulfil their responsibilities effectively and efficiently.

## **8. Board performance evaluation**

- 8.1 To support board performance and improve the ongoing functioning of the board, the board should undertake regular assessments (at least annually) of the effectiveness of the board as a whole and of its specialized committees. The board should:
- periodically review its structure, size and composition, as well as that of its specialized committees and the coordination between them;
  - determine if the board or its committees collectively lack any skills or expertise to discharge their responsibilities effectively, and identify steps for improvement; and
  - review the effectiveness of its own governance practices and procedures, determine any improvements that may be needed, and make any necessary changes.
- 8.2 The ongoing suitability of each board member should be assessed by the board at least annually, taking into account the member's performance during meetings of the board and, where relevant, its specialized committees, and other relevant factors as appropriate.
- 8.3 To enhance the objectivity of the assessment, the board may engage external consultants or facilitators to provide assistance in the evaluation process.
- 8.4 Where the performance of individual board members does not meet expectations or there is serious concern on a member's integrity, the board should take timely and appropriate action, including seeking the resignation of the director concerned or the appointment of new members.

## **9. Governance in group structures**

### **9.1 AI as a parent or holding company**

- 9.1.1 Where an AI is a parent or holding company, the AI's board should ensure that there are governance strategies and governance policies and procedures in place appropriate to the structure, business and risks of the group as a whole and its component entities. The AI should recognise that it may ultimately have to support its subsidiaries over and above the extent of any direct legal liability. The AI's capital adequacy, liquidity and risk exposures should all be considered with this in mind.
- 9.1.2 The board of the AI should be aware of the material risks and issues that may affect both the institution itself and its subsidiaries, and should therefore exercise adequate oversight over the activities of the subsidiaries while respecting the independent legal and governance responsibilities that apply to subsidiary boards. The board of the AI should ensure that enough resources are available for each subsidiary to meet both group standards and local governance standards.
- 9.1.3 In order to fulfil its corporate governance responsibilities, the board of the AI should, among other things:
- establish a group structure and a corporate governance framework with clearly defined roles and responsibilities, including at the parent company level and at the subsidiary level as appropriate based on the complexity and significance of the subsidiary and taking into account applicable legal or regulatory requirements;
  - define an appropriate subsidiary board and management structure which takes into account the material risks to which the group, its businesses and its subsidiaries are exposed and applicable legal or regulatory requirements<sup>15</sup>;
  - assess whether the group's corporate governance framework includes adequate policies, processes and controls and whether it sufficiently addresses risk management across the businesses and legal entity structures within the group;
  - ensure the group's corporate governance framework includes appropriate processes and

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<sup>15</sup> Applicable to the extent practicable for subsidiaries which are not wholly owned by the AI. Where an AI's subsidiary conducts key parts of the business of the AI as a group, the AI is expected to have control over the key functions of its subsidiary.

controls to identify and address potential intragroup conflicts of interest;

- have sufficient resources to monitor the compliance of subsidiaries with all applicable legal, regulatory and governance requirements;
- maintain an effective relationship with both the home regulator (i.e. HKMA) and, through the subsidiary board or direct contact, with the regulators of all subsidiaries; and
- establish an effective internal audit function that ensures audits are being performed at the subsidiary level (either within the subsidiary or for the subsidiary), and for parts of the group (where necessary), as well as at the group level.

## **9.2 AI as a regulated subsidiary**

- 9.2.1 Where an AI belongs to a larger group of companies, the board of the AI might generally be expected to align the AI's strategic objectives, risk governance arrangements, corporate values and governance principles with those of its parent company. Key governance strategies, policies and procedures of the AI may be determined and centralised at the holding company level.
- 9.2.2 The subsidiary AI is however a separate legal entity, and its directors are not absolved from responsibility in relation to the effects of policies and actions that are applied to the AI irrespective of whether this is "group" policy or strategy. The board of the AI retains its own corporate governance responsibilities and will be ultimately responsible for the implementation and effectiveness of all group policies and practices applied to the AI and for the conduct and financial soundness of the AI.
- 9.2.3 To ensure that the group policy does not put the AI in breach of any applicable legal, regulatory or supervisory rules or standards, the board should provide appropriate input to the formulation of group policy or conduct timely evaluation of any group-level policies. If the board is not satisfied that the group-level policies and practices are appropriate in the circumstances of the AI, the board should notify the holding company and discuss appropriate modifications. Similarly, if the group policy set by the holding company may, in the board's opinion, conflict with any applicable legal or regulatory requirement or may be detrimental to the sound and prudent operation of the AI, or if the holding company does not respond adequately to the concerns raised by the

board, the board should record its dissent to the policies and practices of the holding company and take necessary actions to protect the AI. In such a situation, the board should consider seeking independent professional advice and raising the issue with the HKMA.

- 9.2.4 In developing or adopting effective risk management processes for an AI, the board and senior management should endeavour to ensure that such processes are capable of supporting risk reporting and risk management at the group level.

## **10. Controls on structures established on behalf of customers**

10.1 The board and senior management of an AI should fully appreciate and understand the extent to which an AI may be indirectly exposed to risk when it performs certain services, or establishes structures, on behalf of customers. For example, the AI may provide a range of trustee services or develop complex structured finance transactions for customers. These activities can serve the legitimate business purposes of customers. However, in some cases customers may use products, structures or services provided by the AI to engage in illegal or inappropriate activities, which in turn pose significant legal and reputation risks to the AI concerned. To this end, senior management, and the board as appropriate, should, among other things, be vigilant in:

- maintaining and reviewing, on an ongoing basis, appropriate strategies, policies and procedures governing the approval and maintenance of such products, structures and services;
- periodically monitoring such products, structures and services to ensure that they remain consistent with their established purpose and are not held, operated or used without adequate justification; and
- establishing adequate procedures to identify and manage all material risks arising from these activities. The AI should only engage in these activities if the material financial, legal and reputational risks can be properly identified, assessed and managed.

## **11. Supervisory processes for evaluation of governance**

### **11.1 Supervisory review process**

- 11.1.1 Board and senior management oversight of an AI is one of the key areas that will be reviewed and assessed in the HKMA's annual Supervisory Review Process (see [CA-G-5](#)). The result will inform the HKMA in its setting of supervisory priorities for the AI concerned. The factors taken into account by the HKMA will include the extent to which the AI's corporate governance framework reflects the standards in this module having regard to the nature, scale and complexity of the AI's business and its organisational structure.
- 11.1.2 In order to facilitate the HKMA's evaluation, the HKMA may require the AI to provide information relating to its corporate governance policies and practices and their implementation. That information may include the following:
- mandate of the board and terms of reference of its committees;
  - information packages for, and the attendance record and minutes of, board meetings and the meetings of board committees;
  - board committees' reports to the full board and the regular reports of the AI's internal control functions to the board and board committees;
  - internal audit reports, external auditors' reports and management letters from external auditors together with the comments of management;
  - board performance evaluation reports;
  - strategies adopted by the AI regarding the establishment and maintenance of structures (including units, branches, subsidiaries or other legal entities) within the group, as well as the AI's internal control measures with respect to the structures established on behalf of customers;
  - the AI's conflicts of interest policy;
  - the AI's Code of Conduct; and
  - the AI's risk appetite statement.

## **11.2 Communication with the board and senior management**

- 11.2.1 On a regular basis, the HKMA will communicate with relevant staff of an AI and, where considered appropriate, the AI's external auditors, to understand and assess the robustness and effectiveness of the institution's corporate governance framework. Relevant staff may include the AI's senior management, personnel responsible for risk

management, compliance and internal audit functions, and, where necessary, individual directors. In the case of licensed banks and any other AI designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important, the HKMA will normally meet with the full board, audit committee or risk committee of such institution at least once every year.

- 11.2.2 Where deficiencies are identified in an AI's corporate governance framework, the HKMA will require the AI's board or senior management, as appropriate, to take timely remedial action.

### **11.3 Fit and proper test**

- 11.3.1 The HKMA will evaluate the processes and criteria used by AIs in the selection of board members and senior management. To enable the HKMA to consider whether a proposed candidate for appointment to an AI's board or as its chief executive, alternate chief executive or executive officer (within the meaning in the Banking Ordinance) is fit and proper to carry out his duties, the HKMA may, where the HKMA considers it appropriate, conduct a face-to-face meeting with the candidate. This will allow the HKMA to assess first-hand the candidate's personal qualities, skills, knowledge and understanding of the AI's business and key regulatory and supervisory requirements (such as requirements relating to risk management practices, capital adequacy and liquidity) and whether he will be able to fulfil adequately the role for which he is being considered.
- 11.3.2 With regard to the appointment of persons undertaking key control functions who fall within the definition of "manager" in the Banking Ordinance, an AI should be prepared to demonstrate to the satisfaction of the MA that they have adequate systems of control and that such systems are working effectively to ensure that any such persons are fit and proper to hold their position within the AI. Nevertheless, the primary responsibility for ensuring that board members and senior management are fit and proper for their roles rests with the board.
- 11.3.3 The HKMA will monitor the individual and collective suitability of board members and senior management. Given the on-going nature of the "fit and proper" criterion applicable to directors and senior management, the HKMA may also conduct meetings with serving directors or senior management of an AI where necessary. In turn, the AI should notify the HKMA as soon as it becomes aware of any material information which may negatively affect the fitness

and propriety of a board member or a member of the senior management.

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