

HKMA responses to comments received on the Consultation Paper (CP) on Empowerment of INEDs in the Banking Industry in Hong Kong

Para in CP	Comments Received	HKMA Response
	I – Constituting the Board and its Committees	
1	One institutional respondent commented that there should be some flexibility in the establishment of board committees and that a combined audit and risk committee could be equally effective in some cases.	We believe separate audit and risk committees are necessary for licensed banks (LB) and other AIs designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important. However, some flexibility may be retained for smaller AIs and should be discussed between the AI and the HKMA based on the circumstances of the AI concerned.
1	One institutional respondent sought clarification on whether AIs that are part of groups can rely on the board committees of a parent or holding company.	This issue is addressed in a separate consultation on proposed changes to the Supervisory Policy Manual CG-1(SPM CG-1) issued on 30 August 2016.

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2	<p>Different views were received regarding the requirement for larger AIs to have two INEDs from an accounting or financial background. One respondent felt that the requirements that all AIs should have at least one INED from such a background, and that such an INED should chair the audit committee, should be recommendations rather than mandatory for deposit-taking companies (DTC) and restricted-licence banks (RLB). Concerns included likely difficulties in finding sufficient suitably qualified persons and a risk of over-emphasising the skills of individual INEDs rather than the balance of skills on the board. On the other hand, three institutional respondents supported the recommendation and one questioned why the requirement for two INEDs from an accounting or financial background should be restricted to larger AIs. Some respondents suggested that it should be permissible for the audit and risk committees to be chaired by the chair of the board or by a Non-Executive Director (NED), rather than an INED.</p>	<p>It is not the intention to over-emphasise the skills of individual INEDs and we fully recognise the importance of balance and diversity of skills within the board. We also recognise that smaller institutions with simpler business models, including RLBs and DTCs, may not require two INEDs with a financial background. We are also mindful of issues of supply of suitable individuals. Indeed part of the motivation for the review is to explore ways to ensure a sustained supply of appropriately qualified people for appointment as director.</p> <p>However, given the nature of AIs' business and the role they play in the financial sector and wider community, we believe that all AIs, whatever their size and business model, should have at least one INED with a background in accounting, banking or other relevant financial industry. Given the crucial role of the audit committee, it should be chaired by an INED with the expertise and experience necessary to understand the often technical financial issues involved. For licensed banks and other AIs that are designated by the MA as systemically important, we believe that two INEDs are likely to be required. Such AIs are expected to have a risk committee in addition to an audit committee. The Guideline</p>

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		<p><i>Corporate Governance Principles for Banks</i>, issued by the Basel Committee on Banking Supervision in July 2015 (BCBS Guideline) states that audit and risk committees “should be required for systemically important banks and recommended for other banks based on a bank’s size, risk profile or complexity”. In our view, both committees should be chaired by INEDs with appropriate skills and the BCBS Guideline states that both the audit and risk committees should “have a chair, who is independent and not the chair of the board or of any other committee”. Having these committees chaired by the same person for a large complex bank is likely to result in that individual being overloaded, with undesirable consequences for overall risk governance.</p>
6 & 7	<p>One institutional respondent suggested that the chair of the board should also be permitted to chair the nomination committee. Another suggested that the remuneration committee could be made up of a majority of NEDs rather than INEDs. Another suggested that the nomination committee should be chaired by the board chairman or an INED and comprise a majority of INEDs.</p>	<p>Paragraph 3.4.5 of the HKMA SPM CG-1 already requires that the board of each LB should establish a nomination committee, chaired by the chairman of the board or an INED and the majority of whose members should be INEDs. The consultation on SPM CG-1 includes a proposal to extend this requirement to all AIs designated as systemically important and to provide that as well as a majority of the members of the nomination committee being INEDs, the chair should be an INED.</p>

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	II – INEDs of AIs	
9	One institutional respondent sought clarification on whether all INEDs are expected to sit on board committees.	While not a requirement, given the check-and-balance function of INEDs, they would generally be expected to be involved in board committees as either member or chair.
11	One institutional respondent suggested that non-listed AIs should not have to establish a separate committee to advise on connected lending, given the extensive controls already in place.	Given the role of AIs in the financial system, the specific risks of connected transactions in banking and the complexity of the statutory and regulatory requirements on connected lending, board oversight is necessary. However, paragraph 3.1.3 of the HKMA’s SPM CR-G-9 already requires that “Exposures to connected parties should be reviewed and approved by the Board (or the Credit Committee or any other committee with authority delegated from the Board)”. In view of this, we agree that the Listing Rules requirement need not be extended to non-listed AIs.
16	Some respondents suggested guidance or a limit on the number of boards that an INED should serve on.	Whether an INED can devote sufficient time to the role is determined by a range of factors, including whether they have a full-time role and whether they sit on other boards. We do not propose to set a numerical limit on the number of boards an INED may sit on. When considering appointment or retention of an INED, the AI should take into account the

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		person’s professional and other commitments and ensure that he or she is able to commit sufficient time to the INED role.
	III – Independence and tenure	
19	One institutional respondent commented that, while the factors listed under paragraph 19 were relevant, they might not be comprehensive and some general guidance on independence should be included.	Agreed. The factors listed are not meant to be exhaustive. It would be difficult to cover all possible factors for consideration and AIs will continue to have to exercise judgement. This will be made clear in the guidance.
19	One institutional respondent suggested that the criteria for assessing independence should be aligned with section 3.13 of the Listing Rules.	We have taken reference to relevant sections in the Listing Rules and do not consider that there is any conflict between the Listing Rules and the criteria set out in the CP. Where the guidance imposes a higher standard, this is to reflect the important role of AIs in the financial system and wider community.
19(b),(e),(i),(j)	One institutional respondent expressed the view that the “cooling off periods” with regard to INED candidates who have been employees of the AI or any of its related companies, or who have immediate family members who have been such an employee, and for employees, partners or principals of professional service providers,	Paragraph 19 of the CP lists factors to be taken into consideration in determining the independence of INEDs rather than hard and fast rules. AIs considering the appointment or retention of an INED should determine whether the person falls into any of these categories and, if they do, give careful consideration to whether that person

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19(d),(g)	<p>were not adequate to guard against potential conflicts of interests. The same respondent felt that the approach to potential conflicts arising from cross directorships and material business relationships was too soft.</p>	<p>may be subject to conflicts of interest that would give rise to doubts about their independence. Such consideration will have to be undertaken case by case.</p> <p>For former employees, we note that “cooling off periods” are common in many jurisdictions. The proposed three-year period is in line with these.</p> <p>For potential INEDs with immediate family members who are or have been employed by the AI or one of its related companies, we believe it would be unreasonable to deny appointment to such a person automatically. The AI should take into account the role of the person’s relative at the AI or related company and whether any conflict arises. Generally speaking, the more senior the role filled by the relative, the greater the likelihood of conflict that the AI concerned should take into account.</p> <p>Regarding former employees, directors, principals and partners of professional service providers, we note the concern but believe that a balance has to be struck. Professional service providers in the legal, accounting, audit and other fields clearly have skills that are highly relevant to</p>

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		<p>the governance of AIs and the INED role. While there is a potential for conflicts of interest where an individual has been engaged in providing services to the AI or related companies, it is common in Hong Kong, and elsewhere, for banks to use the services of multiple professional firms so that it would be impractical to exclude such persons from serving as INEDs with AIs and doing so would greatly restrict the availability of highly qualified individuals. We believe the restriction periods proposed strike an appropriate balance. That said, we will include language in the guidance to the effect that an INED's suitability should be kept under review and reconsidered if information comes to light after appointment relating to professional services provided by the firm in question when the individual was associated with it and which might call his or her independence into question.</p> <p>Regarding potential conflicts arising from material business relationships, we will strengthen the guidance to the effect that persons who have material business relationships with the AI or its related companies should not normally be considered independent.</p>

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	<p>Two institutional respondents raised concerns about the appointment of former government officials, including former regulators, as INEDs.</p>	<p>We recognise that, while many former officials have skills and knowledge that are relevant to good corporate governance, there is also potential for conflict of interest. However, government officials in Hong Kong are generally subject to sanitisation requirements, whereby they must obtain approval from the Civil Service Bureau or their former departments for any paid employment in Hong Kong within a set period. Similar requirements are also common overseas. We will include guidance requiring AIs to consider whether the individual's former government service may give rise to any conflict and ensure that any sanitisation requirements have been met or necessary approvals obtained.</p>
19(h) & 29	<p>Several respondents questioned whether the fact that an INED has served on a board for 9 years should be a factor in assessing independence, with some mentioning it should make no difference. One institutional respondent supported the proposal and suggested that the nomination committee should be required to make a declaration to the HKMA specifying the basis on which the director is still considered independent. One individual respondent suggested a shorter period of 6 years.</p>	<p>The proposal in paragraph 29 of the CP is not that an INED who has served 9 years or more should automatically cease to count as independent. Rather, where this is the case, the nomination committee should assess whether he or she can still be considered independent and make a specific recommendation to the board with reasons. The aim is to guard against a situation where an INED has served so long on the board of a particular AI that independence, the ability to stand back and provide objective advice, may be compromised. As mentioned in the CP, this is in line with</p>

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		<p>requirements in the Listing Rules. There are also similar requirements internationally. It should be noted that the issue here is independence and not competence. Even if a director has served a long period with the same AI, and may no longer be considered independent, one possibility would be for the person to be reappointed as a non-executive director, with someone new being brought into the independent role.</p>
	IV – Remuneration of INEDs	
23	<p>One institutional respondent commented that remuneration in the form of share options should be allowed for INEDs.</p>	<p>The intention of this recommendation is that INEDs’ independence should not be compromised by the structure of their remuneration. Performance-based remuneration, including share options, may make INEDs more inclined to favour risk-taking by the AI and potentially less able to take an objective view of the AI’s risk appetite.</p>
25	<p>Two institutional and two individual respondents expressed reservations over prescribing a minimum level of remuneration on the grounds that this should be a matter for negotiation or set by the market. One institutional respondent suggested that a range could be</p>	<p>We agree that remuneration should generally be set by market forces. However, we believe it is essential that INEDs are appropriately remunerated for the skills and expertise they bring to the role, the time and effort they commit and the liabilities that they bear. While many serving INEDs</p>

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	<p>set to take account of different types and sizes of AIs and another expressed concern that the \$400,000 figure could operate as both a floor and a cap. Other respondents supported the proposal and one institutional respondent commented that “Hong Kong has suffered from market failure, characterised by a race to the bottom in some segments of the market, related to directors.”</p>	<p>undoubtedly see the role as a form of public service, the banking sector should not over-rely on this motivation. Appropriate remuneration is also an important factor in ensuring an adequate supply of suitably qualified people in the future. We have reviewed the practices of banks and listed companies in Hong Kong and of public companies in other jurisdictions. While the information available publicly is not complete and not always directly comparable, taken together it suggests that the Hong Kong banking sector lags behind in this regard, in some cases by a wide margin. We therefore believe that the \$400,000 threshold proposed in the CP as a minimum for basic INED services is appropriate. We do not propose to set a range because many international banks set INED remuneration based on group policies.</p>
	<p>V – Board practices in relation to INEDs</p>	
<p>26</p>	<p>One institutional respondent suggested that insurance for INEDs should be reviewed at least annually to ensure coverage matches the changing scale and type of the AI’s business and associated risks.</p>	<p>Agree it is good practice for insurance cover to be reviewed regularly and will incorporate this into the guidance.</p>

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31	One institutional respondent felt that advice on the language used in board papers may be seen as impinging too far on the detailed operational arrangements of AIs.	It is not the intention to be too prescriptive. However, feedback from serving INEDs suggests that overly technical language in board papers can make them difficult to understand and for the INEDs to fulfil their role.
36	Two institutional respondents suggested that, where the chair of the board is not an INED, a senior INED should convene and chair meetings of INEDs.	Agree this is good practice and will incorporate this into the guidance.
37	One institutional respondent sought clarification of whether representation of INEDs on the audit and risk committees could satisfy the requirement for separate meetings with the internal audit and risk management functions.	Membership of the audit and risk committees should not be seen as a substitute for separate meetings with the internal audit and risk management functions. While the audit and risk management committees should comprise a majority of INEDs, including the chair, they may also contain executives. We consider that it is good practice for the INEDs to meet these functions without the presence of executives and other representatives of the AI.
38	One institutional respondent suggested that principles should be established that INEDs may, under certain circumstances, have a duty to raise matters with regulators other than the HKMA or ensure that they are raised.	The HKMA is the primary regulator for the banking industry and cooperates closely with other domestic financial regulators under MOUs. Where any matters affecting another regulator are brought to the attention of the HKMA, the HKMA will inform that regulator as appropriate.

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39	<p>One institutional respondent commented that the frequency of performance evaluations of the board should be set by the AI according to its specific needs rather than being required annually. One individual respondent was opposed to evaluations of the performance of individual directors, commenting that it was difficult for such evaluations to be conducted fairly and objectively.</p>	<p>We recognise that performance evaluations of boards and individual directors can be difficult to conduct and may be time-consuming. However, given the pivotal role of the board, we believe that such reviews are essential and that the optimum interval is at least annually. The board should take stock at least once a year of whether it and individual directors are fulfilling their roles adequately. Such review need not be very elaborate on every occasion. One way to strike a balance would be for more comprehensive reviews, perhaps involving an external facilitator, to be conducted at intervals of, for example, three years, and shorter, less comprehensive reviews in the intervening years. As mentioned in the CP, reviews by individual directors of each other and the board, may be particularly useful.</p>
	<p>VI – Training and development requirements for INEDs</p>	
42, 46	<p>One institutional respondent felt that the list of training topics was too prescriptive and that AIs should have flexibility to design their own training rather than there being a requirement for accredited training.</p>	<p>The topics in paragraph 42 of the CP are intended as a minimum. Although we recognise that some INEDs with specific expertise might not require training in certain areas (in some cases they could be asked to give such training), all INEDs are likely to require training on areas specific to the AI, such as its operations and business and the risks it is</p>

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		<p>exposed to, and to keep abreast of regulatory and other developments. We recognise that many AIs already provide high-quality training for INEDs and support the continuation of this. Paragraph 46 of the CP recommends that the MA may consider an accreditation mechanism for training in the longer term. Such training, if introduced, should not replace in-house training by AIs but is likely to be a resource for smaller AIs that do not have sophisticated in-house programmes and for persons, who wish to become qualified as INEDs, but are not yet serving on the board of an AI.</p>
	Consultation questions	
Q3	<p>One institutional respondent suggested that the HKMA should cooperate with the HKIoD and HKICS to establish a pool of qualified INEDs.</p>	<p>AIs may consider pools maintained by the HKIoD and HKICS (and possibly other bodies) as a source of INEDs. However, we do not think such pools should be the only route to appointment as an INED in the banking sector, which could have the effect of restricting the pool of available candidates.</p>
Q5	<p>Most respondents favoured an implementation period of about 1 year.</p>	<p>We will adopt one year for AIs in general, but individual AIs that experience difficulty in implementing certain requirements on time may discuss with the HKMA possible ways to deal with the special circumstances.</p>

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	Other recommendations	
	One institutional respondent recommended a pathway towards introducing “majority INED” as a recommended practice.	We believe that the current three-or-one third standard is appropriate for the time being. AIs can, and some do, appoint more INEDs.
	One institutional respondent suggested non-executive chairs or lead directors, according to AIs’ circumstances.	The consultation on proposed changes to SPM CG-1 issued on 30 August 2016 proposes that the Chair of the board should be an NED or INED.
	One institutional respondent suggested that requirements similar to those of HKEx’s corporate governance code that the division of responsibilities between the chair and CE should be clearly established and set out in writing should also apply to unlisted banks.	SPM CG-1 already gives guidance on the role of the Chair.