

Systems of Control for the Appointment of Managers

The Banking (Amendment) Ordinance 2001 (BAO 2001) was enacted on 19 December 2001. A major part of the BAO 2001 relates to legislative amendments in relation to the managers of authorized institutions (AIs). These include a revised definition of “manager”, a new authorization criterion requiring AIs to maintain adequate systems of control to ensure the fitness and propriety of their managers and new notification requirements for such appointments. Ancillary to these amendments, the HKMA has prepared a statutory guideline to: (i) set out some key principles that AIs should follow to identify the positions that are captured under the revised definition of “manager”; and (ii) specify the systems of control that AIs should have for ensuring the fitness and propriety of individuals appointed as managers. The guideline has undergone industry consultation and will be issued upon the commencement of the BAO 2001 later in the year. On-line access to the guideline is available under the icon of “Supervisory Policy Manual” in the HKMA’s public website (www.hkma.gov.hk).

In order to prepare for the implementation of the revised regime, AIs should, among other things, review their existing management structure and identify all individuals who fall within the revised definition of “manager”. This memo explains the revised definition and illustrates its application by use of some simplified, hypothetical examples. AIs should consult the HKMA or their legal advisers in case of questions about how the revised definition should apply to their organisation.

Revised definition of “manager”

Under the old definition of “manager”, any person employed by the AI who exercises managerial functions under the immediate authority of a director or the chief executive (including an alternate chief executive) is regarded as a manager. Since this definition is based on the reporting hierarchy of an AI, persons who are not responsible for managing functions that have a significant impact on the AI’s safety and soundness (e.g. public relations, human resources, training, etc.) may also be captured. On the other hand, because of the different ways in which AIs organise

themselves (e.g. some have more layers of reporting than others), certain persons in charge of key functions may not be captured.

To overcome these drawbacks, the new definition of “manager”, in relation to a locally incorporated AI, captures any individual (other than a director, the chief executive or an alternate chief executive) appointed by the AI, or by a person acting for or on behalf of or by arrangement with the AI, to be principally responsible, either alone or with others, for the conduct of any one or more of its affairs or business specified in the Fourteenth Schedule to the Banking Ordinance. A similar

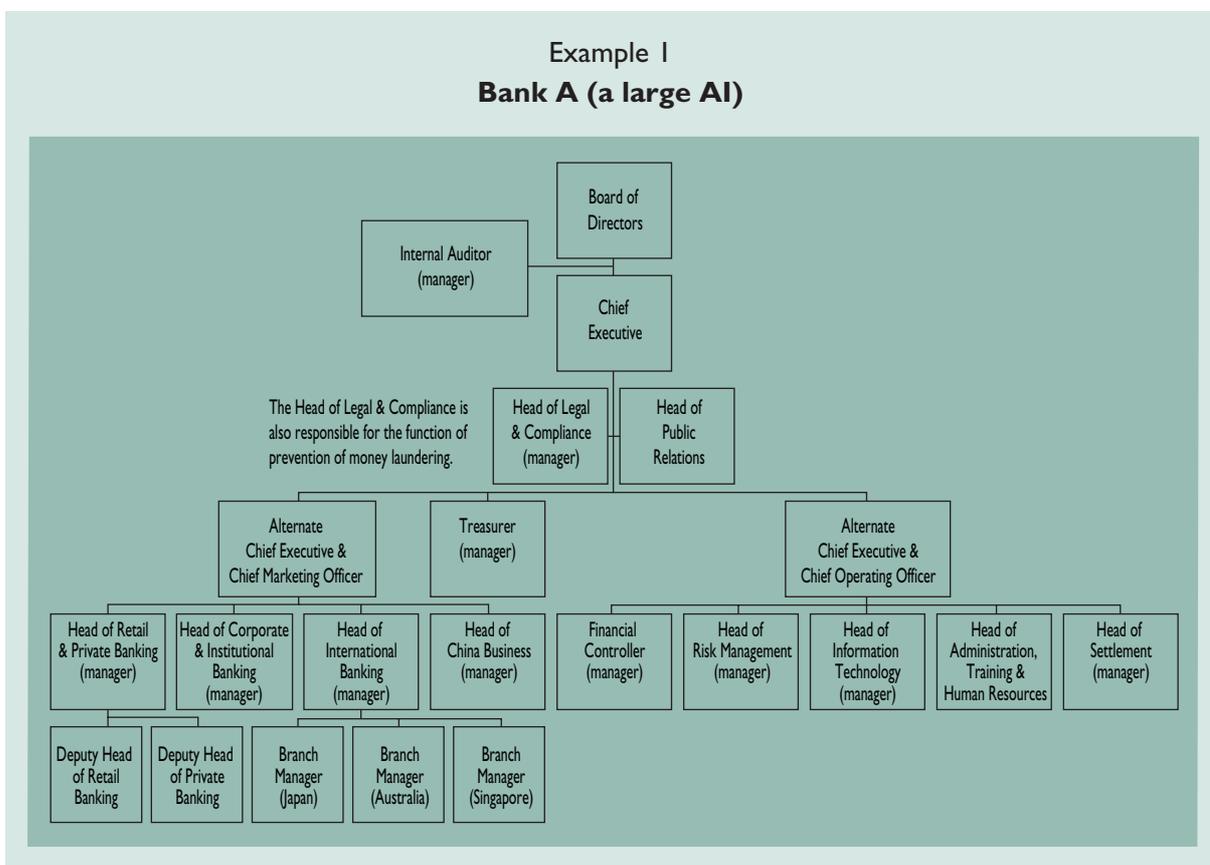
definition applies to overseas incorporated AIs in respect of the conduct of their relevant affairs or business in Hong Kong. By relating the definition of “manager” to a person’s functional responsibilities, rather than to their reporting line, it enables individuals to be captured on the basis of their significance to the business of the AI concerned.

The business or affairs specified in the Fourteenth Schedule for the purposes of the definition of “manager” are:

- the carrying on of retail banking, private banking, corporate banking, international banking, institutional banking, treasury or any other business which is material to the AI (business function);
- the maintenance of the accounts or the accounting systems of an AI (accounting function);

- the maintenance of systems of control of an AI, including those systems intended to manage the risks of the AI (risk management and control function);
- the maintenance of systems of control of an AI to protect it against involvement in money laundering (prevention of money laundering function);
- the development, operation and maintenance of computer systems for an AI (information technology function);
- the conduct of internal audits or inspections of the AI’s affairs or business (internal audit function); and
- the function of ensuring that an AI complies with laws, regulations or guidelines that are applicable to it (compliance function).

Application of definition



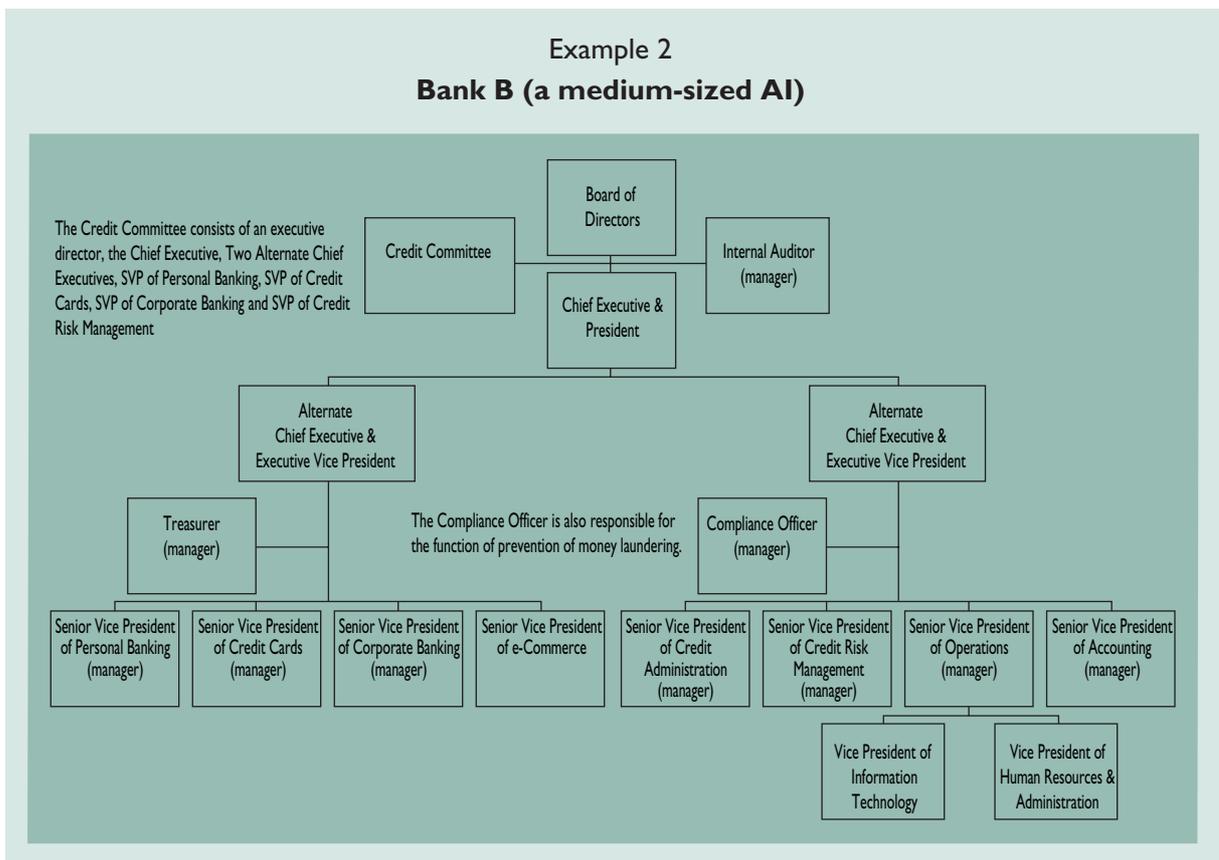
The managers of Bank A in this example would be:

Title of position	Affairs or business specified in the Fourteenth Schedule
Internal Auditor Head of Legal & Compliance	<ul style="list-style-type: none"> • Internal audit function • Compliance function
Treasurer Head of Retail & Private Banking	<ul style="list-style-type: none"> • Prevention of money laundering function • Business function – treasury • Business function – retail banking and private banking
Head of Corporate & Institutional Banking	<ul style="list-style-type: none"> • Business function – corporate banking and institutional banking
Head of International Banking	<ul style="list-style-type: none"> • Business function – international banking
Head of China Business	<ul style="list-style-type: none"> • Business function – international banking
Financial Controller	<ul style="list-style-type: none"> • Accounting function
Head of Risk Management	<ul style="list-style-type: none"> • Risk management and control function
Head of Information Technology	<ul style="list-style-type: none"> • Information technology function
Head of Settlement	<ul style="list-style-type: none"> • Risk management and control function

Points to be considered:

1. The directors, the Chief Executive and the two Alternate Chief Executives of Bank A do not fall within the new definition of “manager”. Neither do the Head of Public Relations and the Head of Administration, Training & Human Resources, who are not in charge of any affair or business specified in the Fourteenth Schedule.
 - iii) authority to make decisions (e.g. assume business risks within pre-set limits) for that business or activity;
 - iv) authority to allocate resources or incur expenditures in connection with the particular department, division or functional unit carrying on the business or activity;
 - v) authority to represent the particular department, division or functional unit within the bank (e.g. in senior management meetings) or in meetings with outside parties.
2. Whether an individual is a manager under the Banking Ordinance will depend on the facts of each case. In particular, he should be principally responsible, either alone or with others, for the conduct of any business or activity specified in the Fourteenth Schedule. In determining this, Bank A should consider whether the individual possesses the following attributes in relation to a particular business or activity:
 - i) accountability for the achievement of business objectives or targets set by the Board of Directors or the Chief Executive;
 - ii) occupying a position within the bank which is of sufficient authority as to enable the individual to exert a significant influence on the conduct of the business or activity in question;
3. The responsibilities of a manager may straddle more than one of the affairs or business specified in the Fourteenth Schedule. In this example, the Head of Retail & Private Banking and the Head of Corporate & Institutional Banking may be regarded as managers responsible for more than one specified function. As the Head of Legal & Compliance also acts as the Compliance Officer for

- prevention of money laundering, he is therefore a manager responsible for the compliance function as well as the prevention of money laundering function.
4. There may also be more than one manager principally responsible for each of the affairs or business specified in the Fourteenth Schedule. In this example, the overall business of “international banking” is divided between two units - international banking and China business. It is therefore necessary for the head of each unit to be appointed as a manager.
 5. In general, the intention is to capture the layer of management immediately below the level of Chief Executive and Alternate Chief Executive, e.g. the Head of Retail & Private Banking, the Head of Corporate & Institutional Banking and the Financial Controller. It may, however, be necessary to go down to a further layer of management within the organisation in some cases. For example, if each of the two deputies is given sufficient responsibility and authority to manage the retail banking and private banking activities respectively, they should also be regarded as managers in addition to the Head of Retail & Private Banking.



The managers of Bank B in this example would be:

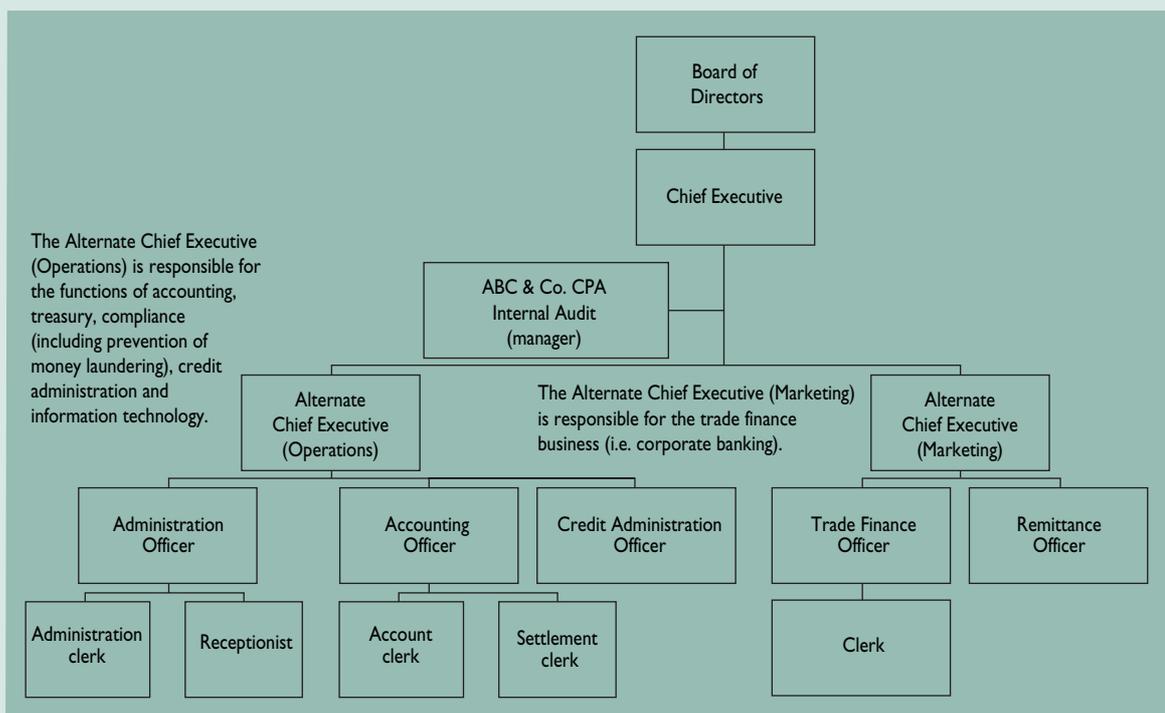
Title of position	Affairs or business specified in the Fourteenth Schedule
Internal Auditor Treasurer Compliance Officer Senior Vice President (SVP) of Personal Banking SVP of Credit Cards SVP of Corporate Banking SVP of Credit Administration SVP of Credit Risk Management SVP of Operations SVP of Accounting	<ul style="list-style-type: none"> • Internal audit function • Business function – treasury • Compliance function • Prevention of money laundering function • Business function – retail banking • Business function – retail banking • Business function – corporate banking • Risk management and control function • Risk management and control function • Information technology function • Accounting function

Points to be considered:

1. For the purposes of identifying the managers, Bank B should consider the nature of the underlying activity or function rather than what it is necessarily called. Taking into account the business nature of the personal banking and credit cards units, both should be regarded as “retail banking”.
2. Under the management structure of Bank B, the Credit Committee is responsible for laying down credit policies and manuals, approving large credits and monitoring the credit risk of the loan portfolio through the review of management reports. In determining whether the members of the Committee (other than the executive director, the Chief Executive and the two Alternative Chief Executives) should jointly be appointed as managers for the risk management and control function, Bank B should first decide whether they are principally responsible for the maintenance of systems for credit risk management within the bank. In this regard, Bank B should take into account the nature of responsibilities and authority of the Committee as well as the frequency of meetings held. In this example, the Credit Committee does not play an active role in the oversight of credit risk management systems, has no regular meeting schedule and only meets infrequently to approve large credits or credit policies. It is thus more appropriate for the bank to appoint the SVP of Credit Risk Management, who is the person principally responsible for managing the bank’s credit risk on a day-to-day basis, as the manager of this function. It is noted, however, that the other three SVPs in the Committee are already managers of other functions.
3. If, however, it is considered that the Credit Committee is principally responsible for managing the credit risk of the bank, Bank B should review the role of each committee member to distinguish between those who have power (i.e. voting right) to influence the decisions of the Committee and those who merely perform an advisory role. Only the former type of members should be appointed as managers responsible for the risk management and control function.
4. As Bank B mainly focuses on domestic retail and corporate banking activities, no manager needs to be appointed for other business activities such as private banking, international banking and institutional banking.

5. Bank B should also assess whether there is any business (e.g. e-Commerce) which is material to it but is not specifically defined in the Fourteenth Schedule. Materiality to an AI can be in terms of the size of business, the profits that it contributes, the risks that it incurs or the resources that it commands. There is no standard measure of materiality as it varies among AIs. AIs may, however, have regard to the following indicators when comparing the relative significance of each type of business:
- i) the proportion of the AI's total operating income (net of interest expense) or net profit before taxation contributed by the business;
 - ii) the value of assets accounted for by the business in relation to the AI's total assets or capital base; and
 - iii) the operating costs (including staff expenditure) attributable to the business in relation to the AI's total operating costs.

Example 3
Bank C (a small AI)

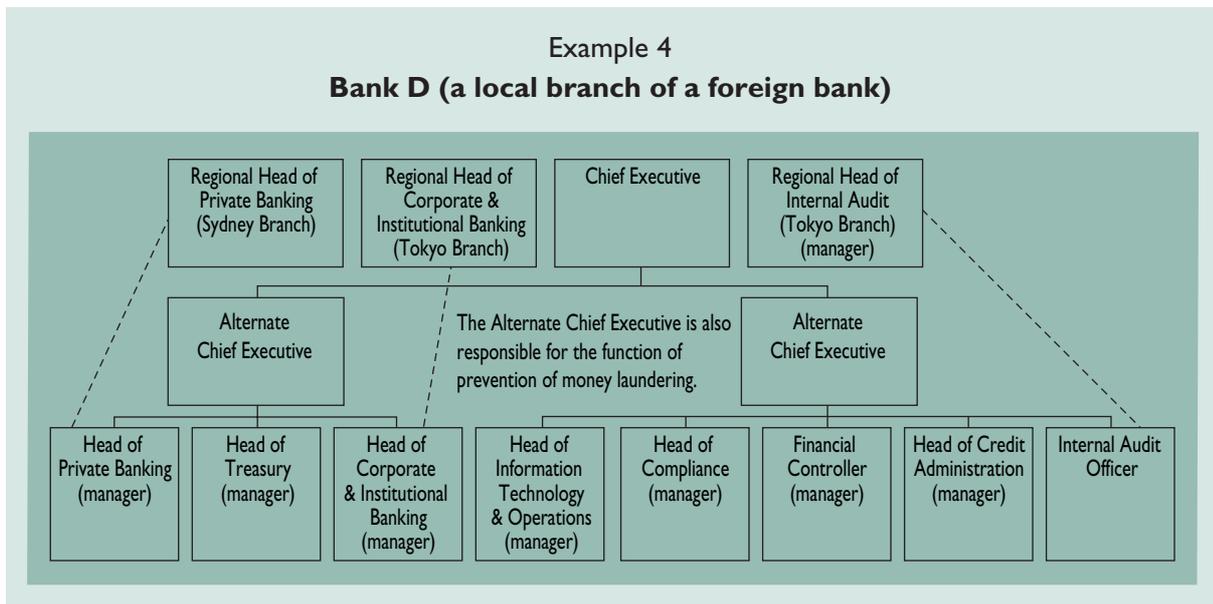


The managers of Bank C in this example would be:

Title of position	Affairs or business specified in the Fourteenth Schedule
Engagement partner of ABC & Co Certified Public Accountants	<ul style="list-style-type: none"> • Internal audit function

Points to be considered:

1. Bank C is a small AI engaging only in trade finance business (i.e. corporate banking). Therefore, no manager needs to be appointed for other business activities specified in the Fourteenth Schedule.
2. Due to the small scale of operation, the two Alternate Chief Executives are principally responsible for most of the functions or activities specified in the Fourteenth Schedule. As they do not fall within the revised definition of “manager”, there is no need to appoint them as managers for such functions and activities.
3. In some cases, an AI may appoint an independent third party to be principally responsible for the conduct of a particular affair or business specified in the Fourteenth Schedule (e.g. compliance, internal audit or data processing). Since Bank C has outsourced its entire internal audit function to ABC & Co Certified Public Accountants, the individual(s) who are responsible for this function in ABC & Co should be appointed as the manager(s) of that function. The picture will, however, change if Bank C has employed a senior executive having overall responsibility for the internal audit function, including the formulation of the annual audit programme, review of the audit procedures (e.g. sample size) and evaluation of the audit work done by ABC & Co. That senior executive should be appointed as the manager of the internal audit function instead.



The managers of Bank D in this example would be:

Title of position	Affairs or business specified in the Fourteenth Schedule
Regional Head of Internal Audit Head of Private Banking Head of Treasury Head of Corporate & Institutional Banking Head of Information Technology & Operations Head of Compliance Financial Controller Head of Credit Administration	<ul style="list-style-type: none"> • Internal audit function • Business function – private banking • Business function – treasury • Business function – corporate banking and institutional banking • Information technology function • Compliance function • Accounting function • Risk management and control function

Points to be considered:

1. Under the management structure of Bank D, the Head of Private Banking, the Head of Corporate & Institutional Banking and the Internal Audit Officer report not only to the Chief Executive of the local branch but also to the respective Regional Head in Tokyo or Sydney. For the purpose of determining the managers of these functions, Bank D should take into account the attributes set out in Example I. As the Internal Audit Officer is only responsible for conducting internal audits but the management role for the internal audit function in Hong Kong is assumed by
2. On the other hand, the Head of Private Banking and the Head of Corporate and Institutional Banking may be regarded as managers of the Hong Kong branch provided that they have been delegated with sufficient responsibility and authority to manage such businesses in Hong Kong. 

- Prepared by the Banking Policy Department