Information Paper for Bills Committee on
Banking (Amendment) Bill 2001

Introduction

At the second meeting of the Bills Committee, the Administration was requested –

(a) to explain the difference between the current proposal and the prevailing mechanism in ensuring the fitness and properness of managers and the liability of the chief executives and directors of authorized institutions (AIs) in the event of frauds committed by their managers;

(b) to provide the different options which the Administration had considered in ensuring the fitness and properness of managers of AIs;

(c) to advise the basis upon which the decision to withdraw the approval requirement for appointment of managers was arrived at; and

(d) to explain in detail the monitoring and penalty mechanisms on advertisements for deposits issued through new technological means, in particular, the internet, and similar regulatory frameworks in overseas countries, including the United Kingdom and the United States.

2. The following paragraphs set out the Administration's response.

Strengthening control over appointment of managers

3. The Hong Kong Monetary Authority (HKMA) conducted a review in 2000 on the level of corporate governance in the banking industry. Among other things, the review highlighted that in today's sophisticated banking environment, it is not just the directors and the chief executive but also other senior executives of an AI, who can exercise significant influence on the conduct and well-being of the AI. However, there is no provision in the Banking Ordinance which provides that only fit and proper persons are allowed to take up these senior executive positions in an AI, nor is there a requirement for an AI to notify the HKMA of the appointment of its senior executives. The current definition of the term "manager" in the Banking Ordinance is also outdated and does not effectively cover those senior executives whose functions are central to the safety and soundness of an AI.

4. To address these shortcomings of the current regime, the current proposals in the Banking Amendment Bill 2001 aim to bring about the following changes –

(a) to update the definition of "manager" to achieve a more effective coverage of persons under the regulatory framework;

(b) to strengthen the ability of the regulator to know who comprises the senior management of an AI; and

(c) to give greater assurance about the fitness and properness of managers.

A new definition

5. At present, the term "manager" is defined in the Ordinance to include the chief executive of an AI and any other person employed by the AI who, under the immediate authority of a director or the chief executive, exercises managerial functions or is responsible for maintaining accounts and other records of the AI. Given the rapid developments in the banking industry, AIs have adopted various organisation structures to facilitate business development, including matrix management. An earlier survey conducted by the HKMA showed that the existing definition of manager based on "reporting line" is no longer effective. The term may not be able to capture persons who exercise important managerial functions. On the other hand, it can bring in persons whose functions are not central to the safety and soundness of AIs (e.g. persons in charge of general administration and public relations etc). A further consequence is that the scope of the term "manager" varies across different AIs depending on the way in which they have structured themselves, i.e. persons doing the same type of job may be a "manager" in an AI, but not in another.

6. There is therefore a need to update the definition of manager in the Ordinance. In this regard, the Bill proposes to re-define "manager" as an individual who is appointed to be principally responsible for the conduct of the key businesses or affairs specified in a new Fourteenth Schedule. The revised definition would ensure that only those senior executives who are in charge of key businesses or affairs, such as retail banking, corporate banking, internal audit, risk management, compliance and information technology etc, will be caught as "managers".

A new notification requirement

7. Apart from updating the definition of manager, it is also important that the HKMA knows the identity of those persons who are, or are to be, a manager of an AI. As mentioned above, the HKMA does not necessarily know who are occupying the key managerial positions within an AI and whether there have been any changes in the responsibilities of such individuals. In light of this, the Bill proposes to introduce a requirement on AIs to notify the HKMA of the appointment of managers,

termination of existing appointments and any changes in the responsibilities of existing managers.

Ensuring the fitness and properness of managers

8. Finally on the objective of ensuring the fitness and properness of managers of AIs, the HKMA had considered three different options to achieve this.

9. The **first option**, which was the initial proposal of the HKMA, would be to introduce an approval requirement for appointment of managers. This would enable the HKMA to carry out a formal assessment of the fitness and properness of the individuals seeking to become a manager. However, significant concerns were raised about this proposal during the consultation[1] with the banking industry and the Financial Affairs Panel of LegCo. In particular, the Hong Kong Association of Banks (HKAB) considered that the proposed power was too intrusive, and might impinge upon the autonomy and responsibility of the board of directors and the Chief Executive of an AI in the appointment of senior staff. Members of the LegCo Financial Affairs Panel also questioned the need to introduce an approval requirement for appointment of managers and expressed concern about over-regulation in this respect.

10. In the light of these comments, the HKMA has considered whether there are other options which might achieve the stated policy objective and address the respondents' concerns at the same time. One option (i.e. the **second option**) that had been considered is to give the HKMA a power to object to the appointment of an existing manager after the event. This would save AIs the trouble of seeking the HKMA's prior approval of a manager, but enable the HKMA to remove a manager if it is not satisfied that the manager appointed by the AI is fit and proper to do his job. While this negative vetting approach should also be effective in ensuring the fitness and properness of managers, it might not address the industry's concerns about over – regulation. With a power to object, the HKMA will in effect have to vet each and every appointment made by AIs and object to certain appointments if it is not satisfied that the individuals concerned are fit and proper to discharge their responsibilities. Arguably this would even be a more intrusive or disruptive arrangement because the AI concerned would be required to remove the manager from his position after the formal contract of employment has been entered into between the AI and the individual concerned. For the above reasons, this option was not considered desirable by the HKMA and was not pursued further.

11. The **third option**, which is the current proposal in the Bill, is to make it an authorization criterion for AIs to maintain adequate systems of control to ensure the fitness and properness of their managers. Under this proposal, the onus of ensuring the fitness and properness of managers would clearly reside with directors and the chief executive of AIs. The regulator's role would be to verify that AIs have

[1] This consultation was undertaken before the relevant Bill was drafted.

in place systems of control to ensure managers' fitness and properness and that these systems operate effectively. After the enactment of the Bill, the HKMA would issue a guideline to set out the key elements that AIs' systems of control for recruitment of senior executives should comprise, including details of what constitutes "fit and proper" in the context of managerial positions. This guideline has already been agreed with the industry. The HKMA will also carry out regular examinations to verify AIs' compliance with the new authorization criterion.

12. The HKMA considers that the directors and chief executive of an AI are already responsible for ensuring the fitness and properness of managers[2]. However, the advantage of inserting a separate provision in the authorization criteria is that it highlights and makes explicit this responsibility. Coupled with the detailed guideline to be issued by the HKMA, this emphasises the importance of ensuring that members of the senior management team are fit for their jobs and should help to make the directors and chief executives of AIs more vigilant in this respect. This is consistent with other parts of the Ordinance which highlight specific aspects of the general requirement on AIs to behave prudently.

13. If a manager of an AI is found to be not fit and proper for his position, and if this is felt to be the result of ineffective systems for the selection of managers, this would call into question whether the AI continues to satisfy the authorization criterion. The powers of the Monetary Authority to revoke the authorization of the AI would then become exercisable. Revocation of authorization would be a drastic step, and the MA would normally consider whether remedial action by the AI concerned would be a viable alternative. Such remedial action might include removal by the AI of a manager whose conduct threatened the safety and soundness of an AI and/or was prejudicial to the interests of depositors. If necessary, the powers of the Monetary Authority to issue directions under section 52(1)(A) could be used to enforce the removal of such a manager.

14. As regards the liability of the directors and chief executive if they appoint a manager who commits serious misconduct such as fraud, this would depend on the circumstances of each case. If the appointment of an unfit manager has resulted from a serious failure of the relevant control systems within an AI or from disregard of the guideline issued by the Monetary Authority or otherwise indicates a serious lack of judgement by the directors and/or chief executive, this would raise doubts as to whether they themselves were fit and proper. In this case, the Monetary Authority might decide to withdraw his approval of one or more of the individuals concerned – in which case, they would have to be removed from their positions. Equally, it is possible to imagine circumstances where a manager commits misconduct which is entirely out of character of the individual concerned and could not reasonably

---

[2] There is already an authorization criterion in the Seventh Schedule of the Ordinance that effectively requires the business of an AI to be carried on with "integrity, prudence and the appropriate degree of professional competence".

have been predicted. In this case, if all the proper appointment procedures had been adopted, it would be difficult to attribute blame to the directors and chief executive.

Internet advertisements for deposits

15. First of all, it should be clarified that the "target at" approach is already implicit in the existing provisions of the Ordinance (i.e. only those advertisements which contain an invitation to members of the public to make deposits are subject to the regulatory requirements under section 92[3]). The proposed amendments in the Bill only aim to make this policy intention clear by clarifying that the term "members of the public" means "members of the public in Hong Kong". So the Bill is not introducing a new requirement in this respect.

16. As mentioned in the Legislative Council Brief in relation to this Bill, this "target at" approach is adopted by a number of leading financial regulators worldwide (including the Financial Services Authority of the UK and the Securities Exchange Commission of the US and the SFC in Hong Kong) and is also endorsed by the International Organization of Securities Commission ("IOSCO").

17. At the request of Members, the HKMA has further checked on the practices of other bank regulators. The practices vary between countries. The US bank regulators advised us that there is no restriction on foreign banks advertising deposit services to US citizens. On the other hand, the Commission Bancaire (the French bank regulator) advised us that they have a similar policy to the UK, which would examine whether a foreign bank had the intention of targeting French customers in offering its services.

18. The Basel Committee on Banking Supervision is now exploring the practicality of developing a convergent approach to regulate online provision of cross-border banking services. In particular, the Basel Committee has suggested that considerations of targeting or organizational intentions be taken into account in determining whether e-banking services are being offered to a certain host country. Possible indicators[4] which might suggest "targeting" intentions include –

(a) the service provider's website is presented in the language and/or the currency of the host country;

(b) the provider's website can be accessed through portals or search engines located in the host country;

---

[3] Please note that section 92 does not prohibit foreign banks from advertising deposit services to Hong Kong, but requires that such advertisements targeting at Hong Kong must comply with certain disclosure requirements as set out in the Fifth Schedule to the Banking Ordinance in order to protect consumers in Hong Kong.

[4] Similar criteria have been adopted by the banking regulators in the UK and France.

(c) the provider's website uses a domain name of a type reserved to or identified with the host country;

(d) the provider's website has inserted banners with hyperlinks with sites in the host country; and

(e) the provider has used other means to advertise its services in the host country.

19. As mentioned at the last meeting of the Bills Committee, the HKMA intends to issue a guideline to provide guidance on the factors that would be taken into account in determining whether an advertisement is targeted at Hong Kong. The HKMA will take into account criteria suggested by the Basel Committee and other relevant supervisors in developing this guideline.

20. The HKMA recognises that there are difficulties in enforcing section 92 particularly in relation to advertisements hosted overseas and targeted at Hong Kong. As explained at the last meeting of the Bills Committee, the HKMA could seek assistance from the overseas supervisory authorities concerned to help enforce the provisions of section 92. The HKMA expects that in most cases, the overseas authorities would be willing to help as they would generally wish their institutions to respect the laws of other jurisdictions. In the event that the overseas authorities were not co-operative or the authorities were unable to assist for whatever reasons, the HKMA could consider issuing a press release to clarify that the relevant advertisement is not in compliance with section 92 and to remind members of the public to take extra caution in placing offshore deposits with such institutions. The HKMA could also take the refusal to cooperate into account in deciding whether to approve any application by such institutions for authorization in the future. The HKMA believes that the current work of the Basel Committee in fostering a greater international cooperation on this issue would be conducive to more effective enforcement of the relevant regulations by banking regulatory authorities.

Hong Kong Monetary Authority
October 2001

L:\BABs\Paper for Bills Committee (2 Nov).doc