NATIONAL RESERVE BANK OF TONGA

Prudential Statement No.9 *Revised 2014*

GOVERNANCE

Introduction

1. This statement is issued in terms of Section 15(3) of the Financial Institutions Act 2004 to establish a minimum guideline to promote sound corporate governance practices for LFIs in Tonga.
2. Corporate governance is defined as "a set of relationships between a company's management, its Board, its shareholders, and other stakeholders."[1]
3. Corporate governance for an LFI involves the manner in which the LFI's business and affairs is directed and oversight exercised by its Board and senior management. Corporate governance affects how the LFI:
   a. Sets corporate objectives;
   b. Determines its risk tolerance/appetite;
   c. Runs the daily operations of the business;
   d. Protects the interests of depositors;
   e. Is accountable to the shareholders;
   f. Takes into account the interests of other stakeholders; and
   g. Operates in a safe and sound manner, with integrity and in compliance with applicable laws and regulations
4. This policy applies to the Board and senior management of locally-incorporated LFIs. In the case of branches of foreign incorporated LFIs, this policy applies only in relation to its Tongan business.
5. The Board and senior management should establish strategic objectives, codes of conduct and ethical standards that will direct the ongoing activities of the LFI, taking into account the interests of all stakeholders.
6. LFIs should maintain an effective compliance function that routinely monitors compliance with rules, regulations and policies to which the LFI is subject and reports to the Board or Board Audit Committee.
7. **Minimum Requirements of Sound Corporate Governance**
   This Policy prescribes the following minimum corporate governance requirements for banks and credit institutions:
   a. (i.) Each LFI must establish and implement an in-house "Corporate Governance Policy", approved by the Board in the case of a locally incorporated institution or Senior Management in the case of a branch operation;
   b. (ii.) Clearly defined authorities and responsibilities for the Board of Directors for locally incorporated institutions;

[1] OECCD definition.

c. (iii.) Clearly defined authorities and responsibilities for the Senior Management for locally and foreign incorporated institutions;
d. (iv.) Appointment of the internal and external auditors of the institution.

Role of the Board

8. The Reserve Bank's approach to the prudential supervision of LFIs is predicated on the view that the prime responsibility for the prudent management of a LFI's business lies with the Board and management of the LFI. It is the responsibility of the Board and management to assess the risks in the activities that the LFI undertakes and continually monitor and control those risks. The Board and senior management are also responsible and accountable for promoting high ethical standards and ensuring that directors and managers are fit and proper as described in Prudential Statement Number 8.
9. The Board has ultimate responsibility for ensuring that an adequate and effective system of internal controls is established and maintained. The responsibilities of the Board include but are not limited to:
    a. Ensuring that the institution has policies covering all aspects of its operations and reviewing and approving liquidity, funding, capital and other risk management policies.
    b. Having a Board charter which defines the Board's purpose, powers, and key responsibilities as well as having charters for any other Board committees;
    c. Reviewing and approving the LFI's organisational structure, business objectives, strategies and plans;
    d. Ensuring that all procedures, processes, and policies are clearly communicated through all relevant levels of the LFI;
    e. Promoting the safety and soundness of the LFI, understanding the regulatory environment, and ensuring that the LFI maintains a close relationship with the Reserve Bank;
    f. Ensuring that the LFI has the necessary back-ups (e.g. contingency plans and succession plans and cross-training) for key personnel to ensure the institution continues operations unhampered;
    g. Undertaking the necessary due diligence in appointing their senior managers. The LFI must have adequate policies and practices for the selection, approval, renewal, and succession of senior managers;
    h. Providing oversight of senior management as part of the LFI's checks and balances by monitoring management's actions and setting performance standards
    i. Ensuring the LFI's compliance with the applicable laws, regulations and the Reserve Bank's guidelines;
    j. Ensuring the LFI's internal policies and contractual arrangements do not explicitly or implicitly restrict or discourage auditors and other parties from communicating with the Reserve Bank; and
    k. Ensuring that the LFI has adequate accounting, management information system and contingency plans consistent with the size and scope of its operations.
10. Amongst other measures the Board of a locally-incorporated LFI should, at a minimum, establish the following committees and the whole Board should have full and timely

access to all reports (and deliberations) of its committees. Each of these committees should have a charter.

a. An **Audit Committee** to oversee the financial reporting process and the work of internal and external auditors in relation to compliance with internal policies and regulatory requirements. The Committee is responsible for ensuring, amongst other things:

- the adequacy and independence of external and internal auditors;
- that internal and external audit plans cover all material risks and financial reporting requirements of the regulated institution;
- that senior management is taking necessary corrective action in a timely manner to address control weaknesses, noncompliance with policies, laws and regulations and other problems identified by auditors.

The Audit Committee should be headed by a non-executive director with relevant experience and non-executives should comprise a majority of members. To the extent there are executive directors on the Committee, auditors should have the ability to meet independently with the Committee Chair.

Where the branch of a foreign incorporated LFI is subject to regular audit by Head Office auditors, there is no need for the branch in Tonga to establish an audit committee. The Reserve Bank will need to be satisfied as to the adequacy of such arrangements and would expect to meet with representatives of Head Office when they visit Tonga to conduct risk reviews of the local operation.

b. A **Risk Management Committee** which has responsibility for directly supervising all aspects of risk management. This includes approving and overseeing the setting of delegation policies, standards and reporting mechanisms for credit risk, trading or market risk, balance sheet risk and operating risk as well as ensuring that remuneration policies do not provide incentives for imprudent risk taking. (Annex 1 of this Statement provides further information on these risks).

c. An **Asset and Liability Committee** (ALCO) responsible for coordinating the LFI's fund raising and lending strategies to meet profitability objectives as market conditions change. The ALCO also has responsibility for ensuring that the LFI implements and maintains a liquidity management policy that is appropriate for its operations and ensuring that it has sufficient liquidity to meet its obligations as they fall due.

11. In the case of LFIs which operate in Tonga as branches of foreign incorporated LFIs, copies of all reports and deliberations of these committees should be provided to the LFI's head/regional office for review.

12. Boards of locally-incorporated LFIs, including subsidiaries of foreign incorporated LFIs, should hold at least one regular meeting each calendar quarter. The boards of locally-incorporated de novo [2] LFIs should hold at least one regular meeting each calendar month unless otherwise advised by the NRBT. At each regular meeting the board should review and approve the minutes of the prior meeting, and review the overall business strategies, operations, activities and financial condition of the LFI. The board may designate a committee from among its members to perform these duties and approve or disapprove the committee's report at each regular meeting. Each action of

[2] A "de novo LFI" for purposes of this Prudential Statement includes any locally-incorporated LFI which has been in operation for five (5) years or less.

the board must be recorded in the minutes of the meeting. If necessary, directors may attend meetings by teleconference provided (i) a quorum of the required directors is present, including directors attending by teleconference, (ii) all directors can at all times hear the comments of others, (iii) copies of all documents intended to be discussed during the meeting are made available at least five (5) calendar days prior to the meeting. A face-to-face meeting of the Board should occur at least annually.

13. Directors of LFIs, including subsidiaries and branches for foreign incorporated LFIs, should avoid situations that could give rise to a conflict of interest or to perceptions of a conflict of interest. To this end, the Board should adopt a formal conflict of interest policy, which includes:

- A requirement that no director should simultaneously serve as a Board member, or in an executive capacity with any other financial institution or a subsidiary or affiliate of a LFI in Tonga;
- a member's duty to disclose any matter that may result, or has already resulted, in a conflict of interest;
- a member's responsibility to withdraw from any discussion or decision making process on the matters in which a conflict exists or might be perceived to exist;
- adequate procedures for transactions with related parties to be made on an arms-length basis; and
- the way in which the board will deal with any non-compliance with the policy.

14. The Board and management should notify the Reserve Bank of any concerns that they hold about the safety and soundness of the LFI. The corporate constitution and Board policies of the financial institution should not prevent directors or management from notifying the Reserve Bank at any time about concerns which they hold.

Role of Management

15. Senior management is responsible for directing and overseeing the effective management of the LFI's operations. Key responsibilities include:

a. Developing and implementing business objectives, strategies, plans, organisational structure and controls, and policies for Board approval;

b. Developing and implementing processes or systems that identify, assess, manage, or monitor risks in relation to business activities and operations;

c. Monitoring the achievement of Board-approved business objectives, strategies, plans and the effectiveness of organisational structure and controls;

d. Promoting the safety and soundness of the LFI, understanding the regulatory environment, and ensuring that the LFI maintains a close and open relationship with the Reserve Bank;

e. Ensuring the LFI's compliance with applicable laws, regulations, and the Reserve Bank's Prudential Statements;

f. Ensuring that the Board is kept well informed, including of correspondence with the Reserve Bank and breaches or potential breaches of the Reserve Bank's prudential requirements; and

g. Ensuring that the LFI's internal policies or contractual arrangements do not explicitly or implicitly restrict or discourage auditors or other parties from communicating with the Reserve Bank.

h. Ensuring that employees have the appropriate level of training and that the LFI has a training development framework.

Composition of the Board

16. Notwithstanding the requirements of the Companies Act 1995[3], the board of a locally-incorporated LFI must consist of not fewer than five (5) nor more than nine (9) directors. The size of the Board should be commensurate with the size, scope and nature of the LFIs operations to ensure that it operates in a sound and prudent manner. The Board of a locally-incorporated LFI should be composed of individuals with an appropriate range of skills and experience to understand its activities so that, as a whole, it is able to control and direct those activities effectively.

17. A major function of a LFIs Board is to bring a perspective that is independent of management to the business in which it engages. To this end the majority of directors should be non-executives of the LFI or any of its subsidiaries or affiliates. Moreover, non-executives should constitute the majority of directors present and voting at any Board meeting.

18. The chairman of a LFIs Board should be a non-executive director. For a foreign owned LFI, the Chairman may be an employee of the parent entity or an affiliate outside Tonga but should be available to consult with the Reserve Bank, if required.

19. The Reserve Bank accepts that for foreign owned LFIs non-executives could include executives of the parent bank or financial institution. At least two (2) directors, however, should be local and independent of the management of the locally-incorporated LFI, its parent and any subsidiary or affiliate. Foreign owned LFIs should consult with the Reserve Bank if they believe that they cannot meet this requirement. Independent directors should also be free of any business association that could materially interfere with their independent judgment, apart from directorship fees and any shareholdings in other LFIs, their subsidiaries and affiliates. Independent directors should have proportionate representation on board committees.

Risk Management Systems

20. It is the responsibility of a LFI's Board and management to ensure that the LFI meets prudential and statutory requirements and has management practices to limit risks to prudent levels. The risk management practices must be detailed in management systems descriptions which should be regularly reviewed and updated (at least annually) to take account of changing circumstances.

21. A LFI is required to provide the Reserve Bank with high level descriptions of its key risk management systems covering all major areas of risks and keep the Reserve Bank informed of all material changes to their risk management systems descriptions as they are made reflecting changing business conditions.

22. Within three (3) months of its annual balance sheet date, a LFI should provide the Reserve Bank with a "declaration" from the chief executive, endorsed by the board or in the case of a foreign LFI branch, by a senior officer from outside Tonga with responsibility for overseeing the Tongan operations.

23. The "declaration" should attest that, for the financial year past:

[3] Section 149 of the Companies Act 1995 requires that a company shall have at least one director.

a. The Board and management have identified the key risks facing the LFI;

b. The Board and management have established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits, and by adequate and timely reporting processes;

c. These risk management systems are operating effectively and are adequate having regard to the risks they are designed to control;

d. The risk management systems descriptions held by the Reserve Bank are accurate and current; and

e. The LFI in the financial year just completed has complied with the statutory and prudential requirements of the Money Laundering and Proceeds of Crime Act, banking licence conditions, Reserve Bank Prudential Statements and other prudential requirements.

24. If a LFI feels it needs to qualify the declaration prescribed in paragraph 22, it would need to explain the reasons for the qualifications, as well as provide plans for corrective action.

25. In addition, a LFI is required to submit to the Reserve Bank on an annual basis NRBT return FID 9 "Certification of Compliance with Financial Institutions Acts 2004 (the Act)".

Loans to, and dealings with, directors, employees and shareholders

26. Section 28 of the Act place limits on loans to directors, employees and shareholders exercising control over 10 per cent or more of the shares of the LFI. Section 30 of the Act requires that any loans, credit facility or guarantee extended to directors, employees and shareholders should be on substantially the same terms, including interest rates and security, as those offered to members of the public. Unsecured[4] advances to employees are not to exceed one year's salary.

27. In addition to the above LFIs should notify the Reserve Bank in writing within 15 (fifteen) calendar days of entering into a lease, rental, or sale/purchase agreement of any kind with their directors.

Training

28. The Board of each LFI must ensure that potential directors and Chief Executive Officer meet the fit and proper standards in Prudential Statement No. 8. In addition appointees should be provided with adequate initial and ongoing training which must include but is not limited to, a familiarisation programme on the LFI's business and risk profile, risk management, governance practices and internal controls.

Group relationships

29. Boards of LFIs should ensure that subsidiaries and affiliates operate in a safe and sound manner and are adequately capitalised for the risks that they undertake.

30. Boards are expected to establish policies on related party (i.e. subsidiaries, affiliates, directors, senior management, and their families) dealings, which include requirements that any such dealings be on commercial terms and conditions and be subject to prudent limits as well as statutory requirements.

31. Where a LFI distributes the financial products of other group members:

[4] "Unsecured" is defined in section 28(1)(a) of the Financial Institutions Act 2004.

- Any staff of the LFI involved must be appropriately qualified and trained to provide the services required;
- There must be no confusion created in customers’ minds about the respective roles of the LFI and the product provider and no impression given that the product is guaranteed or otherwise supported by the LFI unless there is a formal legal agreement in place to this effect with the approval of the Reserve Bank.
- The identity of the product provider must be prominently displayed in the relevant marketing material and product documentation; and
- The customer must make the purchase decision in his/her own right.

Compliance with Prudential Statement No. 9

32. This statement is effective from 1 May 2014. Non-compliance with the requirements of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga
April 2014

ANNEX 1

DEFINITION OF RISKS

- **Credit risk** is the potential financial loss resulting from the failure of customers to honour fully the terms of a loan or contract. The Reserve Bank has issued Prudential Statements on Asset Quality (Prudential Statement 1) and Credit Risk Grading Systems (Prudential Statement 2).

- **Balance sheet risk** is the potential risk to earnings and capital resulting from changes in interest rates, liquidity conditions, and the impact of exchange rate fluctuations on foreign currency capital positions.

- **Trading or market risk** is the potential risk to earnings resulting from changes in interest rates, currencies and equity and commodity prices.

- **Operating risk** is the potential inherent risk in day to day business operations. Risks include natural disaster, system failure, fraud and forgery.

The Reserve Bank may issue (or amend) Prudential Statements in relation to the management of these risks.