

## Consultation Paper on Proposed Direction on Corporate Governance

### A. Background

Effective Corporate Governance (CG) is critical to the proper functioning of the financial institutions. Governance weaknesses at financial institutions plays a significant role in the failure of financial institutions as evidenced globally during the Global Financial Crisis (GFC) and in Sri Lanka during recent failures of Licensed Finance Companies (LFCs). Primary objective of CG is to safeguard stakeholder’s interest and with respect to financial institutions shareholder interests are secondary to depositor’s interest.

### B. The Existing Directions on Corporate Governance

At present, there are 4 Directions relating to CG on LFCs.

Finance Companies (Corporate Governance) Direction No. 03 of 2008	Directions covers areas such as responsibilities of the board, board composition, meetings of the board, board appointed committees, related party transactions and disclosure requirements.
Finance Companies (Assessment of Fitness and Propriety of Directors and Officers Performing Executive Functions) Direction No. 03 of 2011	Criteria for assessment of fitness and propriety and procedure to be followed when assessing fitness and propriety.
Finance Companies (Corporate Governance-Amendment) Direction No. 06 of 2013	Several amendments were made to disclosure requirements in the original CG Direction.
Finance Business Act (Amendment to Corporate Governance) Direction No. 04 of 2020	With the prior approval of the Monetary Board, permit a Director who is already holding office, and who attains the age of 70 years on or after the date of this Direction comes into effect, to continue in office as director.

### C. Rationale to introduce the New Direction

In order to keep in pace with the latest developments of best practices of good governance, the new Direction on Corporate Governance was drafted to articulate sound principals of good Corporate Governance among LFCs.

Further, existing direction on Corporate Governance applicable for LFCs and SLCs provide some forbearances when compared to the Corporate Governance principles applicable to banks. Therefore, with a view of strengthening the CG principles among non-banking sector, the following amendments were suggested.

## **D. Provisions of the Direction**

### **1. Board's overall responsibilities**

**1.1.** The Board shall have overall responsibility and accountability for the Finance Company (FC), including approving and overseeing management's implementation of the FCs corporate strategy, setting up the governance framework, establishing corporate culture and ensuring compliance with regulatory requirements. The Board shall carry out the functions listed in Direction 1.2 to 1.7 below in effectively discharging its responsibilities.

### **1.2. Corporate Strategy and Governance Framework**

- a) Approving and overseeing the implementation of strategic objectives, including, the overall business strategy with measurable goals for at least next three years and update annually in light of the current developments.
- b) Approving and implementing FCs governance framework in the light of the FCs size, complexity, business strategy and regulatory requirements.
- c) Assessing the effectiveness of its governance framework periodically, including: (i) the selection, nomination appointment and election of directors and appointment of key management personnel; (ii) the management of conflicts of interests; and (iii) the determination of weaknesses and implementation of changes where necessary.
- d) Approving the implementation of a policy of communication with all stakeholders, including depositors, creditors, shareholders and borrowers
- e) The Board shall appoint the chairman and the chief executive officer and define and approve the functions, roles and responsibilities in line with Direction 6.

### **1.3. Corporate Culture and Values**

- a) Play a lead role in establishing the FCs corporate culture and values.
- b) Ensuring that there is a sound corporate culture within the FC which reinforces ethical, prudent and professional behavior.
- c) Promoting sustainable finance through appropriate environmental, social and governance considerations in the FC's business strategies.

**1.4. Risk Appetite, Risk Management and Internal Controls**

- a) Ensuring the implementation of appropriate systems to identify and manage risks prudently.
- b) Approve the overall risk policy (risk appetite) and risk management procedures and mechanisms with measurable goals.
- c) The Board shall review the adequacy and the integrity of the FCs internal control systems and management information systems periodically on a continuous basis through reviewing reports on internal control.

**1.5. Board Time and Resources**

- a) Ensure all members of the Board possess adequate skills, knowledge and experience
- b) All members of the Board shall devote sufficient time on dealing with the matters relating to affairs of the company.
- c) The Board shall adopt a scheme of self-assessment to be undertaken by each director annually on its own performance and that of its committees and maintain records of such assessments.

**1.6. Oversight of Key Management Personnel (KMP)**

- a) Identifying and designating key management personnel (KMP), who are in a position to (i) significantly influence policy, ii) direct activities; and (iii) exercise control over business operations and risk management.
- b) Defining the areas of authority and key responsibilities for the KMPs.
- c) Ensure that the KMP possess the skills, experience and knowledge to achieve the FC's strategic objectives.
- d) Ensure that there is appropriate oversight of the affairs of the FC by KMP, that is consistent with the FC's policies.
- e) Ensuring that the FC has an appropriate succession plan for KMP.
- f) Meeting regularly with the KMP to review policies, establish lines of communication and monitor progress towards corporate objectives.

**1.7. Adherence to the Existing Legal Framework**

- a) Ensuring that the FC does not act in a manner that is detrimental or prejudicial to the interests of, and obligations to, depositors, shareholders and other stakeholders.

- b) Understanding the regulatory environment, and ensure compliance with relevant laws, regulations and ethical standards.
- c) Approving and overseeing business continuity plans for the FC to ensure stability, financial strength, and preserve critical operations and services under stress.
- d) Act with due care and prudence and be aware of potential civil and criminal liabilities that may arise from their failure to discharge their duties diligently.

**2. Governance Framework**

Board shall develop and implement a Board Charter including but not limited to the following; (a) role and responsibilities of the Board; (b) matters reserved for the Board; (c) delegation of authority; (d) composition of the Board; (e) the Board’s independence; (f) access to information and independent advice; (g) capacity building of Board members; (h) the Board’s performance evaluation; (i) role and responsibilities of the chairman and the chief executive officer; (j) role of company secretary; (k) Board sub committees and their role; and (l) limits on related party transactions and managing conflicts of interest.

**3. Qualification of the Board members and Composition of the Board**

- 3.1.** The Board’s composition shall ensure a balance of skills and experience as may be deemed appropriate and desirable for the requirements of the size, complexity and risk profile of the FC. Relevant areas of competence may include, but not limited to banking, finance, strategic planning, risk management, legal and corporate governance.
- 3.2.** The number of directors on the Board shall not be less than 7 and not more than 13.
- 3.3.** The total period of service of a director other than a director who holds the position of chief executive officer/executive director shall not exceed nine years.
- 3.4.** Provided, however non-executive directors appointed for shareholder representation who directly or indirectly holds more than 10% of the voting rights are eligible to exceed nine years of service, subject to written approval of Director.
- 3.5. Executive Directors**
  - a) An employee of an FC shall be appointed, elected or nominated as a director of the FC (hereinafter referred to as an “executive director”) provided that the

number of executive directors shall not exceed one-third of the number of directors of the Board. One of the executive directors shall be the chief executive officer (CEO) of the company.

- b) At any instance, a non-executive director cannot be appointed or function as the CEO/executive director of the FC. Therefore, at the time of completion of nine years of service non-executive directors shall not appointed as executive directors of the FC.
- c) A shareholder (direct/indirect), who holds a substantial interest in the FC, shall not be appointed as executive director or KMP. This serves to preserve an appropriate separation between ownership and management of the FC in line with the broader responsibilities to various stakeholders. The transitional provision set out in direction 18 will be applicable.
- d) Executive directors including the CEO shall have a formal reporting line in the organization structure/organization chart of the FC. The executive directors are required to report to Board through CEO.
- e) Executive Directors including the CEO shall refrain from holding executive positions in other establishments.

### **3.6. Non-executive Directors**

- a) Non-executive directors (NED) shall possess credible track records, have necessary skills and experience to bring independent judgment to bear on issues of strategy, performance, resources and standards of business conduct

### **3.7. Independent Directors**

- a) The number of independent directors of the Board shall be at least three or one third of the total numbers of directors, whichever is higher.
- b) A non-executive director shall not be considered independent if such:
  - i. director or a close relative has direct or indirect shareholding exceeding 10% of the voting rights of the FC or exceeding 20% of the stated capital of any FC.
  - ii. director or a close relative has or had during the period of one year immediately preceding his appointment as director, material business relationship with the FC, as described in direction 12.3 hereof, aggregate

value outstanding of which at any particular time exceeds 10% of the stated capital of the FC as shown in its last audited statement of financial position;

- iii. director has been employed by the FC or its affiliates or has been a director of any of its affiliates during the one year, immediately preceding the appointment as director;
- iv. director has been a professional advisor or consultant to the FC or its affiliates during the one year preceding the appointment as director;
- v. director has a close relative, who is a director or CEO or a KMP of the FC or has been a director or CEO or a KMP of the FC in the during one year, immediately preceding his appointment as director or holds shares exceeding 10% of the stated capital of the finance company or exceeding 20% of the stated capital of another FC;
- vi. director represents a shareholder, debtor, or such other similar stakeholder of the FC;
- vii. director is an employee or a director or has direct or indirect shareholding of 10% or more of the stated capital in a company or business organization, in which any of the other directors of the FC is employed or a director;
- viii. director is an employee or a director or has direct or indirect shareholding of 10% or more of the stated capital in a company or business organization, which has a transaction with the FC as defined in direction 12.3, or in which any of the other directors of the FC has a transaction as defined in direction 12.3, aggregate value outstanding of which at any particular time exceeds 10% of the stated capital as shown in its last audited statement of financial position of the FC; (Hold cross directorships and has significant links)

**3.8.** The Nomination Committee and Board should determine whether there is any circumstance or relationship, which is not listed at direction 3.7, which might impact a director's independence, or the perception of his or her independence.

**3.9.** An independent director shall immediately disclose to the Board any change in his circumstances that may affect his status as an independent director. In such

a case, the Board shall review his designation as an independent director and notify the Director in writing of its decision to affirm or change his designation.

### **3.10. Cooling off Periods**

- a) A director, who fulfills the criteria to become an independent director, shall only be considered for such appointment after a cooling off period of one year, if such director has been previously considered as non-independent under the provisions of this Direction.
- b) There shall be a cooling off period of six months prior to an appointment of any person as a director, CEO or KMP of the FC, who was previously employed as a CEO or director, of another FC.

### **3.11. Common Directorships**

Director or a KMP of a FC including CEO shall not be appointed, elected or nominated as a director of another FC except where such FC is a parent company, subsidiary company or an associate company of the first mentioned FC subject to conditions stipulated in Direction 3.5(e).

**3.12.** A director of a FC shall not hold office as a director or any other equivalent position (shall include alternate directors) in more than 20 companies/societies/bodies corporate, including subsidiaries and associates of the FC.

### **3.13. Alternate Directors**

- a) Representation through an alternate director is allowed only if,
  - With prior approval of the Director under Finance Business Act (fitness and proper) Direction No. .
  - If the current director is unable to perform his duties as a director due to prolonged illness or unable to attend more than three consecutive meetings due to being abroad.
- b) The alternate director appointed shall not be a part of the FCs current Board.
- c) A person appointed as an alternate director to one of the directors cannot extend his role by acting as an alternate director to another director in the same Board.
- d) An alternate director cannot be appointed to represent an executive director.

- e) In the event an alternate director is appointed to represent an independent director, the person so appointed shall also meet the criteria that apply to the independent non-executive director.
- 4. Assessment of Fit and Proper Criteria**
- 4.1.** No person shall be appointed, elected or nominated as a director of the FC or continue as a director of such FC unless that person is a fit and proper person to hold office as a director of such FC in accordance with Direction on fit and proper requirements/Section 21 of the FBA. The Finance Business Act Direction (Assessment of Fit and Proper) Direction No. will be applicable.
- 5. Appointment and resignation of directors/ chief executive officer and KMPs**
- 5.1.** There shall be a formal and transparent procedure for the appointment of new directors to the Board and procedures in place for the orderly succession of appointments to the Board.
- 5.2.** All directors appointed to fill a casual vacancy shall be subject to election by shareholders at the first general meeting after their appointment.
- 5.3.** No member of the Board/CEO and KMPs shall without prior approval of the Director, resigned or be removed from the FC.
- 5.4.** If a director resigns or is removed from office, the Board shall announce to the shareholders, regarding the resignation or removal of the director and the reasons for such resignation or removal, including but not limited to information relating to the relevant director's disagreement with the Board, if any.
- 6. The Chair and the Chief Executive Officer**
- 6.1.** There shall be clear division of responsibilities between the chair and CEO to ensure a greater balance of power and authority, so that powers are not concentrated on any one individual and responsibilities of each of these persons shall set out in writing.
- 6.2.** The chair shall be an independent director.
- 6.3.** In case where the chair is not independent, the Board shall appoint one of the independent directors as a senior director if chair is not independent with suitably documented terms of reference to ensure a greater independent element. Senior director will serve as the intermediary for other directors and shareholders. Led by senior director, non-executive directors shall meet at least annually to assess the Chair's performance and other occasions, as necessary.



**6.4.** To promote robust and open deliberations by the Board on matters referred by the Board committees, the chairman of the Board shall not chair the two of the main committees, i.e. Audit Committee and Integrated Risk Management Committee.

**6.5. Responsibilities of the Chair**

The chair's role in preserving good corporate governance is crucial. The chair shall:

- a) provide leadership to the Board;
- b) maintain and ensure a balance of power between executive and non-executive directors;
- c) secure effective participation of both executive and non-executive directors;
- d) ensure that the Board works effectively and discharges its responsibilities;
- e) ensure that all key issues are discussed by the Board in a timely manner;
- f) responsible for the preparation of the agenda for each Board Meeting and may delegate the function of preparing the agenda to the company secretary;
- g) not engage in activities involving direct supervision of KMPs or any other day to day operational activities; and
- h) ensure that appropriate steps are taken to maintain effective communication with shareholders and that the views of shareholders are communicated to the Board.

**6.6. Responsibilities of the CEO**

The CEO shall function as the apex executive-in-charge of the day-to-day-management of the FCs operations and business. The responsibilities of the CEO shall include:

- a) implementing business and risk strategies in order to achieve the FCs strategic objectives;
- b) establishing a management structure that promotes accountability, and transparency throughout the FCs operations, and preserves the effectiveness and independence of control functions;
- c) promoting, together with the Board, a sound corporate culture within the FC which reinforces ethical, prudent and professional behaviour;

- d) strengthening the regulatory and supervisory framework; and
- e) addressing the supervisory concerns and non-compliance with regulatory requirements or internal policies in a timely and appropriate manner.

**7.Meetings of the Board**

- 7.1.** The Board shall meet at least twelve times a financial year at approximately monthly intervals. Obtaining the Board's consent through the circulation of papers shall be avoided as far as possible.
- 7.2.** The Board shall ensure that arrangements are in place to enable all directors to include matters and proposals in the agenda for scheduled Board Meetings.
- 7.3.** A notice of at least 3 days shall be given for a scheduled Board Meeting to provide all directors an opportunity to attend. For all other Board meetings, a reasonable notice shall be given.
- 7.4.** A director shall devote sufficient time to prepare and attend Board Meetings, and actively contribute his views and suggestions in taking FC forward.
- 7.5.** A meeting of the Board shall not be duly constituted, although the number of directors required to constitute the quorum at such meeting is present, unless at least one fourth of the number of directors that constitute the quorum at such meeting are independent directors.
- 7.6.** The chair shall hold meetings with the non-executive directors only, without the executive directors being present, as necessary and at least twice a year.
- 7.7.** A director shall abstain from voting on any Board resolution in relation to a matter in which he or any of his relatives or a concern in which he has substantial interest, is interested, and he shall not be counted in the quorum for the relevant agenda item in the Board meeting.
- 7.8.** A director who has not attended at least two-thirds of the meetings in the period of 12 months, immediately, preceding or has not attended the immediately preceding three consecutive meetings held, shall cease to be a director. Provided that participation at the directors' meetings through an alternate director shall be acceptable as attendance. However, continuous attendance (more than 6 meetings) through an alternate director will result in discontinuation of the directorship of the original director.

### **7.9. Scheduled meetings and ad hoc meetings**

For the scheduled meetings director's participation in person is encouraged and for ad hoc meetings where director cannot attend on a short notice, participation through electronic means is acceptable. If a director cannot attend in person, participation through video conferencing will be acceptable with proof of attendance.

### **8. Responsibilities of Board Secretary**

- 8.1.** The Board shall appoint a company secretary whose primary responsibilities shall be to handle the secretarial services to the Board and shareholder meetings, and to carry out other functions specified in the statutes and other regulations.
- 8.2.** The company secretary shall keep confidential the affairs of the finance company at all times subject to compliance with section 61 of the Act.
- 8.3.** All directors shall have access to advice and services of the company secretary with a view to ensuring that Board procedures and all applicable laws, directions, rules and regulations are followed.
- 8.4.** If the chairman has delegated to the company secretary the function of preparing the agenda for a Board meeting, the company secretary shall be responsible for carrying out such function.
- 8.5.** The company secretary shall maintain the voice recordings/video recordings in addition to the minutes of Board meetings within a period of 10 years. The minutes shall be open for inspection at any reasonable time, on reasonable notice by any director.
- 8.6.** The company secretary is responsible for maintaining minutes in an orderly manner and shall follow the proper procedure laid down in the Articles of Association of the FC.
- 8.7.** Minutes of Board meetings shall be recorded in sufficient detail so that it is possible to gather from the minutes, as to whether the Board acted with due care and prudence in performing its duties. The minutes of a Board meeting shall clearly contain or refer to the following: (a) a summary of data and information used by the Board in its deliberations; (b) the matters considered by the Board; (c) the fact-finding discussions and the issues of contention or dissent which may illustrate whether the Board was carrying out its duties with due care and

prudence; (d) the explanations and confirmations of relevant executives which indicate compliance with the Board’s strategies and policies and adherence to relevant laws and regulations; (e) the Board’s knowledge and understanding of the risks to which the FC is exposed and an overview of the risk management measures adopted; and (f) the decisions and Board resolutions.

**9. Delegation of Functions**

- 9.1.** The Board shall also give clear directions to KMPs, as to the matters that shall be approved by the Board before decisions are made by KMPs, on behalf of the FC.
- 9.2.** The Board shall not delegate any matters to a board sub-committee, CEO, executive directors or KMP, to an extent that such delegation would significantly hinder or reduce the ability of the Board as a whole to discharge its functions.
- 9.3.** The Board shall review the delegation processes in place on a periodic basis to ensure that they remain relevant to the needs of the FC.

**10. Board appointed committees**

- 10.1.** a) For the purpose of specifying the requirements for board committees, FCs are divided into two categories. FCS with asset base of more than 20 bn considered as category A and FCs with asset base of less than 20 bn to be considered as category B.

	<b>Category A</b>	<b>Category B</b>
<b>Board Committees</b>	Shall establish a Board Audit Committee (BAC), Integrated Risk Management Committee (IRMC), Nomination Committee, Human Resource and Remuneration Committee and Related Party Transactions Review Committee	Shall establish at least the BAC and IRMC
<b>Meetings</b>	Monthly meeting shall be held for BAC and IRMC	At least quarterly meeting for all sub committees.
<b>Chair of the sub committee</b>	Common chairmanships are not allowed in the BAC and IRMC. However, common chairmanship in other sub committees are allowed	Chair of BAC and IRMC shall be independent. Common chairmanships are allowed in sub committees.

- b) Each sub-committee shall have a written term of reference specifying clearly its authority and duties.

- c) The Board shall present a report on the performance of duties and functions of each committee, at the annual general meeting of the company.
- d) Each committee shall appoint a secretary to arrange its meetings, maintain minutes, voice recordings, records and carry out such other secretarial functions under the supervision of the chairman of the committee.
- e) Each board sub-committee shall have at least three members who have the skills, knowledge and experience relevant to the responsibilities of the board sub-committees. The Board shall consider occasional rotation of members and of the chairman of such sub-committees, as to avoid undue concentration of power and promote new perspectives.

## **10.2. Board Audit Committee**

The following shall apply in relation to the Audit Committee

- a) The chairman of the committee shall be an independent director who possesses qualifications and experience in accountancy and/or audit.
- b) The Board members appointed to the committee shall be non-executive directors and majority shall possess qualifications and experience in accountancy and/or audit and majority shall be independent directors.
- c) The secretary to the audit committee may be the chief internal auditor.

### **d) External Audit Function**

i. The committee shall make recommendations on matters in connection with: (i) the appointment of the external auditor for audit services to be provided in compliance with the relevant statutes; (ii) the service period, audit fee and any resignation or dismissal of the auditor.

### **ii. Rotation of external auditors and audit partners**

Engagement of an audit partner shall not exceed five years, and that the particular audit partner is not re-engaged for the audit before the expiry of three years from the date of the completion of the previous term. Further, FC shall not use the service of an external auditor not more than ten years consecutively.

- iii. Audit partner of an FC shall be a substantial shareholder, director, KMP or employee of any finance company.
- iv. The committee shall review and monitor the external auditor's independence and objectivity and the effectiveness of the audit processes in accordance with applicable standards and best practices.
- v. **Non-audit Services:** External audit partner shall not undertake any consultancy or other non-audit services with an FC during the same financial year in which the audit is being carried out.
- vi. The committee shall, before the audit commences, discuss and finalise with the external auditors the nature and scope of the audit.
- vii. The committee shall review the financial information of the FC, in order to monitor the integrity of the financial statements of FC.
- viii. The committee shall discuss issues, problems and reservations arising from the interim and final audits, and any matters the auditor may wish to discuss including those matters that may need to be discussed in the absence of key management personnel, if necessary.
- ix. The committee shall review the external auditor's management letter and the management's response thereto.
- e) The committee shall at least annually conduct a review of the effectiveness of the system of internal controls.
- f) The committee shall ensure that the KMPs are taking necessary corrective actions in a timely manner to address internal control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors and supervisory bodies with respect to internal audit function of an FC.
- g) Internal Audit function:**
  - i. The committee shall establish an independent internal audit function that provides an objective assurance to the committee on the quality and effectiveness of the FC's internal control, risk management, governance systems and processes.

- ii. The internal audit function shall have a clear mandate, be accountable to the BAC, and be independent of the audited activities. It shall have sufficient expertise and authority within the FC to carry out their assignments effectively and objectively.
- iii. The committee shall take the following steps with regard to the internal audit function of the FC:
  - Review the adequacy of the scope, functions and skills and resources of the internal audit department, and satisfy itself that the department has the necessary authority to carry out its work;
  - Review the internal audit program and results of the internal audit process and, where necessary, ensure that appropriate actions are taken on the recommendations of the internal audit department;
  - Review any appraisal or assessment of the performance of the head and senior staff members of the internal audit department;
  - Ensure that the internal audit function is independent of the activities it audits and that it is performed with impartiality, proficiency and due professional care;
  - The committee shall consider the major findings of internal investigations and management's responses thereto;

h) Committee shall review the statutory examination reports of the Central Bank of Sri Lanka (CBSL) and ensure necessary corrective actions are taken in a timely manner and monitor the progress of implementing the timebound action plan quarterly.

**i) Meetings of the Committee**

- i. The committee shall meet monthly as specified in direction 10.1 (a) above, with due notice of issues to be discussed and shall record its conclusions in discharging its duties and responsibilities.
- ii. Other Board members, the CEO, KMPs or any other officer employee may attend meetings upon the invitation of the committee. However, at least once a year the committee shall meet with the external auditors without any other directors/employees being present.

### 10.3. Integrated Risk Management Committee

The following shall apply in relation to the Integrated Risk Management Committee:

- a) The committee shall be chaired by an independent director. The membership shall consist of at least three non-executive directors and shall include members who have experience in risk management issues and practices. The chief executive officer and chief risk officer may attend the meetings upon invitation. The committee shall work with KMPs closely and make decisions on behalf of the Board within the framework of the authority and responsibility assigned to the committee.
- b) The secretary to the integrated risk management committee may be the chief risk officer.
- c) The committee shall assess all risks, *i.e.*, credit, market, liquidity, operational and strategic risks to the FC on a monthly basis through appropriate risk indicators and management information and make recommendations on the risk strategies and the risk appetite to the Board;
- d) The committee shall review the FCs risk policies at least annually;
- e) Oversee management's processes to ensure adherence to the risk policies.
- f) The committee shall review the adequacy and effectiveness of management level committees to address specific risks and to manage those risks within quantitative and qualitative risk limits as specified by the committee.
- g) The committee shall assess all aspects of risk management including updated business continuity plans.
- h) **Compliance function**
  - (i) The committee shall establish an independent compliance function to assess the FCs compliance with laws, regulations, directions, rules, regulatory guidelines, and approved policies on all areas of business operations.
  - (ii) For category A FCs, a dedicated compliance officer selected from KMP with sufficient seniority who is independent from day-to-day management shall carry out the compliance function and report to the



committee periodically. The compliance officer shall not have management or financial responsibility related to any operational business lines or income-generating functions, and there shall not be 'dual hatting', i.e. the chief operating officer, chief financial officer, chief internal auditor or any other senior manager also shall not serve as the compliance officer. For category B FCs an officer with adequate seniority shall be appointed as compliance officer, in which his other responsibilities shall not result in any conflict of interest.

(iii) The responsibilities of a compliance officer, would broadly encompass the following: (a) develop and implement policies and procedures designed to eliminate or minimize the risk of breach of regulatory requirements; (b) ensure that compliance policies and procedures are clearly communicated to all levels of the FC; (c) ensure that reviews are undertaken at appropriate frequencies to assess compliance with regulatory rules and internal compliance standards; (d) understand and apply all new legal and regulatory developments relevant to the business of FC; (e) secure early involvement in the design and structuring of new products and systems, to ensure that they conform to regulatory requirements, internal compliance and ethical standards; (f) highlight serious or persistent compliance problems and where appropriate, work with the management to ensure that they are rectified within an acceptable time; and (g) maintain regular contact and good working relationship with regulators based upon clear and timely communication and a mutual understanding of the regulators' objectives.

**i) Risk management function**

(i) The committee shall establish an independent risk management function responsible for managing risk-taking activities across the FC. For category A FCs it is expected to have a separate risk management department.

(ii) For category A FCs, a dedicated chief risk officer selected from KMP

shall carry out the risk management function and report to the committee periodically. The chief risk officer has the primary responsibility for implementing the Board approved risk management policies, processes and reports to ensure that the FC's risk management function is robust and effective to support its strategic objectives and to fulfill broader responsibilities to various stakeholders.

(iii) The chief risk officer is responsible for developing and implementing a Board approved Integrated Risk Management framework that covers: (a) various potential risks and frauds; (b) possible sources of such risks and frauds; (c) mechanism of identifying, assessing, monitoring and reporting of such risks and frauds; (d) effective measures to control and mitigate risks at prudent levels; and (e) relevant officers and committees responsible for such control and mitigation. The framework shall be reviewed and updated at least annually. The chief risk officer shall also participate in key decision-making processes such as capital and liquidity planning, new product or service development, etc. and make recommendations on risk management.

(iv) The committee shall take appropriate actions against the officers responsible for failure to identify specific risks and take prompt corrective actions as recommended by the committee, and/or as directed by the Director.

j) The committee shall submit a risk assessment report for the upcoming Board meeting seeking the Board's views, concurrence and/or specific directions.

#### **10.4. Nomination Committee**

The following shall apply in relation to the Nomination Committee:

- a) The committee shall be constituted with NEDs and preferably the majority may be independent directors. The CEO may be present at meetings by invitation of the committee. One independent Director shall chair the committee.
- b) The secretary to the nomination committee shall be the company secretary.
- c) The committee shall implement a formal and transparent procedure to

select/appoint new directors, CEO and KMPs.

- d) The committee shall strive to ensure that the Board composition is not dominated by any one individual or a small group of individuals in a manner that is detrimental to the interests of the depositors and the FC as a whole.
- e) The selection process shall include reviewing whether the proposed directors (i) possess the knowledge, skills, experience, independence and objectivity to fulfill their responsibilities on the board; (ii) have a record of integrity and good repute; and (iii) have sufficient time to fully carry out their responsibilities.
- f) The committee shall ensure that directors, chief executive officer and KMPs are fit and proper persons to perform their functions as per the Finance Business Act ( Fit and Proper requirements) Direction.
- g) Upon the appointment of a new director to the Board, the FC shall immediately disclose to shareholders: (i) a brief resume of the director; (ii) the nature of his expertise in relevant functional areas; (iii) the names of companies in which the director holds directorships or memberships in Board committees; and (iv) whether such director can be considered as independent.
- h) The committee shall ensure that all continuing directors submit themselves for re-election annually before the annual general meeting and re-appointment shall not be automatic.
- i) The committee shall consider and recommend (or not recommend) the re-election of current directors, taking into account the combined knowledge, performance towards strategic demands faced by FC and contribution made by the director concerned towards the overall discharge of the Board's responsibilities.
- j) The committee shall set the criteria such as qualifications, experience and key attributes required for eligibility to be considered for appointment or promotion to the post of CEO and the KMPs.
- k) The committee shall consider and recommend from time to time, the requirements of additional/ new expertise and the succession arrangements

for retiring directors, CEO and KMPs.

- l) A member of the nomination committee shall not participate in decision making relating to his/her own appointment/ reappointment and the chair of the board should not chair the committee when it is dealing with the appointment of their successor.

#### **10.5. Human Resource and Remuneration Committee**

The following shall apply in relation to the Human Resources and Remuneration Committee:

- a) The committee shall be chaired by a non-executive director and the majority of the members shall consist exclusively of non-executive directors.
- b) The secretary to the human resource and remuneration committee may be the head of human resources department
- c) The committee shall determine the remuneration policy (salaries, allowances, and other financial payments) relating to the directors, CEO and KMP of the FC.
- d) There shall be a formal and transparent procedure in developing the policy and no director shall be involved in deciding his/her own remuneration/ allowances/ other financial payments.
- e) A remuneration shall be paid only for the executive directors, whereas board sitting fees or an allowance shall be paid for the non-executive directors.
- f) The committee shall approve the remuneration policy on paying salaries, allowances and other financial incentives for all employees of the FC. The policy shall be subject to periodic board review of the Board, including when material changes are made.
- g) The remuneration structure shall be in line with the business strategy, objectives, values and long-term interests of the FC. It shall also incorporate measures to prevent conflicts of interest. In particular, incentives embedded within remuneration structures shall not incentivize staff to take excessive risk or to act in self-interest.
- h) The committee shall evaluate the performance of the CEO and KMPs against the set targets and goals at least annually, and determine the basis for revising

remuneration, benefits and other payments of performance-based incentives.

- i) The CEO and other KMPs shall abstain from attending committee meetings, when matters relating to them are being discussed.
- j) Disclosure on remuneration shall be made on the annual report: The company shall be transparent on its remuneration policies, level and mix of remuneration of each individual Director, the procedure for setting remuneration, and the relationships between remuneration, performance and value creation.

**11. Internal Controls**

- 11.1.** FCs shall adopt well-established internal control systems, which include the organizational structure, segregation of duties, clear management reporting lines and adequate operating procedures in order to mitigate operational risks.
- 11.2.** A proper internal control system shall: (a) promote effective and efficient operation; (b) provide reliable financial information; (c) safeguard assets; (d) minimize the operating risk of loss from irregularities, fraud and errors; (e) ensure effective risk management systems; and (f) ensure compliance with relevant laws, regulations and internal policies.
- 11.3.** All employees shall be given the responsibility for internal controls as part of their accountability for achieving objectives. Employees shall be trained with the necessary knowledge and skills to establish and operate the system of internal control.

**12. Related Party Transactions**

- 12.1.** The Related Party Transaction Review Committee shall take the necessary steps to avoid any conflicts of interest that may arise from any transaction of the FC with any person, and particularly with the following categories of persons who shall be considered as “related parties” for the purposes of this Direction:
  - a) Director or key management personnel;
  - b) A significant shareholder;
  - c) A subsidiary, associate, affiliate (sister company), holding company, parent company and any party (including their subsidiaries, associates and affiliates) that the FC exert control over or that exert control over FC;

- d) Director or key management personnel of a legal person in paragraph (b) or (c);
- e) Close relative of a natural person described in paragraph (a), (b) or (d);
- f) A concern in which any of the FCs directors or KMP or a close relative of any of the FCs directors or KMPs or any of its significant shareholders (exceeding shareholding of 10%) has a substantial interest; or
- g) Any other party deemed by the Central Bank to be a “related party” on a case-by-case basis.

**12.2.** All category A FCs shall establish a Related Party Transactions Review Committee and be responsible to comply with the provisions of this Direction and maintain the documents of the deliberations accordingly. At least one independent director shall be a member of the committee.

**12.3.** The business transactions with a related party that are covered in this Direction shall be the following:

- a) Granting accommodation;
- b) Creating liabilities to the FC in the form of deposits, borrowings and investments;
- c) Providing financial or non-financial services to the FC or obtaining those services from the FC; or
- d) Creating or maintaining reporting lines and information flows between the FC and any related party which may lead to share proprietary, confidential or information not available in the public domain or otherwise sensitive information that may give benefits to such related party.

**12.4.** Following restrictions apply;

- a) No FC shall grant any accommodation to a director and/or a close relative of a director, or to its parent company. However, granting accommodation on approved securities are allowed. (e.g. loans against Fixed deposit) Alternatively, the FC shall not grant any accommodation on the guarantee or indemnity of a director and/or a close member of a director.

b) A FC may grant accommodation to its subsidiary companies or associate companies subject to the limits specified in the Directions on Single Borrower Limit and on such terms as may be applicable to similar facilities granted to other borrowers of the FC. The particulars of such accommodations including the name of the borrower company, the date of grant of such accommodation, amount granted, repayment period, security and the rate of interest shall be reported to the Director as specified in Finance Business Act (Disclosure Requirements) Direction No. of 2020.

**12.5.** The Board shall ensure that the FC does not engage in business transactions with a related party in a manner that would grant such party “more favourable treatment” than that is accorded to other similar constituents of the FC. For the purpose of this paragraph, “more favourable treatment” shall mean:

(i) Granting of “total net accommodation” to a related party, exceeding a prudent percentage of the FCs regulatory capital, as determined by the Board, subject to the provisions in direction 12.3 of this Direction.

The “total net accommodation” shall be computed by deducting from the total accommodation, the cash collateral and investments made by such related party in the FCs share capital and debt instruments with a remaining maturity of 5 years or more.

(ii) Charging of a lower rate of interest than the FCs best lending rate or paying a rate of interest exceeding the rate paid for a comparable transaction with an unrelated comparable counterparty;

(iii) Providing preferential treatment, such as favourable terms, covering trade losses and/or waiving fees/commissions, that extends beyond the terms granted in the normal course of business with unrelated parties;

(iv) Providing or obtaining services to or from a related party without a proper evaluation procedure;

(v) Maintaining reporting lines and information flows between the FCs and any related party which may lead to share proprietary, confidential or otherwise sensitive information that may give benefits to such related party, except as required for the performance of legitimate duties and functions.

**12.6.** An FC shall not, without the approval of the Director, conduct a business transaction with a related party of the company where the total value of transaction/s exceeds 1% of the stipulated minimum core capital. Conducting of any business transaction by a FC with a related party shall be subject to the provisions in this Direction or any other related Direction.

**12.7.** The provisions of direction 12.6 hereof, shall not apply to accepting of time and savings deposits from a related party in conformity with the Finance Companies (Deposits) Direction No.01 of 2005 and Maximum Interest Rates on Deposits and Debt Instruments No.01 of 2019 and on terms and conditions that are applicable to the other depositors of the FC and to payment of interest on similar deposits.

**13. Group  
Governance**

**13.1. Responsibilities as a holding company**

a. The FC is responsible for exercising adequate oversight over its subsidiaries and associates while complying with the independent legal, regulatory and governance responsibilities that apply to them.

The Board and senior management of the apex FC shall:

- (a) ensure that the group governance framework clearly defines roles and responsibilities for the oversight and implementation of group-wide policies;
- (b) ensure that the differences in the operating environment, including the legal and regulatory requirements for each company, are properly understood and reflected in the group governance framework;
- (c) have in place reporting arrangements that promote the understanding and management of material risks and developments that may affect the apex FC and its subsidiaries;
- (d) assess whether the internal control framework of the group adequately addresses risks across the group, including those arising from intra-group transactions; and
- (e) ensure that there are adequate resources to effectively monitor compliance of the apex FC and its subsidiaries with all applicable legal and regulatory requirements.



**13.2.** The FC, as the apex entity, shall ensure that the group structure does not undermine its ability to exercise effective oversight. The Board shall establish a clearly defined process of approving the creation of new legal entities under its management and identifying and managing all material group-wide risks through adequate and effective policies and controls.

Alternatively, the FC shall discharge its own legal and governance responsibilities as a separate entity, if it is a member company of a group.

**13.3. Responsibilities as a Subsidiary**

If the FC is a subsidiary of another financial institution or of a foreign entity subject to prudential regulation, FC must discharge its own legal and governance responsibilities.

**13.4.** The Board and senior management of the FC shall validate that the objectives, strategies, policies and governance framework set at the group level are fully consistent with the regulatory obligations of the FC and ensure that company-specific risks are adequately addressed.

The FC shall avoid setting up complicated structures that lack economic substance or business purpose that can considerably increase the complexity of the operations.

**14. Corporate culture**

**14.1.** A FC shall adopt a Code of Ethics which provides guidelines on appropriate conduct and addresses issues of confidentiality, conflicts of interest, integrity of reporting, protection and proper use of company assets, fair treatment of customers, and disallowing activities such as fraud, breach of sanctions, money laundering, anti-competitive practices, bribery and corruption, etc. The FC shall maintain records of breaches of code of ethics and address such breaches in a manner that upholds high standards of integrity.

**14.2.** A FC shall establish a Whistleblowing policy that sets out avenues for legitimate concerns to be objectively investigated and addressed. Employees shall be able to raise concerns about illegal, unethical or questionable practices in confidence and without the risk of reprisal.

**15. Conflicts of interest**

- 15.1.** a) There shall be assurance that the relationships between the directors amongst themselves as well as between the directors and the KMPs is at a level that does not suggest the existence of excessive familiarity, undue influence or coercion. In this context, very long-standing relationships could sometimes impair the high sense of values, independence and objectivity that is needed in the discharge of the duties of a director.
- b) Directors shall avoid conflicts of interests, or the appearance of conflicts of interest, in their activities with, and commitments to, other organizations or related parties. If a director has a conflict of interest in a matter to be considered by the Board, which the Board has determined to be material, the matter shall be dealt with at a Board meeting, where independent non-executive directors who have no material interest in the transaction, are present.
- c) The Board shall have a formal written policy and an objective compliance process for implementing the policy to address potential conflicts of interest with the related parties. The policy shall include:
- i. Identify circumstances which constitute or may give rise to conflicts of interests;
  - ii. Express the responsibility of directors and key management personnel to avoid, to the extent possible, activities that could create conflicts of interest;
  - iii. Define the process for directors and KMPs to keep the Board informed on any change in circumstances that may give rise to a conflict of interest;
  - iv. Implement a rigorous review and approval process for directors and KMPs to follow before they engage in certain activities that could create conflicts of interest;
  - v. Identify those responsible for maintaining updated records on conflicts of interest with related parties;
  - vi. Articulate how any non-compliance with the policy will be addressed.

- 16. Disclosures**
- 16.1. FC shall comply with the requirements of Finance Business Act (Disclosure Requirements) Direction No. of 2020.
- 16.2. During the transitional period, all FCs shall follow the “Guideline on Disclosure Requirements” annexed.
- 17. Definition**
- “Act” shall mean the Finance Business Act, No.42 of 2011
- “Accommodation” shall have the same meaning as contained in the Finance Companies (Lending) Direction, No.1 of 2007 or as amended
- “Board of Directors” shall, include Executive Directors or otherwise and shall include alternate directors as well
- “Close relative” means spouse, children, parents and siblings by blood or adoption.
- “Director” means Director of the Department of Supervision of Non-Bank Financial Institutions of Central Bank of Sri Lanka.
- “Executive Director” A director is deemed to be an executive director, if he is in full-time salaried employment of the FC and/or any of its affiliates.
- “Key Management Personnel” of a FC as stated in the Section 74 of the Finance Business Act No. 42 of 2011. In addition to above, officers in the immediate two layers below the level of CEO on the organization structure
- “Direct or indirect shareholding’ shall mean holding of shares carrying voting rights by a company, an incorporated body, or an individual or held in aggregate by:
- a. a company and one or more of the following:
    - (i) its subsidiary companies;
    - (ii) its holding company;
    - (iii) a subsidiary company of its holding company; or
    - (iv) a company in which such company or its subsidiary company, or its holding company, or a subsidiary company of its holding company has a substantial interest; or
  - b. an individual and one or more of the following:

- (i) his relatives – “relative” shall have the same meaning as contained in the definition in section 74 of the Finance Business Act, No. 42 of 2011;
  - (ii) a company in which he has a substantial interest or in which his relative has a substantial interest; the subsidiary company of such company; a holding company of such company; a subsidiary company of such company’s holding company; a company in which such company, or its subsidiary company or its holding company or a subsidiary company of its holding company has a substantial interest; or
  - (iii) an incorporated body other than a company in which such individual; or his relative has a substantial interest; or
- c. companies in each of which an individual or company as the case may be, has either directly, indirectly or beneficially a substantial interest or significant management interest.

“Affiliate” in relation to a licensed finance company refers to any corporation that controls, is controlled by, or is under common control with, the licensed finance company, includes subsidiary, associate, holding company, companies under common group.

“Significant shareholder” shall mean a person who is among the top ten shareholders of the licensed finance company and/or hold more than ten percent of the shares of the company.

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| <b>18. Transitional Provisions</b> | 18.1 | All FCs are required to comply with the provisions of this Direction from .....   |
|                                    | 18.2 | For the provisions contained in Direction 3, transitional period of .... years will be applicable, unless otherwise specifically stated.<br><br>For direction 3.5 (c) a transitional period of ..... years will be applicable until ..... |
|                                    | 18.3 | On the date of this Direction, if the number of executive directors in a finance company is more than one third of the number of directors of the Board, the Board shall expressly identify the excess executive directors and inform the |

names of such excess executive directors to the Director within three months from the date of this Direction.

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