

The Hongkong and Shanghai Banking Corporation Limited
– Sri Lanka Branch

Disclosures on Corporate Governance 2019



Independent Assurance Report

To the Branch Management of The Hongkong & Shanghai Banking Corporation- Sri Lanka Branch

1. We were engaged by the Branch Management of The Hongkong & Shanghai Banking Corporation- Sri Lanka Branch (“the Branch”) to provide assurance on the Branch Management Statement on Internal Control (“the Statement”) for the year ended 31 December 2019.

The Branch Management’s responsibility

2. The Branch is responsible for the preparation and presentation of the Statement in accordance with the “Guidance for Directors of Banks on the Directors’ Statement on Internal Control” issued in compliance with the section 3(8)(ii)(b) of the Banking Act Direction No. 11 of 2007, by the Institute of Chartered Accountants of Sri Lanka.

Our responsibilities and compliance with SLSAE 3050

3. Our responsibility is to issue a report to the Branch on the Statement based on the work performed. We conducted our engagement in accordance with Sri Lanka Standard on Assurance Engagements SLSAE 3050 – Assurance Report for Banks on Directors’ Statement on Internal Control issued by the Institute of Chartered Accountants of Sri Lanka.

Summary of work performed

4. Our engagement has been conducted to assess whether the Statement is both supported by the documentation prepared by or for the Branch and appropriately reflects the process the Branch has adopted in reviewing the system of internal control for the Branch.

5. To achieve this objective, appropriate evidence had been obtained by performing the following procedures:

- (a) Enquired from the Branch and obtained an understanding of the process defined by the management for their review of the design and effectiveness of internal control and compared their understanding to the statement made by the Branch.
- (b) Reviewed the documentation prepared by the Branch to support their Statement.
- (c) Related the Statement made by the Branch to the auditor’s knowledge of the Branch obtained during the audit of the financial statements.
- (d) Reviewed the minutes of the meetings of the Executive Committee and of relevant other Management Committees of the Branch.

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- (e) Considered whether the Management Statement on Internal Control covers the year under review and that adequate processes are in place to identify any significant matters arising.
- (f) Obtained written representations from the Branch on matters material to the Statement on Internal Control when other sufficient appropriate audit evidence cannot reasonably be expected to exist.
- (g) Discussed with the Branch whether steps have been taken by them to determine what process it has applied to deal with material internal control aspects of any significant problems.
- (h) Obtained an understanding from the Branch as to whether there is an ongoing process for identifying, evaluating and managing the significant risks faced by the bank, whether it has been in place for the year under review, whether it is regularly reviewed and whether the explanations are consistent with auditor's understanding.

6. SLSAE 3050 does not require us to consider whether the Statement covers all risks and controls, or to form an opinion on the effectiveness of the Branch's risk and control procedures. SLSAE 3050 also does not require us to consider whether the processes described to deal with material internal control aspects of any significant problems disclosed in the financial statements will, in fact, remedy the problems.

Our conclusion

7. Based on the procedures performed, nothing has come to our attention that causes us to believe that the Statement is inconsistent with our understanding of the process the management has adopted in the review of the design and effectiveness of internal control of the Branch.

COLOMBO

A handwritten signature in blue ink, appearing to read 'Priscilla Kumarasinghe', is written over the printed name of the firm.

CHARTERED ACCOUNTANTS

10 April 2020

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
STATEMENT OF COMPLIANCE

The Hongkong & Shanghai Banking Corporation Limited – Sri Lanka Branch ('HSBC Sri Lanka') is registered in Sri Lanka as a branch of The Hongkong and Shanghai Banking Corporation Limited ('the Company'), a company incorporated in Hong Kong. HSBC Holdings plc, a company incorporated in England, is the ultimate holding company.

HSBC Sri Lanka has effective processes in place to ensure compliance with applicable laws and regulations pertaining to the banking industry in Sri Lanka, including The Banking Act, Prevention of Money Laundering Act No 5 of 2006 (PMLA) and Amendment No 40 of 2011, Financial Transactions Reporting Act No 6 of 2006 and related Acts, Companies Act No. 7 of 2007 and the Central Bank of Sri Lanka directions and guidelines. Additionally, we are also bound to comply with the applicable directions of the Company. Also the Banking Act Direction No. 11 of 2007 and its amendments ("the said Direction") on Corporate Governance for Licensed Commercial Banks in Sri Lanka, issued by the Monetary Board of the Central Bank of Sri Lanka under section 46 (1) of the Banking Act No. 30 of 1988 provides that the mandatory requirements set out in section 3 of the said Direction should be complied with by Licensed Commercial Banks. All branches of foreign banks are requested to adhere to sections 3 (8) and 3 (9) of the said Direction and HSBC Sri Lanka complies with the same on Corporate Governance.

The Company has adopted an integrated operational risk and internal control management framework, referred to as the Three Lines of Defence model. The model ensures it achieves its commercial aims while meeting regulatory and legal requirements and its responsibilities to shareholders, customers and staff.

The First Line of Defence, comprising of a majority of employees, identifies the risks and ensures that the right controls are in place to prevent, manage, and reduce the risks including the delivery of fair conduct outcomes

The Risk Owners in the Lines of Businesses are accountable for setting risk appetite, identifying, owning, and managing non-financial risks for their Business in line with appetite, i.e. within the limits set out by the HSBC Group. The Control Owners, who may sit within a Lines of Business or Function within HSBC, monitor, assess and manage the processes, activities, or systems to ensure that they are operating effectively. They work with the Risk Owners to understand and manage the risks. The Chief Control Officers (CCO), who may sit within a Lines of Business or Functions, drive effective governance and management of non-financial risks for their organization area. They work closely with Risk Owners and Control Owners to ensure operational risk management activities are effectively executed.

The Second Line of Defence consisting of "Chief Risk Officers", "Risk Stewards" and "Operational Risk" functions, provide review and challenge of ILOD activities to help ensure risk management decisions and actions are appropriate, within risk appetite and support the delivery of conduct outcomes. The Second Line of Defence is independent of the day to day commercial risk-taking activities undertaken by the First Line of Defence. The Chief Risk Officers oversee the risk management for areas within their remit. The Risk Stewards, sitting within the Functions, perform the specialist role in the review and challenge of, and subject matter expert for, the First line of Defence activities for a given risk type. The Operational Risk function provides advice and guidance on the use of the Risk Management Framework. They also challenge the effectiveness of the framework in use both in the first and second lines of defence.

The Third Line of Defence is Internal Audit which independently assures that the HSBC is managing its non-financial risks effectively.

The existing Compliance team of HSBC Sri Lanka has two distinct sub-functions: Financial Crime Compliance (FCC) and Regulatory Compliance (RC).

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FCC is focused on:

- Anti-Money Laundering (AML), Counter Terrorist Financing & Proliferation Finance
- Sanctions
- Anti-Bribery and Corruption (AB&C)
- Internal and External Fraud
- Tax Evasion
-

RC is focused on:

Understanding the regulatory landscape and working with the business to help them identify and manage their regulatory compliance risks. RC provides independent and objective oversight and challenge, and promote a compliance-orientated culture, supporting the business in delivering fair outcomes for customers and achieving HSBC's strategic objectives.

The Regulatory Compliance team is responsible for setting the policies and standards which cover HSBC's regulatory requirements, and supports the management of Conduct and Reputational Risk issues. The team works closely with the Global Businesses and Functions while maintaining an independent and challenging mind set. This is a critical part of being the Second Line of Defence.

Given the dynamic and evolving regulatory environment HSBC is operating today, the Regulatory Compliance team would grasp the regulatory change agenda and ensure that the businesses understand the implications and are prepared for change.

The Regulatory Compliance team also monitors how the Global Businesses and Functions manage their responsibilities with regard to complying with the required regulations, and will support the resolution of compliance deficiencies.

In 2019 and beyond HSBC has been maintaining clear focus that has driven the Bank's progress over recent years, with a Compliance strategic plan that has four interdependent pillars. The Bank will;

- Continue to embed a sustainable approach to financial crime and regulatory compliance risk management, simplifying our approach where we can
- Orientate ourselves to support HSBC's refreshed strategic priorities, supporting the business as it returns to growth mode
- Deliver advanced capabilities that enable us to provide more targeted and real time advice and insights
- Help the Lines of Business to navigate any complex and evolving regulatory landscape.

At the operational level, the Head of FCC and Head of RC of HSBC Sri Lanka will:

- Undertake regular monitoring and ad-hoc reviews to verify that operational controls are robust and understanding of / adherence to procedures is maintained;
- Report compliance control failures, or incidents which may indicate a need to review Risk Compliance Assessments or mitigating procedures as well as facilitating reporting within the business e.g. to Risk Management Committees and/or regulators.

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In addition to RC and FCC, a number of teams are formed within RC and FCC to support the two functions, for example, Regulatory Affairs & Policy (RAP), Financial Crime Risk Assurance (FCRA) and Regulatory Compliance Monitoring & Testing (RCMAT).

Regulatory Affairs and Policy (RAP) is responsible for all Regulatory Engagements, Regulatory Development and Policy Governance in Sri Lanka and Maldives.

RCMAT is responsible for carrying out monitoring activities to provide a reasonable assurance to the business that their first line of defense is sound and sufficient as far as RC is concerned. This is being established through two main activities:

- By testing the adequacy of existing RC controls in the first line
- By identifying any gaps in the control environment for RC and advising the businesses to develop or maintain controls to mitigate any potential risks.

FCRA is responsible for carrying out monitoring activities to provide a reasonable assurance to the business that their first line of defense is sound and sufficient as far as FCC is concerned.

This is being established through two main activities:

- By testing the adequacy of existing FCC controls in the first line
- By identifying any gaps in the control environment for FCC compliance and advise the Business to develop or maintain controls to mitigate any potential risks.

[Signed]

Matthew K Lobner

Head of International, Asia Pacific

Head of Strategy & Planning, Asia Pacific

[Signed]

Mark G Prothero

Chief Executive Officer, HSBC Sri Lanka and Maldives

Date: 29 May 2020

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
HEAD OFFICE STATEMENT ON INTERNAL CONTROLS

RESPONSIBILITY

The Hong Kong & Shanghai Banking Corporation Limited – Sri Lanka Branch (‘HSBC Sri Lanka’) is registered in Sri Lanka as a branch of The Hong Kong and Shanghai Banking Corporation Limited (‘the Company’), a company incorporated in Hong Kong, and as such follows all policies and procedures laid out by the Company. HSBC Holdings plc, a company incorporated in England, is the ultimate holding company.

In line with the Banking Act Direction No. 11 of 2007, Section 3 (8) (ii) (b), and the subsequent circular 02/17/550/002/002 dated 3rd January 2011, the Head of the Office supervising HSBC Sri Lanka, namely HSBC International, presents this Report on Internal Control.

HSBC International, together with the regional teams of Global Businesses and Global Functions (“collectively the “Head Office”), are responsible for overseeing the implementation of the system of internal controls at HSBC Sri Lanka (‘the Bank’). This system is designed to manage the Bank’s key areas of risk within an acceptable risk profile, rather than to eliminate the risk of failure to achieve the policies and business objectives of the Bank. Accordingly, the system of internal controls can only provide reasonable but not absolute assurance against material misstatement of management and financial information and records or against financial losses or fraud.

HSBC Group has established an ongoing process for identifying, evaluating and managing the significant risks faced by the Bank and this process includes enhancing the system of internal controls as and when there are changes to the business environment or regulatory guidelines. HSBC Sri Lanka has regularly reviewed the process and further considered the Guidance for Directors of Banks on the Directors’ Statement on Internal Control issued by the Institute of Chartered Accountants of Sri Lanka taking into account principles for the assessment of internal control systems as given in that guidance.

The Head Office is of the view that the system of internal controls in place is sound and adequate to provide reasonable assurance regarding the reliability of financial reporting, and the preparation of Financial Statements for external purposes has been done in accordance with Sri Lanka Accounting Standards and regulatory requirements of the Central Bank of Sri Lanka.

The Chief Executive Officer (“CEO”) and the Executive Committee (“EXCO”) of HSBC Sri Lanka, together assist the Head Office in the implementation of policies and procedures on risk and control by identifying and assessing the risks faced, and in the design, operation and monitoring of suitable internal controls to mitigate and control these risks.

KEY PROCESSES ADOPTED AND APPLIED IN REVIEWING THE DESIGN AND EFFECTIVENESS OF THE INTERNAL CONTROL SYSTEM ON FINANCIAL REPORTING

The key processes that have been established in reviewing the adequacy and integrity of the system of internal controls with respect to financial reporting include the following:

Various committees have been established to ensure the effectiveness of the Bank’s daily operations and that the Bank’s operations are in accordance with the corporate objectives, strategies and the annual operating plan as well as the policies and business directions that have been approved.

All employees are responsible for identifying and managing risk within the scope of their role as part of the three lines of defence model, which is an activity-based model to delineate management accountabilities and responsibilities for risk management and the control environment. The second line of defence sets the policy and guidelines for managing specific risk areas, provides advice and guidance in relation to the risk, and challenges the first line of defence (the risk owners) on effective risk management.

The primary role of the Global Internal Audit function as the third line of defence is to help the Board and management protect the assets, reputation and sustainability of the Group. Global Internal Audit does this by

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HEAD OFFICE STATEMENT ON INTERNAL CONTROLS

providing independent and objective assurance on the design and operating effectiveness of the Group's governance, risk management and control framework and processes, prioritising the greatest areas of risk.

The Group Audit Committee ('GAC') is responsible for advising the Board on the effectiveness of our systems of internal controls and compliance in relation to financial matters and on meeting financial reporting obligations. The GAC also has responsibilities in relation to risk governance and oversight and internal controls. Regular reports are provided to the Board, the Group Audit Committee, the Group Risk Committee on credit exposures and the loan portfolio, asset, liability and risk management, liquidity, litigation and finance, compliance and reputational issues. The agenda and supporting papers are distributed in advance of all Board and committee meetings to allow time for appropriate review and to facilitate full discussion at the meetings. All Directors of the Company have full and timely access to all relevant information and may take independent professional advice if necessary.

Local Senior Management ensures compliance with policies and procedures and where there has been a breakdown in internal controls, or breach of authority, the CEO is advised in a timely manner. Additionally, such issues are escalated and tabled at the monthly Risk Management Meeting ("RMM"). Where the CEO deems the issue material, it is reported up the functional and management lines to Regional Functions and GBL INA.

The scheduling of audits is an on-going dynamic process reflecting changes in internal audit's assessment of the inherent risk of the auditable entities within the audit population. The Risk Calculator is used for decisions on the scheduling of audits by seeking to identify and measure entity level risks across the audit population to determine the prioritization of audit visits and to enable audit resources to be directed to the most appropriate areas. Audits are conducted on a risk-based approach particularly where the Bank has its own internal control function, where Group Audit can rely on the work undertaken locally.

Global Internal Audit – Sri Lanka & Maldives is primarily responsible to:

- Provide independent and objective assurance as to whether the design and operational effectiveness of the Group's framework of risk management, control and governance processes, as designed and represented by management, is adequate.
- Focus on key risks across the Bank and assess the effectiveness of primary and secondary controls.
- Implement Audit coverage through a combination of governance and internal audits.
- Assess the control risk and management's effectiveness in identifying, assessing and remediating control issues and risks within their area of responsibility.

The comments made by the external auditors and the internal audit department in connection with internal control system in the financial year to 31st December 2018 were reviewed during the year and appropriate steps have been taken to rectify them. The recommendations made by the external auditors and the internal audit department in the financial year to 31st December 2019 in connection with the internal control system have already been dealt with and in some instances are in the process of being actioned upon. The Management is of the opinion that these recommendations are intended to further improve the internal control system and they do not in any way detract from the conclusion that the financial reporting system is reliable to provide reasonable assurance that the financial statements for external use are true and fair and comply with Sri Lanka Accounting Standards (SLFRS & LKAS) and the regulatory requirements of the Central Bank of Sri Lanka (CBSL).

CONFIRMATION

Based on the above, the Regional Finance in Head Office confirms that the financial reporting system of the Bank has been designed to provide reasonable assurance regarding the reliability of financial reporting and that the preparation of Financial Statements for external purposes has been done in accordance with Sri Lanka Accounting Standards and regulatory requirements of the Central Bank of Sri Lanka.

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HEAD OFFICE STATEMENT ON INTERNAL CONTROLS

REVIEW OF THE STATEMENT BY EXTERNAL AUDITORS

The External Auditors have reviewed the above Head Office Statement on Internal Control of the Bank for the year ended 31st December 2019 and reported to the Bank that nothing has come to their attention that causes them to believe that the statement is inconsistent with their understanding of the process adopted by the Management in the review of the design and effectiveness of the internal control system over financial reporting of the Bank.

By order of HSBC International,
The signatories for the bank

[Signed]
Matthew K Lobner
Head of International, Asia Pacific
Head of Strategy & Planning, Asia Pacific

[Signed]
Mark G Prothero
Chief Executive Officer, HSBC Sri Lanka and Maldives

Date: 29 May 2020

1 DETAILS OF ACCOMODATION GRANTED AS AT 31 DECEMBER 2019

1.1 Total accommodation granted to each category of related parties (in LKR ‘000)

| | |
|--|---------|
| Bank’s subsidiary companies | N/A |
| Bank’s associate companies | N/A |
| Directors of the bank | N/A |
| Bank’s key management personnel | 253,603 |
| A close relation of any of the bank’s directors or key management personnel | 11,949 |
| A shareholder owning a material interest in the bank | N/A |
| A concern in which any of the bank’s directors or a close relation of any of the bank’s directors or any of its material shareholders has a substantial interest | N/A |

1.2 Total accommodation granted to each category of related parties as a percentage of the bank’s regulatory capital

| | |
|--|--------|
| Bank’s subsidiary companies | N/A |
| Bank’s associate companies | N/A |
| Directors of the bank | N/A |
| Bank’s key management personnel | 0.426% |
| A close relation of any of the bank’s directors or key management personnel | 0.020% |
| A shareholder owning a material interest in the bank | N/A |
| A concern in which any of the bank’s directors or a close relation of any of the bank’s directors or any of its material shareholders has a substantial interest | N/A |

THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED
SRI LANKA BRANCH
DISCLOSURES ON CORPORATE GOVERNANCE

2 TRANSACTIONS OF THE BANK WITH ITS KEY MANAGEMENT PERSONNEL

| | LKR '000 |
|---|----------|
| Aggregate remuneration paid for the year ended 31 December 2019 | 310,849 |
| Total accommodation granted as at 31 December 2019 | 265,552 |
| Total deposits as at 31 December 2019 | 35,855 |
| Total investments made as at 31 December 2019 | NIL |

3 STATEMENT OF REGULATORY AND SUPERVISORY CONCERNS

We confirm that to the best of our knowledge that The Hong Kong and Shanghai Banking Corporation Limited Sri Lanka have not encountered any supervisory concerns on lapses in bank's risk management, or non-compliance with these Directions that have been pointed out by the Director of Bank Supervision, if so directed by the Monetary Board to be disclosed to the public.

[Signed]

Mark G Prothero

Chief Executive Officer

HSBC Sri Lanka and Maldives

[Signed]

Angelo Pillai

Chief Financial Officer

HSBC Sri Lanka and Maldives

Date: 29 May 2020