香港董事學會
The Hong Kong Institute of Directors

23 April 2015

Resolution Regime Consultation
Financial Services Branch
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Sirs

HKIoD's Response to Consultation on Establishing An Effective Resolution Regime for Financial Institutions in Hong Kong Second Consultation Paper (21 January 2015)

The Hong Kong Institute of Directors ("HKIoD") is pleased to forward our response to the captioned paper.

HKIoD is Hong Kong's premier body representing directors to foster the long-term success of companies through advocacy and standards-setting in corporate governance and professional development for directors. We are committed to contributing towards the formulation of public policies that are conducive to the advancement of Hong Kong's international status.

In developing the response, we have consulted our members and organised focused discussions.

Should you require further information regarding our response, please do not hesitate to contact me on tel no. 2889 9986.

With best regards

Yours sincerely
The Hong Kong Institute of Directors

Dr Carlye Tsui
Chief Executive Officer

cc: Mr Henry Lai, Chairman of Council, HKIoD & Chairman, Corporate Governance Policies Committee

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An Effective Resolution Regime for Financial Institutions in Hong Kong
Second Consultation Paper (21 January 2015)

In relation to the captioned Second Consultation Paper, The Hong Kong Institute of Directors wishes to present the following views and comments.

General comments

If a resolution regime is necessary, what is its actual utility?

To put in place a resolution regime may be the necessary step to keep Hong Kong in pace with what other financial markets have done. The rules and policy of that regime can, however, affect its actual utility.

To some people, the utility of a resolution regime may be in terms of whether it can effectively end the “too big to fail” phenomenon. Another utility worth considering is whether it can actually deal with the “too many to fail” phenomenon, i.e., a correlated failure scenario brought on by a simultaneous insolvency-driven failure of multiple financial firms.

In this response, we seek to limit ourselves to Questions 31-34 and the accompanying text in the Second Consultation Paper. Those questions pertain to “automatic removal” of managers and directors, and to “remuneration claw back”. In addressing those issues, we have made some observations that might have implications on the utility of the resolution regime being proposed. We will discuss them briefly here.

Automatic removal and “too many to fail”

The Second Consultation Paper contemplates a policy of automatic removal (Question 31 refers). Face with the prospect of removal, managers and directors across FIs may in fact have more incentives to conjure a messy prospect for any of the options under the resolution regime in the hope of an outright bailout when things go sour.

A large number of FIs failing simultaneously will overwhelm any Resolution Authority acting alone or in concert. This would be a near-cataclysmic chain reaction of correlated failure. And in this scenario, the Government may in fact be more obliged to retain managers and directors, rather than removing them altogether. The existing managers and directors do know the business, and it is not easy to find people to take over many FIs at the same time.

To achieve the prospect of a correlated failure scenario, each FI will try not to be the first domino to fall. Managers and directors across FIs can attempt to achieve that feat by “bunching up” together. FIs following parallel business strategies will be more likely to fail simultaneously, to the extent that they hold similar investments that could decline in value all at about the same time. FIs can also attempt to achieve that feat by fostering “interconnectedness” (e.g., by being counterparties to each other who have similar risk profiles.)

A key ingredient to this sort of correlated failure scenario is indeed long-term insolvency, not mere temporary illiquidity. To the extent that the resolution regime is designed to be invoked only when an FI is deemed non-viable, the FI may already have become balance-sheet insolvent.

Prudential regulation should of course have a role to play, to encourage (or require) beneficial diversification of asset holdings among FIs and to reduce the degree of their interconnectedness. The actual utility of a resolution regime, however, may be best manifested in its ability to intervene early enough before mere temporary illiquidity slips into insolvency, and to intervene in such a way that gives the honest and reasonable managers and directors already in place and who did not actually cause the demise a decent chance to rescue and resurrect the business.

Remuneration claw back and "too big to fail"

Those FIs with more talent are more competitive; competent senior executives and directors of financial institutions are relatively rare in number.

Faced with the prospect of remuneration claw back, managers and directors may in fact have more incentives to seek employment at FIs that are perceived to have a lesser risk of failure. The bigger better FIs, the ones perceived to have a lesser risk of failure, will be those which can offer packages that are less likely subject to claw back. The less-capitalised riskier FIs may be at a disadvantage for those talents.

Compounded with factors like ever higher compliance costs and the desire to up the business scale and extend market reach that have led to more combinations of FIs, all this could lead to the emergence of a few concentrated FIs, perpetuating the "too big to fail" problem".

If there is indeed the possibility of recoupment liability entrenching an advantage commanded by the bigger better FIs in competing for talents, it can be redressed by a strict requirement to connect recoupment with causation, allowing clear opportunities for managers and directors to fend off recoupment liability by dispelling causal link. The strict causation requirement is to enable managers and directors to discount the potential recoupment liability by the likelihood of their conduct causing actual harm. This probability calculus will not vary across firms, and so there will be healthier competition for talents, reducing the likelihood of a concentration of firms that perpetuate the "too big to fail" phenomenon.

What implications?

Regulations probably cannot cover all eventualities. Well-intentioned efforts to correct real or potential problems can still lead to unintended consequences. It may be that the design of an effective resolution regime to combat systemic risk cannot be done at the macro-level alone. The financial system is made up of FIs, which are run by managers and directors, and since managers and directors are economic animals, they will seek to devise business strategies according to the economics of the rules and policies in place.

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<u>Responses to specific questions</u>

Subject to the foregoing general comments, we respond to specific consultation questions as follows:-

Question 31 Do you agree that resolution should result in the automatic removal of all the directors, the CEO and Deputy Chief Executive Officer ("DCEO") (where relevant) of an FI in resolution and that the resolution authority should have powers to remove other senior management at its discretion?

HKIoD Response:

- As to automatic removal, DISAGREE whether as to directors, as to CEO or as to Deputy Chief Executive Officer.
    - To automatically remove managers and directors is to presume liability solely based on title and job responsibility. This creates a probable likelihood of punishing someone who actually caused the FI little or no loss. Plus, automatic removal may deprive financial companies of the services of personnel who might be best positioned to maximise value.
- As to powers of the resolution authority to remove other senior management at its discretion, we can AGREE, but such discretion must only be exercised when there is some proper basis or rationale for removal as determined on a careful case by case basis, and not as a routine matter to render a near-automatic effect that castigates guilt merely by title and responsibility. The removal of other senior management may deprive an FI in resolution the services of personnel who might be best positioned to maximise value.
- A removal should not automatically imply those managers or directors are or must be subject to remuneration claw back.

Question 32 Do you agree that the resolution authority should be able to apply to the court to seek remuneration claw-back from those parties identified in paragraph 165 whose actions or omissions have caused or materially contributed to an FI entering resolution?

HKIoD Response:

- We have reservations about remuneration recoupment or claw-back.
- We first note that those parties identified in paragraph 165 are the following: “relevant current or former directors, those involved in management and those identified and categorised as risk-takers of an FI in resolution.”
- We note also, that the remuneration claw back would apply to those parties “whose actions or omissions have caused or materially contributed to an FI becoming non-viable and so entering into resolution.”
    - Recoupment liability must be founded upon a causal link; causation is key. If recoupment is detached from causation, it can lead to over-deterrence as much as under-deterrence. Over-deterrence comes about because managers and directors and risk-takers will refrain from taking business decisions that may be erroneously seen as a wrong with hindsight bias when in fact other factors or events intervened to cause an FI’s demise. Under-deterrence comes about because managers or directors or risk-takers may be tempted to cover for the potential recoupment loss with even riskier ventures that might bring a higher payoff.
    - Although the context of Question 32 and the accompanying text in the Second Consultation Paper appears to recognise the importance of a causal connection for recoupment liability to attach, it is not clear how and to what extent a manager or director or risk-taker will be permitted to dispel that causal connection for liability to attach.
    - A manager or director or risk-taker must be allowed to prove that other events or factors intervened to cause the demise of the FI in resolution. If the FI would have failed anyway, it would be incorrect to attribute the FI’s demise all to the manager or director or risk-taker. For instance, the demise could have been caused by general market credit tightening, or through employee misconduct for which the manager or director or risk-taker is not a part of. This leads to a

second element in the ability to fend off liability. A manager or director or risk-taker must not be held liable if he has been honest and reasonable and has been performing his duty for a proper purpose with the degree of care and diligence that he rationally believed to be reasonable under the circumstances.

- Recoupment liability not based on causation and which could attach through mere negligence could lead to concentration of financial talent and perpetuate too big to fail. See general comments.

Question 33 Do you have views on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested)?

HKIoD Response:

- Whether fixed or variable, whether vested or unvested, recoupment liability must only attach when there is causation. The manager or director must have the opportunity to defend by dispelling causation. A manager or director must not be held liable if he has been honest and reasonable and has performed his duty with the degree of care and diligence that he rationally believed to be reasonable under the circumstances.
- Nonetheless, if there is to be remuneration claw back, applying it to only the variable portion will merely invite FIs to structure compensation packages tilted towards fixed remuneration. It will follow that the bigger better FIs will be more able to offer those packages, and the better financial talents will gravitate to and be kept by those FIs. The result may just be a reinforcement of the "too big to fail" phenomenon. See also the general comments.

Question 34 In light of the practices adopted in other jurisdictions, do you have views on how far back in time a remuneration claw-back power should reach?

HKIoD Response:

- We have reservations about remuneration claw back.
- Recoupment liability must only attach when there is a causal link. Without the causal link, then, for so long as there is a claw-back penalty, the possibility of over-deterrence or under-deterrence is there.
- Based on practices adopted in other jurisdiction, it should be no more than two years.

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