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香港董事學會
The Hong Kong Institute of Directors

18 January 2016

Hon CHAN Kam-lam
Chairman of Bills Committee
Legislative Council
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Sirs

HKIoD's Response to the Bills Committee on Financial Institutions (Resolution) Bill

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 of Corporate Governance Policies Committee

香港董事學會有限公司
The Hong Kong Institute of Directors Ltd
香港灣仔軒尼詩道48號上海實業大廈2104
2104 Shanghai Industrial Investment Building, 48 Hennessy Road, Wan Chai, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網址 Web-site: www.hkiod.com

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Financial Institutions (Resolution) Bill

We at HKIoD have pleasure in submitting views to the Bills Committee on the Financial Institutions (Resolution) Bill. We look forward to working closely with the Bills Committee, the Administration and other stakeholders to achieve the intended benefits of the Bill.

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The Bill is about establishing a resolution regime for systematically important financial institutions. HKIoD previously commented on the subject matter in our April 2015 response to the Second Consultation Paper (issued in January 2015) on An Effective Resolution Regime for Financial Institutions in Hong Kong. As we did in that April 2015 response, we also seek to limit ourselves in this submission to several aspects that may have implications on the actual utility of the resolution regime.

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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 institutions.

Power to remove directors, CEO and deputy CEO
The Bill gives certain preparatory powers to a Resolution Authority, including that which an RA *may* remove a director, the CEO or deputy CEO of a within scope FI, or its holding company, from office where the RA is of the opinion that doing so will assist in meeting the resolution objectives. (Clause 24)

The power is said to be only exercisable if the RA is satisfied that the within scope FI has ceased, or is likely to cease, to be viable and the non-viability of which poses risks to the stability and effective working of Hong Kong's financial system. (Conditions 1 and 3 in Clause 25) It is not necessary for Condition 2, that there is no reasonable prospect that private sector action (outside of resolution) would result in the financial institution again becoming viable within a reasonable period, to be satisfied. The RA must give reason. (Clause 23, 24 and 25)

The Bill does represent a change from the proposals in the Second Consultation Paper which contemplates a policy of automatic removal for directors and CEO and deputy CEO, and removal of other senior management at the RA's discretion.

As we stated in our April 2015 response, the power to remove directors, CEO or deputy CEO (or other senior management) must only be exercised when there is some proper basis or rationale for removal as determined on a careful case by case basis. If not, the power to remove will be a power to castigate guilt merely by title and responsibility. We appreciate that the Bill now does not stipulate automatic removal. We nonetheless felt it necessary to caution that, when the Bill becomes law, the power to remove is not let to be invoked as a routine matter to render a near-automatic effect. And a removal should not automatically imply those managers or directors are or must be subject to remuneration clawback.

Removal power and "too many to fail"
Facing 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. And even in an ensuing resolution, the removal of managers and directors may in fact deprive an FI in resolution the services of personnel who might be best positioned to maximise value. We therefore felt it necessary to caution that, when the Bill becomes law, the power to remove is not let to be invoked as a routine matter to render a near-automatic effect.

Power to give directions
The Bill gives certain preparatory powers to a Resolution Authority, including that which an RA *may* give direction(s) to require financial institutions to take, or refrain from taking, certain specified action(s) within certain specified periods of time. (Clause 22) The power is said to be only exercisable if the RA is satisfied that the within scope FI has ceased, or is likely to cease, to be viable and the non-viability of which poses risks to the stability and effective working of Hong Kong's financial system. (Conditions 1 and 3 in Clause 25) It is

not necessary for Condition 2, that there is no reasonable prospect that private sector action (outside of resolution) would result in the financial institution again becoming viable within a reasonable period, to be satisfied. The RA must give reasons. (Clause 21, 22 and 25)

We appreciate that the Bill now has a provision (Clause 22(4)) that a director is not to be regarded as failing to discharge any duty owed to any person because of any act done or omitted to be done in good faith in compliance with , or in giving effect to, a direction. This Clause 22(4) apparently is there to relieve a director from duty (and associated liability) owed to the FI (and its shareholders) of the FI when complying with the direction.

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 (and to continue to perform the duty they owe to the FI (and its shareholders)). The power to give directions, if not fettered or if not exercised with caution and restraint, may in fact deprive those managers and directors already in place who knows the business that chance. We felt it necessary to caution that, when the Bill becomes law, the power to give direction(s) is not let to be invoked in such manner that predisposes the lack of prospect of private sector action to be taken by the managers and directors already in place.

Power to direct removal of impediments to orderly liquidation
The Bill gives certain preparatory powers to a Resolution Authority, including that which an RA *may* direct a within scope FI or its holding company to take actions to remove impediments to orderly liquidation so as to improve resolvability. This power is to be exercised in connection with the earlier stage of resolution planning (where a resolution is being assessed). Not complying with the RA's direction is punishable with hefty fine. (Clause 14 and 16)

We appreciate that the Bill provides for a mechanism for an aggrieved FI to seek review of the RA's decision at the Resolvability Review Tribunal. (Clause 17) 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.

Conceivably, the FI could be in a state of distress due to illiquidity, but rescuable with rational and commercial efforts or arrangements to keep the FI from plummeting further from what could in fact be a temporary illiquidity into true insolvency. Rational and commercial efforts or arrangements, if seen by the RA as impediments to orderly liquidation, could be precluded from being put into action. To have to contend with the RA's direction at the tribunal could discourage the managers and directors from even attempting such rescue efforts.

We felt it necessary to caution that, when the Bill becomes law, the power to give direction(s) to remove impediments is not let to be invoked in such manner that routinely results in the substitution of an RA's judgment for the business judgment of those managers and directors. If we are to be concerned with impediments to orderly liquidation of an FI that has indeed become not viable, we should give equal policy consideration to remove impediments to rescue and resurrection of an FI (e.g., a run on the FI by its creditors) at a time when the FI would still be viable.

Remuneration clawback

The Bill enables an RA to apply to the Court of First Instance for a clawback order against an officer or former officer of a within scope FI that it is resolving. The Court may make a clawback order if it is satisfied that the officer has acted in a way that caused, or materially contributed to, the financial institution ceasing, or being likely to cease, to be viable, and the act was done, or the omission was made, intentionally, recklessly or negligently. Ordinarily a clawback order relates to the 3-year period immediately before the initiation of resolution but the Court may extend that period by up to another 3 years in cases of dishonesty. (Clause 143)

As we stated in our April 2015 response, HKIoD has reservations about remuneration clawback. If *arguendo* there is to be remuneration clawback, recoupment must be founded on a strong exacting causal link between the act or conduct at issue and the extent to which it actually caused the FI to become not viable.

Causal link 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.

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 and could not reasonably have prevented despite reasonable efforts to have put proper safeguards in place.

We appreciate that the Bill now has a provision (Clause 143(2)) that would have the effect of recognising the importance of a causal connection for recoupment liability to attach, but the Bill will impose liability on being negligent. 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. It should require more than mere negligence for recoupment liability to attach.

The Bill provides for an ordinary "controlled period" of three years. As we stated in our April 2015 response, the lookback period should be no more than two years, based on practices adopted in other jurisdictions. HKIoD does have reservations about remuneration clawback in general.

The Bill also provides for an extended lookback period in cases of dishonesty, which will be up to six years (controlled period plus three). HKIoD also has reservations about an extended lookback period. If *arguendo* there is to be a longer lookback period in cases of dishonesty, remuneration clawback in resolution regime context must remain predicated on a strong exacting causal link between the dishonest act or conduct at issue and the extent to which that dishonest act or conduct actually caused the FI to become not viable. (The dishonest act or conduct can and should still be pursued and punished in accordance with law.)

The Bill provides that either fixed or variable, vested or unvested remuneration may be the subject of a clawback order. (Clause 144) HKIoD has reservations about remuneration clawback in general. If *arguendo* there is to be remuneration clawback, we would nonetheless agree with the Bill's intended coverage. Applying clawback only to 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.

Remuneration clawback 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.

Facing the prospect of remuneration clawback, 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 clawback. 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.

In this submission, we assume there will be willing managers and directors serving at FIs. Managers (and those executive directors) do get a decent even handsome compensation package in return, so all things considered, they may still accept the prospect of removal and remuneration clawback so long as the risk and liability does not exceed the challenge or pleasure or expected monetary gain from such positions.

What about (independent) non-executive directors? They are hardly paid enough to take decisions that involve medium level of risk, much less the decisions that could bring about the systemic risks that might trigger a correlated failure scenario. What could be clawed back from their directors' fees may be meager, but the castigation of guilt by mere title and responsibility of a director could make even fewer people bother to accept INED appointments willingly, or they would be those who are all about going along with the management. The economy will then find it impossible to get capable, competent outside directors to be the gatekeepers of corporate governance at financial institutions.

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