

## **Bills Committee on Financial Institutions (Resolution) Bill**

### **Response to Matters Raised by Members at the Meetings on 18 and 19 April 2016**

This paper sets out the Government's response to the matters raised by Members in relation to the Financial Institutions (Resolution) Bill (the Bill) at the Bills Committee (BC) meetings on 18 and 19 April 2016.

#### Schedule 3 – Stamp duty exemption for securities transfer instruments

According to the Inland Revenue Department, any “sale or purchase” of Hong Kong stock under the securities transfer instruments (i.e. Schedule 3 to the Bill) will be subject to stamp duty under the Stamp Duty Ordinance (Cap. 117), and stamp duty exemption may be granted to the instruments on a case-by-case basis. Members are of the views that the Bill should provide certainty on stamp duty exemption for the securities transfer instruments to facilitate smooth conduct of resolution, especially for carrying out the stabilization options with transfers to a bridge institution and to a temporary public ownership which will involve government ownership. Stamp duty exemption for the instruments will be justified recognizing the purpose of the transfers is to protect financial stability and integrity of the financial system. The Administration is requested to consider and respond to members’ views.

2. We are considering the matter and will respond in due course.

#### Clauses 83 and 84 – Suspension of obligations and excluded obligations

Clause 83 enables a resolution authorities, in a Part 5 instrument, to suspend obligations of a within scope financial institution (FI) to make a payment or delivery arising under a contract to which the FI or its subsidiary is a party. Clause 84 sets out the excluded obligations (e.g. end of year payment and terminal payment) from a suspension under Clause 83. Members are concerned that the provisions may have effect allowing the FI to make payment for the remuneration to senior officers of the FI who have/may have contributed to the non-viability of the FI (e.g. the acts of the officers involved excessive risk taking). The Administration is requested to:

(a) consider adding relevant provisions in the Bill to address members’ concern;

3. Clause 83 is intended to impose only a short (two business days) suspension on payment and delivery of obligations under contracts to which an FI (or its subsidiary) is a party. The suspension can be imposed at the discretion of the resolution authority in order to preserve continuity of critical financial services (which is a primary objective of resolution), in other words, it is not an automatic mandatory suspension and there may be good reasons not to impose such a suspension.

4. Clause 84 is designed to limit the power of the resolution authority under clause 83 with a view to ensuring that any suspension will not spread contagion or impose undue hardship on certain individuals during the two-day period, despite its short duration. In restraining a resolution authority from suspending payment of “wages” and certain non-discretionary entitlements which an FI in resolution would otherwise be obliged to pay under the Employment Ordinance (Cap. 57) (EO), the intention was to prevent temporary hardship to employees.

5. Clause 84 is not designed to allow or facilitate discretionary bonus payments upon initiation of resolution. “End of year payment” is intended to refer to an annual payment (including a 13<sup>th</sup> month payment) which an employee, employed under a continuous contract, is entitled to receive from his employer as a term of his contract (please see paragraphs 23-27 below for further discussion). In other words, it is non-discretionary and it does not include any payment which is of a gratuitous nature payable at the discretion of the employer.

6. The question of whether an FI in resolution would have a contractual obligation to pay any form of remuneration, even in the event of resolution, will depend upon the terms of the relevant employment contract. However, post-crisis, measures have been taken to develop standards for FIs (particularly banks) to ensure that their internal frameworks and contractual arrangements for variable remuneration (i.e. bonuses) reflect the sustainable overall performance of the FI as a whole (as well as that of relevant business units and individual employees), and are subject to a degree of deferral in payment, thereby rendering it unlikely that full bonuses will be paid in circumstances where an FI becomes non-viable, triggering resolution (see paragraphs 13-22 below for an explanation of the relevant guidance for banks in Hong Kong).

7. The general concept underpinning the approach in the Bill to existing contractual arrangements, of whatever nature, is to minimise interference with contractual rights and limit it only to the extent necessary to achieve orderly

resolution, thereby preserving as much continuity and certainty in the markets as practicable and respecting the legal rights of persons affected.

8. Other post-crisis measures, introduced as part of the Basel III framework, are also designed to restrict banks from making discretionary bonus payments where a bank has suffered deterioration in its financial condition. This has been implemented in Hong Kong through the Banking (Capital) Rules (Cap. 155L) (BCRs) which impose requirements on authorized institutions (AIs) to restrict the distribution of earnings where their capital position is deteriorating. Specifically, section 3F of the BCRs restricts an AI incorporated in Hong Kong from making “distribution payments” (which include, “discretionary bonus payment[s] to the directors, senior management and employees of the institution...” (see section 3E of the BCRs)) in circumstances where the AI’s capital position has deteriorated to a certain level. The underlying philosophy is to ensure that an AI is required to use earnings to restore its capital position rather than using them to fund discretionary payments to shareholders, directors etc.

9. More specifically, the restrictions apply where an AI’s net Common Equity Tier 1 (CET1) capital ratio falls below a “buffer level” (section 3G of the BCRs), which level is set through the cumulation of the three capital buffer ratios established as a result of the implementation of the Basel III capital framework in Hong Kong (namely the “capital conservation buffer ratio”, the “countercyclical capital buffer ratio” and the “higher loss absorbency ratio”).<sup>1</sup>

10. The degree of the restriction on “distribution payments” is determined on a sliding scale tied to the extent to which an AI’s net CET1 ratio has fallen below the buffer level, up to a maximum of 100% (i.e. an AI cannot pay out any its earnings as “distribution payments”) where the net CET1 ratio falls within the fourth quartile of the buffer range.

11. So as structured, where an AI’s net CET1 capital ratio falls below its buffer level and it approaches the point of non-viability, the restrictions automatically take effect to restrain the AI’s distribution of earnings for payment of “distribution payments”, including discretionary bonuses to its directors,

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<sup>1</sup> The development of the capital buffers in the Basel III framework was driven by the principle of ensuring that, outside of periods of stress, banks should build-up and hold a buffer of capital above the regulatory minimum. This should bolster banks’ resilience as the buffers are designed to be drawn upon to absorb losses which a bank may suffer in any subsequent period of stress. Should a bank deplete all or part of its buffer, then it should be required to retain earnings in order to once again rebuild its capital base and enhance its resilience.

senior management and employees.

12. The attribution of responsibility to officers of an FI for causing, or materially contributing to, the FI's failure and the clawback of remuneration in such circumstances is sought to be covered in Part 8 of the Bill through an independent Court based process. The Court, upon the application of the resolution authority, will consider the extent to which an officer was at fault, thereby ensuring procedural fairness and removing the question from the discretion of the resolution authority.

(b) provide Hong Kong Monetary Authority (HKMA)'s guidelines to AIs on the governance and control arrangements for AIs' remuneration systems, and explain how the guidelines could enable HKMA or an AI to defer payment of variable remuneration to the AI's senior management to address possible subsequent problems on the AI arising from misbehaviour of the AI's senior management;

13. The HKMA's Supervisory Policy Manual (SPM) Module "Guideline on a Sound Remuneration System" (CG-5) is at Annex A. This SPM Module implements the Financial Stability Board's (FSB) Principles for Sound Compensation Practices and their corresponding Implementation Standards (P&S). Hong Kong underwent peer reviews by the FSB of its implementation of the P&S in 2010 and 2011 with no adverse findings identified.

14. Under the SPM Module AIs should devise remuneration packages with a proportionate balance of fixed and variable (bonus) remuneration reflecting the seniority, role, responsibilities and activities of their employees (section 2.2.1). The proportion of variable pay should increase in line with seniority and responsibility, so that a substantial proportion of the remuneration of the senior management and material risk takers (referred to in the SPM Module as "Key Personnel") should be paid in the form of variable remuneration and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance.

15. The SPM Module further provides that an AI's variable remuneration should take into account the AI's performance over the longer term (e.g. by reference to financial results spanning three to five years or by using a moving average of financial results) (section 2.3.3). This is to prevent short term gains, generated by short term higher risk taking, from leading to higher variable remuneration.

16. Variable remuneration should be symmetric with performance (section 2.3.6) and an AI should operate a truly discretionary and fully flexible policy such that it may withhold all or part of the variable remuneration if the payment is not justified by the performance of the institution or when it is necessary to protect the financial soundness of the institution (section 2.3.7). Thus an AI's remuneration framework should itself provide for bonuses to be withheld in the event the AI's condition is such that it is no longer financially sound (and, in the language of the Bill, likely to become non-viable).

17. In addition, in line with the FSB P&S, the SPM Module covers the deferral of variable remuneration to allow: (a) employees' performance, including the associated risks, to be observed and validated over a suitable period of time before payment is actually made, and (b) the amount to be paid to be adjusted to enable the remuneration ultimately received by employees to more accurately reflect risk and risk outcomes (section 2.4.1).

18. A "claw-back" provision (here meaning "claw-back" by the AI) should operate in respect of unvested deferred remuneration where it is later established that any performance measurement was based on data which is later proven to have been manifestly misstated or it is later established that there has been fraud or other malfeasance on the part of the relevant employee or violations of internal control policies (section 2.4.3). The departure of an employee from an AI should not trigger early payout of deferred remuneration that is still within the deferral period (section 2.4.4).

19. The SPM Module also sets out disclosures (quantitative and qualitative) to be made by AIs relating to remuneration in order to encourage transparency and market discipline (section 3).

20. When the SPM Module was first issued in March 2010, AIs were required to complete a self-assessment of compliance with its terms. Thereafter, as part of its risk-based supervisory process, the HKMA has monitored AIs' compliance with the SPM Module through off-site reviews and on-site examinations of the remuneration practices of selected institutions. Under the SPM Module AIs should carry out regular (at least annual) reviews of their remuneration systems, independently of management, and submit the result to the HKMA (sections 2.1.3 and 2.1.8.6). Under section 2.1.8.6, the review should include an assessment of the extent to which the remuneration system is consistent with the SPM Module and this provides an additional basis for supervisory follow-up by the HKMA.

21. The results of the HKMA's supervisory assessment will feed into the annual review of an AI's supervisory CAMEL (Capital adequacy, Asset quality, Management, Earnings, Liquidity) rating (which in turn influences Scheme Members' amounts of contribution to the Deposit Protection Scheme) and, for locally incorporated AIs, will be taken into account in determining whether additional capital should be held to cover risks (section 1.4.2).

22. Should weaknesses in remuneration practices be identified, remedial actions will be required. Failure to take timely corrective measures will result in the HKMA taking appropriate supervisory measures. In more extreme cases, such measures could include: calling into question the fitness and properness of senior management under the Banking Ordinance (Cap. 155) (BO) in view of their failure to maintain adequate systems of control; requiring an AI to set a quantitative limit on the total variable remuneration payable (section 1.4.3); or even supervisory intervention powers to give directions under section 52 of the BO should an AI's remuneration system encourage excessive risk-taking so as to amount to carrying on business in a manner detrimental to depositors, or should the AI become likely to become unable to meet its obligations. Finally, ongoing authorization criteria in Schedule 7 to the BO require the Monetary Authority to be satisfied that the AI has adequate systems of control. Should a remuneration system significantly jeopardise risk-control, then this may call into question the AI's ability to meet its licensing criteria.

(c) clarify the coverage of the excluded obligations "end of year payment" and "terminal payment" in Clause 84(1)(c); and

23. Under section 11A(1) of the EO, "end of year payment" means any annual payment (whether described as "thirteenth month payment", "fourteenth month payment", "double pay", "end of year bonus" or otherwise) or annual bonus of a contractual nature, but does not include any annual payment or any annual bonus, or any proportion thereof, which is of a gratuitous nature or which is payable only at the discretion of the employer.

24. Terminal payments are a form of remedy which the Labour Tribunal (LT) could award to an employee as it considers just and appropriate for cases of unreasonable dismissal, unreasonable variation of the terms of the employment contract, or unreasonable and unlawful dismissal, where no order for reinstatement or re-engagement is made. Terminal payments, where awarded by the LT, are payable by an employer under section 320 of the EO.

25. “Terminal payments” refer to the statutory entitlements under the EO that an employee has not been paid, and to which he is entitled, upon the termination of his contract of employment, or that he might reasonably be expected to be entitled to upon the termination of the contract of employment had he been allowed to continue with his original employment or original terms of the contract of employment to attain the minimum qualifying length of service required for the entitlements under the EO.

26. According to section 32O(3), terminal payments include:

- (a) any wages and other payments due to the employee under his contract of employment;
- (b) any payment in lieu of notice payable under Part II of EO, in the case of a dismissal without due notice;
- (c) any end of year payment payable under Part IIA of EO;
- (d) any maternity leave pay or sum payable under Part III of EO;
- (da) any paternity leave pay payable under Part IIIA of EO;
- (e) any severance payment payable under Part VA or any long service payment payable under Part VB of EO;
- (f) any sickness allowance or sum payable under Part VII of EO;
- (g) any holiday pay payable under Part VIII of EO;
- (h) any annual leave pay payable under Part VIIIA of EO; and
- (i) any other payments due to the employee under EO and under his contract of employment.

27. An employee may be awarded terminal payments even if he has not attained the qualifying length of service required for the entitlements. In such cases, the terminal payments shall be calculated according to the actual length of time that the employee has been employed under that contract of employment with the employer.

- (d) consider the need to revise the terms in (c) above to better reflect the remuneration systems in the financial services industry.

28. As explained above, “end of year payment” and “terminal payment” are defined terms under the EO in relation to employees’ entitlements. Where remuneration paid by an FI falls within the definition of one of these terms, it is afforded the relevant protections under the EO and is excluded from the imposition of a temporary suspension under clause 83 of the Bill (and excluded from bail-in, as per section 2(n) of Schedule 5). On the above basis, we do not consider it appropriate to revise these terms which have already been clearly defined under the relevant provisions of the EO in order to avoid any possible

confusion or temporary hardship that interference with such payments might cause to the employees of an FI in resolution.

#### Clause 95 – Appointment of appointing person

To decide whether any pre-resolution shareholder and pre-resolution creditor of an FI is eligible for compensation under the “no creditor worse off than in liquidation” principle, Clause 96 provides for the appointment of an independent valuer for making a valuation in relation to a failing FI. Clause 95 provides for the appointment by the Financial Secretary (FS) of a person (i.e. the appointing person) to be responsible for appointing the independent valuer under Clause 96. Some members express concern about the proposal for FS to appoint an appointing person who in turn will be responsible for appointing the independent valuer. They consider that the independent valuer should be appointed by FS direct and FS should take direct responsibility in making such appointment. The Administration is requested to:

- (a) review the relevant provisions to address members’ concern; and
- (b) provide information on the appointment mechanisms for independent valuer adopted by overseas jurisdictions in their resolution regimes.

29. The provisions cited are designed to provide comfort to the shareholders and creditors of an entity whose resolution has been initiated that an independent valuer performing the “no creditor worse off than in liquidation” (NCWOL) valuation (following the initiation of resolution) is, and is seen to be, at least a step removed from the Government, which itself may have an incentive to minimise any NCWOL compensation given that public moneys may need to be deployed in the first instance to service the payment of any such compensation pending subsequent recovery from the industry through the resolution levy.

30. The FSB’s “Key Attributes of Effective Resolution Regimes for Financial Institutions” are designed to provide high-level policy directives. Although they establish the NCWOL principle underpinning resolution regimes, they do not set standards in respect of who must be appointed to perform a valuation for that purpose or indeed how the appointment process must operate. As explained above, the intention of the proposed appointing person approach is to provide for a valuation process that is, and is seen to be, independent and impartial, taking into account practice that we have seen in other jurisdictions.



31. Further information on our understanding of the appointment mechanisms for independent valuers adopted by overseas jurisdictions, where we have found examples of such practice, is at Annex B.

Clause 95(6) provides that the resignation of an appointing person would only take effect when the relevant notice is published in the Gazette. However, Clause 95(3) only requires FS to publish a notice in the Gazette on the appointment of an appointing person. It is unclear when the appointment of an appointing person would take effect. The Administration is requested to:

(a) clarify when the appointment of an appointing person would take effect;

32. The appointment of an appointing person takes effect upon gazettal.

(b) review the relevant provisions in Clause 95 to remove the ambiguity; and

33. In light of paragraph 32, we will move a Committee Stage Amendment (CSA) to clause 95 to specify explicitly that the appointment of an appointing person takes effect upon publication of the gazette for better clarity.

(c) review the need of Clause 95(7) on the validity of the acts of an appointing person despite there have been defects in the appointment process.

34. As explained at the BC meeting on 19 April 2016, the defects mentioned at clause 95(7) are intended to be confined to those that are procedural in nature. This provision therefore provides for a certain degree of flexibility such that the appointment of an independent valuer by the appointing person would not automatically be null and void should it be discovered later that there had been a procedural defect in the appointment of the appointing person. The underlying rationale being that even if a defect in the process for the appointment of the appointing person were to be discovered, it does not mean that the appointing person would not have performed their functions under the Bill reasonably and in good faith. Absent the provision in 95(7), if the appointing person's acts were to be declared void, the appointment of the independent valuer could be void as a result and as such the whole appointment, and valuation, process would have to be recommenced, which could

significantly slow down the process of the NCWOL valuation and in turn the determination of whether compensation is payable to pre-resolution shareholders and creditors of an FI in resolution.

### Drafting issue

In the light of comments by the legal adviser to the Bills Committee, the Administration is requested to review the wording of clause 81(5) as the Chinese text “大致上相類” seems to have different meaning from the English text “substantially similar to”.

35. According to the Concise Oxford Dictionary, the meanings of the word “substantially” include (1) “to a great or significant extent” and (2) “essentially” (which means “[regarding] the fundamental elements”, or “in substance”). Having considered the context of clause 81(5), we consider meaning (2) is applicable. We will move a CSA to amend “大致上” to “實質上” at clause 81(5) to improve clarity.

36. We have also taken the opportunity to review other clauses in the Bill which include “substantially” in the English text, i.e. clauses 47(1)(a) and 186(2). For clause 47(1)(a), we consider the phrase “substantially all” should be interpreted as a whole to mean “almost all”. For clause 186(2), we consider the word “substantially” means “to a significant extent” (meaning (1)) in the context. In order to improve clarity, we suggest moving CSAs to amend “大致上全部” to “接近全部” at clause 47(1)(a), and to amend “大致上相等於” to “在相當程度上相等於” at clause 186(2).

Clauses 120 and 137 respectively provide that any determination or order of the Resolvability Review Tribunal (RRT) and the Resolution Compensation Tribunal (RCT) is final and is not subject to appeal unless with the leave of the Court of Appeal under Clauses 122 and 139. Clauses 122(5) and 139(5) provide that the decision of the Court of Appeal on the grant of leave to appeal or otherwise by it to the applicant party is not subject to appeal. Some members express concern about the validity of Clauses 120, 122(5), 137 and 139(5) as provisions of similar nature have been ruled null and void by the court before. The Administration is requested to:

- (a) review the provisions to address members’ concern; and
- (b) provide information on court rulings of past cases where similar

provisions were ruled null and void.

37. We are considering the matter and will respond in due course.

Clauses 123 and 140 – Powers of Court of Appeal

Clauses 123(3) and 140(3) stipulate that the Court of Appeal may make any order as to the costs of the appeal that it considers appropriate. In the light of comment of the legal adviser to the Bills Committee, the Administration is requested to clarify if the Court of Appeal allows an appeal, whether the provisions also empower the Court of Appeal to vary a cost order made by RRT or RCT on the case concerned.


38. We are considering the matter and will respond in due course.

Schedules 8 and 9 – Appointment of Tribunal chairperson

Sections 2 of Schedules 8 and 9 to the Bill provide that the Chief Executive (CE) must, by notice published in the Gazette, appoint a person as the chairperson of RRT and RCT respectively. While the Bills Committee notes the Administration's policy intent that more than one RRT/RCT can operate at the same time and hence CE can appoint more than one tribunal chairperson for the purpose, the relevant provisions in Schedules 8 and 9 have not clearly reflected this arrangement. The Administration is requested to review the provisions concerned with reference to similar provisions for the appointment of chairperson and operation of the Board of Review (Inland Revenue Ordinance).

39. We duly noted Members' views expressed at the BC meeting on 19 April 2016. Although we do not consider that the present drafting prevents the establishment of additional tribunals as and when necessary, to improve clarity, we agree to move a CSA to amend clauses 110 and 126, to the effect that the Chief Executive may establish additional tribunals should he consider appropriate to do so. One model we will consider is that under sections 97(3) and 97(4) of the Insurance Companies Ordinance (Cap. 41).

**Financial Services and the Treasury Bureau (Financial Services Branch)  
Hong Kong Monetary Authority  
Securities and Futures Commission  
Office of the Commissioner of Insurance  
April 2016**

 <b>HONG KONG MONETARY AUTHORITY</b> 香港金融管理局		
<b>Supervisory Policy Manual</b>		
<b>CG-5</b>	<b>Guideline on a Sound Remuneration System</b>	V.2 – 12.03.15

This module should be read in conjunction with the [Introduction](#) and with the [Glossary](#), which contains an explanation of abbreviations and other terms used in this Manual. If reading on line, click on blue underlined headings to activate hyperlinks to the relevant module.

## Purpose

To provide guidance to AIs on the key elements of a sound remuneration system, to set out the approach which the HKMA will adopt in the supervision of AIs' remuneration systems, and to outline the level and type of disclosure in relation to remuneration expected to be made by AIs

## Classification

A non-statutory guideline issued by the MA as a guidance note

## Previous guidelines superseded

CG-5 "Guideline on a Sound Remuneration System" (V.1) dated 19.03.2010

## Application

To all AIs

## Structure

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## 1. Introduction

### 1.1 Legal framework

- 1.1.1 Section 7 of the Banking Ordinance provides that the MA shall promote the general stability and effective working of the banking system and shall promote and encourage proper standards of conduct and sound and prudent business practices amongst AIs. The MA therefore has a particular interest in ensuring that AIs' remuneration systems are sound and prudent and do not pose risks to AIs' safety and soundness.
- 1.1.2 The principles relating to sound remuneration systems set out in this module supplement the Supervisory Policy Manual module on Corporate Governance of Locally Incorporated Authorized Institutions ([CG-1](#)) issued under section 7(3) of the Banking Ordinance. The [CG-1](#) module provides that Boards of locally incorporated AIs should be responsible for ensuring effective internal control systems are in place so that an AI's operations are properly controlled and comply with



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policies approved by the Board as well as applicable laws and regulation, and for ensuring in this context that the AI's remuneration policy is consistent with its ethical values, objectives, strategies and control environment.

- 1.1.3 This module should also be read in conjunction with [IC-1](#) "General Risk Management Controls" and [IC-2](#) "Internal audit function". The sound practices contained therein are also applicable to a sound remuneration system.

## 1.2 Objectives

- 1.2.1 The main objective of this module is to ensure that AIs' remuneration systems are consistent with and promote effective risk management, in recognition of the fact that remuneration systems which create incentives towards inappropriate and excessive risk-taking could threaten the safety and soundness of the individual AI concerned and potentially thereby the stability of the local banking system. To this end, this module also describes the HKMA's supervisory approach with regard to remuneration practices, in the context of the HKMA's risk-based supervision of AIs.
- 1.2.2 It is recognised that, so far as remuneration systems are concerned, "one size will not fit all" AIs. The HKMA's intention in issuing this module is therefore not to prescribe a particular remuneration system, or levels of, or limits on, individual remuneration. The development of remuneration systems and the setting of such levels and limits are and remain the responsibility of AIs' Boards of Directors (Boards)<sup>1</sup> and senior management. This module focuses rather on the governance and control arrangements for, and operation of, AIs' remuneration systems in the context of the incentives for risk-taking they may create. AIs

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<sup>1</sup> In this module, the term "Board" is used to mean the Board of Directors of a locally incorporated AI or the Board of Directors and/or local management of an overseas-incorporated AI where appropriate.



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are expected to establish and operate their remuneration policies, structures and incentives awards with due regard to the principles set out in this module.

### 1.3 Scope of application

- 1.3.1 To meet the objectives referred to in paragraph 1.2.1 above and ensure a level playing field within the local banking sector, this module applies to all AIs including, in the case of locally incorporated AIs, their overseas branches and subsidiaries subject to the HKMA's consolidated supervision. Where, because of local laws or regulations in any relevant overseas jurisdiction, an overseas branch or subsidiary is unable substantively to reflect the principles set out in this module in its remuneration system, the HKMA should be informed.<sup>2</sup>
- 1.3.2 AIs are expected to demonstrate to the satisfaction of the HKMA that their remuneration systems (or, in the case of overseas-incorporated AIs, the remuneration systems applicable to officers and employees engaged in the conduct of their business and operations in Hong Kong) are sound and in compliance with the principles set out in this module. In any case where an AI's remuneration system does not reflect certain aspects of the principles set out in this module, the AI's Board should satisfy themselves and the HKMA that either: (a) the relevant aspects of the module are not reasonably applicable to their institution or to certain business units within their institution or to certain groups of their employees, as the case may be, or (b) their institution has adopted alternative control measures which are equally effective in ensuring that their remuneration systems do not provide incentives to take inappropriate or excessive risk and that the systems are subject to adequate oversight by the Board.<sup>3</sup>

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<sup>2</sup> In such circumstances, the AI may be requested to demonstrate to the HKMA's satisfaction that the remuneration systems actually operated in such branches or subsidiaries are consistent with local laws or regulations in the relevant jurisdiction, do not incentivise inappropriate or excessive risk-taking and promote effective risk management.

<sup>3</sup> A general reference to prevailing market practices as an explanation for any deviation from this module will not be regarded as sufficient for this purpose.



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- 1.3.3 A proportionate approach may be adopted by AIs in applying this module to the development and operation of their remuneration systems, based on the size, scope, nature and complexity of their business and the extent to which they use incentives-based compensation arrangements. Thus, for example, an AI with a large, complex, multifaceted business which employs large numbers of employees engaged in diverse risk-taking activities and which makes extensive use of variable incentive compensation arrangements will be expected to have more formalised, systematic and detailed policies, procedures, and systems and to undertake more extensive monitoring and reviews than an AI which is engaged in more simple business, on a smaller scale, and which uses variable incentive-based awards on a limited basis only.
- 1.3.4 Similarly, the provisions in this module concerning the balance of fixed and variable incentives-based remuneration, the mix of instruments used for the “payment” of variable remuneration, the measurement of long-term performance, and the arrangements for deferral of variable remuneration may be applied in a manner commensurate with the seniority, responsibility, role and activities of the relevant employees. It may not be appropriate to apply measures such as these to junior-level employees who receive relatively insignificant amounts of variable remuneration, or to employees whose duties are of such a nature that they would not be capable of, or in a position to, materially impact the risk profile of the AI.<sup>4</sup> The taking of a longer-term perspective for the purposes of certain aspects of the operation of the remuneration system (including deferral arrangements) may also not be relevant for employees whose duties are such that the risks incurred by their activities will be fully reflected in current year performance.

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<sup>4</sup> AIs should however remain alert to the effects of their incentive compensation arrangements on groups of employees, where each individual employee may not be in a position individually to impact the AI’s risk profile materially but where their behaviour, collectively, in response to similar incentives created by remuneration schemes, could do so.





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- 1.3.5 AIs are encouraged to discuss with the HKMA any concerns they may have regarding the applicability of this module to given aspects of their remuneration systems in the light of their specific conditions.

#### 1.4 Supervisory approach

- 1.4.1 The HKMA will take into account the potential risks that may arise from an AI's remuneration system<sup>5</sup> as part of its risk-based supervisory process, reviewing the institution's remuneration policies, practices and outcomes when assessing its overall risk environment. For this purpose, all information which the HKMA may require in order to enable it to undertake an assessment of: (a) the risks inherent in, or relating to, an AI's remuneration system; and (b) the extent to which an AI's remuneration system is broadly consistent with the principles set out in this module; should be made available to the HKMA upon request.
- 1.4.2 The results of the HKMA's supervisory assessment will feed into the annual review of an AI's supervisory CAMEL rating and, for locally incorporated AIs, will be taken into consideration in the determination of whether additional capital should be held by the AI to cover risks not covered, or not adequately covered, under the AI's existing minimum capital requirements.
- 1.4.3 If the HKMA's assessment indicates that an AI's remuneration system is inconsistent with the principles set out in this module and poses a risk to the safety and soundness of the AI, the HKMA will expect the AI to implement measures promptly to address and mitigate any risks identified in respect of its remuneration arrangements, such as reducing the potential risk inherent in given employees' activities or changing its remuneration system to bring it into line with the principles in this module. Failure by the AI to take timely corrective measures in a manner satisfactory to

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<sup>5</sup> In the case of overseas-incorporated AIs, the remuneration systems applicable to officers and employees engaged in the conduct of their business and operations in Hong Kong.



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the HKMA will result in the HKMA taking such supervisory measures as it considers appropriate.<sup>6</sup>

- 1.4.4 Where an AI in Hong Kong is part of a banking group (i.e. a subsidiary of a banking group or a branch of an overseas-incorporated bank), the institution may adopt the remuneration policy formulated at the group level if it can demonstrate to the HKMA's satisfaction that the relevant group remuneration policy is broadly consistent with the principles set out in this module, having regard to local circumstances or, if and to the extent that it is not so consistent in any respect, that such group policy contains alternative control measures that are equally effective in ensuring that it promotes effective risk management. The AI should also provide, and ensure that it is in a position to provide, to the HKMA such information and documentation as the HKMA may require in order to assess: (a) the risks inherent in, or relating to, the AI's remuneration system; and (b) the extent to which the AI's remuneration system is broadly consistent with this module. Where appropriate, the HKMA may obtain relevant information and opinions regarding the remuneration system from the home supervisor of the AI's parent bank or head office for reference, or may raise any instances of inconsistency with the principles in this module with them.

## 1.5 Implementation

- 1.5.1 Following the issuance of the first version of this module in 2010, AIs should already have taken action to reflect the principles set out in the module within their remuneration systems and to bring such systems into line with the module's provisions. The purpose of this revised module is to incorporate existing guidance in relation to remuneration disclosures as set out in the HKMA's circular letter dated 23 November 2011. AIs

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<sup>6</sup> In extreme cases, where the HKMA has serious concerns about the interaction of the AI's remuneration arrangements and its capital strength, the HKMA may consider the need (notwithstanding paragraph 1.2.2 above) to set a quantitative limit on the total variable remuneration payable by the AI (such as limiting total variable remuneration to a percentage of total net revenues) if the HKMA considers this necessary in all the circumstances as a capital conservation measure.



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are generally expected to have implemented these disclosure requirements over the past three years. If however they have not fully done so, they should promptly commence any necessary system upgrades for generating the required data and information for the purpose of making the required remuneration disclosures. Any AI that has not already fully implemented the disclosure requirements and that is encountering any problem in doing so should approach the HKMA to discuss the outstanding issues and likely timeframe required for them to be resolved. The HKMA will monitor AIs' adoption of the principles set out in the module in its on-going prudential supervision of AIs.

- 1.5.2 The HKMA anticipates that this module will be developed further in the light of implementation experience and the development of best practices, both locally and overseas. AIs are encouraged to consider the operation of their remuneration systems as part of their capital planning process; to monitor developments in methods and practices for making remuneration sensitive to risk-taking; and to incorporate emerging methods and practices that are likely to enhance safety and soundness into their remuneration systems.

## 2. Elements of a sound remuneration system

### 2.1 Governance

#### *Remuneration policy*

- 2.1.1 The Board of an AI should establish and maintain a written remuneration policy covering all employees<sup>4</sup> which reflects the principles in this module. In particular, the policy should ensure that the institution's overall approach to risk management is supported, and not undermined, by the remuneration arrangements for employees whose activities during the course of their employment (individually or collectively) could have a material impact on the AI's risk profile and financial soundness. In this regard, the policy should have specific regard to the remuneration of the following



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personnel, as well as their role in the institution's remuneration system where relevant :

- 2.1.1.1 senior management who are responsible for oversight of the AI's firm-wide strategy or activities or those of the AI's material business lines (including, but not limited to, executive directors, the chief executive, and other senior executives);<sup>7</sup>
  - 2.1.1.2 individual employees ("Key Personnel" for the purposes of this module) whose duties or activities in the course of their employment involve the assumption of material risk or the taking on of material exposures on behalf of the AI (for example, proprietary traders and dealers who are in a position to take on material exposures);
  - 2.1.1.3 groups of employees whose activities in the aggregate may expose the AI to material amounts of risk and who are subject to the same or similar incentive arrangements (including, but not limited to, employees who are incentivised to meet certain quotas or targets by payment of variable remuneration for example, personnel in marketing, sales and distribution functions and loan officers); and
  - 2.1.1.4 employees within risk control functions (including, but not limited to, risk management, financial control, compliance, legal and internal audit functions).
- 2.1.2 The remuneration policy should be designed to encourage employee behavior that supports the AI's risk tolerance, risk management framework and long-term financial soundness. It should be in line with the

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<sup>7</sup> Managers (as defined in section 2 of the Banking Ordinance) may also fall within this category of personnel to the extent that their role or position within the AI gives them responsibility for oversight of the strategy, conduct and operation of material business lines in Hong Kong.



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objectives, business strategies and long-term goals of the AI and structured in a way that will not encourage excessive risk-taking by employees but allows the AI to attract and retain employees with relevant skills, knowledge and expertise to discharge their specific functions.

2.1.3 Information regarding the performance measurement and remuneration of employees should be clearly documented. An AI should conduct regular internal monitoring to ensure that its processes for ensuring compliance with its remuneration policy are being consistently followed. Such monitoring should be conducted by compliance, audit or other personnel in a manner consistent with the AI's overall framework for compliance monitoring. In addition, the remuneration policy and its implementation should be subject to a regular (at least annual) review, independent of management, by the Board (or by a party commissioned by the Board) to ensure that the policy remains adequate and effective and that the operation of the remuneration system is consistent with the intended purposes and long-term interests of the AI. Remuneration outcomes, risk measurements, and risk outcomes should be reviewed for consistency with intentions. The AI's internal audit function should provide support to the Board in the review process and report any material weaknesses which are identified.

2.1.4 To enforce desirable employee behavior which is consistent with the AI's strategy and risk management, the key principles underpinning the remuneration policy should be accessible to all employees. Employees should know in advance how their performance will be measured and compensated. AIs may determine the appropriate level of information to be provided to employees at various ranks and within various business units within their organizational structures but, in order to effectively enable the remuneration policy to influence employee behaviour, at least: the financial and non-financial factors to be used to measure the employees' performance; the risk adjustments to be made; and the "payout function" to determine how and



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when the employees will be paid for their performance; should be disclosed to employees.

- 2.1.5 The remuneration policy and information on the AI's regular monitoring and review of the operation of the remuneration policy should be provided to the HKMA on request.

#### *Board oversight and remuneration committee*

- 2.1.6 The Board of an AI is ultimately responsible for overseeing the formulation and implementation of the AI's remuneration policy. In exercising its oversight, the Board should ensure that its judgements and decisions relating to remuneration arrangements are taken independently of the management and in the best interests of the AI.
- 2.1.7 The Board of an AI (or the Board's remuneration committee with the necessary delegated authority) should approve the remuneration packages<sup>8</sup> (and any subsequent adjustments) of the AI's senior management (referred to in paragraph 2.1.1.1 and the AI's Key Personnel (referred to in paragraph 2.1.1.2). To avoid conflicts of interest, executive directors should play no part in making decisions in respect of their own remuneration. The remuneration packages of other employees granted in accordance with the AI's remuneration policy may generally be approved below Board level.
- 2.1.8 The Board of a licensed bank should establish a board remuneration committee to assist the Board in discharging its responsibility for the design and operation of the AI's remuneration system. This remuneration committee should have the following attributes:
- 2.1.8.1 The members of the committee should be independent non-executive directors or,

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<sup>8</sup> Including fixed salary and incentive compensation arrangements.



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where executive directors are to be members of the committee, the majority of its members should be independent non-executive directors. If an AI encounters difficulties in achieving this balance of membership within its remuneration committee, it should approach the HKMA to discuss the matter. An AI may appoint other relevant persons (such as compliance managers or risk managers) as advisers or observers to the committee.

- 2.1.8.2 The committee should have written terms of reference which clearly define its role and responsibilities, authority and tenure, and which should be updated as appropriate.
- 2.1.8.3 The committee should make recommendations in respect of remuneration policy and practices to the Board. In so doing, it should ensure that the AI's remuneration policy is consistent with the principles set out in this module and any other legal or regulatory requirements applicable to employees' remuneration.
- 2.1.8.4 The committee should be able to exercise competent and independent judgement on remuneration policies and practices and the incentives thereby created for managing risk, capital and liquidity. It should carefully evaluate any practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the AI's financial condition and future prospects (please see paragraph 2.1.10 below).
- 2.1.8.5 The committee should make recommendations to the Board in respect of the remuneration packages for the AI's



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senior management (referred to in paragraph 2.1.1.1) and Key Personnel (referred to in paragraph 2.1.1.2) in cases where the approval authority for such remuneration packages rests solely with the Board.

2.1.8.6 The committee should ensure that a regular (at least annual) review of the AI's remuneration system and its operation, either internally conducted or externally commissioned, is carried out independently of management and the result is submitted to the HKMA. Such review should include an assessment of the extent to which the remuneration system is consistent with the principles set out in this module.

2.1.8.7 The committee should work closely with other relevant committees of the AI's Board such as the risk committee and the audit committee and should have the ability to consult the AI's compliance function in the evaluation of the incentives created by the remuneration system. The committee should report any material issues in relation to the AI's remuneration system to the Board on a regular basis (please see paragraph 2.1.12 below).

2.1.9 Where a licensed bank is part of a banking group (i.e. a subsidiary of a banking group or a branch of an overseas-incorporated bank), the establishment of a remuneration committee at group level will be regarded as consistent with the principles set out in paragraph 2.1.8 if the committee has the attributes set out in that paragraph or, failing which, if the AI can demonstrate to the HKMA's satisfaction that it is constituted in such a way that it is independent of management and demonstrably able to exercise competent and independent judgement on compensation practices and the incentives thereby created for managing risk, capital and liquidity. To monitor adherence to the group's





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remuneration policies and the principles set out in this module, regular compliance monitoring should be put in place to review the management and operation of the AI's remuneration systems at the local level. The results of the local compliance monitoring should be regularly reported to the group remuneration committee.

- 2.1.10 Those members of the Board most involved in the formulation and operation of the AI's remuneration policy (including the members of the remuneration committee) should possess sufficient expertise and experience to form an independent judgement on the suitability of the AI's remuneration policy and its implications for risk and risk management. If the Board (or the remuneration committee) seeks professional advice from external advisors, the advice should be commissioned by, and provided directly to, the Chairman of the Board (or of the remuneration committee as the case may be) independently of management.

#### *Risk control functions*

- 2.1.11 Risk control personnel, independent of an AI's business units, should have appropriate authority and be actively involved in the process of design and implementation of the AI's remuneration policy. Such personnel should also play a continuing role in the operation of the remuneration system in relation to matters such as risk measures and risk judgements. The Board (or its remuneration committee) should consult risk management, financial control and compliance personnel to obtain input, independent of the relevant business lines, on how compensation relates to risk at various levels within the organization. Whilst the views of risk control personnel on risk measures and risk judgements have a key role to play in risk adjustment of compensation, it is not necessary for risk control personnel to be involved in the allocation of remuneration at the individual staff level.
- 2.1.12 Remuneration of risk control personnel should be determined in accordance with their performance



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objectives and should be commensurate with their key role in the institution. To avoid possible undue influence from business units, risk control personnel should be compensated in a manner that is independent of the performance of the business areas which they oversee. Management of business units should not be able to determine the remuneration of personnel in risk control functions.

## 2.2 Structure of remuneration

### *Proportionate balance of fixed and variable remuneration*

2.2.1 In determining an appropriate balance between fixed and variable incentive-based remuneration, AIs should have regard to the seniority, role, responsibilities and activities of their employees and the need to promote behaviour amongst employees that supports the AI's risk management framework and long-term financial soundness. For some employees, including those at more junior levels, a remuneration package consisting entirely of fixed salary may be appropriate whilst for others a package consisting of both fixed and variable incentive-based elements may be considered more effective in aligning the employees' interests with those of the AI. In devising remuneration packages which consist of both fixed salary and variable incentive-based compensation, an AI should seek to achieve an appropriate balance between these elements and should consider the need to avoid situations where: (a) the fixed component is set at such a low level that: (i) it is insufficient to attract and retain employees with relevant skills, knowledge and expertise to discharge their functions; or (ii) it effectively renders the incentive-based compensation element "non-discretionary" or severely hinders the exercise of discretion in respect of the incentive-based element; or (b) the variable component is set at such a level that it induces excessive risk-taking. Generally, the proportion of variable remuneration to total remuneration would be expected to increase in line with the seniority and responsibility of an employee such that a substantial proportion of the remuneration of the senior



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management and Key Personnel should be paid in the form of variable remuneration.<sup>9</sup> An AI adopting a different policy for its senior management and Key Personnel should be prepared to demonstrate to the HKMA's satisfaction that its alternative approach results in suitably balanced remuneration packages for such employees which do not undermine the AI's prudent risk management or reward failure.

#### *Use of instruments for variable remuneration*

2.2.2 Variable remuneration should be paid in such a manner as to align an employee's incentive awards with long-term value creation and the time horizons of risk and should reflect the employee's seniority, role, responsibilities and activities within the AI. In this regard, equity-related instruments could be effective in restraining the risk-taking incentives of senior management and Key Personnel whose activities could have a material impact on the overall financial performance of the AI. In these cases, the payment of a substantial proportion of their variable remuneration<sup>10</sup> in the form of shares or share-linked instruments should better align incentives with risk and longer term value creation. Where an AI considers it inappropriate to use shares or share-linked instruments in the payment of variable remuneration to its senior management and Key Personnel, it should ensure that alternative measures are in place (such as risk adjustment of awards, longer periods of performance measurement or deferral of payment, or the use of other non-cash benefits) which are designed to achieve effective alignment of incentives awards to the time horizon of risks. In the case of other employees, equity-related instruments may not be as effective in restraining risk-

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<sup>9</sup> The FSB Implementation Standards (No.6) recommend that for significant financial institutions a substantial proportion of remuneration for senior executives and other employees whose actions have a material impact on the risk exposure of the firm should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance.

<sup>10</sup> The FSB Implementation Standards (No.8) indicate that more than 50% might be appropriate in the case of significant financial institutions.



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taking incentives and the proportion of any variable remuneration paid in the form of shares or share-linked instruments should take into account the level, nature and duration of the risks that such employees' activities create for the AI and the extent to which they may affect its overall performance. In these cases, other measures should be adopted to align any incentive awards to the time horizon of risks as appropriate.

- 2.2.3 Awards in shares or share-linked instruments should be subject to an appropriate share retention policy which should require employees to retain such instruments for a specific period of time before they are allowed to dispose of them.<sup>11</sup> It may be appropriate for share retention periods to differ between different levels of employee.

#### *Exceptional use of guaranteed minimum bonuses*

- 2.2.4 Guaranteed minimum bonuses, that have no regard to an employee's performance, are not consistent with sound risk management.<sup>12</sup> The award of any such guaranteed minimum bonus to senior management or Key Personnel should be subject to the approval of the Board (or the Board's remuneration committee with the necessary delegated authority).

## 2.3 Measurement of performance for variable remuneration

### *Pre-determined criteria for performance measurement*

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<sup>11</sup> In the case of awards of shares or share-linked instruments subject to a vesting period and in the case of share-options which only become exercisable after the elapse of a specified period of time, these periods may be taken into account in considering suitable retention periods.

<sup>12</sup> If an AI considers it necessary, in exceptional circumstances, to offer such a bonus, the offering should be restricted for (a) the purpose of hiring new staff and in such circumstances should be strictly limited in time (as a benchmark the FSB Implementation Standards (No.11) provide for limitation to the first year of employment) or (b) the purpose of retaining existing staff in a business which is being wound-down or sold (in circumstances where the retention of the employee is reasonably considered necessary by the AI to bring the winding-down or sale to a successful conclusive) and in such circumstances should be limited to a time period considered reasonably necessary to complete the winding-down or sale.



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- 2.3.1 The award of variable remuneration should depend on the fulfilment of certain pre-determined and assessable performance criteria. These criteria should include both financial and non-financial factors so that the quality of the performance of employees in the overall course of their employment (and not solely their financial performance) can be assessed as an integral part of their performance measurement and hence be appropriately reflected in their awards of variable remuneration.
- 2.3.2 Performance in relation to non-financial factors such as adherence to risk management policies, compliance with legal, regulatory and ethical standards, results of internal audit reviews, adherence to corporate values, and customer satisfaction should form a significant part of the overall performance measurement of employees, given that poor performance in these factors can be indicative of significant risks to the AI. Adverse performance in non-financial factors, where appropriate, should override outstanding financial achievements, and be reflected by a reduction to, or elimination of, any variable remuneration.
- 2.3.3 To better align remuneration with sustainable performance, the overall amount of an AI's variable remuneration should take into account the AI's performance over the longer term.<sup>13</sup> This approach can prevent short-term gains, generated by taking greater risks, from leading to higher variable remuneration. *Adjustments to performance assessment*
- 2.3.4 AIs may adopt financial factors (e.g. profit, revenue, turnover, or volume) as a basis for assessing the performance of their employees and determining their variable remuneration. However, the size and allocation of variable remuneration should take into account the full range of current and potential risks associated with the activities of employees, and in

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<sup>13</sup> E.g. by reference to financial results spanning three to five years or by using a moving average of financial results.



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particular: (a) the cost and quantity of capital required to support the risks taken; (b) the cost and quantity of the liquidity risk assumed in the conduct of business; and (c) the timing and likelihood of potential future revenues incorporated into current earnings. For this purpose, AIs should incorporate adjustments for risk and capital charges based on such risk measures<sup>14</sup> as the AI reasonably considers prudent and appropriate for this purpose.

- 2.3.5 To control individual employees' risk appetites and to bring remuneration practices into line with an AI's broader strategies and the maintenance of shareholder value, the performance measurement for, and allocation of, variable remuneration should take account of the overall performance of the relevant business units and the AI as a whole as well as the contribution of individual employees to such performance.
- 2.3.6 Variable remuneration should be symmetric with performance. Deterioration in the financial performance of an AI should generally lead to a contraction (and negative financial performance should generally lead to a considerable contraction) in the total amount of variable remuneration paid by the AI, taking into account both current remuneration and reductions in payouts of amounts previously deferred.
- 2.3.7 An AI should operate a truly discretionary and fully flexible policy such that it may withhold all or part of the variable remuneration if the payment is not justified by the performance of the institution or if business objectives are not achieved, or when it is necessary to protect the financial soundness of the institution.

#### *Exercise of judgment*

- 2.3.8 A purely mechanical process based on pre-determined performance criteria or formula-based assessment metrics will have its own limitations and weaknesses.

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<sup>14</sup> E.g. regulatory capital, economic capital reflecting VaR or other metrics, or economic profit.



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Whatever performance measurements are adopted and whatever adjustments are made, a substantial amount of judgement and common sense may be required during the process to arrive at a fair and appropriate remuneration decision. The exercise of any judgement should support sound risk management and be consistent with the spirit of an AI's remuneration policy. The rationale for the exercise of judgement and the final outcomes should be clearly recorded in writing. To the extent that it is impracticable to maintain such records at the individual employee level, an AI should at least maintain such records at the bonus pool level for given ranks of employees or for employees within given business units in a manner sufficient to enable assessment to be made as to whether the process is consistent with the AI's remuneration policy.

#### 2.4 Alignment of remuneration payouts to the time horizon of risks

##### *Deferral of variable remuneration*

2.4.1 Some of the risks to which an AI is exposed and the outcomes of such risks can only be adequately measured or observed over the longer term. Deferral of the payment of a portion of variable remuneration will allow employees' performance, including the associated risks, to be observed and validated over a period of time before payment is actually made and the adjustment of the amount to be paid will enable the remuneration ultimately received by employees to more accurately reflect risk and risk outcomes. The appropriate proportion of variable remuneration to be deferred will vary from employee to employee depending upon a number of factors, including an employee's seniority, role, responsibilities and activities within the AI, the time horizons of the risks incurred by the employee's activities and the overall level of their variable remuneration both in absolute terms and as a proportion of their fixed salary. For some employees employed in roles where the end results of their activities are observable and susceptible to validation within a short timeframe, deferral may not be an appropriate mechanism. For others, in roles where the



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risks taken by them are harder to measure or will be realized over a longer timeframe, deferral will be appropriate. Generally, the proportion of variable remuneration made subject to deferral would be expected to increase in line with the seniority and responsibility of the employee in question.<sup>15</sup> AIs adopting a different policy to deferral of variable remuneration should be prepared to demonstrate to the HKMA's satisfaction that their alternative approach is conducive to restraining excessive short-term risk-taking and to aligning actual variable remuneration payments with risks and risk outcomes.

- 2.4.2 The award of deferred remuneration should be subject to a minimum vesting period and pre-defined vesting conditions in respect of the future performance of an AI, the relevant business units and the employee in question. The deferred remuneration should generally vest gradually over a period of years and no faster than on a pro rata basis, subject to fulfilment and validation of the pre-defined performance conditions. If the vesting conditions are not fulfilled in any year during the vesting period, all or part of the unvested portion of the deferred remuneration should be foregone<sup>16</sup> (subject to the realised performance of the AI or the relevant business unit). The vesting period and vesting conditions should be determined by the AI's Board (or its remuneration committee) and reviewed as appropriate. The Board should strike a reasonable

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<sup>15</sup> The FSB Implementation Standards (No.5) recommend that for significant financial institutions, a substantial portion (such as, say, 40 to 60 percent) of the variable remuneration of senior executives, and other employees whose actions have a material impact on the risk exposures of the firm, should be made subject to deferral arrangements over a period of years. For the most senior management and the most highly paid employees, the FSB Implementation Standards provide for the percentage of variable remuneration that is deferred to be substantially higher (for instance, say, above 60 percent).

<sup>16</sup> Often referred to as "clawed-back" notwithstanding that it is not vested and not due and payable until such time as the pre-defined vesting conditions are fulfilled. To the extent that the deferred remuneration is in the form of shares, the initial award is by number of shares rather than by value and the initial award was subject to appropriate adjustments for risk, the Board (or the Board's remuneration committee with the necessary delegated authority) may consider whether the share price can appropriately be regarded as a proxy for the vesting condition related to the future performance of the AI.





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balance between providing effective incentives and validating the performance measures according to the nature and associated risks of the business undertaken by the employees. In this regard, the minimum vesting period should be appropriately aligned with the nature of the business, its risks, the activities undertaken by the employee in question and the timeframe during which the risks from these activities are likely to be realized.<sup>17</sup>

- 2.4.3 A “claw-back” provision should also operate in respect of unvested deferred remuneration in circumstances where it is later established that any performance measurement was based on data which is later proven to have been manifestly misstated, or it is later established that there has been fraud or other malfeasance on the part of the relevant employee, or violations by the employee of internal control policies.
- 2.4.4 The departure of employees from an AI should not trigger early payout of deferred remuneration that is still within the deferment period. Subject to any prevailing legal requirements, severance pay, if any, should be related to performance achieved over time and designed in a way that does not reward failure. In exceptional cases, such as on compassionate grounds for ill-health, early payment of deferred remuneration might be approved. The rationale and justification for such early payment should be recorded and retained in writing and, in the case of senior management and Key Personnel, the early payment should be approved by the Board (or the Board’s remuneration committee with the necessary delegated authority).
- 2.4.5 Practices that involve making payments to a prospective employee to effectively compensate him for the deferred remuneration which he will forfeit on

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<sup>17</sup> The FSB Implementation Standards (No.7) indicate that the deferral period for senior executives and other employees whose actions have a material impact on the risk exposure of the firm should not be less than 3 years. Als adopting shorter deferral periods should be prepared to demonstrate to the HKMA’s satisfaction that the periods they adopt are sufficient to enable the performance of the relevant employees in question to be adequately observed and validated.



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leaving his previous employer, as a term to attract and recruit that employee, are not in line with the spirit of deferment of variable remuneration (please see paragraph 2.2.4 above). If, in any exceptional case, it is considered absolutely necessary to offer such a compensatory payment, the AI concerned should ensure that any such compensatory payment proposed to be made to the employee should: (a) itself be subject to deferral and pre-defined vesting conditions by reference to the AI's future performance; and (b) in the case of senior management and Key Personnel be approved by the Board (or the Board's remuneration committee with the necessary delegated authority); and (c) have its rationale and justification recorded and retained in writing.

#### *Restriction on hedging exposures*

2.4.6 Obviously, the spirit of, and risk management advantages to be gained by, deferment of variable remuneration will be undermined if employees who receive remuneration in this form, engage in personal hedging strategies or remuneration- and liability-related insurance to hedge their exposures in respect of the unvested portion of their deferred remuneration. AIs should therefore endeavour to seek undertakings from such employees not to engage in such activities. Further, whilst the HKMA acknowledges the difficulties inherent in attempting to "police" compliance with any such undertakings, AIs should endeavour to establish such compliance arrangements as they consider practicable in the circumstances (in the light of their existing compliance arrangements for their employees' personal trading, investment and other financial activities). This could include, for instance, seeking declarations from employees' either regularly or when they engage in certain trading, investment or other financial activities.

### 3. Disclosure on remuneration

#### 3.1 Importance of disclosure



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- 3.1.1 Recognising the importance of sound remuneration policies and practices for risk management AIs (save as provided below) should, in order to increase transparency and promote market discipline, make disclosures in relation to their remuneration systems in accordance with paragraphs 3.2 and 3.3 below.
- 3.1.2 However, (i) if an AI has been granted an exemption by the MA under section 3(7) or 3(9) of the Banking (Disclosure) Rules (BDR) it will not be expected to make such disclosure; and (ii) overseas-incorporated AIs will not be expected to make separate disclosures in relation to remuneration in respect of their local operations, provided that such information already forms part of the disclosures made by the head office of the institutions concerned.
- 3.1.3 Section 52(ba) of the BDR requires locally incorporated AIs to disclose the extent of their compliance with the disclosure requirements set out in Part 3 of this guideline, and section 52(c) requires such AIs to disclose particulars of, and the reason for, any failure to so comply.
- 3.1.4 The remuneration disclosures described below should not be read or construed as replacing other disclosure requirements under relevant legislation or accounting and financial reporting standards. An AI should comply with all such other disclosure requirements under the Companies Ordinance (Cap. 622), the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, and the Hong Kong Financial Reporting Standards as applicable.

### 3.2 Frequency and method of disclosure

- 3.2.1 An AI should make the relevant disclosures on remuneration at least on an annual basis.
- 3.2.2 For ease of reference by the likely users of the information, an AI should, as far as possible, provide its remuneration disclosures on one site or in one document (e.g. in a Remuneration Report or a single section of its annual report). If equivalent disclosures



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have already been made by the AI elsewhere, it is acceptable for the AI to include on the relevant site or in the relevant document a direct link through which the disclosures can be readily accessed.

3.2.3 In order to improve clarity, all AIs' remuneration disclosures should include quantitative figures for the previous reporting year together with the information for the current reporting year to aid comparison.

### 3.3 Key disclosures

3.3.1 **Annex A** sets out the information that AIs should include in their remuneration disclosures. AIs should also make any additional disclosures considered appropriate in the specific circumstances of a given AI. An AI should, as far as possible, articulate how the qualitative and quantitative factors in the Annex complement and support its overall risk management framework.

3.3.2 Quantitative disclosures should be made separately in respect of an AI's senior management and in respect of its other Key Personnel. **Annex B** provides an illustrative format for the breakdown of remuneration awards for a financial year in relation to (i) senior management and (ii) other Key Personnel.

3.3.3 If an AI has such a small number of executives that individuals' remuneration could be easily deduced from disclosure of a breakdown of the figures, it is acceptable for the AI, in so far as the sensitivity of the information will be disadvantageous to the AI, to disclose aggregate figures for senior management and Key Personnel. This is, however, provided that this fact and the reason for doing so (i.e. disclosing aggregate figures instead of disclosing separate figures) are adequately disclosed.



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#### Annex A : Remuneration disclosures

The following table sets out qualitative and quantitative information that an AI should include in its annual disclosure statements regarding remuneration:

Qualitative disclosures	
(a)	<p>Information relating to the governance structure of the remuneration system, including:</p> <ul style="list-style-type: none"><li>• name, composition and mandate of the bodies (e.g. remuneration committee) overseeing remuneration;</li><li>• external consultants whose advice has been sought, the bodies by which they were commissioned, and the areas of the remuneration process in respect of which their advice was sought;</li><li>• a description of the decision-making process used to determine the firm-wide remuneration policy;</li><li>• a description of the scope of the AI's remuneration policy (e.g. by regions and/or business lines), including the extent to which it is applicable to foreign subsidiaries and branches; and</li><li>• a description of the types of employees considered as (i) senior management and as (ii) Key Personnel<sup>1</sup>, including the number of employees in each category.</li></ul>
(b)	<p>Information relating to the design and structure of the remuneration processes, including:</p> <ul style="list-style-type: none"><li>• an overview of the key features and objectives of the remuneration policy;</li><li>• whether the bodies charged with overseeing remuneration reviewed the AI's remuneration policy during the past year, and if so, an overview of any changes that were made; and</li><li>• a discussion of how the AI ensures that employees within risk</li></ul>

<sup>1</sup> See definitions of (i) senior management, (ii) Key Personnel and (iii) employees within risk control functions in section 2.



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	control functions <sup>1</sup> are remunerated independently of the businesses they oversee.
(c)	<p>Description of the ways in which current and future risks are taken into account in the remuneration processes, including:</p> <ul style="list-style-type: none"><li>• an overview of the key risks that the AI takes into account when implementing remuneration measures;</li><li>• an overview of the nature and type of the key criteria and measures used to take account of these risks, including risks that are difficult to measure (values need not be disclosed);</li><li>• a discussion of the ways in which these measures affect remuneration; and</li><li>• a discussion of how the nature and type of these measures have changed over the past year and the reasons for any changes, as well as the impact of changes on remuneration.</li></ul>
(d)	<p>Description of the ways in which the AI seeks to link performance during a performance measurement period with levels of remuneration, including:</p> <ul style="list-style-type: none"><li>• an overview of the main performance criteria and metrics for the AI, top-level business lines and individuals;</li><li>• a discussion of how the amounts of individual remuneration are linked to firm-wide and individual performance; and</li><li>• a discussion of the measures the AI will in general implement to adjust remuneration in the event that performance metrics are weak.<sup>2</sup></li></ul>

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<sup>2</sup> This should include the AI's criteria for determining "weak" performance metrics.



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(e)	<p>Description of the ways in which the AI seeks to adjust remuneration to take account of longer-term performance, including:</p> <ul style="list-style-type: none"> <li>a discussion of the AI's policy on deferral and vesting of variable remuneration and, if the fraction of variable remuneration that is deferred differs across employees or groups of employees, a description of the factors that determine the fraction and their relative importance; and</li> <li>a discussion of the AI's policy and criteria for adjusting deferred remuneration before vesting and (where applicable) after vesting through clawback arrangements.</li> </ul>
(f)	<p>Description of the different forms of variable remuneration that the AI utilizes and the rationale for using these different forms, including:</p> <ul style="list-style-type: none"> <li>an overview of the forms of variable remuneration offered (i.e. cash, shares and share-linked instruments and other forms<sup>3</sup>); and</li> <li>a discussion of the use of the different forms of variable remuneration and, if the mix of different forms of variable remuneration differs across employees or groups of employees, a description of the factors that determine the mix and their relative importance.</li> </ul>
<b>Quantitative disclosures</b>	
<p>Information covering (i) senior management and (ii) Key Personnel, broken down between these two categories for the <u>current</u> and <u>past</u> reporting years:</p>	
(g)	<ul style="list-style-type: none"> <li>Number of meetings held by the bodies (e.g. remuneration committee) overseeing remuneration during the financial year and remuneration paid to their members.</li> </ul>
(h)	<ul style="list-style-type: none"> <li>Total amount of outstanding deferred remuneration, split into vested and unvested.</li> </ul>
(i)	<ul style="list-style-type: none"> <li>Total amount of outstanding deferred remuneration, split into cash, shares and share-linked instruments and other forms.</li> </ul>

<sup>3</sup> A description of the elements corresponding to other forms of variable remuneration (if any) should be provided.



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(j)	<ul style="list-style-type: none"> <li>Total amount of deferred remuneration awarded, paid out and reduced through performance adjustments during the financial year.</li> </ul>
(k)	<ul style="list-style-type: none"> <li>Breakdown of amount of remuneration awards for the financial year to show: <ul style="list-style-type: none"> <li>➤ fixed and variable (with number of beneficiaries in each category);</li> <li>➤ deferred and non-deferred; and</li> <li>➤ different forms used (cash, shares and share-linked instruments, other forms<sup>3</sup>).</li> </ul> </li> </ul> <p><i>Remark: An illustrative example of the format for disclosure is provided in <b>Annex B</b>.</i></p>
(l)	<p>Quantitative information about employees' exposure to implicit (e.g. fluctuations in the value of shares or performance units) and explicit adjustments (e.g. malus, clawbacks or similar reversals or downward revaluations of awards) of deferred remuneration and retained remuneration<sup>4</sup>:</p> <ul style="list-style-type: none"> <li>total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit and/or implicit adjustments;</li> <li>total amount of reductions during the financial year due to ex post explicit adjustments; and</li> <li>total amount of reductions during the financial year due to ex post implicit adjustments.</li> </ul>
(m) <sup>5</sup>	<ul style="list-style-type: none"> <li>Number and total amount of guaranteed bonuses awarded during the financial year, and number of beneficiaries of such payments;</li> </ul>

<sup>4</sup> "Retained remuneration" refers to shares or share-linked instruments that are subject to a retention period under a share retention policy (see paragraph 2.2.3).

<sup>5</sup> AIs should disclose information described in this item at least on an annual basis to the extent they reasonably can without, in effect, disclosing the identity of the individuals concerned. Nevertheless, AIs should disclose such information to the HKMA to assist the HKMA in its assessment of AIs' remuneration practices and outcomes.





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- Number and total amount of sign-on awards made during the financial year, and number of beneficiaries of such payments;
- Number and total amount of severance payments made during the financial year, and number of beneficiaries of such payments; and
- Number and total amount of severance payments awarded during the financial year, and number of beneficiaries of such payments, and highest such award to a single person.



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#### Annex B : Illustrative example on breakdown of remuneration awards for a financial year

<b>(i) Senior management</b>		
<b>Total value of remuneration awards for the current financial year</b>	<b>Non-deferred</b>	<b>Deferred</b>
<b>Fixed remuneration</b>		
• Cash-based	X	X
• Shares and share-linked instruments	X	X
Other ( <i>Please specify</i> )	X	X
<b>Variable remuneration</b>		
• Cash-based	X	X
• Shares and share-linked instruments	X	X
Other ( <i>Please specify</i> )	X	X

<b>(ii) Key Personnel</b>		
<b>Total value of remuneration awards for the current financial year</b>	<b>Non-deferred</b>	<b>Deferred</b>
<b>Fixed remuneration</b>		
• Cash-based	X	X
• Shares and shared-linked instruments	X	X
• Other ( <i>Please specify</i> )	X	X



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<b>Variable remuneration</b>		
• Cash-based	X	X
• Shares and share-linked instruments	X	X
• Other ( <i>Please specify</i> )	X	X

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**Selected jurisdictions’ approaches to appointment of an independent valuer in relation to resolution compensation schemes**

Jurisdiction	Legislation	Mechanism for appointment	Extract from legislation (emphasis added)
Canada	Canada Deposit Insurance Act (1985) CDI Ac) <sup>1</sup>	The Governor-in-Council, who is appointed by the Governor General, <sup>2</sup> appoints an “assessor”.	<p><b>Appointment of assessor where offerees dissent<sup>3</sup></b></p> <p><b>Subsection 39.29</b> “The <b><u>Governor in Council</u></b> shall, within sixty days after the date of a notice under subsection 39.24(1) or within one hundred and twenty days after the date of a notice under subsection 39.24(2), <b><u>appoint as assessor</u></b> a judge who is in receipt of a salary under the Judges Act, if, in the case of a notice under</p> <p>(a) subsection 39.24(1), there are dissenting offerees in respect of the offer or the fact that no offer was made; or</p> <p>(b) subsection 39.24(2), the federal member institution notifies the Corporation that it objects to the offer or the fact that no offer was made.”</p>

<sup>1</sup> CDI Act 1985: <http://laws.justice.gc.ca/eng/acts/C-3/>

<sup>2</sup> Governor-in-Council (GIC) appointments are made by the Governor General, on the advice of the Queen's Privy Council of Canada (Cabinet). GIC appointments are made for heads of agencies to members of quasi-judicial tribunals. The responsibilities of Governor in Council appointees range from making quasi-judicial decisions to providing advice and recommendations on policy issues. Further information can be found at: <http://appointments-nominations.gc.ca/prsnt.asp?page=Process&lang=eng>.

<sup>3</sup> **CDI Act Section 39.23 – Definitions – In sections 39.24 to 39.37, *assessor* means a person who is appointed as assessor under section 39.29; *dissenting offerees* means the persons (a) who, immediately before the shares and subordinated debt of a federal member institution are vested in the Corporation by an order made under paragraph 39.13(1)(a), together held at least 10 per cent of the shares of a given class, or at least 10 per cent of the principal amount of the subordinated debt of a given class, of the federal member institution, or the assignees or successors in interest of those persons, and (b) who notify the Corporation within thirty days after the date of the notice of the Corporation under section 39.24 of their objection to the offer or to the fact that no offer is being made.**

			<p><b>Determination by assessor</b></p> <p><b>Subsection 39.31(1)</b> “The <b><u>assessor shall determine the amount of compensation to be paid</u></b> to the dissenting offerees for the shares or subordinated debt of the class in respect of which there are dissenting offerees or to the federal member institution, as the case may be...”</p>
<b>Ireland</b>	Central Bank and Credit Institutions (Resolution) Act (2011) <sup>4</sup> (CBCIR Act)	The resolution authority (Central Bank of Ireland, the Bank) appoints the “assessor”.	<p><b>Section 36 - Appointment of an Assessor—</b></p> <p>“(1) Where the Court makes one or more orders under section 35<sup>5</sup> in relation to a creditor or creditors of a transferor, <b><u>the Bank shall</u></b>, not later than 6 months after the date of the last order in relation to the creditors of that transferor, <b><u>appoint a person (referred to in this Act as the “Assessor”) to determine, in accordance with this Act, the fair and reasonable amount, if any, payable to each creditor concerned...</u></b>”</p>
<b>United Kingdom</b>	Banking Act (2009) (UKBA) <sup>6</sup>	HM Treasury to appoint an appointing person to appoint the independent valuer	<p><b>Section 54 - Independent valuer: compensation scheme order or bail-in compensation order –</b></p> <p>“... (2) An order must provide for the <b><u>independent valuer to be appointed by a person appointed by the Treasury</u></b> (the appointing person)...”</p>

<sup>4</sup> CBCIR Act (2011): <http://www.irishstatutebook.ie/eli/2011/act/27/enacted/en/html>

<sup>5</sup> Under section 35 of the CBCIR Act a creditor of a residual FI that is wound up must apply to the Court to seek an order to apply for compensation under the Act.

<sup>6</sup> UKBA: <http://www.legislation.gov.uk/ukpga/2009/1/contents>