afme/

Response from the Association for Financial Markets in Europe

Committee of European Banking Supervisors consultation paper on guidelines on remuneration policies and practices (CP42)

Introduction

The Association for Financial Markets in Europe (AFME)[1] is pleased to respond to the Committee of European Banking Supervisors (CEBS) consultation paper on *Guidelines on Remuneration Policies and Practices* (CP42). AFME recognises that the production of draft guidance, for both firms and supervisors, on often complex principles, will have been a difficult task, particularly given the short time available. We would be pleased to discuss or provide CEBS with further information on any points raised in this response, if this would be helpful.

By way of overview and general comment we would make the following points:

- **Global inconsistency**: The industry has recognised the need to develop and implement remuneration incentives to align better with effective risk management and has moved quickly to implement remuneration policies consistent with the Financial Standards Board (FSB) principles. However, there are concerns about the different regulatory environments evolving globally which could create competitive disadvantages for global firms in some jurisdictions and make complying with these different regulatory frameworks extremely complex. Ideally, international regulators should cooperate so that the need to demonstrate compliance separately to each regulator is reduced.
- **EEA Member States' implementation:** We welcome guidance from CEBS in respect of the implementation of the remuneration requirements in the Capital Requirements Directive 3 (CRD3). In order to help create a level playing field and to achieve a consistent approach, especially for those firms which operate a subsidiary structure within the European Economic Area (EEA), each of the EEA regulators should apply and maintain a flexible, less prescriptive (as described below) approach to the implementation of CRD3 and the Guidelines (including in respect of the application of the proportionality principle). This would allow firms to tailor their approaches to their business environments while maintaining consistency across jurisdictions.

---

[1] AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

Association for Financial Markets in Europe
St. Michael's House • 1 George Yard • London EC3V 9DH • United Kingdom
T: +44 (0)20 7743 9300 • F: +44 (0)20 7743 9301 • www.afme.eu
Company Registration No: 6996678 •European Union Register of Interest Representatives No: 65110063986-76

It would also be helpful if EEA groups (including EEA sub-groups of non-EEA groups) were able to deal with a lead EEA regulator that could act as coordinator of the groups' other EEA regulators, when applying the proportionality principle, at the consolidated group level, to determine "Identified Staff". Such an approach would assist the regulators of subsidiaries since independently reviewing the firms in their jurisdictions, without taking fully into account the Group structure and the level of governance operated by the parent company, will not provide the same appreciation of which staff have an impact on the risk profile of the group.

- **Flexibility**: In the past 18 months, we have responded to a number of different proposals to reform remuneration in the financial services industry[2] by saying that, amongst other things, any prescriptive measures should enhance rather than reduce financial stability over the longer term. For example, measures taken by regulators should not inadvertently encourage firms to increase fixed, contractual remuneration and thus reduce the ability to lower remuneration expense in times of stress. Flexibility in respect of remuneration policy is a key tool for maintaining the safety and soundness of an organisation.

- **Further prescription:** We have stated previously[3] that remuneration incentives can best promote growth and stability if they:

  - are aligned with the interests of shareholders and the long term profitability of the firm;
  - align individual risk taking with the risk appetite of the firm; and
  - to the extent possible, reflect the risk profile of the particular business line in which the remuneration is awarded and the time over which profits will be realised.

  The detailed provisions of CRD3, and particular aspects of the Guidelines, introduce further prescription on the design of incentive arrangements and further restrict firms' ability to develop the most appropriate remuneration structures for their own organisations.

  Each firm should be allowed to develop the most appropriate remuneration structure for its organisation. Regulatory principles should remain high level and outcome-focused and avoid prescription on structures and other matters where firms should have flexibility to adopt different approaches. In particular we believe firms should have flexibility with respect to the following (as more fully described below):

  - to set the ratio between fixed and variable remuneration;
  - to set the mix of compensation: we are particularly concerned about the integration of the 40/60 per cent deferral requirement with a 50 per cent equity rule;

---

2 See e.g. memorandum [copy from FSA response].

3 In our response to the UK Financial Services Authority's CP10/09 and CP10/19.

  - the circumstances under which a firm provides guarantees to new hires and makes retention awards to existing employees; and
  - determining a retention policy for equity.

- **Implementation:** while we recognise that the remuneration provisions in CRD3 are due to be brought into effect by Member States on or before 1 January 2011, we are concerned – particularly given that the final Guidelines will not be published before December – that insufficient time will be available for firms to, amongst other things, develop the necessary (and, in some cases, complex) remuneration structures and inform the staff of the changes to their 2010 remuneration. We would, therefore, ask CEBS to apply, initially, a phased 'evolutionary' (c.f. paragraph 146 of the Guidelines re disclosure) approach to implementation.
- **Need for an ex-poste review:** given the impact that the Guidelines may have on the competitiveness of EEA firms in non-EEA jurisdictions, we believe that CEBS should set a review date for the Guidelines to assess their effectiveness and impact (including unintended or adverse consequences). Ideally this review should take place ahead of the April 2013 date by which the Commission will review the principles for remuneration policies in CRD3 (recital (6) of CRD3). As part of this review, CEBS should consult with and seek input from the industry and other interested stakeholders.

Detailed comments

We have followed the same structure (and headings) as the Guidelines in responding:

1 Outlines

- **Which Remuneration (1.1.1):** We agree that remuneration should not be structured in a way to circumvent the requirements of CRD3. However, the overly prescriptive requirements in CRD3, which are developed further in the Guidelines, will reduce flexibility and are likely to affect the ability of firms to reduce costs in an economic downturn. Increased fixed costs are also likely to be a barrier to entry to new firms.
- **Which Staff (1.1.3):** As it will be important to have a consistent approach to the determination of Identified Staff, the guidance set out in the Guidelines is helpful. The Guidelines define "remuneration bracket" as the lowest to the highest paid employees in the senior management and risk taker categories. However, we believe it would be appropriate, for the purposes of assessing "other employees/persons" to provide firms with the flexibility to exclude remuneration outliers at the bottom (e.g. then lowest 10%) of the remuneration bracket.

  When determining the members of staff whose professional activities have a material impact of the institution's risk profile, large multinational firms should be permitted to make the assessment at the consolidated group level in the EEA – or, for consistency, the global

group – based on the proportionality principle. Where an institution belongs to a large international financial services conglomerate, its staff members do not have the same impact on the risk profile as a standalone institution of similar size, given the strength and resources of the global group and the additional group level supervision.

- **Group Context (1.3):**
  - **EEA Groups:** We are concerned that CRD3, as implemented by the EEA regulators, will apply to Identified Staff globally. This could put EEA-headquartered firms at a disadvantage when recruiting and retaining staff outside the EEA if they are competing against local firms who are not subject to CRD3. In order to avoid competitive distortion in non-EEA jurisdictions, we recommend applying FSB requirements, as implemented by local (third country) regulations, with the CRD3 provisions applying only if the FSB requirements have not been implemented locally.
  - **Non-EEA Groups:** We are concerned about the potential for conflict between different regulatory requirements, especially where a non-EEA firm has a third country lead regulator and the principles in CRD3 are inconsistent with the lead regulator's requirements. Within the non-EEA global group, the localisation of the remuneration policy to comply with CRD3 may make the remuneration unattractive for staff to agree to transfer to the EEA region. Multinational businesses will also be subject to greater cost and administrative burden if they cannot operate global remuneration policies.

    Where staff are employed by a parent company based in a non-EEA jurisdiction but perform duties/services for an EEA based firm, the principle of proportionality should apply if the duties/services performed/provided in the EEA are not significant when compared with all the duties of the individual; in which case the CRD3 remuneration requirement should not apply.
  - **Groups with activities outside the scope of CRD3:** We agree that where institutions carry on activities that fall outside the scope of the CRD (e.g. insurance), consideration should be given to applicable sectoral requirements. To enable firms to compete effectively, this principle should also apply to non-regulated businesses within a financial services conglomerate firm, so that the remuneration requirements do not have to apply to non-regulated businesses.

2 Governance of remuneration

- **Supervisory function (2.1.2, paragraph 47)**: Given that, for example, US firms award share incentives to their outside directors, the Guidelines should clarify that covered firms are permitted to pay members of their supervisory function fixed remuneration (e.g. annual retainer fees) in the form of shares or share-based awards. In addition, for non-EEA firms, the remuneration of a group supervisory function should be in accordance with the governance rules of the jurisdiction in which the firm is headquartered.

- **Role [of the Remuneration Committee] (2.2.3):** The Remuneration Committee should be able to approve, as part of their governance role, the compensation model used for Identified Staff. However, we do not believe that it is necessary for the Remuneration Committee to also recommend remuneration proposals for the highest paid individuals or senior officers in the control function (as discussed in section 2.3.3 of the Guidelines) if these individuals are not Identified Staff.

3 General Capital Requirements on Risk Alignment

- **The general remuneration policy, [including the pension policy] (3.1.1):** We believe that this section – in particular the two aspects to which firms should give due regard when developing remuneration policies – would benefit from greater clarity in drafting. The reference, however, to supervisors being able to restrict a firm's ability to pay competitively may, as an unintended outcome, further reduce competition and increase barriers to entry.
- **Guaranteed variable remuneration (3.2.1)**: We understand the issues on guaranteed arrangements for new hires. We would note again, however, that for EEA global firms and non-EEA firms with a branch and sub-group structure extending beyond the EEA, the requirement puts these firms at a competitive disadvantage when hiring in non-EEA territories, since local, third country firms will not be subject to CRD3 and will be able to hire without these, more prescriptive than FSB, constraints.

4 Specific Requirements on Risk Alignment

- **Ratio between fixed and variable remuneration (4.1.2):** We agree with the approach not to fix the ratio between fixed and variable remuneration – which would be unnecessarily prescriptive and uneconomic – and to allow firms to set their own ratios given their circumstances, the businesses they operate and the relevant staff. Firms should, however, have the opportunity to justify to their supervisors circumstances where there is an unusually high leverage between fixed and variable remuneration when awards are recommended.
- **Common requirements for the risk alignment process (4.2.2):** We agree with the approach that the balance between accrual and payout will depend on the type of business and activity of the staff (paragraph 87) and the deferral schedule should take into account the various factors (as described in paragraph 115). However, we are concerned about the level of prescription in terms of the requirement to have a retention period for equity settled remuneration, whether it is immediately vested or deferred.
- **Non-deferred and deferred remuneration (4.4.1):** The requirement that 50% of the portion of variable compensation must be paid in illiquid equity instruments introduces tax consequences that could – in some Member States – reduce an individual's bonus into a tax liability. We urge that the CEBS guidelines be amended to explicitly allow a

Member State to facilitate the immediate release of whatever portion of the award is necessary to satisfy the tax triggered by the award.

- **Cash v Instrument (4.4.2):**

(a) **Kind of instruments:** For asset management businesses, it has been market practice for many firms to have some part of the variable remuneration granted in their own managed funds, which closely aligns fund manager to their investors. Where variable remuneration is linked to managed assets, it should be regarded as "equity/equity like" for the purposes of these Guidelines.

Also, a number of firms will not be using equity or other instruments by applying the rules of proportionality. This would put larger firms, which are more likely to use equity and other instruments, at a disadvantage, against other firms who will not have such levels of deferral or retention, given the amount of capital that would be tied up for considerable periods . The approach proposed by CEBS assumes there will be no constraints on a company issuing its shares; shareholders may, however, object to their interests being diluted.

(b) **Retention periods:** As noted above, we are concerned about the level of prescription in terms of the requirement to have a retention period for equity settled remuneration whether it is immediately vested or deferred. Firms should be afforded the flexibility to determine appropriate retention periods for both the deferred and non-deferred share-based elements of variable remuneration, based on, for example, the time horizon of risk and the level of risk associated with the roles undertaken by particular groups of employees.

(c) **Minimum portion of instruments and their distribution over time**: We are concerned about the interpretation of the CRD3 provisions in relation to the interaction of the deferral requirement with the portion to be granted in equity-linked instruments, which is more prescriptive than is required under the FSB remuneration principles. Where an EEA group has to apply this provision in countries outside the EEA, it will be competing with local firms who do not have to comply with this level of detail for the variable pay component. There should, to the extent possible under CRD3, be alignment between CEBS Guidelines and the FSB to create global consistency.

The way that the CEBS Guidelines are currently drafted, the 50% non-cash requirement applies to both deferred and non-deferred elements of variable compensation. This effectively limits the ability to deliver cash to individuals to 20 – 30% of the total value of the variable compensation, which, after tax, significantly reduces liquidity. Firms should be permitted the flexibility to apply the 50% non-cash requirement to total variable

compensation as they deem appropriate, in consideration of their own risk profile.

- **Ex-post Risk incorporation of risk of variable remuneration (4.4.3):** We agree with, and most members firms already have in place, a procedure to enable some level of adjustment or forfeiture prior to deferred awards vesting. There is no objection to adjustment where there is employee misbehaviour or a failure of risk management. However, while adjustments may be appropriate and firms should have the flexibility to forfeit deferred compensation in the event of inappropriate risk behaviour and to operate a malus clause, adjustment will not always be appropriate where there is a material downturn in financial performance. In particular, adjustment may not be appropriate at a business unit level if a business suffers a material downturn due to strategic reasons, or the business is immature or in a developing market, and the firm needs to retain and incentivise employees of that business unit. Supervisors should enable firms to implement measures to incorporate ex-post risks as appropriate for their businesses. Such measures may also require changes to employment law in the Member States to make the arrangements effective.

5 Disclosure

- In relation to disclosure and any further guidance given on the disclosure requirements it is important that the remuneration package of an individual whose remuneration is not currently required to be made public should not be deduced from the disclosures to preserve commercial confidentiality and the privacy of the individual. We would, therefore, welcome confirmation that the quantitative disclosures are to be made confidentially to supervisors alone. There needs to be a careful balance between transparency and the risk that individuals' remuneration details will be identifiable.
- It is also important that agreement is reached between EEA regulators (and ideally significant third-country regulators) with respect to general remuneration disclosures, so that the disclosure made in a firm's home State will be sufficient to meet the requirements in all other EEA Member States in which the firm operates.