McLAGAN
FACT-BASED ADVICE

Lloyds Chambers
1 Portsoken Street
London E1 8BT

T 44.2076.807400
F 44.2074.813210
www.mclagan.com

McLagan Response to CEBS Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)

Reference: LV/CEBS

McLagan welcomes the opportunity to comment on the CEBS Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42). The role of the CEBS in the effort to align regulations on remuneration internationally is appreciated and the Guidelines can play an important role in establishing international consistency, in particular, within the context of G20 nations.

The Guidelines provide clear direction on a number of issues following from the CRD III including specific deferral, vesting and retention periods and methods as well as the potential proportionality leading to neutralisation of some of the directives' consequences for the whole institution and identified staff specific pay-out structures.

We are pleased to see that the Directive and in particular the Guidelines seek close adherence to the original FSB principles on sound remuneration from April 2009.

Through adherence to the FSB principles global consistency can be enhanced between the EU regulators, the US Federal Reserve Board and other regulators within the G20 context. This global consistency will greatly support the regulations achieving their goal in terms of safeguarding prudent risk taking and sufficient levels of solvency for loss absorbing capacity.

This letter is set out in two parts; the first part covers aspects which we think can further enhance the alignment of the CRD Guidelines with the FSB and therefore enable a stronger international alignment between the G20 nations on remuneration regulations. The second part deals with some practical complications such as the use of equity type vehicles and the use of retention periods on top of deferral periods.

In light of the international alignment with the FSB regulations we would like to propose the following additions for the final version of the Guidelines:

1. Enhanced FSB alignment through proportionality

The FSB principles on remuneration deal primarily with the situation where bonuses based on annual revenues do not always reflect the real risks involved over time in generating these revenues. In particular, when revenues are volatile, have a significant impact on the balance sheet and/or are generated over a significant time period, the revenues can lead to significant losses which are difficult to predict when entered into the commercial contract underlying these revenues and thus when paying bonuses over that particular year.

Therefore the FSB principles rightly called for an upfront adjustment of bonus pools for risk through an adjustment of profit for risk and cost of capital. In addition, when adjustments can not be made ex ante, the bonus can be (ex post) deferred for a period of three years to five years to ensure that any unidentified tail end risk is taken into account for the final bonus payment through the use of malus adjustments.

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This principle was based on the notion that bonuses were paid out on profits that were calculated annually and therefore pay-outs needed to be adjusted ex post for any risks which would become visible only over a longer time horizon.

However if bonuses are based on profits (adjusted for risk weighting, cost of funding) which are calculated over a series of years (e.g. three year assessment) tail end risks will diminish. Equally when bonuses are paid out only after the risk has been cancelled entirely (at the end of the lifetime of a fund) there are no tail end risks left that need to be dealt with. In both of these situations a deferral seems unnecessary for most of the identified staff involved in the day to day operations.

If an institution calculates bonuses over a three year period with sufficient adjustments to ensure that paid out bonuses do not relate to subsequent tail end risks the need for a deferral on those bonuses should no longer exist.
Not only does this align to the FSB principles, it also aligns closely to the FRB regulations where deferral is just one of the many measures to adjust for risk.
In addition, from a stakeholder perspective, it aligns more closely to shareholder and depositor's interests. An investor would want to know as much as possible about the risks on the balance sheet and their valuation instead of having to rely on the deferral component to deal with unexpected tail end risk.
The exception would be executives. Investors in particular would require executives and senior management to still have appropriate deferrals aligned to shareholder value creation to ensure further alignment with their interests in developing and executing the strategy of the institution.

In its CRD Guidelines the CEBS has allowed for proportionality to include neutralisation in those instances where the institution is of lower systemic risk or has managed to adjust for risks in a way which diminishes the potential tail end risks. In particular we would envision this to refer to fund managers where the bonus is paid out after the investment is returned in full to the investors. Banking organisations can likewise correct their annual bonus pools in a similar way to the fund manager paying back the investors before bonuses are paid out in full. Our experience with some of the largest most systemic banks in the world have proven that risk adjustment, multi year assessments and cost of capital adjustments have become far more sophisticated and effective in ensuring that bonuses are based on real results where tail end risks are accounted for. This approach to a more long term incentive instead of an annual bonus program is not uncommon for executives and can also be based on equity or equity like vehicles in the same way as deferrals.

To recognise and support the development of better ex ante adjustments of bonus pools, we would propose to add an explicit wording for the proportionality aspect regarding neutralisation of pay out deferral (Guideline 20 on page 19):

Where the time horizon of the institutions' business activities is reflected in a multi year assessment of performance and at the end of that assessment period most, if not all, of the market and credit risks from the initial year have been accounted for, the pay-out structure can be adjusted proportionally to limit the use of deferrals and retentions to those who are executive members and senior management instead of all identified staff.

2. Practical complications

The practical implications of the CRD Guidelines can cause serious implementation issues in particular for the largest organisations.

We would especially propose the following aspects to be considered for the final version:

a. Timing of the implementation
Whilst the timing itself is very challenging to even the largest and best resourced firms, this forced timing will inevitably create an uneven playing field between different countries on pay-outs. Any consideration on behalf of the CEBS for a phased implementation of pay-out restrictions would be greatly appreciated by the industry in particular if firms can prove that they have made substantial progress in implementing the overall principles of the FSB.

b. Deferral period and retention period
Whilst we understand that the retention period is meant to deal with equity on an upfront basis (the 50% of the upfront payment without deferral) the retention period in addition to a deferral period is complicating matters for the firms and employees. We would recommend that to avoid taxation firms are allowed to use deferrals instead of retention periods on the upfront equity component.

c. Equity type vehicles
We understand why the combination with solvency requirements would lead to the need of having a loss absorbing buffer based on bonuses which reflects the credit worthiness of the firm. Though equity has advantages from an accounting perspective it is the least likely vehicle as a loss absorbing buffer.
It will strongly diminish in market value just before it is needed as a buffer. In addition it will introduce a market risk to the compensation of an identified staff employee which could influence behaviour significantly. If the majority of one's pay is dependent on market valuation in some well documented cases this has lead to window dressing of results for the purpose of increasing the markets valuation of the shares.
In addition for many firms equity will not be an option due to their ownership structure. In particular asset managers are often not listed.

We would propose to add the possibility of cash based deferrals with the same upside as equity. For loss absorbing capacity the use of cash based deferral vehicle would actually be more effective whilst the connection between future pay-outs and the credit worthiness of the firm remains strong. Cash deferrals can be adjusted downwards on solvency ratio's, profitability over a longer period of time and even individual performance over the vesting period the same way equity deferrals would without the potentially negative impact of market risk on solvency and pay.

d. Identified staff
We understand that a firms' risk is created, managed and controlled by identified staff and that as a result specific requirements are needed in relation the remuneration of these staff categories. We would however encourage further differentiation between these categories of staff given their role.

- *Executives and Senior Management* are responsible for the creation and execution of the firm's strategy. As a result they are often required by shareholders to have a substantial portion of their remuneration in equity. The CRD Guidelines seem to address this adequately.

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- *Control functions* however, given their independent control nature should not be remunerated in equity but instead, as outlined in the FSB principles, be remunerated mostly independent of financial performance. Deferrals linked to future profitability (equity or cash) would diminish their independence.
- *Other risk takers.* Given their day to day impact on the use of the balance sheet as individuals or collectively, the strong emphasis on equity (80% for top variable earners) can lead to the unintended effect that they care more about the immediate share price than about the long term profitability of the firm. With an exposure to market valuations at this extensive level without being held accountable under securities laws it can create situations where the risk taker will hide information affecting the share price of the firm. In addition the risk taker will require a higher base salary to deal with the risk and cash flow implication of an equity portion of 80% on variable pay. We would propose to lower the deferral percentages substantially to avoid adverse incentives to this population and instead emphasise the ex ante bonus pool adjustments on risk (weighting), cost of capital and add a multi year assessment on employee performance where appropriate given the nature of the business.