ABI Associazione Bancaria Italiana

Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)

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POSITION PAPER

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General remarks

ABI welcomes the opportunity to comment on the CEBS Consultation Paper on Guidelines on Remuneration Policies in Financial Institutions (CP 42).

ABI strongly welcomed the endorsement of the FSB principles on remuneration by the G20 group of nations. For the time being however, the implementation of these standards across G20 jurisdictions is highly unequal.

The Italian Banking Association, in line with the EBF, has always called for a level playing field at global level to avoid competitive distortions. The CEBS guidelines mention the level playing field but only at EU level; however, since the major financial institutions have a global activity and not only a European one, there is a need for a global level playing field.

In the USA and Asia, the FSB principles have only been implemented at a very high level. In those markets, financial institutions still have large powers when determining the structure of their variable compensation arrangements. In contrast, the CRD III sets out very precise rules with regard to the structure of the remuneration concerning variable vs. fixed remuneration, deferral rules and the use of restricted equity instruments. Thus, EU financial institutions competing in these overseas markets are left with very little flexibility concerning their variable remuneration arrangements.

As a general remark it should be noted that, due to the prescriptive nature of the CRD3 provisions, the envisaged measures risk to contribute reducing institutions' flexibility regarding remunerations and consequently and paradoxically their ability to decrease remunerations in times of stress, considerably affecting their competitiveness.

Therefore the Guidelines should not interpret more strictly some of the provisions of CRD 3 as happens, for instance, with regard to the following point 2.

With the new CRD III rules as interpreted by the CEBS guidelines, US and Asian banks will also be able to pay out a significantly higher portion of the variable compensation in upfront cash in comparison to their EU counterparts.

The ultimate risk of the competitive distortion for EU banks is business relocation, be it of EU banks being forced out of the US and Asian markets, or of non-EU banks relocating their previously EU based activities to jurisdictions with less stringent remuneration requirements. Another possible undesirable consequence of the CRD III remuneration requirements is across-the-board inflation of remuneration, mainly on the fixed component, in order to maintain a minimum cash compensation level for EU banks to remain competitive.

Similarly, the CEBS guidelines do not fully address the cross-sector level playing field. ABI believes that the latter should be ensured even if some other initiatives cover investment funds and insurance (AIFM, UCITS IV and Solvency II). The remuneration of risk takers is not only a banking issue but concerns also the entire asset management area (classical funds, pension funds, alternative and hedge funds).

The different tax regimes applied to financial instruments that ought to be used to pay part of the variable remuneration can create significant differences in the "net" treatment of bank employees.

Specific Comments

Introduction

3. Implementation Date

Regarding the date of implementation, financial institutions intend to implement the CRD III principles as soon as possible. However, national implementations will probably take place by the end of 2010 and it seems very difficult in such a short time to fully apply the CRD III requirements for the 2010 remunerations.

The regulations in question could lead to a need for implementation through shareholders' meeting resolutions, where an individual bank's remuneration policy is non-compliant with the new rules. In Italy the calling of a shareholders' meeting is subject to strict rules and call methods for which no exceptions are allowed, in addition to being a particularly expensive obligation.

Where adaptation to the supervisory rules also calls for amendments to the bank's articles of association, the technical timing also needs to be taken into consideration – in accordance with art. 56 of the Consolidated Banking Law – to obtain Bank of Italy authorisation (the corresponding supervisory rules allow 90 days).

This very strict timing means the idea of adapting to the new rules with effect from 1 January 2011 is unrealistic. This is most likely to happen in 2011 at the shareholders' meeting called to approve the financial statements.

Then from a different point of view, the fact that the provisions in question apply to remuneration paid in 2010 appears to conflict with the principle that excludes legitimate rights acquired by the parties, based on an agreement compliant with regulations in force at the time the agreement was signed. Assuming that such agreements would be void seems incompatible with the substantial and labour law provisions in force in Italy.

For the above reasons, ABI requests:

- the introduction of a grandfathering clause, protecting remuneration agreed for 2010 and 2011;
- that application of the new rules be ordered with effect from 2012 or at least, as allowed in § 146 of the Guidelines for disclosure, that institutions should also be permitted to "undertake an evolutionary process for the first periods" also with regard to implementation of CP 42.

ABI regrets that the consultation paper has a very strict approach in implementing the CRD III (stricter interpretation adopted and in some cases new provisions inserted) without taking into account the concrete conditions of business and the labour market. ABI, as also requested by the EBF, suggests that the guidelines should be re-examined in order to be identical to other international standards and particularly the FSB principles.

Point 19 of CRD III (page 8 of the CEBS paper) states "it would be appropriate for the CEBS … to analyse related potential costs and benefits"

The CEBS paper includes no reference to development and maintenance costs of the proposed system. In our opinion the administrative management, especially the deferred part, will lead to quite a few management problems with consistent action on personnel administration procedures. So for these purposes also, the implementation date is particularly critical.

1.Outlines

1.1. Scope of the guidelines

1.1.1. Which remuneration?

Regarding the definition of remuneration (1.1.1), the text refers to all forms of payments and benefits paid directly and indirectly. It also refers to *"pension fund contributions"*.

Benefits comparison – not only in terms of their cost, but above all their value – on an international basis is a highly complex task.

1.1.3. Which staff?

The paragraph 1.1.3 (15) of the consultation paper let the responsibility to institutions to identify members of the staff whose professional activities have a material impact on the institution's risk profile. ABI supports this approach. However, the following paragraph (16) set up a presumption of involvement for a very numerous categories of staff. The institution must demonstrate that these categories of staff have no material impact on the risk profile if they do not want to apply remuneration requirement to them.

CEBS is interpreting the term “risk taker” as covering not only executives and senior management, but also staff responsible for control functions, other risk takers and other employees in the same remuneration bracket.

This takes the FSB’s sensible approach to identifying risk-taking staff to absurd lengths. The FSB envisages that institutions should apply a special remuneration policy to a comparatively small group of staff. By broadening the interpretation of “risk taker” to cover the entire institution, this special focus is lost. CEBS defines a so-called “group risk taker”, i.e. staff who may collectively as a group, unit or department influence the institution’s risk profile. Given the number of potentially material types of risk, this means the vast majority of staff at any bank will find themselves in a group of risk takers. Adding to this the requirement to include staff in the same remuneration bracket as well would lead to a definition that is likely to cover all employees at most banks. This not only flies in the face of the original intention of the FSB and the CRD but would in addition place a significant administrative burden on banks for no justifiable reason.

As for the staff involved ABI believes that principles could be considered at EU and International level to address possible weaknesses in remuneration practices but considers that those principles should remain high-level and should be restricted to managerial functions, risk-takers and control functions. As high-level principles in this area are targeted to adequately address risks for the financial institution, only those functions and categories of leading managerial personnel whose decisions could potentially lead to expose the financial institutions to financial risks linked to the performances of market instruments, should be taken into account.

ABI therefore holds the opinion that not all employees and activities within a financial institution should be addressed by these principles which should not interfere with national collective agreements.

1.2. Proportionality

CEBS confirms that some institutions may be exempt from applying significant parts of the remuneration principles (including those relating to remuneration structures) depending on their "size scope and complexity". The guidelines state that it will be up to the relevant institution to determine whether it would be disproportionate to apply the remuneration principles in full.

The ability to dis-apply certain aspects of the remuneration proposals on proportionality grounds is welcome, but without additional detailed guidance on the criteria to be applied by an institution making this assessment, this creates uncertainty and the risk that firms will all approach this exercise in different ways. It could also be problematic if the relevant authority takes a different view at the end of the year when that institution comes to make bonus payments as it will be difficult to ensure compliance retrospectively

given the need to amend contracts and set up deferred remuneration schemes.

The CEBS guidelines also suggest that, as well as allowing some institutions to dis-apply aspects of the remuneration principles on the basis of their institution's "nature, scale, scope and complexity", they will also allow institutions to dis-apply aspects of the principles in respect of specified groups of staff within the institution on the same grounds. ABI welcomes the avoidance of a one size fits all approach.

Moreover, when determining the members of staff whose professional activities have a material impact on the institutions risk profile, large international conglomerates should be allowed to make this assessment at the consolidated Group level within the EEA, based on the proportionality principle. When an institution belongs to a large international financial conglomerate, its staff members do not have the same impact on the risk profile as a standalone institution of similar size, since such conglomerates are subject to group level supervision. Large international conglomerates will be at a disadvantage if the proportionality principle is not applied across borders within the EEA; therefore EEA regulators should concert on this issue.

2. Governance of remuneration

2.3. Control functions

ABI is of the opinion that Control functions should be involved in high level principles, but not in micro-design of incentive schemes and, even more so, in setting amounts. ABI would suggest to review the guideline whereby the recommended role of control functions includes involvement in "setting individual remuneration awards".

3. General requirements on risk alignment

3.1. The basic principle of risk alignment

3.1.2. Discretionary pension benefits

As mentioned, the system proposed in the CEBS consultation paper on guidelines on remuneration proves inapplicable in Italy as it assumes pension scheme operating methods that do not exist under Italian law.

In fact, the idea of breaking down one of the variable remuneration components as supplementary pension benefits aligned with the long term interests of the bank/employer appear to presume the use of complementary pension schemes:

- created ad hoc for individuals, who therefore invest in financial instruments owned by the individual and, in the case in question, in the bank/employer's shares;
- assignment of the fact that pension rights maturity does not begin from the time of subscription and payment, and in the long term therefore suffers a development consistent with the duration of the payments, related entity, return on the investments, and it is bound to certain terms established by the employer (e.g. the employee's minimum service for that company).

These elements are not related to the Italian complementary pension systems.

4. Specific requirements on risk alignment

The proportionality criterion should explicitly establish:

- the pay mix threshold
- the remuneration threshold

below which the provisions in terms of remuneration for the entire system do not apply, regardless of the size of the bank.

With reference to the building up of the bonus-pool, the bottom-up method allows an easy risk alignment by the bank and allows also to control in an efficient way remuneration policies in the way prescribed by the guidelines.

4.1. Fixed versus variable remuneration

ABI is particularly concerned about the combined interpretation of cash vs. equity and upfront vs. deferred requirements, which is more prescriptive than is required under the FSB remuneration principles. In line with the principle of proportionality and in the interests of a flexible remuneration policy able to maintain alignment with business and people strategy as well as sound risk management, firms should be permitted to consider their own risk profile and determine whether: equity should be used up front; an appropriate level of retention should be applied; or equity should be used as the deferred element of the variable pay (again with appropriate levels of deferral and/or retention to meet requirements and align properly with risk).

The Guidelines prescribe the application of the 50% equity payment to each of the immediate portion of the variable remuneration and the deferred portion.

ABI does not share this interpretation of the CRD3, since it is not explicitly stated that the 50% calculation for equity payments should be based on each portion of the variable remuneration (immediate and deferred).

Instead ABI interprets that the requirement that " at least 50 %, of any variable remuneration shall consist of an appropriate balance of: (i) shares or equivalent ownership interests, (…) (ii) where appropriate, other instruments within the meaning of Article 66(1a)(a) (…) This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (p) and the portion of the variable remuneration component not deferred" (CRD 3 as adopted by the Council on 11 October 2010, Annex V, 11., 23.o) as meaning that the 50% calculation should be based on the total variable remuneration, both immediate and deferred.

Each Institution should then be able to allocate the cash and non cash component of any variable remuneration as it may deem appropriate to achieve the risk alignment objectives set forth in its remuneration policy, provided that it is made in a consistent manner and that the overall cash component does not exceed 50% of the total variable remuneration.

In particular ABI would also comment that the prohibition of an upside on long term incentives seems an unnecessary restriction with unclear rationale in terms of risk-taking implications.

The Italian Banking Association also notes that the use of equity or share-based instruments is in any case subject to shareholder approval and the indications risk creating a situation whereby shareholders interests, in terms for example of dilution or preferred incentive vehicles, may not be in agreement with the strict equity provisions. For smaller financial institutions and for employees where bonus payments are relatively low the burden of issuing and monitoring financial instruments might be overly high. It might be an acceptable alternative to link this requirement to the profitability of the financial institute using other performance indicators which are agreed with the local regulator.

The proposed application of retention policies for equity, especially in conjunction with other recommended practices such as deferral and multi-year performance conditions which already form the basis for a solid risk-aligned approach, may become excessively rigid. ABI suggests to clarify that the principle of proportionality is key in determining whether a sound remuneration practice built on rigorous performance measures and appropriate deferral should be further subject to additional retention policies.

Regarding the use of "contingent capital" ABI suggests that the existing CEBS guidelines on hybrid instruments be further elaborated to clarify their use as a vehicle for incentive payouts, given the lack of clarity, precedent, market and uncertain administration implications. Moreover, it may be useful to provide examples of what is considered "appropriate and applicable" and under what circumstances shares or equivalent should be "combined" with contingent capital.

With specific reference to the payment of equity-based remuneration, the results of corporate simulations over 5/6 years show a significant dilution of capital. A number of cooperative banks have pointed out that the problem of share issues for this category is highly intricate and that even now they do not feel it appropriate to adapt the variable remuneration structure.

4.2. Risk alignment of variable remuneration

The Italian Banking Association notes the distinction made between "quantitative" and "qualitative" criteria to assess performance. ABI wishes to point out that we consider quantitative criteria as those measureable via a quantifiable KPI and therefore not solely financial but also other performance drivers measured via quantitative criteria but cited in the guidelines as "qualitative"– eg. customer satisfaction, people engagement, reputation, etc. We suggest to clarify the distinction between quantitative (measureable metrics) and qualitative (primarily relying on discretional elements as the basis for judgement).

4.2.3. Risk measurement

Reference to Second Pillar and ICAAP are very complex to be included in incentive systems.

4.2.4. Performance measurement

With specific reference to § 95, note that the financial markets crisis led to a keen interest from the Authorities in the impact of incentive schemes on risks, and therefore on corporate results. If on the one hand regulatory developments tend to spread awareness of the existing relations between incentives, risks, capitalisation and liquidity, on the other hand the paper proposes an incentive system that envisages the measurement of financial and non-financial performance, without any clear reference to company performance. It is therefore necessary a clear interpretation on this point.

4.4. Payout process

For asset management businesses, it has been market practice for many firms to have some part of the variable pay in their own managed funds, which closely aligns fund managers to their investors. Where variable pay is linked to managed assets, it should be regarded as "equity/equity like" for the purposes of the guidelines.

ABI would note that the retention period should be aligned with the time horizon of the risk rather than the materiality of that risk.

The Italian Banking Association refers to the phrase *"institutions must apply the same chosen ratio between instruments and cash for their total variable remuneration to both the upfront and deferred part"*: the most appropriate ratio of cash and equity may be influenced by differing conditions and

characteristics of upfront vs. deferred payouts. ABI therefore suggests this level of prescription be removed so that institutions are able to define appropriate ratios separately for upfront and deferred parts.

ABI appreciates clarifications on aspects of the reward and payout process. However ABI observes that the definitions of "accrual period", "vesting period" and "deferral period" are not compatible with some widespread practices that are demonstrably aligned with sound risk management. For example, stand-alone Long Term Incentives may take the form of Performance Shares whereby the "accrual period" over which performance is evaluated corresponds to the "vesting period" and, in the case of cliff vesting, to the deferral period. The Italian Banking Association suggests that the guidelines be formulated in such a way as to accommodate different remuneration practices that comply with underlying principles via differing mechanisms.

4.4.2. *Cash vs. instruments*

With regard to the definition of instruments for guidance application purposes, as the reading of the first point of paragraph 121 is unclear, an opinion is requested on the interpretation according to which listed banks are allowed not only to use shares but also share-indexed instruments.

The Italian Control Authority (CONSOB) in 2007 has assimilated compensation plans based on financial instruments to remuneration plans linked to financial instruments with variable compensation related to the value of the instruments.

Regarding the second point of paragraph 121, the consultation paper's reference to art. 66 of the CRD seems incorrect for the purpose of identifying instruments affecting the issuing bank's credit quality as a going concern, in that the provision refers to the extent these financial instruments may be considered as assets. In this respect, it would instead be necessary to refer to the definition of lending banks' own funds as per art. 57 of the Directive (as amended by CRD II – Directive 2009/111/EC), in particular Tier 1 hybrid instruments.

It seems opportune to underline that the retention restraints can be subject to exceptions in order to consent the employee to meet fiscal obligations.

Paragraph 129 says that *"the minimum retention period of, for example, 3 years"....* It should be cleared that this example is not applicable to all situations. In fact, a retention period of three years, applied to the cost deferred rate (minimum three years later) of an incentive completed at the end of a three years accrual period, could be erogated nine years after the agreement.

5. Disclosure

In relation to disclosure and any further guidance given on the disclosure requirements, it is important that agreement is reached between regulators in different countries with respect to general remuneration disclosures, so that disclosure in a headquarters country can be sufficient to meet the requirements in all the countries in which a firm operates. ABI is concerned that differences in the level of disclosure required will lead to competitive disadvantage and would argue that the information disclosed be standardized for all firms subject to the guidelines. If jurisdictions decide to require disclosure not only at consolidated level but also for "significant subsidiaries" they should ensure this in any case takes due consideration of the parent company disclosure, is consistent with proportionality as expressed by parent company and reviewed by relevant home company regulator, and in no case differs in the disclosure required across jurisdictions.

Annex 1 - Concepts

Lastly, in reference to the annexes and more precisely:

Accrual vs. deferral vs. retention – the application of retention also on the deferred element extends the payment times and leads to full distribution no less than 6 years (to which the clawback clauses would then be added) from the year in which the results were produced.

The long period of reference of variable remuneration could determine difficulties for the bank in order to assess labour contracts no longer in existence.

Pro rata spreading in a deferral scheme should not be more than 4 years.

In the same year more incentive plans could be in place: this leads to the necessity to make reference to a single plan in order to proceed or not, to the payment of the variable part of remuneration.

The existing procedures are not able to mark this difference and need to be changed. These changes to the new discipline need time and will provide additional costs for banks.