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Consultative paper CP23 "Draft high-level principles of Remuneration Policies"

Ladies and Gentlemen,

We would like to thank you for the opportunity to comment on the Consultation Paper "Draft high-level principles of Remuneration Policies". Please find the comments of the German banking industry below.

Zentraler Kreditausschuss (ZKA) represents the interests of the German banking industry both on a national and on an international level. Its members are constituted of the German banking industry's apex associations. On aggregate they represent some 2300 banks and savings banks with a consolidated balance sheet total of approximately EUR 5 billion.[1]

We would like to preface our more detailed comments on the proposals contained in the present Consultation Paper by a number of general remarks.

[1] The present comments are subject to the approval of the bodies of BdB (Bundesverband deutscher Banken).

General

Currently, the markets of the real economy and of the financial industry are haunted by a severe crisis. An analysis of the latter demonstrates that remuneration schemes and other incentive mechanisms feature certain risk relevance. Hence, we are supportive of the Committee of European Banking Supervisors’ plans to draft fundamental principles for remuneration policies. We also feel that the chosen approach is meaningful, i.e. deriving specific recommendations on the basis of recent experience. The responsibility for the remuneration policy rests ultimately with the institutions themselves or, moreover, their owners, as noted under item (1) on page 1 of the consultation paper.

The paper deals with remuneration aspects exclusively from the point of view of risk-bearing capacity. It fails to take account of the fact that the implementation of the principles may violate national labour legislation or special national rules and regulations pertaining to the area of service contracts; This may, for instance, happen if and when interference with existing employment contracts between the employee and the employer becomes necessary. Furthermore, Germany’s Constitution stipulates the principle of autonomy in collective bargaining agreements, i.e. employer and employee or, moreover, both sides of industry (management and trade unions) are free to agree corporate working conditions without any state interference. It is absolutely necessary that there be room for accommodating such national idiosyncracies. Nor should it be overlooked in this context that under the EC Treaty the type and style of remuneration fixing and remuneration levels do not fall under the jurisdiction of the EU (EC Treaty, Art. 13).

We would like to welcome the Consultation Paper's general approach: The misdemeanor of a limited number of players before and during the crisis has not spurred any excessively stringent micro-management regulation in the present Consultation Paper. Instead, the Consultation Paper focuses on general principles and transparency as well as governance aspects.

Comments on the Principles

i.	The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should also be adequately rewarded to attract skilled individuals.

We see an urgent need for the requested remuneration policy or, moreover, a corresponding sustainable "remuneration strategy" and we would like to particularly underline the need of synchronizing the latter with pivotal corporate values. This will at the same time allow a wide array of possible arrangements – e.g. concerning the ratio between base pay and bonus elements as well as participation of employees in negative corporate performance trends. Hence, the regulatory scope can only be confined to identifying a "range of good practices".

Pursuant to principle (i), a remuneration policy must not violate the institution's long-term interests. Whilst, at first glance, this simple requirement may appear trivial, it might easily be misunderstood during the interpretation. In the final analysis, the practice of MBO (management by objectives) on an exclusively individual basis must remain possible, or, moreover, it must remain possible to create short-term financial incentives (in the form of variable pay elements) for attainment of specific, short-term performance goals by employees. Very often, time is of the essence. For instance when entering a market, it shall and must remain possible to take account of this principle. In this case, long-term corporate performance would only be an indirect driver.

ii.	The remuneration policy should be transparent internally and adequately disclosed externally.

Principle (ii) calls for internal transparency and appropriate external disclosure of remuneration policy. With a view to employees, the explanation specifies that the latter should be aware of the principles of the remuneration policy as well as that they should know in advance the criteria that will be used to determine their (variable) remuneration; furthermore, there is the specification that the process which in the final analysis fixes these remuneration levels should be documented and transparent. In this regard, the CEBS proposals reflect the actual corporate practice. However, the need for a differentiated level of granularity in the communication, i.e. a multi-tiered approach *vis à vis* the various target groups should be clearly emphasized. This is the only way in which the flexibility necessary for efficient allocation of financial and other incentives to the respective business units and hierarchical levels can be maintained. However, this is not a contradiction with regard to the principle that all employees must have access to the principles and policies for the remuneration policy (which does not signify that they shall and must have access to the specific remuneration levels of individual employees or employee groups).

By way of analogy, this also applies to the disclosure *vis à vis* stakeholders and thus the general public. Disclosure of policies and principles for remuneration may give rise to more market discipline. At the same time, there is a fundamental conflict between a detailed disclosure on the one hand and a bank's right to confidential treatment of business information as well as data privacy rights of individual employees on the other hand.

iii. The management body, in its supervisory function, should determine the remuneration of the management body, in its management function. In addition it should have oversight of the overall remuneration policy of the firm. The implementation of the remuneration policy should be subject to central and independent review.

Principle (iii) firstly addresses the role of senior management and of the supervisory board. This is followed by an extension of the scope to the entire bank. With regard to the entire bank and thus to all employees, the explanation of principle (iii) appears spurious when it says that centralised decision-making bodies are better able to align individual pay-out with the company's overall performance. At this point, the consultation paper should make a stronger differentiation between remuneration principles, the specific remuneration system and its organisational incorporation or the actual remuneration of individual employees.

Political and strategic aspects undoubtedly have to be coordinated from a central point. However, definition of the final amount of variable remuneration elements for each employee by a central interface would be counterproductive. Apart from the inevitable bureaucratic cost, remuneration would thus be limited to those figures which are centrally available. However, more often than not, centralized or top-down assessment of the achievement of qualitative objectives or soft factors will hardly be possible. This will, *inter alia*, prove counterproductive with regard to the transparency requested under principle (ii) for the respective employee.

iv. Where the pay award is performance related, remuneration should be based on a combination of the individual performance's assessment, the performance of the business unit and the overall results of the company or group. When defining the individual performance other factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include an adjustment for risks and cost of capital.

Principle (iv) refers to performance measurement as a basis for variable remuneration. The Consultation Paper quite rightly highlights the major importance of measurement of the performance which needs to be remunerated as the basis for a successful remuneration policy. In its explanations, it simultaneously points out that principle (iv) may not be applicable to all areas or, moreover, employees of a bank. Against this background, the requirement for any performance-related remuneration to be based on a combined assessment of individual, business unit or even company-wide or group-wide performance needs to be examined in particular.

We feel that this is appropriate for certain employee groups, whose decisions have a corresponding relevance for the performance of the overall company. This remuneration policy would, however, at the same time impose significant restrictions on the possibility of directing employees who do not take or manage risks. For direction of these employees, senior management's options of reverting to the method of management by objectives (MBO) and of compensating them on the basis of individual attainment of previously agreed targets, would be extremely curtailed. However, linking remuneration and responsibility, is both legitimate and preferable as far as remuneration policy is concerned. Particularly high performers will see this as a priority. Remuneration policies, which are primarily based on the total result of a bank or of a unit constitute a general problem in that they are not sufficiently attractive for high performers.

This weakness becomes especially visible if an individual company is in the process of going through a trough and has to keep high performers on board. Generally speaking, in highly performance driven companies, individual employees perceive compensation based on individual performance as more "equitable" and – provided the company is still writing black figures – by no means wish to be penalized for poor performance of other units nor do they want to be held responsible for a lacking overall performance. Based on the foregoing, the scope of this remuneration policy should be confined to that group of persons which – within the bank or within individual corporate units – bears direct responsibility for risk prevention.

Furthermore, one should state that – *per se* – collective goals do not resolve existing governance issues. Yet, they may lead to a loss in the capacity to direct staff. Conversely, individual objectives *per se* do not lead to governance issues; yet, in many cases, they increase a bank's possibility of directing its employees.

Within the framework of the principles, there needs to be a clearer differentiation between variable pay for employees who may take or manage considerable risks on behalf of a bank whilst seeking to attain their individual objectives and those employees who seek to achieve a certain objective but where performance is not associated with any perverse incentives and were, if any, only irrelevant risks are incurred for the bank. In the latter case, the efficiency loss that would result from a broad based definition of performance could offset the benefits inherent in limiting perverse incentives and risks.

We also feel that a stronger differentiation would make sense in terms of non-financial parameters within the framework of variable remuneration. We subscribe to the view that an undifferentiated focus on financial aspects may lead to undesired behavioral patterns. Yet, at the same time, we do not see any sense in particularly highlighting non-financial aspects, e.g. acquired skills in the framework of the selected principles. Using such non-financial parameters in the framework of variable remuneration rather more needs to be chosen carefully. It needs to be customized with regard to the respective group of employees because an undifferentiated consideration of this could, *per se*, become the cause of new perverse incentives.

Furthermore, a critical review is required with regard to the call for reflecting the cost of capital or even the firm's economic capital model. It needs to be considered that, in practice, the costs of capital– and this applies especially in crisis situations – can only be ascertained with difficulties. In other words, they can only serve to a limited extent as a basis for remuneration policies. In addition to this, we should like to point out that publicly traded firms tend to adopt more short-term strategies in order to deliver shareholder value.

v. There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure upfront cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.

Principle (v) is geared towards the specific tools for remuneration. In this context, the Consultation Paper calls for an adequate relation between fixed and variable remuneration elements. Furthermore, it requests that large bonus payments shall not be paid upfront in cash but in the form of flexible, deferred instruments on the basis of future performance and materialised risks.

Yet, the language chosen is not immediately accessible. We feel that the focus on the selection of remuneration instruments in turn should not be geared so much to the absolute level of the variable pay or to the ratio between variable pay components and fixed pay components. Instead, it should be based on risk-taking by the respective employees who might be induced by variable remuneration elements. As a matter of fact, if material parts of the variable remuneration components are geared towards a company's overall performance, a large share of the variable remuneration component itself might even become a tool for risk management – namely as regards HR costs / HR capacity.

Principle (v) furthermore gives rise to the impression that for meeting this requirement the specific transactions of an employee would have to be monitored permanently and until the end of their duration. If for nothing else, this is not feasible under practical aspects especially in view of the fact that the initiator in the individual case might be controversial in view of the fact that there is the four-or-more eyes principle which exists in the banking industry. It is also unclear on which basis negative developments are supposed to be quantified. Furthermore, for banks with the focus on long-term business, a shift from bonus payments over several years and payment only on the basis of *ex post* assessments would lead to inacceptable results. Besides, measurement of long-term success is extremely complex. We feel that under labour law, the possibility of a clawback is not an option.

Yours sincerely

For
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i. V.

(Bernhard Krob)