



The voice of banking
& financial services

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Ms Franca Rosa Congiu
Committee of European Banking Supervisors
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Dear Ms Congiu,

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

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players headquartered in the UK are members of the association as are the large international European Union (EU) banks with operations in the UK, the US banks operating in the UK and many other financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit-taking and other retail/commercial banking activities.

The BBA is pleased to respond to the CEBS's consultation on the draft rules and guidance on remuneration.

Key messages

The original intention of the Financial Stability Board (FSB) Principles on Sound Compensation Practices was to ensure a coordinated response to reforming remuneration in the Financial Services Sector. It was viewed as essential that these principles were coordinated centrally and implemented consistently to ensure a global level playing field to allow firms to compete fairly in the global market place.

The CEBS guidelines, which go far beyond regulatory requirements in other international markets, are applicable globally to all EEA headquartered organisations. This means that non-EEA organisations will enjoy a competitive advantage in jurisdictions where they are not bound by such prescriptive rules on remuneration policy. The BBA is keen to understand how CEBS intends to address this issue and would urge CEBS to be flexible in the way that the rules are applied to subsidiaries outside the EU to mitigate the severe competitive impacts on European banks.

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UK firms have already aligned their practices so that their remuneration policies are consistent with and promote sound and effective risk management. They have also complied with the principles established by the Financial Stability Board through the requirements of the 2009 FSA Remuneration Code. As part of this code, the FSA signed off on the remuneration policy statements of the largest UK banking firms earlier this year.

The industry recognises that effective measures on remuneration, including CRD 3, are important. However, if these are not progressed in a practical and proportionate manner there is a risk that key personnel will either seek to relocate outside the EU, or be reluctant to move to the EU. Over time this would have an increasingly significant impact on the amount of financial services jobs, activities and revenues located in the EU. Other regions, notably North America and Asia-Pacific, would stand to gain.

Furthermore, depending on how prescriptively and conservatively the rules and guidance are implemented, the impact is likely to be felt most intensely in only a small number of larger international markets (i.e. London, Paris and Frankfurt).

Given the heavy concentration of global markets activity in these three EU Member States, the key focus of new rules should be about ensuring a level playing across the EU. High quality standards should have the flexibility to support the EU's ability to compete for global talent while ensuring that it supports effective risk management. We would urge CEBS to take the lead to ensure that this happens.

Some of our members, both British and continental-headquartered, have reported difficulties in recruiting and/or retaining employees in third countries in the past 18 months. Not only do the new rules make it more difficult for EU banks to execute their strategy, which have often been agreed with supervisors as part of the capital management process, they make it more difficult for these banks to support their clients in key, often emerging, markets.

The fact that some third countries scope banks into their rules, which are derived from the FSB's principles, but not other financial institutions, adds to the uneven playing field.

We would also encourage CEBS to take a more granular approach in considering which employee groups requirements should focus on. In particular, we would suggest that the relatively small number of globally mobile staff should be recognized as a different group within distinct recruitment and retention issues that must be dealt with at a global level to ensure a consistent, fair and robust approach.

Technical issues

Retention

The industry would appreciate clarity on two issues. Firstly, we would like to know CEBS's intention regarding the use of a retention period. In particular, the BBA is interested in understand if equity that is fully vested during the retention period must be structured as requiring outright ownership of the shares by the employee, or can notional ownership be continued, but with malus/clawback conditions ceasing to apply?

Secondly, a number of operational implications arise as a direct result of the use of a retention period. For instance, in the United Kingdom a potential tax charge would arise at the time the upfront equity is awarded for higher rate tax payers. As the position stands, an employee would be prohibited from selling a portion of the shares to settle this tax liability. On this basis they would be required to use the upfront cash award, and potentially some of their own personal income, to settle the tax due, significantly reducing the value of the cash award, in some cases to nil. Given these fundamental issues, which extend to multiple jurisdictions, firms would welcome comments from

CEBS on the extent to which the impact of tax and the potential for personal tax liabilities has been considered.

We believe that the examples provided by CEBS where shorter retention periods are allowable are unrealistic. The total deferral and retention period needed to satisfy the requirements is in excess of a normal employee's life cycle at most firms.

Guarantees

We believe that limiting guarantees in the ways proposed, in particular the limitation to only offer guarantees to new hires and only in the first year of service, will produce a "poachers' paradise" by incentivising companies to focus on external hiring (rather than developing and rewarding their own talent). This will be particularly important in times of instability, for example during change of control conditions, when employers will be unable to motivate current staff with guaranteed variable remuneration and so will focus instead on external hiring. This requirement will also prevent companies from responding to external approaches on their staff, and make retaining the most talented and desired employees extremely difficult, particularly in non-EEA markets. Within the EU this will lead to structural instability into the labour market (through higher turnover and potentially higher remuneration), which is unlikely to be consistent with good risk management. In addition, we believe that retention bonuses for existing staff should be permitted in exceptional limited circumstances.

Ratio of fixed to variable pay

The application of a potential ratio (fixed versus variable, paragraphs 78 – 83) may lead to an increase in the overall level of fixed compensation and a reduction in variable compensation, with employers aiming to keep the level of total compensation whole. This would reduce the amount and proportion of compensation already subject to forfeiture or adjustment provisions. Clearly, this is not in line with CEBS's intended outcome as any reduction in variable compensation also reduces the ability of firms to apply risk adjustment measures as well as decreasing the opportunity to reduce total compensation where the performance of the business or individuals is below expectations.

Further to the above reference to ratios, there should be no hard caps on fixed and variable pay. This will allow firms greater flexibility when implementing the revised Code.

Firms should have the opportunity to justify circumstances where there is unusually high leverage between fixed and variable pay at the point awards are recommended, rather than setting a pre-defined ratio.

Other issues

Proportionality

The BBA welcomes CEBS's recognition through proportionality clauses of the huge variety of size and business model in firms that will be covered by the Guidelines. We also support a flexible approach that allows firms to balance a variety of risk-adjustment techniques to achieve a remuneration model that best matches their business requirements and risk frameworks. We also welcome an approach in which local supervisors are free to respond to breaches of remuneration requirements in a way which best suits the nature of the breach and the company involved without necessarily resorting to automatic, punitive quantitative measures.

Alignment

For global firms it is likely that several sets of remuneration regulations, home and host, EU and third country, will apply. We would welcome further guidance from CEBS on how this would work in practice. Therefore, we urge CEBS to ensure a practicable solution, for example by way of colleges of supervisors as referred to in paragraph 31. We would also welcome co-operation between international regulators to reduce the need to demonstrate compliance separately to each regulator in every country in which a banking group operates. Our members would also welcome the opportunity of only dealing with one, lead, regulator in the EU whichever structure is adopted.

We would also like to draw CEBS's attention to overlaps between the proposals made by the Alternative Investment and Fund Managers Directive (AIFMD) and Solvency II. We urge CEBS to liaise with CESR and CEIOPS to ensure that no contradictions arise and there is no double counting of capital when making adjustments.

Conclusion

Firms should have the autonomy to decide on the most appropriate mix of remuneration provided it supports sound risk management. Remuneration policy and practice should be consistent with risk management and the avoidance of excessive risk.

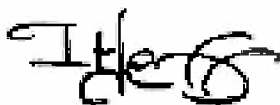
The financial services industry operates in a global and competitive environment so a global solution is needed. The failure to align practice between the EU and the rest of the world may lead to arbitrage and the loss of business as firms locate operations outside the EU, and to less regulated and/or more tax-advantageous jurisdictions.

Many firms operating in the EU have global remuneration policies that are set outside the EU. Without a co-ordinated global approach, further reform will be difficult to implement consistently and have only partial effect.

The Annex to our letter contains observations and questions arising from the CP.

We hope that you will find our comments useful. Please do not hesitate to get in touch either by e-mail (irving.henry@bba.org.uk) or telephone on 020 7216 8862.

Yours sincerely,



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Annex

The 50% rule and the limit on upfront cash bonuses

CEBS has taken a different view to the FSA on the application of the CRD 3 "50% rule". The CEBS Guidelines state explicitly that the requirement to deliver 50% of any variable remuneration in the form of shares and other non-cash instruments must be applied (separately) to both the non-deferred and deferred portion of variable remuneration. This means that the maximum cash bonus that can be delivered to Identified Staff (Code Staff for the purposes of the FSA Remuneration Code) is, respectively 20% (in a case where 60% deferral is applied) and 30% (in cases where a 40% deferral is applied).

BBA: How long will national supervisors have to consult and change their existing/proposed rules to implement what CEBS requires?

The 50% rule – non-cash instruments

Under CRD 3, unlisted entities are able to satisfy the requirement to deliver 50% of any variable remuneration in the form of a non-cash instrument by offering shares and "share-linked instruments or non-cash instruments".

BBA: CEBS has not provided any substantive guidance on the sorts of instruments that would fall within this description, other than a footnote referring to the fact that "non-cash equivalent instruments are under full development in the industry. Some examples include stock appreciation rights, phantom plans."

CEBS has not elaborated what unlisted firms or legal entities that are not joint stock companies should do or what would be a safe harbour for them. No evidence has been given of plans being developed by industry.

The guidelines also refer to a second "category" of non-cash instruments known as "other instruments" and CEBS seems to emphasise that "where appropriate and proportionate" the non-cash remuneration must include these other instruments as well. It is unclear what CEBS means by this and what these other instruments are.

The 50% rule – retention policy

CEBS has indicated that firms should establish a "minimum retention period" for the 50% of any upfront payment delivered in the form of shares and other non-cash instruments. Although the appropriate retention period is left up to the firm in question, CEBS has said that for senior staff the retention period in some circumstances should be longer than the three or five year deferral period for the deferred instrument.

BBA: No guidance is given as to what these circumstances are, or what an appropriate period may be. If there is no retention, or the period is not acceptable to supervisors, will a capital charge be imposed on the firm?

The 50% rule – general comments

It would be appropriate to allow a de minimis bonus threshold to be set under which bonuses do not have to be deferred or retained for Code Staff.

The guidelines indicate that “where appropriate and applicable, the proportion of the variable remuneration that is paid out in instruments (either upfront or deferred) must be a combination, appropriately balanced, of both categories”. This requirement generates complexity for employees on the nature of their remuneration and so has an impact on the perceived value. Some of our cross-border members would also like to highlight that there are circumstances where local legislation prohibits variable remuneration from being paid in equity or such instruments – we believe this would be an allowable exception to this requirement.

With reference to the requirement to retain 50% of total variable pay in equity or “tier 1 hybrid instruments”, some of our members believe the usefulness of contingent capital is undermined by concerns about market adoption and liquidity. The BBA and its members have had discussions with investors and the buy-side have expressed doubts about buying these securities.

There should be alignment between the FSB and CEBS to drive global consistency. Firms should be able to determine the relevant deferral and retention periods which can be explained and justified to national supervisors.

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.

BBA: 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 ability to dis-apply certain aspects of the remuneration proposals on proportionality grounds is welcome. We hope that the FSA will expand its guidance to the revised Remuneration Code to provide greater clarity for small credit institutions and investment firms on the extent to which they may dis-apply the Code.

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.

BBA: We welcome the avoidance of a one size fits all approach. Without greater clarity, the concept of inter-firm proportionality could lead to wide variation in the expectations of national regulators from different firms. For significantly smaller firms, governance processes should be simpler as there is greater line of sight between decision-makers and the employees over which they have remuneration oversight. However, the concept of proportionality could be exploited by some firms in order to deliver a lower standard of governance. We do not believe this is the intention of the proportionality approach

Other issues

“Sign-on” bonuses - The guidelines confirm that “sign-on” bonuses will be treated in the same way as guaranteed bonuses.

BBA: no comment

- Individuals covered by the Remuneration Principles - CEBS have confirmed that individuals that fall into the same remuneration bracket as senior managers and SIF's (significant influence function) still have to be "material risk takers" in order to qualify as "Identified Staff" (FSA Code Staff), meaning that employees do not fall into this category on the basis of pay levels alone.

BBA: This suggests that control functions (audit, risk and compliance) should not necessarily fall into scope, which is welcome as their impact on the risk profile of the firm is quite different from that of traders, relationship managers etc. This is a welcome recognition that these functions are sufficiently paid to maintain their independence and to recruit and retain high quality staff.

Employees exercising significant influence functions (SIFs) are easily identifiable in the United Kingdom given the Financial Services Authority's (FSA) strong governance rules. The industry would benefit from more rigorous perimeters around who are regarded as "senior management" and, more importantly, "material risk takers". Consistent application of these terms also falls within the notion of a level playing field.

It is important to identify which individuals can have a significant impact on the risk profile of the firm. The BBA welcomed the definition set out in the FSA Code and believes that current differences between CEBS and the FSA are due to drafting of the requirements rather than an intended material difference. With appropriate governance structures in place, groups of individuals should not, under normal circumstances, be able to have an impact on the risk profile of the firm. Therefore, we would suggest that CEBS removes this from their definition.

Identified / Code Staff population should be structured so that it covers all appropriate roles and there should not be a separate population (i.e. control functions) whose remuneration the Remuneration Committee is required to approve as well.

- "Golden parachute" – The guidelines strongly discourage such arrangements. Severance payments can include payments relating to notice period, redundancy, loss of office and for entering into restrictive covenants, but should not reward failure.

BBA: no comment

- Fixed and variable remuneration - The guidelines say "an institution should set in its remuneration policy explicit maximum ratio(s) on the variable component in relation to the fixed component of remuneration". CEBS has stopped short of saying what that ratio should be, but have provided guidance on what factors firms ought to take into account when setting such a policy.

BBA: A bigger fixed component adds to the cost base, which may encourage the firm to pursue higher risk strategies so that it generates enough returns to cover its costs (paragraphs 78 - 79). The right balance, respecting the nature, scale and complexity of the firm, should be struck.

- Forfeiture/performance adjustment conditions

BBA: The guidelines on forfeiture and performance adjustment conditions exceed the requirements of CRD 3, which state that total variable remuneration should be considerably contracted when subdued or negative financial performance of the firm occurs.

The CEBS approach reflects the approach adopted by the FSA in its draft Remuneration Code in making reference to evidence of behaviour or serious error by staff or a significant failure of risk management in the institution or relevant business unit. It is important that this issue is implemented consistently across Member State regulators to prevent competitive disadvantage.

Ex-post risk adjustment is appropriate at an individual or team level where performance fails to crystallise or was materially misstated. However, this would not be appropriate at a divisional or organisational level, as individual accountability should be able to be attributed. Similarly where there

is a material downturn in a firm's financial or business unit performance this should drive ex-ante risk adjustment of forward looking remuneration rather than ex-post from previously awarded remuneration.

- Geographical scope – The guidelines make it clear that the CRD 3 remuneration principles apply in respect of an EEA subsidiary of a non EEA group at the level of the EEA subsidiary (or its EEA holding company) and cover its subsidiaries and other companies (both EEA and non-EEA) subject to EU consolidated supervision. However, the non-EEA parent company does not have to apply the remuneration principles at the parent company level.

BBA: The application of the remuneration principles to EU bank subsidiaries in non-EEA countries has the potential of placing the EU bank at a competitive disadvantage if non EEA banks operating in that jurisdiction are not subject to such stringent rules. In addition there may also be difficulties in complying with the principles if the local jurisdiction's employment, company or other legislative provisions conflict with the remuneration principles.

- Conflicting Directives

BBA: The guidelines do not acknowledge that some firms coming within the scope of the CRD 3 requirements may subsequently be caught by the slightly different remuneration provisions contained in the Alternative Investment Fund Managers Directive which is currently being finalised. It is to be hoped that the final version of the CEBS guidelines acknowledges the importance of consistency of approach across the two Directives or in the alternative that a proportionate approach would allow an institution to elect to comply with the remuneration provisions of one regime only.

- Taxation

Regulation should not give rise to tax liabilities that do not currently arise or impact upon the ability of firms and individuals to pay their tax bills in the way they do now. In particular, deferral requirements should not impede the receipt of cash by individuals to enable them to pay their tax bills.

The above is linked to the geographical scope of the requirements and the companies within a group that are subject to the requirements. There are wider international issues for non-UK individuals who may have tax liabilities in other jurisdictions.

CEBS's proposal of an additional retention period (by the employee) after vesting (paragraphs 125 – 129), ie when ownership of the shares and cash transfers from the employer to the employee, has an impact on UK tax policy.

Under British tax practice, shares become legally the employee's property upon vesting, which results in a tax liability for the employee. Typically under existing arrangements, employees would sell shares to meet the tax liability.

At the end of the vesting period CEBS is proposing a further retention period (which may be equal to the vesting period). This would also apply to the proportion of non-deferred award that must be held in shares and vests immediately.

The tax liability may be deemed due on vesting, but due to the retention period the employee would not be able to sell shares to satisfy the tax liability. Given the 50/50 split between shares and cash on both the deferred and non-deferred elements, and assuming a 50% tax rate then all of the net cash could be taken up paying the cash liability.

Tax applies to the value of the shares at vesting. However, the value of the shares may in theory fall to zero by the time the employee has the right to sell them (after the expiry of the retention date) meaning they could pay a tax charge for no realised value.

For example:

100 units variable pay, delivered as:

20 immediate cash
 20 immediate shares but with retention period
 30 deferred cash
 30 deferred shares with retention period to follows

The 20 immediate shares potentially trigger a tax charge of 10, which would be paid by the net value of the immediate cash.

The 30 deferred shares potentially trigger a tax charge of 15 on vesting, which would be paid by the net value of the deferred cash.

The end result of this is no cash being paid to the employee.

There are also tax implications with regard to discretionary pension benefits (paragraph 67).

In short, the combination of deferral, vesting and internationally mobile employees creates a large degree of complexity for both organisations and individuals. This could result in an employee having a tax liability for remuneration which ultimately has no value at the end of the retention period.

- State support and remuneration

We welcome the flexibility detailed in paragraphs 40 - 41.

- Governance of remuneration

Remuneration of members of the management and supervisory function (to be decided by the Remuneration Committee): This is already the case in the United Kingdom (paragraph 46).

Composition (Remuneration Committee): There may be a lack of candidates due to the greater role of and need for non-executive directors, and their new and increased legal obligations (vide the UK's Walker Review). Therefore, a transition or regulatory forbearance is in order (paragraph 53).

- Role of the Remuneration Committee

We believe that the Remuneration Committee should approve the compensation of Identified / Code Staff as an effective governance model. We do not believe it is necessary for the Remuneration Committee to also recommend remuneration proposals for the highest paid individuals, should these individuals sit outside the Code Staff population (paragraph 54).

- Disclosure

We believe that the key focus should be to align disclosure requirements across different national supervisors so that the home country disclosure satisfies all national supervisors across the EEA. However, there needs to be a balance between transparency and the public being able to identify individual remuneration details.

- Performance measurement

The mix of approaches is correct (paragraphs 95 – 97).

- Risk adjustment

The mix of approaches is correct (paragraph 111).

- Time horizon and vesting

There may be suggestion that deferral applies to either cash or shares, but not both (paragraph 116).

- Kind of (non-cash) instruments

Basel III and the CRD address the issue of capital being raised by means of hybrid and other non-equity instruments. Basel III, to be followed by CRD IV, gives greater prominence to equity due to its loss bearing characteristics. Therefore, hybrid capital will play a lesser role in the structure of banks.