

*Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.*

## **EBF Response to the CEBS Consultation Paper on Guidelines on Remuneration Policies in Financial Institutions**

### **Key Points**

- The EBF strongly believes that branches and subsidiaries of EU banks situated outside the EEA should have the possibility to take into account the local business environment when applying the CRD III provisions potentially through the principle of proportionality. This provision is meant to guarantee a level playing field at international level.
- The proposal of an additional retention period (by the employee) after vesting, ie when ownership of the shares and cash transfers from the employer to the employee, has an impact on tax policy and should be reviewed.
- When implementing the CRD III requirements, financial institutions should undertake an evolutionary process for the *first periods* due to the short deadline for implementation and legal issues linked to the fact that compensation policies might be included in labour contracts or collective agreements.

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Related documents: CEBS Consultation Paper (CP 42) : <http://www.c-eps.org/documents/Publications/Consultation-papers/2010/CP42/CP42.aspx>

## **I. General remarks**

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

As mentioned in its report “remuneration policies after the crisis” published in spring 2010, the EBF 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 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. 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 fact that EU financial institutions are required to apply the CRD III remuneration requirements to their branches and subsidiaries on a global basis will lead to competitive distortions and EU banks will not be in a position to compete on equal terms in the US and Asian labour markets; EU banks will be greatly weakened and potentially forced out of these markets. In this context, it is regrettable that CEBS did not follow the EBF interpretation on this point (separate interpretation of the rules on variable remuneration and deferral).

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. The EBF 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) and insurers.

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.

In particular, legal issues must be analyzed in each Member state, namely where compensation policies have been included in labour contracts or collective agreements. The EBF believes that financial institutions should undertake an evolutionary process for the *first periods* (as indicated in § 146 of the guidelines related to Disclosures).

Finally, the EBF 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. **The EBF suggests that the guidelines should be re-examined in order to be identical to other international standards and particularly the FSB principles.**

## **II. Specific Comments**

### **Scope of the guidelines**

The paragraph 1.1.3 (15) of the consultation paper gives the responsibility to institutions to identify members of the staff whose professional activities have a material impact on the institution's risk profile. The EBF supports this approach. However, the following paragraph (16) sets up a presumption of involvement for 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.

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.

The EBF suggests the following wording for the first sentence of paragraph (16):

*"The following categories of staff, if they have a material impact on the institution's risk profile, must include:"*

## Proportionality

CEBS confirms that some institutions may be exempt from applying certain 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 and should be as large as possible. As a number of banks will be unable to apply all the requirements in a similar way, further clarification could be added in paragraph 20. **In particular, the EBF strongly believes that branches and subsidiaries of EU banks situated outside the EEA should have the possibility to take into account the local business environment when applying the CRD III provisions. This provision is meant to guarantee a level playing field at international level.**

European-headquartered banks 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, for example Hong Kong (Monetary Authority), scope banks into the rules, but not securities firms, adds to the uneven playing field.

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. The EBF 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.

Similarly, CEBS guidelines should specify that if there is a remuneration committee at the level of the parent company (setting the remuneration policy for the entire group), there should not be a requirement to establish remuneration committees in subsidiaries. This should be the case regardless of the location of the subsidiaries.

### Level Playing Field

Section 1.3 of the consultation paper takes into account that “subsidiaries might have local responsibilities in the implementation of remuneration policies”. The guidelines for supervisors request an examination of “subsidiary responsibilities with regard to remuneration and practices”. With respect to these principles, the EBF believes FSB rules as implemented by local regulators outside of the EEA should be applied. Only in cases where no FSB rules have been implemented locally, the CRD III directive would apply.

With respect to article 38 of the Directive 2006/48/EC, the provision (29) concerning non-EEA branches of third country parent company would be stricter. We propose the wording that “each jurisdiction should apply” in place of “each jurisdiction should consider applying the remuneration requirements to the staff of non-EEA branches of third country parent company”. Moreover and in order to ensure a level playing field, each jurisdiction should apply the remuneration requirements to the staff of non-EEA branches of third country parent companies operating within EEA Member States. For this purpose, supervisors should modify the existing memorandum of understanding (MOU) signed with the supervisors of the non-EEA institution or adopt appropriate MOU which will ensure that the non-EEA supervisor apply similar provisions to the CRD III.”

Similarly, the EBF welcomes the application of the CRD III remuneration requirements to all institutions which are already covered by the CRD. These are credit institutions and investments firms as defined by article 4 of Directive 2004/39/EC (MiFID). However, the collective Asset Management activities (whereas firms are only covered by AIFMD, UCITS IV or Solvency II) are not covered because of the provision of paragraph 2 h) which excludes “collective investment undertakings” from the scope of the directive. In this context, it must be absolutely clear that on the one hand the asset management activities of banking groups covered by the CRD III and CEBS guidelines are only the portfolio management (which is an investment service under the MiFID) and on the other hand that the portfolio management activities undertaken by asset management companies are also covered by the CRD III and CEBS guidelines.

The EBF considers that the collective asset management activities of larger financial institutions will not need to change their remuneration structures unless and until equivalent remuneration regulations are implemented for these businesses. If hedge funds and insurance businesses, in comparison with financial institutions, are able to operate more flexible compensation arrangements for employees carrying out identical functions, they would have a distinct advantage in attracting and retaining talent. This would create a further competitive distortion within the financial services sector and should therefore be avoided.

### Ratio between fixed and variable remuneration components

As specified in paragraph 78, the CRD III requires institutions to strike an appropriate balance between fixed and variable remuneration components. CEBS’s interpretations are often open

to misunderstanding, which will make it more difficult for supervisors to properly assess the suitability of the policies a bank applies.

CEBS begins by stating that, if the fixed component is too low, it may subsequently prove impossible to reduce the variable component to zero. However, increasing the proportion of the fixed component will not give banks more flexibility since fixed components unlike variable ones certainly cannot be reduced at short notice.

On top of this, CEBS implicitly equates variable remuneration with an incentive to take risks and concludes that a low variable component offers a simple method of protection against undesirable risk-based incentives. Both theoretical and practical experience suggest however that an incentive to take risks is by no means the only kind of undesirable incentive: for instance, the desire for prestige or excessive interest in a pet project can also encourage staff to overinvest. The more decision-making authority an employee has, the greater the likelihood of such incentives arising and the higher the associated danger. Variable remuneration is a valuable tool used to combat undesirable incentives of this kind. Its effectiveness in this regard is primarily determined not by the size of the variable component but its composition (deferred elements, dependence on the bank's overall performance). An especially low ratio of variable to fixed remuneration will therefore not be a suitable solution for every bank. A bank-specific limit in this area could merely offer a sensible line of defence against extreme situations such as before the financial crisis.

Furthermore, a big(ger) 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.

**Proposed amended paragraphs:**

*79. Consequently, an institution may set in its remuneration policy explicit ratio(s) on the variable component in relation to the fixed component of remuneration. This ratio must be set for the different relevant categories of staff whose professional activities have a material impact on the risk profile of the institution. The balance between fixed and variable remuneration should be set in a sufficiently granular way, so that exceptions are avoided or are kept at a minimum. If an exception is, however, needed, it should be justified on grounds that do not harm the risk alignment of the remuneration structure in question – if not it should immediately be flagged to the management body in its supervisory function.*

*80. The appropriate balance of the fixed and variable remuneration components may vary across the staff, according to market conditions and the specific context in which the financial undertaking operates.*

**Payout Process: deferral, cash and instruments**

In Section 4.4, CEBS proposals for deferrals and cash vs. instruments are excessively stringent and go beyond those laid down in the CRD III.

In particular, paragraph 130 calls for the cumulative application of these two aspects: the requirement for at least 50% of all variable remuneration to be paid in shares or share-like



instruments is to be applied to both the deferred and the non-deferred portion. There is no basis for such a requirement in the CRD. Shares and share-like instruments are by their very nature deferred components because they are subject to a retention policy. In consequence, CEBS's interpretation would require the deferred part of a senior executive's total variable remuneration to be at least 80% (= 60% + 0.5 x 40%). **Neither the FSB principles nor the CRD III specify such a rule. It is not mentioned in the directive that the upfront cash must be limited to 20 % or 30 %.**

Furthermore, under CRD III, 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".

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 should do or what would be a safe harbour for them. No evidence has been given of plans being developed by industry.

### Retention Periods

The CEBS guidelines provide for a minimum retention period for deferred equity awards over and above the initial vesting period of 3 to 5 years. It is our view that this rule goes beyond the CRD III remuneration requirements, and far away from international standards.

The EBF believes that the deferred equity portion, at the end of a vesting period of 3 to 5 years already meets the requirement of "an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution" to the extent that the equity instruments, for which the initial value is based on the share value at the time of award, remain unavailable to the employee during the vesting period and is subject to the market fluctuations of the share value over that vesting period. The only specificity is that *malus* (*claw back*) clauses also apply during this period.

In that context, imposing an additional retention period over and above the initial vesting period seems therefore unnecessarily restrictive and severe particularly in relation to non-senior staff. Once again, it is far more restrictive than the current practices which non EU jurisdictions will continue to apply where share retention is generally limited to three to four years for non-executive staff.

Moreover, the requirement for an additional retention period will encourage the implementation of a shorter deferral period (i.e. deferral of 3 years plus retention of 1 year is less restrictive than 4 years deferral but the later would not meet the requirement).

### Proposed amended paragraphs:

*125. Retention periods are included in the vesting of instruments for deferred variable remuneration. To obtain the necessary risk alignment for instruments, a minimum retention period should be determined by the institution in the remuneration policy. The institution should be able to explain how this minimum retention period relates to other risk alignment measures in its policies and should explain whether and how they differentiate between instruments paid upfront and deferred instruments, since deferred instruments carry already stronger risk adjustment possibilities. Supervisors will determine whether the retention periods proposed by the institution are deemed to be sufficient and appropriate.*

*126. The minimum retention period should be sufficient to align incentives with the longer term interests of the institution. Different factors may tend to suggest that this period should be longer or shorter. For example, it would be appropriate to apply longer retention periods for staff with the most material impact on the risk profile of the institution well.*

### **Taxation**

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

Under some Member States' 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, which can be 3 - 5 years, CEBS is proposing a further retention period (which may be equal to the vesting period).

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. 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 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 is no cash

### **Shareholders' involvement**

Section 2.1.3 addressing shareholders' involvement seems to promote the idea that shareholders should be more involved in the approval of the remuneration policy and the determination of executive compensation whereby the CRD III does not directly address this issue. As future EU legislation is expected on such issues, CEBS guidelines should not create potential confusion for national legislators. The CEBS guidelines should either delete any reference to a shareholders' vote on the remunerations policy (as it is not in the CRD III) or make clear that this should only be a possibility offered to the financial institutions.

The EBF suggests adapting paragraph 48 as follows "An institution may choose to assign to the shareholders' meeting the approval of its remuneration policy and, where appropriate, decisions relating to the remuneration of members of the management body, [...]"

### **Discretionary Pension**

The CEBS guidelines lead to some confusion concerning the dispositions for discretionary pension benefits, with respect to which staff are concerned. We understand from paragraph 6 that only the first part of (s) on Annex V falls in the general requirements (institution-wide obligatory), whereas the second part of (s) only applies to Identified Staff. However, section 3.1.2 of the text which addresses the second part of (s) is included in the General requirements on risk alignment section of the document instead of in the Specific Requirements on risk alignment. Section 3.1.2 should therefore be moved to section 4 of the document to avoid confusion for national legislators.