# EFSA's answer to CEBS' consultation paper on Guidelines on remuneration policies and practices (CP42)

**1.** EFSA welcomes CEBS' Guidelines on the remuneration requirements of the Capital Requirements Directive 3 (CRD3) (the Guidelines), which constitute a fundamental tool to assist in consistent implementation across the EEA.

Consistency is absolutely essential with respect to remuneration, which is an important competitive tool between financial institutions. Human capital creates the capacity for future growth and development both domestically and abroad. This principle is at the heart of EFSA's answer to the consultation launched by CEBS on its proposed Guidelines.

## Consistency within the EEA as regards remunerations' rules is a pre-requisite

**2.** **Firms located in the EEA that fall in the scope of the Directive should compete on equal terms as regards remuneration, wherever the parent company is located**.

Entities located in the EEA that are part of a non-EEA group should be subject to the same remuneration requirements as those that apply to their local competitors. The wording of the CEBS' guidance in this respect is somewhat ambiguous: where the EEA subsidiary is part of a non EEA group, "*the solo entity might need to ensure that the group-wide remuneration policies were taken into consideration within its own remuneration policies*" (*§29 of the Guidelines*). But what if the group-wide policies, set in accordance with the home rules, conflict with the EEA rules? Would that create the conditions for the EEA subsidiary to favour its home rules and potentially gain advantage over EEA based firms? Or would the group be subject to regulatory sanctions from its home regulator because it has not abided by its home requirements? There is obviously a need to ensure regulators co-operate to ensure on the one hand, that firms do not have to prove compliance with conflicting rules and on the other hand, that no competitive distortion is created.

**3.** Similarly, the Guidelines state that "*each jurisdiction should consider applying the remuneration requirements to the staff of non-EEA branches of third country parent companies, operating within EEA member States*" (§29 of the Guidelines). This statement is ambiguous as to the staff it is aiming at:

- If the objective is to apply the remuneration requirements to all staff of a non EEA group that has operations within the EEA, it is not acceptable, as there is no basis on which EU rules could be extended to these persons;
- If the objective is to aim at the staff of entities operating in the EEA under the freedom to provide services principle then for the sake of a level playing field within the EEA, the application of the remuneration requirements should not be left to the consideration of each jurisdiction – **a common rule should apply irrespective of where the operations take place in the EEA**.

**4.** Furthermore, any EEA rules should apply consistently the Directive requirements to other participants in the financial system that compete for the same talent as firms that fall within the scope of the rules. It is otherwise likely that the most talented workforce will shift to the less stringently regulated firms, endangering the ability of European banks and investments firms to remain innovative, dynamic and competitive. The resulting regulatory gap could also lead these institutions to take on additional risk, without the safeguard created by the rules on remunerations[1].

**EFSA therefore strongly recommends that CEBS consider how similar requirements, adapted to their specific characteristics, could apply to other participants to the financial system that compete for the same talent.**

## A global level playing field in respect of remuneration requires flexibility as regards application of EEA rules outside of the EEA

**5.** Financial institutions that compete for talent in local labour markets should all be subject to the same rules and regulations in respect of remuneration. This need for a level playing field as regards remuneration is recognised by the G20 and the FSB, both of whom underline the necessity to avoid competitive distortion[2]. The CEBS Guidelines do consider the issue but only from a perspective internal to the EEA, *i.e.*, without regard to rules and regulations outside the EEA. As far as non-EEA subsidiaries and branches are concerned, the Guidelines state that "*the parent company should ensure that the requirements of a group-wide remuneration policy are coherently observed at group and subsidiary level (including non-EEA subsidiaries)*" (*§ 27 of the Guidelines*).

**6.** Although EFSA believes that a group-wide remuneration policy is necessary to create consistency around fundamental principles governing remunerations of all staff**, flexibility should be left to non-EEA entities of the group (including non-EEA branches) to implement these principles in accordance with local rules, taking into account not only local regulations but also local practices, which in several geographical areas, will differ from EEA rules and practices**. This is of special importance if EEA firms are to remain competitive in these labour markets against their local counterparts and maintain their chance for further development, or even a presence, in non-EEA countries. To insist on rigid global adherence will put EEA firms at a severe competitive disadvantage relative to their North American and Asian counterparts in some of the strongest growth markets.

[1] Recognition that these institutions may take on risk, significant for the financial system, appears in the "Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories" : "*The scope of the Regulation is wide and lays down uniform requirements covering financial counterparties, non financial counterparties (exceeding certain thresholds) and all categories of OTC derivative contracts (…)*" (*Proposal, article 4.3.1*)

[2] "*Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions*", FBS Implementation Standards on Compensation, September 2009; "*We fully endorse the implementation standards of the FSB*", Pittsburgh's G20, Leaders' statement, 24-25 September 2009.

**7.** Such flexibility should especially exist in those countries that are bound by the G20 commitments and the FSB principles and standards on remuneration. To the extent that world leaders, including in the EEA, are satisfied that these principles and standards constitute the appropriate global benchmark, and that a process exists to check countries' compliance[3] with them, there should not be a need to apply to EEA group's entities located in these countries the detailed requirements of CRD3, which in many cases are considerably more prescriptive, e.g.:

- the use of deferral plans and payment in restricted equity instruments;
- the limitation on the cash that can be paid upfront; and
- guaranteed arrangements for new hires.

As a result of these prescriptive provisions, EEA firms, which generally are not leading institutions in these markets, are left with very little flexibility concerning their variable remuneration arrangements, compared with the local firms they compete against for talent. A likely and adverse consequence of that could be an increase in fixed remunerations paid out by EEA firms, in order to remain competitive. Due to the prescriptive nature of the CRD3 provisions, this risk also exists within the EEA, thus these measures could paradoxically contribute reducing firms' ability to decrease remunerations in times of stress.

**8.** The competitive disadvantage that EEA firms will face in non-EEA countries will be exacerbated by conflicting or additional local rules. **As differences are set to remain among countries outside of the EEA in the way they implement the FSB's principles and standards, the CEBS Guidelines should provide the needed flexibility to allow EU financial firms to adapt to specific circumstances for their entities located outside of the EEA so they can keep their rank in the global competition.**

## The Guidelines interpret more strictly than necessary or desirable some provisions of CRD3

**9.** The Guidelines introduce further prescription on remuneration structures, which are not adapted to all firms. These super equivalent requirements create social issues and increase competitive distortions with non-EAA financials firms as described.

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

**10.** EFSA does not share this interpretation of CRD3; 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). The CEBS' interpretation of CRD3 means de facto that the deferred portion of the variable remuneration will be higher than the 40% minimum limit set in the Directive, as employees will not be able to sell their shares immediately vested before the end of a retention period.

We interpret that the requirement that "*(o) a substantial portion, and in any event 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] Cf. FSB's peer review process

*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.

Besides, EFSA regrets that equity payments are considered as a necessary tool for risk alignment. In EFSA's view, the alignment of remunerations to risk can be as efficient with ex-post explicit adjustments (versus implicit ones based on the fluctuations of the share price), which could also include a consideration of the share price evolution as an input into the decision over the final payment of the amount already accrued.

**11.** Also, some countries tax equity instruments at vesting, irrespective of whether the owner is allowed to make use or not of the instruments, meaning that **employees will have to pay upfront taxes on amounts that are not only unavailable immediately but also are at risk should the share value fall over the retention period**. This could also give rise to complex and problematic double-taxation issues in the case of international mobile employees, due to the lack of convergence of international taxation rules on such issues.

**- The Guidelines introduce the obligation to add to the deferral period a retention period**

**12.** Whereas CRD3 calls for "*an appropriate retention policy designed to align incentives with the longer-term interests*" of the firm, the Guidelines set a prescriptive provision that any vesting of instruments should be coupled with a retention period. **EFSA is of the opinion that it goes beyond CRD3 requirements and that it is neither proportionate nor adapted to all institutions, whose risk profiles may differ significantly**.

**13.** Implementing such a measure would prove very complex for firms who would have to design compensation structures with several layers (cash upfront + equity upfront subject to retention + deferred cash + deferred equity subject to retention as well), whose characteristics would differ depending on the categories of staff considered and which will need to be administered separately over time and will give rise to unwarranted accounting and taxation complexity. Additionally, such a provision would heighten the acuteness of the tax issue highlighted above[4]

These considerations are especially important when considering the poor outcome of the retention period in terms of aligning incentives with risk taking. In our opinion, **the deferral period meets this objective better than the retention period**.

**14. EFSA therefore strongly supports a more flexible approach to this issue to allow firms to take responsibility for the practicalities of the way they align incentives with risks as regard matters of retention/deferral.**

[4] The combination of the 50% equity rule and the deferral and retention requirements means that the upfront cash component is effectively limited to 20 to 30% of the total variable remuneration.

## Implementation issues and review clause – the need for a proportionate approach

**15.** Publication of the guidelines as well as national transpositions of CRD3 will take place late in the year (and likely even at the beginning of 2011), leaving a very short time to firms to adapt and inform their staff of the changes made to their remuneration structures. Moreover, these regulatory changes can lead to very complex remuneration structures and legal issues that will need to be resolved. In cases where work contracts or collective agreements include some provisions of the remuneration policy, firms will need to set up relevant instruments in a sound and non-risky way, investigate labor law and tax concerns that in some cases may even trigger changes to legislations, hold shareholders' general meetings as and where necessary, and negotiate and execute new agreements with staff.

This also clearly contrasts with the requirement, also explicitly set forth in the Guidelines, that "*staff members should know in advance the criteria that will be used to determine their remuneration*".

Hence, a full implementation by January 1 would undoubtedly raise important operational risks. In EFSA's view this creates a strong basis for considering a proportionate implementation. EFSA believes this is particularly warranted by the high degree of uncertainty that has pervaded the final contours of key provisions and which will not be dispelled until mid-December. **EFSA therefore suggests, as allowed in § 146 of the Guidelines for disclosure, that institutions also be permitted to "*undertake an evolutionary process for the first periods*" with regard to implementation. In particular, considering the difficulties described above, firms should at least not be required to make equity payments during 2011 for remunerations based on 2010.**

**16.** In addition, as the Guidelines provide interpretations of the Directive that could be difficult to implement consistently in the EEA and that are likely to create major competitive distortions outside of the EEA, **CEBS should consider planning for a review of the Guidelines after a given period to reconsider their appropriateness. The review should allow ample time for consultation and conclude sufficiently early in the year that the problems with retrospective application that are a necessary consequence of the current process could be avoided. For economic reasons, this review should take place hopefully no later than April 2012 and in any case before the one planned by the Directive whereby** "*by 1 April 2013, the Commission should review the principles on remuneration policy with particular regard to their efficiency, implementation and enforcement, taking into account international developments including any further proposals from the FSB and the implementation of the FSB principles in other jurisdictions including the link between the design of variable remuneration and excessive risk-taking behaviour*" (recital (6) of the Directive).

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