POSITION PAPER

ESBG response to the EBA consultation on draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013

ESBG (European Savings and Retail Banking Group)

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA's consultation on *draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013.*

Question 1: ***Are the definitions provided sufficiently clear; are additional definitions needed?***

We would like to ask the EBA to clarify the definition of "any other person acting on behalf of the institution". From ESBG's point of view, this definition should not include e.g. advisors, attorneys, etc.

Question 2: ***Are the guidelines in chapter 5 appropriate and sufficiently clear?***

Please see answer to question 1.

Question 3: ***Are the guidelines regarding the shareholders' involvement in setting higher ratios for variable remuneration sufficiently clear?***

We would like to comment on para. 32, which states that […] "the approval of an institution's remuneration policy and, where appropriate, decisions relating to the remuneration of members of the management body (or other identified staff), may be also assigned to the shareholders' meeting". […]

ESBG is not convinced that having a remuneration policy that has to be agreed upon in the shareholders' meeting would be the right way to go. In our opinion, the purpose of the annual shareholders' meeting is to decide on the most important issues of the company as set forth by law (especially the company's act). The decision-makers have made a decision on what issues should be brought to the attention of the shareholder and, indeed, we believe that this list is extensive and conclusive. The purpose of the shareholders' meeting is not to mingle into the daily business of the company, which is rather the task of the management board. The approval and say on certain policies, including remuneration policies, is clearly an operative business and it contains many technical and administrative procedures.

Hence, in our opinion, it would not be appropriate to bring remuneration policies to the attention of the shareholders because dealing with the content of these technical and administrative procedures would not serve their purposes. The remuneration of the management and supervisory boards are reported anyway to the shareholder through the corporate governance report, which will also be

distributed to each shareholder in the shareholders' meeting. This report includes the basic mechanism of the boards' remunerations.

Furthermore, Art. 94(1)(g)(ii) CRD IV refers to a situation in which the shareholders' votes are required. However, since no other situations with shareholders' votes are foreseen in the CRD IV's remuneration chapter, one could argue that it would not be within the EBA's mandate to introduce additional situations where the shareholders need to signal their agreement through a vote.

Additionally, one option discussed concerning the current debates on the proposal for a directive as regards the encouragement of long-term shareholder engagement is that only the remuneration policy regarding directors could be submitted to a vote at the general meeting. As a consequence, one could question whether it would be appropriate to extend, through Guidelines, the need for a shareholders' approval to the entire remuneration policy.

In conclusion, ESBG does not regard it necessary, appropriate and useful to report in the shareholders' meeting on certain policies, such as remuneration policies.

***Question 4:* Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?**

The draft Guidelines state that "a member of the risk committee should participate in the meetings of the remuneration committee, where both committees are established and vice versa" (para. 49). Even though we consider that the participation of the risk committee in the remuneration process is positive and logical, it should be taken into account that this participation should have the limit of the independence and separation of committees. In this sense, ESBG considers that the examination of the risk committee referred to in para. 48 ("examine whether incentives provided by the remuneration policies and practices take into consideration the institution's risk, capital, liquidity and likelihood and timing of earnings") would be useful for the intended purpose, but the incorporation of a member of the risk committee in the remuneration committee should be reassessed, as it may prove to be contradictory with the purpose of the Guidelines.

Additionally, it should be noted that the new approach of the draft Guidelines (proportionality among other aspects) would lead to deep changes in large consolidated groups, even more when they are established in third countries as well. Therefore, we would welcome a *vacatio legis* period or, at least, a phase-in period, in which groups could make the changes required by the new framework proposed.

***Question 5:* All respondents are welcome to provide their comments on the chapter on proportionality, with particular reference to the change of the approach on 'neutralisations' that was required following the interpretation of the wording of the CRD. In particular institutions that used 'neutralisations' under the previous guidelines for the whole institution or identified staff receiving only a low amount of variable remuneration are asked to provide an estimate of the implementation costs in absolute and relative terms and to point to impediments resulting from their nature, including their legal form, if they were required to apply, for the variable remuneration of identified staff: a) deferral arrangements, b) the pay out in instruments and, c) malus (with respect to the deferred variable**

remuneration). In addition those institutions are welcome to explain the anticipated changes to the remuneration policy which will need to be made to comply with all requirements. Wherever possible the estimated impact and costs should be quantified, supported by a short explanation of the methodology applied for their estimation and provided separately for the three listed aspects.

ESBG would appreciate applying a broad interpretation of the CRD IV in order to keep the possibility of neutralisations, which were in line with previous guidelines, for the whole institution and for categories of staff. There are a significant number of institutions which do not have any complex business strategy or pay lower amounts of bonuses or no bonus at all. These institutions should still have the possibility to apply a full neutralisation of pay-out under consideration of their complexity, risk profile, risk appetite, etc. or the amount of bonuses paid to specific categories of staff.

The new approach to the principle of proportionality is based on the assumption that the CRD IV does not provide for any explicit provision that allows the so-called neutralisation. In contrast to this, ESBG understands that, *inter alia*, Recital 66 CRD IV allows for such neutralisation. In fact, the wording of this recital indicates that waiving certain remuneration principles in respect of certain institutions (based on the proportionality principle) would be allowed.

Similarly, Art. 92(2) CRD IV states that "Competent authorities shall ensure that, […] institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities". Art. 94(1) CRD IV further states that "the following principles shall apply in addition to, and under the same conditions as, those set out in Article 92(2)".

According to Art. 74(1) CRD IV, institutions shall have robust governance arrangements, which include, amongst other things, "remuneration policies and practices that are consistent with and promote sound and effective risk management". Art. 74(2) CRD IV specifies that the "arrangements, processes and mechanisms referred to in Art. 74(1) CRD IV shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities". In short, in ESBG's view, Art. 74 CRD IV also clearly advocates a broad application of the proportionality principle in connection with the remuneration policies.

Also, historical arguments show that the proportionality principle, and even neutralisations, go hand in hand with the EU's remuneration policies. In its CRD III proposal (COM(2009) 362 final, 13 July 2009), the European Commission itself held that "the proposal allows firms the flexibility to comply with the new obligation and high level principles in a way that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities. This approach is likely to minimise the up-front and on-going compliance costs for firms, and was therefore preferred over an alternative of requiring a strict and uniform compliance by all firms, irrespective of their size, with the principles set out in Commission Recommendation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial services sector." In fact, CRD III already contained very similar provisions on proportionality to the ones in the currently applicable CRD IV: compare Recital 4 CRD III and Recital 66 IV as well as Art. 22 CRD III and Art. 74 CRD IV.

Furthermore, the European Parliament, in its Resolution on remuneration of directors of listed companies and remuneration policies in the financial services sector (7 July 2010) stated that

"compensation systems should be proportionate to the size, internal organisation and complexity of financial institutions and should reflect the diversity between different financial sectors such as banking, insurance and fund management" (para. 11).

Finally, ESBG would like to refer to the 2010 CEBS Guidelines on remuneration policies (paras. 19 et seqq.), which do not only speak generally about proportionality, but also about the possibility to neutralise certain requirement (para. 20).

Consequently, we believe that the principle of proportionality is rooted in the CRD IV text, applying also to the chapter on remuneration policies.

At any rate, to ESBG it is clear that the main interpretative guideline of any legal act should be the text of this act itself. In the present case, Recital 66 CRD IV is very helpful as it refers to the legislator's intention and explains its purposes. It holds that "the provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles."

Therefore, ESBG concludes that the wording of CRD IV allows some institutions (investment firms, for instance) not to apply some of its principles regarding remuneration to some institutions , in so far as it would not be proportionate to ask them to comply with all those principles. Thus, one could derive a neutralisation principle directly from CRD IV, in particular from Recital 66.

The omission of neutralisations would lead to disproportion between institutions and would hit small institutions comparatively hard – demanding extraordinary organisational efforts from them (human resources for execution, purchasing and handling of remuneration software, etc). Hence, ESBG would very much welcome in this context if the EBA considered differences between investment banks, retail banks and non-bank subsidiaries regarding their risk profile and the amount of their bonus payments.

Additionally, we consider that the stricter application, following the interpretation of the EBA's legal service, would not lead to the effects strived for. This interpretation establishes a stiffness in the risk adjustment system of variable compensation (scenario A) and raises a conflict of external competitiveness (scenario B), both of which would be counterproductive to the objectives of the regulation itself.

- **Scenario A:** ESBG believes that the interpretation of the proportionality principle should not be understood as a technique to avoid the application of an article, but rather as a way to simplify its implementation and impact. In this regard, we understand that the fact that all professionals included in the identified group should receive their variable remuneration with deferred payment and in instruments could generate undesirable situations; mainly in relation to identified staff who only receives a low amount of variable remuneration or whose bonuses represent a small percentage of their remuneration.

  Moreover, we understand that one of the main objectives of the deferral is to effectively implement the risk-aligned "malus" policies and the ex-post adjustments; in addition to

moving the market risk of the shares to professionals as an aggregate interpretation of the results and market risks assumed by the bank. According to this approach, for low amounts of bonuses or for bonus amounts which weigh little in relation to the total remuneration of a professional, the effect of deferring it by three years and paying 50% in cash and 50% in other instruments – with the consequent decrease in taxes – is to generate small monetary amounts that are often neither really relevant for the professional nor for the purpose of the regulation to achieve its objectives. Conversely, the professionals would consider these amounts as temporarily unavailable, and would only await confirmation of the payment. This perception does not modify their behaviour, in our view. It would only make them perceive the risk alignment system as a barrier to liquidity, a barrier to the ability to consolidate individual savings and as difficulty in the management of taxes.

For example, for a professional whose fixed remuneration is EUR 160,000 with a bonus target of 25% (EUR 40,000), with an award scheme of 60% upfront (EUR 24,000), the deferral of the 40 % (EUR 16,000) in three years would result in EUR 5,333 annually (EUR 2,667 in shares and EUR 2,667 in cash). Taxes (for instance, 35%) would also still apply to these EUR 2,667, regardless of the change in the share price, the final yield would be EUR 1,733 (cash and stock totalling EUR 3,466). On the whole, this would be only around 2% of their salary. So it seems understandable that the professional would not focus their efforts, especially on results aligned with the risk profile in the long term, but rather in achieving a promotion which would become economically more important.

- **Scenario B:** The above situation is aggravated by the consideration that based on market data, the remuneration of the professionals in the control and support areas is less leveraged in variable remuneration. It would therefore be understandable that the dysfunction presented in scenario A would be concentrated in these areas. As these professionals, except for risk management, are not as specific as other professional profiles of the financial sector, this situation poses the risk of a lack of external competitiveness in terms of salaries and, therefore, a leakage in attracting talent. This effect may be exacerbated by applying the criteria of deferral in cascade to professionals in consolidated group companies not related to the financial sector.

For all these reasons, ESBG believes that, without undermining the objectives of the remuneration policies, it would be positive for the financial sector if the EBA considered the option of keeping CRD III's interpretation of the proportionality principle in CRD IV and developing quantitative criteria for its application in order to lessen the asymmetry of interpretations. For example, ESBG would appreciate the application of a (materiality) threshold at the European level, approved by the EBA, with regard to neutralisation. We would like suggest a threshold range between EUR 100,000 and EUR 150,000 in order to ensure a level playing field. Indeed, we would welcome more guidance on the amount and percentage of bonuses on the fixed remuneration that should be considered as a minimum. Above this minimum, it would be mandatory to pay with deferral and instruments. This nominal amount could be considered as a reference to establish a common framework within the EU or internationally, and then each institution could adapt it to the reality of each country, using indices based on purchasing power parity.

Finally, giving an example in this regard, one ESBG member currently interprets the proportionality principle in such a way that staff are exempted from deferral and payment in shares if they are not

members of the senior management, and earn bonuses of less than EUR 100,000 and less than 30% of their fixed remuneration. The application of the draft Guidelines, sticking to the reviewed approach, would have an impact on 30% of the identified group, which, from 2016, would receive their variable remuneration with deferral and payment in shares.

Question 6: ***Are the guidelines on the identification of staff appropriate and sufficiently clear?***

In respect of branches of credit institutions (para. 107), our practical experience has shown us that branches and subsidiaries (not only those located in third countries) which identified their staff according to the criteria laid down in the RTS on *criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile* (RTS on Categories of Staff) had to identify almost their entire staff because of the small scope. According to our estimation, this should not be the objective of the aforementioned RTS. Therefore, we would like to ask the EBA to review its wording in para. 107 to the extent that small and less complex branches and subsidiaries should not be subject to the scope of application in the same way as other, more complex, institutions. The principle of proportionality needs to be respected.

In particular, we refer to Art. 3(4 et seqq.) RTS on Categories of Staff.

Question 8: ***Are the requirements regarding categories of remuneration appropriate and sufficiently clear?***

The requirements to determine whether remuneration is fixed or variable, as formulated in para. 117, are not sufficiently clear. Therefore, we would like to ask the EBA for further clarifications regarding the following terms:

- "are non-revocable" (para. 117e) and "the payments cannot be reduced, suspended or cancelled by the institution" (para. 117f): We have understood that fix-base salary components can be revoked/reduced to lower base salaries in some European countries (e.g. Croatia) based on management decisions. Furthermore, other fix-base salary components, such as overtime and management allowances, can be revoked/reduced/cancelled (e.g. in Austria). Thus, the descriptions of paras. 117e and 117f do not seem to be appropriate.

- "do not provide incentives for risk assumption" (para. 117g) is not sufficiently clear as, generally speaking, every job position exposes a company to some kind of risk.

- "do not depend on performance" (para. 117h): In this case, we would like to suggest either a deletion or a modification of the wording which would read as follows: "do not depend *only* on performance"(since fixed remuneration is typically based on elements such as experience, job, skills, performance development, commitment, etc).

***<u>Question 16:</u>* Are the provisions on the award of variable remuneration in instruments appropriate and sufficiently clear? Listed institutions are asked to provide an estimate of the impact and costs that would be created due to the requirement that under Article 94(1)(l)(i) CRD only shares (and no share linked instruments) should be used in parallel, where possible, to instruments as set out in the RTS on instruments. Wherever possible the estimated impact and costs should be quantified and supported by a short explanation of the methodology applied for their estimation.**

According to our understanding (in particular, paras. 246-248), listed corporations should use shares instead of share-linked instruments/phantom shares under Art. 94(l)(i) CRD IV. In this regard, introducing shares as an instrument at one of ESBG's members would lead to significantly higher costs. The expected increase of annual costs in this specific case would approximately amount to EUR 1 million, based on additional full-time equivalent (FTE) capacities (for example: human resources, payroll, compliance), administrative costs, group-wide software implementation costs, administration of employee rights into a share plan, monitoring of potential hedging activities (by compliance team), non-trading days monitoring, etc.

Furthermore, in some EU countries, for instance in Croatia, the tax legislation foresees the moment of granting and not the moment of cash-in of actual shares as the moment for demanding personal tax income. The negative development of the share price is then a risk for the individual person as tax already paid is not returned at the moment of granting the right to turn shares into cash.

For this reason, ESBG would like to suggest slightly revising the draft Guidelines' provisions regarding the use of shares instead of share linked instruments. As a possible solution to this issue, the EBA could allow the use of both shares and phantom shares. ESBG would welcome a wider, more flexible approach.

Apart from this, one should also bear in mind that the "recommendation" to use – next to shares – a mix of Tier 1 and 2 instruments, where they are available, could increase complexity:

- It could lead to increased operating costs and deadlines for settlement;
- As not all professionals of the identified staff are specialists in financial markets, the suggested additional payment in Tier 1 and 2 instruments may make their financial planning more difficult;
- It could complicate the staff's understanding of the expected amounts to be collected from their remuneration, blurring the line between performance and achievement, which could reduce the effect of variable compensation as an incentive to performance;
- For small bonuses it may mean that the pay-out in a mix of different instruments leads to very low nominal amounts, which could dilute the effects intended by the decision-makers;
- Liquidity could be reduced.

Again, ESBG would appreciate a more flexible approach. Listed institutions should also be free to use only shares if they consider it a mechanism that takes factors, such as risk adjustment, deferral, restricted sales period, appropriately into account. Otherwise, one could understand that the EBA would hold the view that shares listed do not accurately and fairly represent the risks and evolution of entities, which would be capable of leading to a deep crisis in the stock markets.

Additional comments:

1. *Compliance function*

The draft Guidelines refer in chapter 5 to the responsibilities, the design, the approval and the oversight of the remuneration policy. In this regard, they state in para. 24: "Risk and compliance functions should have significant input into the setting of bonus pools, performance criteria and remuneration awards where those functions have concerns regarding the impact on staffs' behaviour, and the riskiness of the business undertaken. The remuneration policy should ensure that no material conflicts of interest arise for staff in control functions."

ESBG fears that the role of the compliance function could be misunderstood due to the wording of the referred paragraph. In this sense, the EBA's Guidelines on Internal Governance (GL 44) from 27 September 2011 define the compliance function as a control function and, thus, as a part of the internal control framework. Moreover, those Guidelines state that "the control functions should be established at an adequate hierarchical level and report directly to the management body. *They should be independent of the business and support units they monitor*" (para. 24(5), page 38).

As a consequence, it should be stated in the Guidelines on remuneration policies that the significant input into the setting of bonus pools, performance criteria and remuneration awards should be done as a controller/supervisor of the procedures concerning these issues, but neither as a part of them nor being involved in the application of them. Otherwise, the institutions' compliance with the present Guidelines would involve, at least, the uncertainty about the institutions' compliance with the Guidelines on Internal Governance, or vice versa.

For these reasons, ESBG proposes the following wording for paragraph 24: "Risk and compliance functions should have significant input *in supervision, taking into consideration its reasonability, of procedures concerning* the setting of bonus pools, performance criteria and remuneration awards where those functions have concerns regarding the impact on staffs' behaviour, and the riskiness of the business undertaken. The remuneration policy should ensure that no material conflicts of interest arise for staff in control functions."

Additionally, ESBG has the impression that there is some redundancy in para. 29 draft Guidelines, which could lead to confusion. To mention an example, to ESBG's knowledge, non-compliance issues are obviously included in the identification of compliance risks. So its explicit mention could lead to the misunderstanding that two different reports are required, which would be an unjustified burden. Therefore, ESBG believes that para. 29 would be clearer as follows: "The compliance function should analyse how the remuneration policy affects the institution's compliance with legislation, regulations, internal policies and risk culture and should report all identified compliance risks ~~and issues of non-compliance~~ to the management body~~, both in its management and supervisory functions~~. The findings of the compliance function should be taken into account by the supervisory function during the approval and review procedures and oversight of the remuneration policy."

2. Remuneration of staff in independent control functions

The draft Guidelines refer in chapter 14.2. to the remuneration of staff in independent control functions, establishing that the methods used for determining their remuneration "should not compromise the objectivity and independence and consider their advisory role to the remuneration committee".

In this regard, ESBG would welcome some specific indications or examples regarding the elements of the variable remuneration which do not affect their independence or their advisory role to the remuneration committee.

About WSBI-ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of €6,749 billion, non-bank deposits of €3,415 billion and non-bank loans of €3,685 billion (31 December 2013).

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