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Finance for Europe

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Bernd Rummel
European Banking Authority
Floor 18 Tower 42
25 Old Broad Street
London EC2N 1HQ

Guidelines on the applicable notional discount rate for variable remuneration

Dear Mr Rummel

Enclosed please find our response to the consultation paper 'Draft Guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU', EBA/CP/2013/40.

Yours sincerely

Michael Percival

Director, Prudential Regulation

Association for Financial Markets in Europe

Consultation response

Guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU

16 January 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the consultation on *Guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU* (EBA/CP/2013/40). AFME represents a broad array of European and global participants in the wholesale financial markets. Our members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We provide below our over-arching response to the consultation paper, which contains the most significant issues, followed by answers to a number of questions asked in the consultation.

Over-arching comments

The key objective of the application of the notional discount rate is to incentivise the use of instruments which are deferred for a period of not less than five years. AFME agrees that such instruments, if widely adopted, could play an important role in supporting stability and prudent risk management by incentivising appropriate risk-adjusted performance over the long term. As explicitly mentioned in Article 94(1)(g)(iii) "The EBA guidelines on the discount rate shall specifically consider how to incentivise the use of instruments which are deferred for a period of not less than five years". A discount rate that adequately takes into account the broad range of elements which are central in determining the value of the deferred award will be the most significant determinant of the extent of use of such instruments.

However, given the level of discount rate achievable under the Guidelines we believe that they, as currently proposed, will not achieve the above mentioned objective as they would not provide the right level of incentive for firms and for employees to shift to more remuneration instruments deferred for five years or more. This is due both to the complexity of the framework proposed in the Guidelines and to the mismatch between discount rates achievable under the Guidelines and the value of deferred awards.

Need to avoid unnecessary complexity and prescription

We believe that the legislators' choice in favour of guidelines – instead of binding technical standards – reflects the need to allow national authorities sufficient flexibility to take into account a broad range of factors and specific circumstances. We note, on the contrary, that the approach taken in the proposed text is very complex and prescriptive, which goes against the intention to allow adequate flexibility to achieve the objective of incentivising awards deferred for five years or more. Therefore, we recommend an approach where, under clear EBA guidance, the text allows sufficient flexibility so that competent authorities, while providing full and clear reasons for their determinations, can adapt the Guidelines to the local legal circumstances and market conditions and practices. Moreover, there are a number of instances where the Guidelines prescribe an approach that seems to be more complicated than is necessary. We believe the approach can be simplified whilst still not diluting the outcome. For example, requiring interest rates to be determined on a country by country basis would not be practical to implement for many firms given the number of territories in which firms operate (see below for more elaboration on this point).

Discount rate does not adequately reflect the real value of the award

The discount rate applied to the awards, which will be the most significant determinant of the extent of use of such instruments, needs to adequately reflect the value that an impartial or market investor would ascribe to the award given the length of deferral, conditions attached and other risks (such as interest rate and illiquidity risk, etc.). For the reasons highlighted in the previous section, we believe that the Guidelines should be flexible in the method used to calculate the discount rate and allow broad discretion for competent authorities to take into account all relevant factors in determining the appropriate rate.

The proposed Guidelines would create a mismatch between discount rates achievable under the Guidelines and the value of deferred awards. As well as not all of the identified risks being considered in the Guidelines, in particular they do not take into account performance conditions on long-term incentive awards (where the level of vesting is determined by reference to achievement of performance conditions) nor the likelihood that an employee may leave an institution before the vesting of long-term awards (explained in turn below). This mismatch will decrease the value of the deferred award whether in the eyes of an impartial investor, the institution or the recipient. This will not result in the desired outcome intended by the Article. Below we have set out some broader factors that we believe should be taken into account in the setting of the discount rate.

Performance conditions

The discount is applied to the total nominal amount, rather than the fair value or IFRS 2 value of the instruments (which would account for the probability of market-based performance conditions being fulfilled). The paper states, on page 7, that claw back and malus mechanisms should not lead to an increase in the discount rate. However, the paper does not distinguish between 'malus' type conditions, which generally target more extreme cases of poor performance and which would typically have a lower probability of occurring (and which should not be reflected in the determination of the discount rate), from more stringent performance conditions which would more typically apply to the long-term awards of senior executives where there are a wide range of outcomes including zero vesting and which by definition do not have a 100% probability of being fulfilled. It does not seem appropriate to base the value used for calculating the cap on variable remuneration on a nominal value that does not reflect the value which the individual can reasonably be expected to receive. Not recognising performance conditions in the Guidelines could incentivise institutions to weaken the performance conditions applicable to the long-term incentive awards of senior executives in order to lessen the gap between the discount rate achievable and the expected value of a deferred award.

Employee turnover

Employee turnover leading to forfeiture of awards is likely to have a very significant impact on the appropriate discount rate. An investor would apply a huge discount to longer-term remuneration as, in many instances, it is likely that the conditions for vesting will not be fulfilled. Having surveyed a number of AFME members, we found that on average a relatively low percentage of employees eligible for a deferred compensation award remained with the same firm after 5 years. In other words, in many cases most eligible employees will have left the employment under which they received a deferred award. This aspect should be factored into the calculation of the discount rate.

Dividends

The non-payment of dividends during the vesting period is not taken into account in the calculation of the discount rate. Such non-distribution of dividends for equity instruments during the vesting period reduces their value at the time of award, the extent of which depends on the length of the vesting period. Note that the IFRS 2 value of an award would take this into account.

Responses to questions

Method of determining 25% – Question 1

We are strongly of the view that CRD Article 94(1)(g)(iii) clearly does not specify whether the maximum of 25% of variable remuneration that can be discounted should be calculated before or after having applied the discount. That is, both the following interpretations are possible: the 25% is calculated based on nominal values for long-term deferred awards, or on the discounted value of such awards. Neither "variable remuneration" nor "total variable remuneration" is a defined term and both interpretations can variously be implied through context when the terms are used throughout the CRD.

We believe that the 25% should be applied to the discounted value of awards. Crucially, this approach is mathematically correct as it applies an 'apples with apples' calculation in values of the same time period. This approach is also consistent with textual references in the CRD to variable remuneration being 'payments'. Payments of variable remuneration are made on a performance-related basis, so a determination today of the level of future payments should take into account the likelihood of the payments being made. This logic supports the inclusion of other factors in setting the discount rate (as outlined in previous sections above) and the use of the discounted amount to calculate the 25%. Furthermore, we believe that it is also consistent to calculate the bonus cap under Article 94(1)(g) on the same basis – i.e., after having discounted any long-term deferred remuneration.

Inflation rates – Question 2

While it may be necessary to allow this as an option (i.e. for countries with particularly high inflation rates), in the interests of simplification we believe that institutions should have in all cases the option of using the HICP rate applicable for the EU parent institution (i.e., even for employees working and paid in another Member State). If inflation rates between the relevant EU Member States are relatively comparable, institutions might prefer to use one single reference inflation rate rather than having to create multiple options in IT systems for slightly differing inflation rates which will have a relatively minor impact on the actual discount. In addition, requiring a different inflation rate per country complicates the reporting provided for in Section 5, which has to be done on a country-by-country basis.

Incentive factors – Question 4

With reference to the discussion above about the need to appropriately incentivise the use of instruments deferred for five years or more, we believe that the discount factor needs to be increased and broadened to reflect the real value for employees of deferred awards. Please see our 'overarching comments' section for more detail.