

*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 on draft high-level principles of Remuneration Policies**

### **General Comments**

The European Banking Federation (EBF) welcomes the opportunity to comment on the CEBS consultation regarding draft high-level principles of remuneration policies.

Although it is hard to prove a direct link, it seems that there is a political consensus that remuneration practices may have been a contributory factor to the market crisis, as they were not adjusted for risk and had a short-term focus. The causes for excessive risk taking are however in our opinion numerous and complex. Further research to establish correlations between remuneration practices and performance could be worthwhile considering in order to avoid the risk of unintended consequences.

Much work has been done in this area at international (Financial Stability Forum (FSF), European Commission, Institute of International Finance (IIF)) and national level in various EU Member States. Specific measures were also adopted in the context of banks' assistance programs.

In order to address this issue and limit the risk for organizations and financial markets, the financial industry at national level (banks and banking associations) has already taken many initiatives to improve the sustainability of its incentive policies. The EBF believes that national responses in implementing principles in this area are more appropriate especially in the context of Article 137 of the EU-Treaty and the principle of subsidiarity.

It is also important to acknowledge the need for the banking industry to retain highly talented staff and the need also not to undermine Europe's competitive position with regard to other international financial centers. **Any initiative at EU level should preferably take into account progress at the international level. Indeed the Banking Industry operates in a global environment and as such there is a need for a coordinated response from**

**regulators. Any initiatives which only impact banks headquartered in Europe could put those firms at a competitive disadvantage.** For the same reasons, it is important to consider a consistent application of principles in remuneration policies across sectors and not only restrict them to the banking industry, except in the case of banking specificities (see below). We are wondering therefore whether more time should be dedicated to analyse the impact of those principles, including within other sectors.

Special requirements on remuneration may however appear in State Aid plans (with the necessary differentiation between banks that benefit from State Aids in view to solve a situation of liquidity difficulty and banks that benefit of these aids as a result of a general state intervention plan to incentive real economy). In this case conditions and limitations to be applied directly are understandable, even though a distinction between distressed and sound banks which benefit from State support is necessary.

This being said, the EBF believes that principles could be considered at EU and International level to address possible weaknesses in remuneration practices but considers that those principles should remain high-level. **As high-level principles in this area are targeted to adequately address risks for the financial institution, only those functions and categories which led to potentially expose the financial institutions to financial risks linked to the performances of market instruments, should be taken into account.**<sup>1</sup> The EBF remains however open to discuss the scope of the principles (i.e. to whom they should apply) as it appears that different approaches are being taken also on the regulatory side (e.g. CEBS, FSF or at national level).

We would like to emphasize that it is crucial that any application of those principles would be implemented on a principles and risk based way. Not every principle should apply in the same way to every firm. A proportionality principle should apply. Regulators should not adopt a 'one size fits all' approach, as substantial differences in business practices have to be taken into account (such as differences between investment banks and retail banks or large and small banks).

The main objective is assessing whether remuneration practices within financial institutions pose unacceptable risks. Initiatives in this area should therefore not address the level of remuneration, which has to be considered as a matter for companies, their board and shareholders. Regulators should then rather focus on ensuring good governance rather than designing remuneration structures.

Further consideration should also be given on how those principles may affect current employment contracts and leaving companies adequate time to potentially review and align their remuneration schemes in a consistent manner.

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<sup>1</sup> EBF members are divided regarding the scope of these principles. Some members (such as the Danish Bankers' Association, the Italian Banking Association, the Norwegian Financial Services Association and the Swedish Bankers' Association) believe that these principles should be restricted to managerial personnel ; others (such as The German Banking Associations, the French Banking Federation and Febelfin) prefer that the principles cover managerial functions, risk-takers and control functions while others (such as the British Bankers' Association) opt to the application of these principles to all employees.

The EBF also believes that any high level principles should be the same for all companies in order to have a level playing field and fair competition. Different principles may only apply in case of banking specificities and such differences should be considered as part of the regulation and supervision to which the banking institutions are subject and not as a corporate governance matter.

More details can be found in the specific details hereunder.

### **Specific Comments**

- i. The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should also be adequately rewarded to attract skilled individuals.*

The EBF agrees with this principle (see footnote 1).

If a firm's remuneration policy is not aligned with effective risk management it is likely that employees will have incentives to act in ways that might undermine effective risk management. In parallel, short term interest might be justified in certain cases, for instance for market entrance reasons. New companies wishing to enter the market might have short term aims. Consequently, a higher risk taking could be justifiable in some case. The EBF would prefer therefore to add "primarily" before "long-term interests" in the first sentence of the paragraph.

Some issues remain unclear and would require further specification. One key issue is the impact of these high level principles on existing contracts. Some employment contracts agreed and signed before the adoption of these high level principles might contain provisions on remuneration that are not totally in line with these principles. Taking into consideration that companies have incentives to keep the best talents in their institutions, sufficient flexibility should therefore be granted to financial institutions in order to deal with these contracts and adapt them accordingly. One possibility would be the provision of a long grace period during which the company would need to comply with the new principles. This provision would be important in order to give sufficient time to renegotiate some contracts and most essentially retain the best talents within the financial sector.

- ii. The remuneration policy should be transparent internally and adequately disclosed externally.*

The EBF supports the issue of transparency of the remuneration policy. It should be clarified however what is the extent of the external disclosure and the relevant stakeholders that might be involved. While a regulator's demand appear legitimate, the current wording leaves the door open to other categories of external stakeholders, which might need to be further detailed.

Of course listed banks should be subject to the normal disclosure requirements on remuneration as other listed companies, while the non listed banks should be excluded from the external disclosure rule and only subject to the requirements vis a vis the supervisor.

For banks, external disclosure seems mostly appropriate towards the supervisor. The EBF believes that the external disclosure of the special requirements of banks' remuneration policies would fit very well in the framework of Pillar 3 where banks would be able to disclose their remuneration as a general policy.

The EBF would like to insist in particular on the fact that external disclosure should not mean that the remuneration of individuals should be disclosed (except normal disclosure applicable to other listed companies). This is important for the industry when it comes to terms and employment and the possibility to retain qualified professionals.

As far as internal disclosure is concerned, flexibility should also be given to companies depending on whom this information is disclosed to. Different levels of disclosure should therefore be permitted, the main reason being to preserve the secret strategy of the company.

It should therefore be considered whether the term "adequately" should not cover both internal and external disclosure.

## GOVERNANCE

- iii. The management body, in its supervisory function, should determine the remuneration of the management body, in its management function<sup>2</sup>. In addition it should have oversight of the overall remuneration policy of the firm. The implementation of the remuneration policy should be subject to central and independent review.*

The EBF supports such principle especially for large complex financial institutions with a large exposure to market risk. A lighter regime would be more adapted and adequate for smaller-sized institutions with less exposure to market risk, and taking into account national structures.

As with other aspects of a firm's systems and controls, what a firm must do in order to comply with these principles will vary according to the nature, scale and complexity of the firm and its activities.

While agreeing with the importance of an independent control, the EBF would like to stress that an independent control should not be interpreted in any case as external control. The EBF also believes that it is important to clarify that the remuneration policy as such should be subject to independent control and not the individual remuneration

## MEASUREMENT OF PERFORMANCE AS A BASIS FOR REMUNERATION

- iv. Where the pay award is performance related, remuneration should be based on a combination of the individual performance's assessment, the performance of the business unit and the overall results of the company or group. When defining the individual performance other factors apart from financial performance should be considered. The measurement of*

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<sup>2</sup> For a definition of the management board in either its supervisory or management capacity, please refer to the definition provided on page 6 of CP03. The definition is designed to address both single and dual tier structures within the EU.

*performance, as a basis for bonus awards, should include an adjustment for risks and cost of capital.*

The EBF believes that this principle is not adapted because it is very much detailed and would interfere with the internal decisions of each company. Principles i. and v. already address the issue of performance related remuneration so there is no need to go into more details as is the case in principle iv.

Moreover, the EBF believes that where the pay is performance related, individual and collective factors should be taken into account. The current draft principle asks for three different factors being the individual performance, the performance of the business unit and the overall results of the company or group. The aim here should be to have a part of the performance based remuneration related to the collective performance without going into details. Flexibility should be given to each company in order to define its own collective criteria that could comprise the performance of the business unit, the overall results of the company or group or both. This choice would depend on the size of the company and could therefore be discussed with the supervisor when disclosing the remuneration policy of the company. It is also important that sufficient incentives remain under the control of each individual institution in order to maintain high motivation and efficiency within financial institutions.

Finally, the current draft suggests that non financial factors should be considered when defining the individual performance. The EBF prefers to replace “should” by “could” because while recognizing the importance of the non financial factors, this issue should be left to Member States as it goes too much into detail for a high level principle.

## **FORM OF REMUNERATION**

- v. *There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure upfront cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.*

The EBF supports the general idea that payment is linked to specific parameters that take the final profitability of the activity and/or of the company into account. However the EBF believes that equity compensation schemes already met the criteria for performance adjusted deferred compensation. It is important therefore to underline that sufficient flexibility should also be given to companies as the form of remuneration has to be considered primarily as a matter for each of them.

Holding funds in escrow is not recommended, however, because it is more difficult to justify clawbacks than a lack of payment. This solution also raises legal and practical questions concerning e.g. the payment of payroll taxes.

As a general principle, the EBF suggests the introduction of an appropriateness approach to this principle. In addition, the impact of this article on existing employment contracts would be important as previously explained. A transition period should therefore be specified with appropriate time.

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