CEBS Consultation Paper on Guidelines on Remuneration Policies in Financial Institutions

Febelfin's answer – 8 November 2010

Febelfin

Febelfin, the Belgian Financial Sector Federation, is the umbrella organization and shared voice of the financial sector. It defends the latter's views and interests and accepts the challenge of playing an important role as a bridge between its members and a range of national and European parties, including policy-makers, supervisory authorities, professional federations and interest groups.

Febelfin monitors trends and developments and helps its members position themselves accordingly. It informs and advises them on legal, tax, prudential and industrial relations issues, and on technical product matters.

Febelfin shares the values of its sector:

- Customer service
- Trust and transparency
- Dynamism and proactivity

Together with its members, Febelfin aims to express these values through the messages and viewpoints the sector communicates. It seeks, by means of a proactive attitude and maximum openness, to engage constructively and positively in the general social debate and to keep in touch with developments in society. At the same time, Febelfin takes full account of the priorities of the different pressure groups and determines how best to respond to their views.

1. Febelfin general remarks

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

As mentioned in its **'Febelfin Code of conduct as for the remuneration of certain categories of financial sector staff members'**, the Belgian finance sector 'will follow the developments concerning the laws and regulations in this matter which already exist or are yet to come, thereby paying special attention to the developments not only on the Belgian but also on the European and international level'.

About a level playing field

Febelfin calls for a level playing field at global and cross sectoral level to avoid competitive distortions. The CEBS guidelines mention the level playing field but only at EU level; however, since many financial institutions have a global activity and not only a European one, **there is a need for a global and cross sectoral level playing field.**

Financial institutions are competing for talent in local labor markets, in what is already a highly volatile and competitive environment, and must be subject to the same rules and regulations governing compensation, **in order to avoid competitive distortion**. The guidelines for the implementation of the CRD III must take account of the current state of play of implementation of the principals and standards of the FSB.

On a global level, there is ***the risk of business relocation***, to states with less stringent remuneration requirements. Another possible undesirable consequence of the CRDIII 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.

About the date of implementation

Financial institutions intend to implement the CRDIII principles as soon as possible. However, national transpositions will probably occur in 2010, and it seems difficult in a so short time to communicate properly to staff, and apply all CRDIII requirements for remuneration due for 2010 performance. Especially, legal issues must be analyzed where compensation policies are laid down in labor contracts or in labor collective agreements. We suggest that institutions can undertake an evolutionary process starting from January 1st, 2011, **more particularly if the financial institutions have already adapted, in the course of 2010, their remuneration policies in order to comply with the new rules that have been imposed by their national supervisory authorities** following the endorsement of the FSB principles on remuneration by the G20 group of nations[1].

Febelfin took part in the preparatory discussions which eventually have led to the European Banking Federation's contribution. Our members fully endorse the general point of view as mentioned in this document as well as the specific remarks that have been communicated to the European Commission.

However, we think it would be useful to highlight a number of aspects the financial institutions that are active in Belgium, would like to draw the attention to.

[1] *As has been the case in Belgium as a consequence of* ***CBFA circular 2009 34 of 26 November 2009*** *according to which the financial institutions have laid down and put into practice the underlying principles of their remuneration policy in the course of 2010*

2. Specific comments

Scope of de guidelines : Which staff?

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

This takes the FSB's sensible approach to identifying risk-taking staff to enormous lengths. 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 institutions risk profile. Given the number of potentially material types of risk, this means **that a lot of staff member 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 numerous employees. **This cannot be the intention of the FSB and the CRD and would in addition place a significant administrative burden on banks for no justifiable reason.**

The following wording is suggested 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 significant parts of the remuneration principles 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.

Without additional detailed guidance on the criteria to be applied by an institution making this assessment, this could create uncertainty and the risk that firms will all approach this exercise in different ways. It could also be problematic if the relevant authority takes a different view at the end of the year when that institution comes to make bonus payments as it will be difficult to ensure compliance retrospectively given the need to amend contracts and set up deferred remuneration schemes.

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. Febelfin welcomes the avoidance of a one size fits all approach.

In any case, the ability to dis-apply certain aspects of the remuneration proposals on proportionality grounds is welcome.

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.

Severance pay

In the CEBS guidelines, attention is being drawn to the aim of introducing a link between severance pay and the actual work over a period of time as well as to the aim of preventing this pay from being defined in a way that it is a reward for failure. Febelfin supports those principles.

In Belgium, one of the criteria which is generally laid down in the Law on labor contracts as well as in case law, for the calculation of this compensation, is that of seniority : the longer an employee has been working at the institution, the higher the severance pay.

The consequences of this may be that :

1. severance pay for an employee with a labor contract may be more than the total wages over a period of two years;

2. some employees may be reluctant to take up a management function, because in doing so, they may incur a partial loss of their existing protection.

In those cases where the severance pay is linked up with actual work over a certain period of time without there being the aim of “reward for failure”, **Febelfin is of the opinion that the seniority criterion should be taken into full account and entail, if possible and in the case of severance, a compensation that is compliant with the general rules that apply as a consequence of the application of the regulation or case law in each Member State**.

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 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 defense 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.

We propose to adapt §79 and §80 of the guidelines :

Proposed amended paragraph of CEBS guidelines:

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, they should be justified on grounds that do not harm the risk alignment of the remuneration structure in question – if not they 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, **the CEBS proposals for deferrals and cash vs. instruments need the following comments :**

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 seems 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%.

The combination, made by the guidelines, of the deferral and equity rules means that the upfront cash component is effectively limited to 20% to 30% of the total variable remuneration. **These rules will give rise to very complex variable compensation structures with multiple layers** (cash upfront + equity upfront subject to retention + deferred cash + deferred equity subject to additional retention period) **which will need to be administered separately over time and will give rise to complex accounting and taxation issues.** These mechanisms are extremely complex and there is no more clear difference between the deferral period and the non deferral period.

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 %.

None of our international competitors have similar requirements as they go beyond G-20 and FSB requirements. **This would lead to a failure in the level playing field worldwide.**

In some countries, taxation of vested compensation has to be paid upfront, this means that the whole non deferred remuneration would be subject to tax, even though between 70% and 80% of this amount cannot be sold between the end of the deferral and retention period. Where the highest taxation rate is 40% or more , the cash part of the non deferred payment would solely be used to pay taxes.

Febelfin considers that the only relevant interpretation of the CRD III text is the following: a large part of the deferred remuneration is paid in shares and in that case the non-deferred part only contains a remaining part in shares and the largest part in cash, and any other interpretation would be inconsistent with FSB standards which state that: *"- A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments [...] - The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually"*.

We suggest that equities must be included in the non deferred component and in the deferred component of remuneration in respect with the CRDIII but the ratio of 50 % must be assessed in consideration with the total variable compensation. Taxation and social contributions consequences must also be taken into consideration.

Furthermore, under the 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.

The guidelines also refer to a second 'category' of non-cash instruments known as "other instruments" and CEBS seems to emphasize that "where appropriate and proportionate" the non-cash remuneration must include these other instruments as well. It is unclear what CEBS means by this and what these other instruments are.

<u>Proposed amended paragraph of CEBS guidelines:</u>

129. It is important to highlight that the upfront payment of instruments, even with a minimum retention period of, for example, 3 years, is not equivalent to deferred instruments. Instruments paid upfront belong to the staff member (they are vested rights) which imply that no malus clauses can be applied to them. This could lead in some EU countries to fiscal implications for vested rights which are taxable when they vest. Institutions could adapt their retention policy in reaction. Although the staff member cannot sell the instruments for a 3-year period, the institution cannot change the number of instruments it has awarded. On the contrary, deferred instruments are subject to an ex-post risk adjustment due to the back-testing of the underlying performance, possibly leading to a reduction in the number of instruments that will eventually be paid out (see below from paragraph 131).

130. Point (o) of Annex V, Point 23, states that at least 50% of any variable remuneration shall consist of equity-linked instruments. The end of the paragraph also states that the payment in shares or share-like instruments shall be applied to both the portion of the variable remuneration component deferred in line with point (i) and the portion of the variable remuneration component not deferred. In other words, institutions must make sure that an appropriate part of the upfront and deferred remuneration is composed of shares or share-like.

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. **This rule goes beyond the CRD III remuneration requirements.**

Febelfin 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". Indeed, 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).

In the same way, **the requirement for an additional retention period cannot be justified within the framework of a retirement**. Also in that case, the requirement of 'an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution' should be applied in a way that is reasonable and suitable.

In reaction, § 125 and 126 of the guidelines could be adjusted as follow:

Proposed amended paragraph of CEBS guidelines:

125. Retention periods are included in the vesting of instruments for non 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.

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.