3rd of November, 2010

CONSULTATION PAPER ON GUIDELINES ON REMUNERATION POLICIES AND PRACTICES (CP42)
FBF'S RESPONSE

We are pleased to respond to the CEBS Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42). We set out herein detailed comments concerning the issues raised by the CEBS guidelines. However, we would like to begin by addressing our key concerns surrounding the new regulations introduced by CRDIII and related CEBS guidelines.

1. Key concerns concerning CRDIII & related CEBS guidelines

First, the FBF would like to recall that the French banking industry was one of the first to fully implement the FSB standards endorsed by the Pittsburgh G20 on the 25th of September 2009, through the publication of a modification of the 97-02 regulation (on internal control of credit institutions and investment firms), published on the 3rd November 2009 and FBF's professional standards published on the 5th of November 2009.

After one year of experience since the FSB standards have been released, the FBF however highlights that the implementation of these standards across G20 jurisdictions is highly unequal.

The key issue of consistent implementation was addressed in the FSB Implementation Standards on Compensation published in September 2009 :

"*Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions*".

It has been universally recognized that financial institutions which are competing for talent in local labor markets, in what is already a highly volatile and competitive environment, must be subject to the same rules and regulations governing compensation, in order to avoid competitive distortion. The need for a level playing field is indeed quoted several times in the CEBS guidelines, which however do not address this issue outside of the EU. Indeed, the most important financial institutions have global activities and not only European ones. There is a need for a <u>global level paying field</u>. 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

However, the requirement that EU financial institutions apply CRDIII remuneration rules to their branches and subsidiaries worldwide, will lead to the very competitive distortion issues which the FSB undertook to avoid. In the US and Asia, where FSB Principles have been implemented only on a very high level basis, financial institutions remain, to a large extent, at liberty to determine the structure of their variable compensation arrangements[1]. In contrast, CRDIII sets out very precise rules with regard to the structure of the remuneration concerning: variable vs fixed remuneration, deferral and the use of restricted equity instruments. Thus, EU financial institutions, competing in these overseas markets, are left with very little flexibility concerning their variable remuneration arrangements. With the new CRDIII rules as interpreted by the CEBS guidelines, US and Asian banks will be able to pay out a significantly higher portion of the variable compensation in upfront cash than their EU counterparts. Moreover, US regulators have a very different approach in assessing the risks linked to the compensation policy. Implementing CRDIII rules in the US will not prevent US branches or subsidiaries of EU financial institutions from being subject to additional requirements set by the US supervisor. **Our principal concern is therefore that European banks, along with other EU-based financial institutions will not be in a position to compete on equal terms in the US and Asian labor markets, ultimately leading us to be forced out of these markets.**

The ultimate risk of competitive distortion for EU banks is that of business relocation, whether by EU banks being forced out of the US and Asian markets, or by non-EU banks relocating their previously EU-based activities to jurisdictions with less stringent remuneration requirements. Another possible undesirable consequence of the CRDIII remuneration requirements is across-the-board remuneration increase, mainly on the fixed component, in order to maintain a sufficient cash compensation level for EU banks to remain competitive.

Paragraph 1-3 of the consultation paper notes that "subsidiaries might have local responsibilities in the implementation of remuneration policies". The guidelines for supervisors request them to examine "subsidiary responsibilities with regard to remuneration and practices". Our recommendation in this respect is to apply FSB rules as implemented by local regulators outside of the EEA. Only where no FSB rules have been implemented locally should the CRDIII directive apply.

In respect to article 38 of Directive 2006/48/EC the guideline (29) concerning non-EEA branches of third country parent company should be stricter. It should specify that "each jurisdiction should apply" in place of "each jurisdiction should consider applying" the remuneration requirement s to the staff of non-EEA branches of third country parent company".

Moreover, to ensure a level playing field we recommend that each jurisdiction should apply the remuneration requirements to the staff of non-EEA branches of third country parent companies, operating within EEA Member States. To ensure this outcome, supervisors should accordingly modify the existing memorandum of understanding (MOU) signed with the supervisors of the non-EEA institution, or conclude appropriate MOUS."

In a similar vein, we note that the CRDIII remuneration requirements apply to all institutions which are already covered by the CRD. These are credit institutions and investments firms defined by article 4 of 2004/39/EC Directive (the MiFID). However the collective Asset Management activities, (as well as those firms covered only by AIFMD, UCITS IV or Solvency II), are not covered because of the provision of article 2 1 h) with excludes "collective investment undertakings" from the scope of the directive. Hence it must be absolutely clear on the one hand that the asset management activities of banking groups covered by CRD 3 and CEBS guidelines are only the portfolio management activities, which is an investment service under the MiFID, and on the other hand that the portfolio management activities carried out by asset management companies are also covered by CRD 3 and CEBS guidelines.

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[1] In a recent speech delivered by Scott G. Alvarez, General Counsel of the Board of Governors of the Federal Reserve System before the Committee on Financial Services of the U.S. House of Representatives concerning **Incentive Compensation**, the Fed recognizes "….the need for flexibility in approaches by financial institutions. As in many areas, one size certainly does not fit all".

The FBF considers that the collective asset management activities of larger financial institutions will not need to change their remuneration structures unless and until equivalent remuneration regulations are implemented for these businesses. If hedge funds and insurance businesses are able to operate more flexible compensation arrangements than major banks for employees carrying out identical functions, they would have a distinct advantage in attracting and retaining talent. This therefore would create a further competitive distortion within the financial services sector.

From a general point of view we regret that the consultation paper takes a very strict approach in the implementation of the CRDIII without taking into account the concrete conditions of business and of the labor market. In all cases, the guidelines adopt the strictest interpretation and in some cases new provisions are inserted. We believe all items should be re-examined in order to be aligned with other international standards and FSB principles.

Concerning the date of implementation. Financial institutions intend to implement the CRD3 principles as soon as possible. However, national transpositions will probably occur very late in 2010, and it seems difficult in such a short time frame to communicate properly to staff, and apply all CRD3 requirements for remuneration due for 2010 performance. Especially, legal issues must be analyzed in each jurisdiction, namely where compensation policies have been included in work contracts or collective agreements. We believe, as mentioned in § 146 of the guidelines related to Disclosures, that institutions should be allowed to progressively implement the new rules over the *first* periods of implementation.

2. Principal issues

Which staff?

Paragraph 1-1-3 (15) of the consultation paper leaves it to institutions to identify staff members whose professional activities have a material impact on the institution's risk profile. We totally agree with this approach. But the following paragraph (16) sets a presumption of such impact for a very large number of categories of staff, for which the institution must demonstrate that they have no material impact on the risk profile in order not to apply the remuneration requirements to them. This approach is inadequate and unfair because it also requires that the firm be "*able to demonstrate to supervisors how they have assessed and selected identified staff".* The categories of staff listed should only be illustrative of staff whose professional activities may have a material impact on the institution's risk profile. Accordingly, we suggest the following wording for the first sentence of (16):

"The following categories of staff should be subject to the specific remuneration principles, if they have a material impact on the institution's risk profile:"

Proportionality

We would argue that when determining the members of staff whose professional activities have a material impact on the institution's risk profile, large international financial groups should be permitted 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 group, its staff members do not have the same impact on the risk profile as a standalone institution of similar size, since they are subject to Group level supervision. Large international groups will be at a disadvantage if the proportionality principle is not applied across boarders within the EEA, therefore EEA regulators should concert on this issue.

<u>40%-60% Deferral and 50% Equity Rules</u>

The CRD3 text is ambiguous relative to the interaction of the minimum deferral and the minimum instruments rules.

CRDIII specifies that at least 50% of any variable remuneration shall consist of share linked instruments and that these instruments are "subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution". It is specified that this point will be applied to both the deferred portion of the variable remuneration and the upfront portion of the variable remuneration

The FBF considers that the only relevant interpretation of this text is the following: at least 50 % of the total variable compensation is to be paid in shares or share-linked instruments and such form of payment should apply to both the deferred and the non-deferred portions of variable compensation ; however the 50 % minimum requirement does not apply separately to each portion ; where the deferred portion contains more than 50 % of share-linked instruments, the non-deferred part must also be paid in share-linked instruments only to the extent necessary to ensure that at least 50 % of the total of the deferred and non-deferred variable remuneration is paid in such instruments ; the remainder may be paid in cash, with cash vesting gradually over the deferral period,
.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*".

The Draft guidelines on cash vs. share-linked instruments would have the following consequences:
- None of our international competitors have similar requirements as they go beyond G-20 and FSB requirements. This would lead to an unlevel playing field worldwide.

In a number of countries (such as UK, Belgium…), equity instruments are taxed at vesting, irrespective of an additional retention period, meaning that staff will have to pay upfront taxes on amounts that not only cannot be sold immediately but are also at risk should the share value fall over the retention period (this will be the case for both the upfront equity portion at award and the deferred equity portion at the time of vesting). Where the highest taxation rate is 40% or more, the cash part of the non-deferred award would have to be used to pay taxes on the whole vested award and the after tax compensation could be reduced to 0. This could also give rise to complex and problematic double-taxation issues in the case of internationally mobile employees, due to lack of convergence of international taxation rules on such issues.

Linked with the current definition of the retention period (see below), this interpretation would also result in delaying the payment of variable remuneration for identified staff longer than the 3 to 5 year period mentioned in the G20-FSB principles.

Under the draft guidelines, the combination of the deferral and equity rules would reduce the upfront cash component to 20% to 30% of the total variable remuneration. <u>CRD III does not include such a rule. It is never stated in the Directive that the cash upfront must be limited to 20 % or 30 %.</u> In addition to the competitive distortion issues mentioned above, 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 so complex that they will be difficult to explain to professional and impossible to explain to the different stakeholders. There would no longer be a clear difference between the deferral period and the non deferral period

We note that US and Asian banks will be able to continue "business as usual", managing less complex incentive compensation structures, to the extent that most large financial institutions already traditionally use mostly equity or equity-linked instruments for their deferral arrangements.

<u>For all the reasons mentioned above we believe that share-linked instruments must be included in the non deferred component and in the deferred component of remuneration in conformity with the CRDIII but that the minimum 50 % proportion must be based on the total variable compensation</u>. Taxation consequences must also be taken into consideration.

Accordingly, we suggest to amend the CEBS guidelines as follows:

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 tax implications for vested rights which are taxable when they vest. Institutions should accordingly be allowed to take this factor into account in setting their retention policy. Although the staff member cannot cash in the instruments before the end of the retention 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 ensure that an appropriate part of the upfront and deferred remuneration is composed of shares or share-like instruments and that the total amount paid in this form represents at least 50 % of the total amount of the variable compensation.

<u>Retention Periods</u>

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. It is our view that this rule goes beyond the CRDIII remuneration requirements, and far beyond FSB/G20 standards.

It is our opinion 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" to the extent that 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 are 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.

We believe that imposing an additional retention period over and above the initial vesting period therefore is 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 (including the vesting period).

Paradoxically, 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 latter would not meet the requirement !).

Moreover, the principle of differentiating the length of deferral and retention periods between different categories of staff would further complicate the administration of such variable compensation arrangements

For all the reasons mentioned above we believe that the total retention period for deferred equity awards must include the deferral period, since during the deferral equities are subject to market fluctuations and to the malus mechanism and only to market fluctuation beyond the deferral period. Only for top executive staff could it be recommended that the retention period go beyond the deferral period. The vesting period for deferred instruments should be deemed to include the retention period.

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Accordingly, § 125 and 126 of the guidelines should be adjusted as follows:

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125.. To obtain the necessary risk alignment for instruments, a minimum retention period should be determined by the institution in the remuneration policy. The vesting period for deferred instruments is part of the retention period. 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. For example, it would be appropriate to apply longer retention periods for staff with the most material impact on the risk profile of the institution.

Ratio between fix and variable remuneration

The CRDIII does not require any maximum ratio between fixed and variable part of the remuneration contrary to proposals made during the discussion of the directive, but which were not ultimately retained in the final text. The CEBS guidelines should therefore not cap the level of remuneration of the employees but be consistent with the risk policy of the financial institution.

We propose to modify §79 and §80 of the draft guidelines as follows:

79. Consequently, an institution should set in its remuneration policy explicit ratio(s) on the variable component in relation to the fixed component of remuneration. This ratio may vary 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, it 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.

Scope of the CEBS guideline – Shareholders' involvement

We understand that the CEBS guidelines are intended to provide clarity concerning the practical implementation of the CRDIII Remuneration requirements, in order to assist the EU countries with the transposition of these regulations on a domestic level. However, in some circumstances it would appear that the CEBS provide a very strict interpretation of the CRDIII Directive and even goes beyond the scope of the Directive. For example, section 2.1.3. concerning 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, while CRDIII does not directly address this issue. As future EU legislation is expected on such issues, CEBS guidelines should not "jump-the-gun", creating potential confusion for national legislators[2]. The CEBS guidelines should either delete any reference to a shareholders' vote on the remunerations policy (as this is not foreseen in the CRD3) or make clear that this should only be a possibility offered to the financial institutions even if the national law and the characteristics of the institution allow it, as for instance in the UK (Say on Pay). We recommend deleting or adapting par. 48 as follows "An institution may choose to assign to the shareholders' meeting the approval of its remuneration policy and, where appropriate, decisions relating to the remuneration of members of the management body, […]"

3. Secondary issue

Discretionary Pension

The CEBS guidelines lead to some confusion concerning the provisions for discretionary pension benefits, with respect to which staff are concerned. We understand from paragraph 6 that only the first part of (s) on Annex V falls in the general requirements (institution-wide obligatory), whereas the second part of (s) only applies to Identified Staff. However, section 3.1.2 of the text which addresses the second part of (s) is included in the General requirements on risk alignment section of the document instead of in the Specific Requirements on risk alignment. Section 3.1.2 should therefore be moved to section 4 of the document to avoid confusion for national legislators.

[2] **Recital (14) CRD III** The provisions on remuneration should be without prejudice to […], applicable legislation regarding shareholders' rights and involvement […]. **Recital (17) CRD III** […] The Green Paper also underlines the need to improve shareholders' involvement in approving remuneration policies. The European Parliament and the Council note the Commission's intention, as a follow-up, to make legislative proposals, where appropriate, on these issues.