AFB comments to the EBA consultation on 'Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU [CRD IV] and disclosures under Article 450 of Regulation (EU) No 575/2013 [CRR]

Introduction

The Association of Foreign Banks (AFB) welcomes the opportunity to provide comments to this Consultation Paper.

The AFB represents the foreign banking sector which provides financial services throughout the UK, mainly in London, through branches, subsidiaries and representative offices. The AFB provides a forum for the sharing of information on industry issues for the mutual benefit of foreign banks operating in and out of the UK and makes representations to industry, government, regulatory bodies and other financial services organisations to ensure the attainment of good international practice.

The foreign banks concerned engage in a wide range of banking and investment business activity in the UK primarily in the wholesale banking markets. They make a significant contribution to London's standing as a major global financial centre and to the depth and breadth of the European Financial Markets facilitating trade across the Community. Member banks and their affiliated organisations range from the largest with several thousand staff to the smallest with ten or less staff.

Whilst the AFB recognises the need to link remuneration with a firm's long term performance, significant concerns remain with respect to the removal of the 'neutralisation' approach. This approach has allowed national member states to apply the remuneration rules in a proportionate manner based on the size of the firm, recognising the impact each firm has on the European and national market. It would appear that the EBA is proposing that the correct interpretation of 'proportionality' refers not to the ability to neutralise certain provisions for those firms which are of minimal risk to the EU or individual member states, but rather to implement super-equivalent requirements on the Directive for firms which are headquartered in the EU. The AFB strongly believes that this is the wrong approach to take and one which will materially damage the standing of Europe as a leading centre for trade and investment.

In a number of areas, including the requirement for ultimate (non-CRD firms) shareholder approval of increases to the fixed to variable ratio for CRR firms, restriction on dividends, complete elimination of proportionality and increased retention requirements, the draft Guidelines appear to diverge from, and/or go beyond, the legislative basis provided for in CRD IV. It is unclear whether

this is the EBA's intention and it may raise questions around the legitimacy and enforceability of certain revisions to the guidelines.

Response to questions

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

   The AFB has no comment on this question.

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

   The AFB has no comment on this question.

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

   The requirement for ultimate (non-CRD firms) shareholder approval of increases to the fixed to variable ratio is likely to have a significant impact on firms that are headquartered outside the EEA and appears very disproportionate when compared to the aims it seeks to achieve.

   This is of particular concern given that some firms may be required to subsidiarise to comply with domestic regime risk appetites, having previously operated as a branch. In these circumstances, shareholders of the ultimate parent entity will have delegated decision-making on certain areas, such as remuneration, to the group which is likely to be implementing a firm wide policy, and so they are unlikely to have the knowledge or desire to get involved in decisions affecting such areas, particularly for a single subsidiary when the group may have a significant number of them globally.

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

   Under the current rules, firms are able to apply different remuneration policies and practices to the different sectors in which they operate. For example, firms which are active in banking and asset management need only apply the CEBS guidelines to their banking business and not to the UK-incorporated entity providing asset management services.

   As a result of the amended Guidelines, and the requirement for consolidating institutions to ensure overall consistency of the group with them, it is highly likely that a number of subsidiaries active in the non-banking sector will be put a competitive disadvantage vis-à-vis their competitors.

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.

The AFB has significant concerns with the EBA's proposed removal of the 'neutralisation' approach that has been permitted under the rules up until this point.

The elimination of the application of proportionality, in the way that it has been applied so far, does not recognise the relative lack of size and significance of many organisations to the European market, particularly where those firms are headquartered outside the EU. When combined with the absence of any recognition of equivalence for third country firms which have remuneration policies and procedures that comply with similar G20 / FSB guidelines, the prescriptive nature of the EBA draft guidelines will result in a highly disproportionate and onerous regime. Ultimately, this will have a cumulative impact far greater than the size and scope of the European operations of non-EEA headquartered firms.

Many smaller firms seek to minimise the variable and deferred compensation for those in control functions, aligning deferral periods to the time horizon of risk. Without the *de minimis* provision that is currently provided for in a number of member states, including the UK, it will be difficult to continue with this practice, which provides a mechanism to limit the degree to which employees within key control roles are subject to business / share price performance, thereby ensuring their ability to operate independently. The AFB would welcome comments from the EBA on how they believe that this independence in decision-making within key control areas can be maintained once the relevant employees have their variable remuneration tied to the firm's share price.

Payment in shares

Whilst the EBA have stated that third country firms should be able to demonstrate that shareholders have approved a higher ratio than 100% of salary where such payments are being sought, there is no recognition that the use of physical shares in employee compensations plans is less common in a number of regions outside of Europe, particularly in North America. Shareholders in these jurisdictions may have concerns with regards to the treasury implications of such share payments, as they could unnecessarily reduce the firm's common share capital and have a dilutive effect on shareholders.

Requiring the implementation of a share plan also does not take into consideration the practicality or cost of seeking shareholder approval to create a plan for a small population of a firm's global workforce, nor does it factor in the cost to implement, or the potentially extraordinary tax and accounting issues that a global firm could encounter as a result. As an example, one AFB member, which had a balance in aggregate of under GBP 5 billion, will be required to implement the new EBA

guidelines for just 0.1% of the global workforce. In this example, and many others, converting from a phantom plan to a share plan for the few employees subject to the guidelines will require a disproportionate amount of resources.

The AFB would suggest that the EBA reconsider their proposals and allow the use of phantom plans by both listed and non-listed companies where they are headquartered in a third country, which will also ensure that firms that are not able to grant share awards because of their legal structure or home state legal restrictions, still have consistent remuneration programmes across all of the regions in which they operate. Phantom plans have the further benefit of still allowing for the alignment of employee reward with shareholder gains, having a retentive effect for employees and ensuring sustainable performance – both aims that are shared by firms and the EBA.

Employee Retention

Failing to recognise the need for the *de minimis* provision will also make it more difficult for banks to compete for talent. Employees in control functions can often perform similar roles in industries outside of banking, where they would be subject to limited deferral and timelines, if at all.

There is also a significant discrepancy in that branches of foreign banks have a higher proportion of employees likely to be caught as Code Staff than would be the case in large EU headquartered banks, making it increasingly difficult for them to recruit and retain talented individuals in their EU operations relative to the rest of the market.

Deferral

The changes proposed will present a significant challenge for a number of foreign banks with European activities, with possible negative tax implications for those mobile employees that move between Europe and the firm's other regions, including the home state.

There is also a lack of clarity around how firms that operate in the EU through a branch should form their European remuneration policies where the home state legal system does not permit deferral for the period required by the guidelines. As an example, Canadian tax legislation has a maximum deferral period of 3 years. Recognition in the Guidelines of how to manage this would be welcomed by firms.

Example

In one AFB member, there were 30 employees identified as Remuneration Code Staff, of which 17 were deemed to be '*de minimis'* as their variable pay was less than £500,000 and less than 33% of total remuneration.

Payments to these employees ranged from £32,000 to £98,000 (7% - 29% of total remuneration), with most sitting in control functions such as audit, compliance, finance, legal and HR, where bonuses are significantly smaller relative to front office, revenue generating Code Staff.

Whilst this firm, and many others of a similar size, already has deferral rules in place for all employees globally, none of the individuals identified above would have had any of the variable pay deferred under it, since the threshold for deferral is higher.

Under the draft Guidelines, these employees would be brought into scope of the deferral rules, resulting in only 30% of their variable pay being paid up front in cash and the rest deferred over 3 years with 50% paid in equity. That deferral period is likely to increase to 5 years, or possibly 7 years, in 2016. We have provided a summary of how this would impact an individual employee paid variable remuneration of £50,000 in Annex 1 of this document.

Given the relatively low level of the bonus payment, this appears to be unfair and disproportionate, with the individual concerned impacted purely as a result of their physical location. For many foreign banks, individuals in these control functions are often seconded from other group entities (outside the EU), for a period of 2-3 years. This type of employee rotation will, however, become increasingly difficult if the proposed deferral rules are put in place as it would serve as a powerful disincentive for any employee considering a UK / EU role.

The AFB is also concerned that firms will have little choice but to exclude the individuals described above from the bonus scheme, having to increase base pay to compensate for the loss of variable pay. This will have a significant impact on a firm's fixed costs and, in the case of one AFB member, would have seen fixed pay increase by almost half a million pounds (GBP) for the UK payroll alone – a significant figure given the size of the UK operations.

There are added complexities for branches of foreign banks whose European operations are small, not only relative to the group, but also to the risk posed to the EU as a whole. In many cases, such firms, which are not always involved in markets based activity, are following their customers from the home state and so have very limited operations globally. For these firms, variable remuneration can be well below £10,000 and having this deferred would be extremely disproportionate and unfair on the individuals concerned. Furthermore, given the small size of the European operations, a greater proportion of the employees are likely to be captured as identified staff, which will make it increasingly difficult to attract and retain talent when the variable remuneration regime is so out of kilter with the risk posed.

Administrative Costs

A further concern, expressed by a significant number of AFB members, is with regards to the administrative and operational challenges that the proposed Guidelines would have, particularly for those branches that are small relative to the overall group (with a similarly small HR function), which is true even for some of the largest global banking groups based in the UK.

All members of the AFB are global banks, operating across borders and in some cases employing tens of thousands of employees, if not more. The Guidelines, if implemented as proposed, will require a much more rigorous governance and auditing process for what will be a very small section of this employee base and it is unlikely that such banks will have the appetite to introduce different remuneration policies for such a subset.

The approach being proposed by the EBA also appears to be at odds with the frequently expressed desire of regulatory authorities globally to increase convergence of international financial services

regulation. Full compliance with the draft guidelines, if implemented as currently worded, will require dedicated resources for the implementation and operation of an entirely separate remuneration plan that is relevant for just one region. For a function such as remuneration, which is generally managed as part of wider operations within a head office, this will remove the advantage that comes with economies of scale, presenting a further negative effect on employees in the European region.

Date of Application

The AFB also has concerns on the date of application being proposed by the EBA. Many firms who have not previously had to apply the rules will face enormous difficulty in having the required systems in place by January 2016, particularly where there is no previous experience of paying out variable remuneration in the form of shares or instruments.

Some employees may also have contractual clauses which will require amendment if variable remuneration is to be paid out in anything other than cash and it is unlikely that this will be feasible on such a short timescale given the individual negotiations that will be required with the employees in question.

With the above in mind, the AFB would ask the EBA to consider extending the proposed implementation timeline to allow impacted firms to transition over a period of 12 months following publication of the finalised Guidelines.

Criteria to be taken into account by institutions and competent authorities

The AFB believes that a further criterion should be added to the list at point 82, to ensure that national authorities take account of the home state legal system of branches of foreign banks when applying the rules. For some foreign banks, the home state legal system does not permit the paying of variable remuneration in the form of instruments, and a clear statement recognising this would be welcome.

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

The AFB has no comment on this question.

7. ***Are the guidelines regarding the capital base appropriate and sufficiently clear?***

The AFB has no comment on this question.

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

The AFB has no comment on this question.

9. Are the requirements regarding allowances appropriate and sufficiently clear?

The AFB has no comment on this question.

10. Are the requirements on the retention bonus appropriate a sufficiently clear?

The AFB has no comment on this question.

11. Are the provisions regarding severance payments appropriate and sufficiently clear?

The AFB has no comment on this question.

12. Are the provisions on personal hedging and circumvention appropriate and sufficiently clear?

The AFB has no comment on this question.

13. Are the requirements on remuneration policies in section 15 appropriate and sufficiently clear?

The AFB has no comment on this question.

14. Are the requirements on the risk alignment process appropriate and sufficiently clear?

The AFB has no comment on this question.

15. Are the provisions on deferral appropriate and sufficiently clear?

The AFB has no comment on this question.

16. 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.

Interest & Dividends during deferral or at vesting

The AFB has significant concern with the restriction on the payment of interest or dividends during the deferral period or at vesting.

Dividends are a signal of a firm's financial strength and sustainable profitability and therefore a key determinant for many employees when looking at potential employers to work for. Furthermore, the ability for a firm to consistently pay dividends on a deferred incentive award is a key advantage resulting from this financial strength along with risk control, forming an essential part of global remuneration strategies. Restricting the payment of interest or dividends will create a remuneration structure in the European region that is significantly out of alignment with other regions, possibly resulting in employees in the European region being treated less favourably than other employees globally.

This is likely to have a negative impact on the firm, which will be less able to attract and retain talent in Europe, but also on the European region as a whole, with talent being drawn away to other regions and financial centres. In order to mitigate this impact, firms will be required to increase overall remuneration, as has already been highlighted, impacting on the ability to maintain consistent performance with vacancies taking longer to fill and employee engagement suffering as a result.

It is also unclear why employees should be treated less favourably than any other class of shareholder. There is a long established principle of equal treatment of shareholders under English law and there appears to be a direct conflict between that principle and what is being proposed. The AFB would welcome clarity from the EBA on how they see this conflict being resolved.

17.Are the requirements regarding the retention policy appropriate and sufficiently clear?

The AFB has no comment on this question.

18.Are the requirements on the ex post risk adjustments appropriate and sufficiently clear?

The AFB has no comment on this question.

19.Are the requirements in Title V sufficiently clear and appropriate?

The AFB has no comment on this question.

20.Are the requirements in Title VI appropriate and sufficiently clear?

The AFB has no comment on this question.

21.Do institutions, considering the baseline scenario, agree with the impact assessment and its conclusions?

The AFB has no comment on this question.

22. ***Institutions are welcome to provide costs estimates with regarding the costs which will be triggered for the implementation of these guidelines. When providing these estimates, institutions should not take into account costs which are encountered by the CRD IV provisions itself.***

The AFB has no comment on this question.

Association of Foreign Banks
June 2015

Appendix 1

Example Payment Schedule for Variable Remuneration under proposed draft Guidelines

Variable Remuneration = £50,000

An employee based outside the EU would receive the full £50,000 in cash up front, an EU based employee would receive only £15,000 cash up front, with the rest deferred in small amounts over 3 and a half years, as is highlighted in the chart below.

Date	Variable Remuneration (GBP)	Payment Type	FCA (GBP)	Payment Type
Dec-15	50,000	Cash	15,000	Cash
Oct-16			15,000	Equity vests Mar 2016 but subject to 6 month retention period
Dec-16		Equity Vesting Date	3,333	Cash
Jun-17			3,333	Equity vests Nov 2016 but subject to 6 month retention period
Dec-17		Equity Vesting Date	3,333	Cash
Jun-18			3,333	Equity vests Nov 2017 but subject to 6 month retention period
Dec-18			3,333	Cash
Jun-19			3,333	Equity vests Nov 2018 but subject to 6 month retention period
	50,000		**49,998**	