The voice of banking

EBA remuneration guidelines consultation

A response by the British Bankers' Association to CP 1/15

June 2015

Introduction

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. BBA members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

All of our members, large UK high street banks, wholesale and foreign banks operating in the UK as well as smaller and challenger banks are likely to be affected by the European Banking Authority's (EBA) proposed guidelines on sound remuneration polices, particularly as it is proposed that the principle of proportionality be removed. So the BBA is please to respond on behalf of its members to the EBA's remuneration guidelines consultation[1].

We have focussed our observations on the elements of the Pillar 2 framework which are subject to change (covered in Appendices 2 and 3) but also have some more general comments, which we set out below.

General Comments

We recognise that the primary CRDIV legislation has established criteria about the way in which those working in banks are paid and particularly, for some of them, the ratio between their fixed and variable remuneration. We are broadly supportive of the European Banking Authority's revision of the Guidelines in order to establish a consistent approach to the implementation of the CRD IV requirements however our members have concerns about the removal of the proportionality principles and the overly prescriptive nature of the regulations as we describe below.

[1] http://www.eba.europa.eu/documents/10180/1002374/EBA-CP-2015-03+%28CP+on+GLs+on+Sound+Remuneration+Policies%29.pdf

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Proportionality

We understand the points raised by EBA in relation to the legal applicability of proportionality which were articulated by EBA at the public hearing on May 8th and we have seen the exchange of letters between the EBA and the Commission. However we have two fundamental concerns:

1. In our view there is no fundamental difference between the text of CRDIII, where proportionality was allowed, and CRDIV where it is proposed to no longer to apply. This has been confirmed by independent legal opinions and leads to three possibilities:

    a. If the original interpretation was incorrect the industry and both EBA and all national competent authorities have been incorrectly administering CRDIII for 5 years, or;
    b. The Commission believes that there was a change in the text of CRDIV sufficient to disallow proportionality, although none of our members is aware of any such discussions or proposals in the debates on CRDIV; or
    c. The Commission has erred in its interpretation.

2. We believe the EBA is supportive of the principle of proportionality both from the prior CEBS guidelines and from the workshop on proportionality in October 2013 (after the finalisation of CRDIV), and we understand, like BBA members, EBA is keen for there to be further legislative clarification, where necessary to permit the use of proportionality. However, the idea that proportionality cannot be used while changes to primary legislation are put in place is a matter of significant and grave concern.

The disapplication of proportionality raises the prospect of further legal challenges, which would not be in the interests of our members, the EBA or national competent authorities. However, if further clarification is needed we question whether it is necessary to make changes to this aspect of the Guidelines at this point in time.

Therefore our recommendation to EBA is to preserve the current guidelines on proportionality.

Prudent Remuneration Practices

Allowing the forfeiture of fixed pay in specified circumstances is consistent with prudential remuneration policy and with maintaining a sound capital base. For example, we suggest that it should be possible in certain circumstances to adjust or forfeit fixed remuneration without re-characterising it as variable pay, provided that it is not used as a means to circumvent the application of the CRD remuneration provisions. This would otherwise result in firms being required to pay out fixed remuneration on a permanent basis, even in circumstances where, for example, an employee engaged in misconduct or where the institution or the relevant business unit is failing or has suffered a material failure of risk management. We consider that the retention of such adjustment or forfeiture provisions does not alter the purpose of the payment or the character of the remuneration as fixed remuneration.

Factors for Determining Fixed Pay - Allowances

Allowances are a prudentially conservative way of paying fixed remuneration. For example, unlike salary, allowances may (i) be excluded in the calculation or valuation of certain ancillary benefits (such as pension or insurances); (ii) be separately categorised for the purposes of calculating severance payments; and (iii) be adjusted more easily when an individual changes roles.

Allowances should not be used as a proxy for bonuses or to avoid the CRD remuneration provisions. In relation to the requirements set out in paragraph 124 (that there should be "equivalence" between individuals in same/similar roles), we agree that national regulations should be vigilant about the possibility that the level of allowances are connected with individual performance. However equivalence should not be a precondition on when an allowance may constitute fixed pay.

There may be many reasons unconnected to individual performance that explain why fixed pay (and allowances specifically) might vary between individuals in the same/similar roles: they may be recruited at different times (whereby there may be variations in demand or supply for individuals); an employee may be performing the same role, but have different skill sets/expertise or an employer might need to pay a premium to attract an individual into the role.

Long-term incentives (LTIPs)

Another key concern is around the proposed calculation of long-term incentive plans with performance conditions at point of vesting, under the terms of the variable cap. The proposed approach will result in some unintended consequences, including:

1. Applying the cap after the application of performance conditions makes LTIP use significantly unattractive and will make their use less common in packages in the future. This removes a very useful risk adjustment mechanism
2. It means that comparing LTIP pay-outs which vest inclusive of any share price fluctuation
3. Inconsistency as to when an individual’s LTIP is caught by the cap. For example, an employee, who is able to retain their unvested LTIP on leaving their firm, would not be caught by any bonus cap on vesting if they are no longer employed.

Valuation of such awards at face value at grant assuming maximum vesting would be a preferable approach to valuation. At a minimum it removes stock price movement impacting the valuation (and potential movement in exchange rates).

Scope of the Guidelines

The scope of the proposed guidelines is too broad. By seeking to create harmonisation of the application of the requirements to all in-scope firms, regardless of their nature, scale and complexity, we believe EBA is being too prescriptive and has failed to understand the practical implications of its proposals. So it should be made clear that where other sector-specific legislation, for instance AIFMD (where there is no variable remuneration cap) determines a staff member’s reward structure, CRDIV – for instance with its variable remuneration cap - should not override this. ESMA’s guidelines confirm this and it would be helpful if the EBA guidelines did so in the same way.

Furthermore as currently drafted the proposed scope will both limit the ability of national competent authorities to make pragmatic decisions as questions or problems arise and also create an overly bureaucratic process for institutions which will not add to regulatory soundness.

For example, requiring remuneration committees and associated disclosure at both parent and material subsidiary levels within a group will impose a significant administrative burden and may impair an institution's ability to implement an institution wide remuneration policy. Similarly the need to obtain approval for a ratio between fixed and variable pay at parent and subsidiary levels in an organisation, together with requiring approval for different ratios for different groups of employees, is bureaucratic in the extreme. It will be time consuming and result in unnecessary compliance costs whilst adding nothing that an exercise executed solely at parent level would not achieve more effectively.

Shareholder Approval

The guidelines are clear when applied to EU headquartered firms, however require clarification that the shareholder approval at group level is sufficient and that no intermediate shareholder approval is required in companies where there are multiple levels of shareholders, as this would create unnecessary administrative cost. We do not believe that paragraph 36b of the draft guidelines, which requires approval from the shareholders of the ultimate parent company of an EU subsidiary of a non-EEA headquartered firm, is appropriate given that Article 94.1(g) refers to the *shareholders of the institution* rather than the consolidated group. We would ask the EBA to modify the guidelines to clarify that approval from the shareholders of the immediate parent company of EU subsidiaries is sufficient for setting the maximum ratio between fixed and variable remuneration.

Our further comments are contained in our answers to the EBA's questions below.

Answer to questions

Q 1: Are the definitions provided sufficiently clear; are additional definitions needed?

A few of the definitions either fail to make sense, or are too broad. However, the definition with which we have most concern relate to the definition of LTIP and staff.

LTIP

'Additional' awards are not made under LTIPs as envisaged by the EBA's definition. Instead awards under an LTIP are made only once, at the point of grant at the start of the LTIP which covers a close ended period of time, for instance 5 years. The amount of the award that will vest at the maturity of the LTIP will depend on meeting performance conditions defined at the start of the LTIP period.

We would therefore propose amending the LTIP definition to read:

> e. 'Long term incentive plans' are variable remuneration components, where ~~a~~ *all or* part of the remuneration ~~is~~ *vests* ~~awarded~~ at ~~one~~ *a predefined* point *in* ~~of~~ time ~~and under the same plan additional awards are made at future points in time~~ subject to *appropriate performance conditions*, including e.g. retention of staff within the institution.

Staff

It would be helpful for the EBA to clarify that this definition excludes third party contractors and secondees from the scope of CRD IV.

Currency conversion

The requirement to use currency conversion rates based on the Commission's guidelines for its own financial programming and budgetary purposes seems unnecessary. The EBA's Material Risk Takers (MRT) - EBA/RTS/2013/11 - already contains guidance on exchange rates which requires banks take into account current exchange rates for converting currency amounts if necessary when the MRT is identified, or otherwise using converted values from financial accounts.

This pre-existing guidance is therefore sufficient. However, we would encourage EBA to allow an exemption so that an employee who has not received a year on year increase in pay should not be identified solely because of a change in exchange rates given their will have been no change in the materiality of that employees role.

Q 2: Are the guidelines in chapter 5 appropriate and sufficiently clear?

Yes.

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

We support involvement of shareholders in the determination and application of remuneration policy but suggest that where a banking group contains a wholly owned subsidiary of the parent bank, which is also subject to the sound remuneration guidelines, shareholder agreement reached at the general assembly of the parent bank, or immediate non-EU parent of an EU regulated subsidiary group should also be considered to apply in respect of the relevant subsidiary of the parent bank or EU regulated subsidiary group.

Similarly paragraph 39 appears to require that all significant institutions within the group to establish their own remuneration committees. This will be administratively burdensome for large groups when the only purpose of such a remuneration committee, in our view, would be to implement the group-wide remuneration policy. Ensuring compliance should be the responsibility of this group level remuneration committee – requiring a cascade of committees will add significant extra cost for no added benefit.

Q 4: Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?

The guidelines are clear but do not reflect the reality of how banking groups establishing remuneration policies.

As we note above group wide remuneration policies are established by the remuneration committee which is a committee of the main parent board. This remuneration committee operates under delegated board authority to oversee the development and operation by management of compensation policies, systems and related control processes and approves the remuneration of relevant senior management. In this model the remuneration committee would not be responsible for preparing decisions, making recommendations and providing supporting advice as suggested in para 44 but rather takes responsibility for these functions. It would be helpful if the EBA confirmed that this *modus operandi* conforms to its proposed guidelines.

Whilst recognising that subsidiary boards have their own independent legal and governance responsibilities we envision that their prime responsibility is to implement the group-wide remuneration policies and procedures developed by the main board remuneration committee. Confirmation by the EBA that this hierarchy also conforms to the proposed guidelines would also be welcomed.

As it stands, paragraph 63 would require applying the requirements to non-CRD entities, which we do not support. We also note that applying the requirements to these entities on a standalone basis would create level playing field distortions in third country jurisdictions where entities not belonging to an EU banking group would not be required to apply the same rules.

Q 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.

It is quite clear to us that Article 92 (2) requires institutions to comply with the principles in sub paragraphs a) to g), which inter alia include requirements relating to fixed and variable remuneration

> 'in a manner and to the extent that [is] appropriate to their size, internal organisation and the nature scale and complexity of their activities'.

This principle of proportionality, which is clearly articulated in the legislation at the beginning of the section of CRDIV relating to remuneration policies, is not modified or dis-applied in article 94 which covers variable remuneration in detail.

We therefore disagree with the EBA's assertion supported by what we consider to be a flawed Commission legal opinion that the principle of proportionality cannot be applied in relation to the variable remuneration.

Applying the bonus cap remuneration requirements present an almost prototypical case in which minimal potential safety and soundness benefits are outweighed by the compliance costs faced by the many hundreds of small banks throughout the EU to which it is now proposed to apply the guidelines. It would be preferable to relieve both competent national authorities and such banks from examining compliance with these kinds of requirements in order to concentrate resources on the real issues presently faced by these institutions, such as cybersecurity and interest rate risks[2].

[2] After Tarullo, D speech to Independent Community Bankers of America Washington Policy Summit 30th April 2015 http://www.federalreserve.gov/newsevents/speech/tarullo20150430a.htm

The removal of proportionality provisions in relation to individual material risk takers rules would force a number of individuals with low variable remuneration to be caught within the scope of CRD IV. Applying the rules on variable pay to very small bonuses, would be impractical, making these roles less attractive, would result in disproportionately high administration costs and inevitably increase fixed remuneration, limiting firms' ability to appropriately risk-adjust individual compensation awards.

It is difficult for our members to quantify the costs of changing the approach on neutralisation. But there is no doubt that in larger institutions more entities and more staff will be included in the scope of the regime. It is our experience that the outturn costs of regulatory change programmes are nearly always higher than originally estimated and we do not expect the implementation of the revised guidelines to be any different!

Among the impacts of the removal of the proportionality principle we except to see are:

- Significantly increased regulatory burden on smaller institutions
- More focus on higher levels of fixed pay which would be counter-prudential as it limits the ability of a firm to risk-adjust individual compensation
- Less appetite for employees of third country institutions to move to the EU as part of career development programmes
- Crystallisation of conflicts between remuneration polices in the EU and other jurisdictions which the application of proportionately currently allows our members to resolve pragmatically
- Difficulty in attracting and retaining new staff where deferral applies to minimum levels of variable compensation

Q 6: Are the guidelines on the identification of staff appropriate and sufficiently clear?

Yes although some of members undertake the identification of staff on a consolidated basis rather than a subsidiary-by-subsidiary basis. This approach enables banks to better understand the totality of an individual's potential impact on the institutions risk profile recognising that any individual may undertake duties for more than one legal entity within the group. The guidelines should reflect this reality.

The proposed requirement that all subsidiaries participate in the identification process is overly burdensome. For instance where a subsidiary does not employ staff whose remuneration package includes variable remuneration there should be no requirement that they should participate in the identification process. Similarly where staff of a subsidiary are subject to another legislative requirement in relation to their remuneration – for instance AIFMD - such subsidiaries should be similarly exempt.

Q 7: Are the guidelines regarding the capital base appropriate and sufficiently clear?

Yes although we note that there is a contradiction between asking firms to build their capital bases to decrease the probability of default in times of low performance whilst simultaneously limiting the use of variable remuneration as a tool to reduce fixed costs during periods of underperformance.

Q 8: Are the requirements regarding categories of remuneration appropriate and sufficiently clear?

We accept that LTIPs should be regarded as variable remuneration. However the proposed treatment of LTIPs does not represent the reality of how they function and would require the measurement of the variable remuneration at the point of vesting, rather than the point of inception when the LTIP is originally granted.

Should the intention of the guidance be to measure the award under the LTIP on vest rather than grant, this would present a number of practical considerations and in turn unintended consequences, including:

- Institutions would be unable to provide upfront clarity/planning of the appropriate balance between fixed and different components of variable pay and work within the parameters of a bonus cap. This is because the value of LTIPs on vesting are typically subject to risk measurements, share price and potentially exchange rate dynamics.

  Instead of allocating an up-front proportion of an LTIP within the limits of the variable pay cap, institutions would have to wait until the award vests (the amount being dependent on performance achieved) in order to calculate the proportion of the cap taken by this award. This could also encourage some firms to circumvent the purpose of the cap by backfilling any headroom remaining in the cap with short term variable awards (i.e. annual bonus) at the point of vesting.

- Under the proposed valuation methodology it is possible to breach the cap (simply due to share price movement), without the individual receiving any variable compensation in the year in which the LTIP vests.

- A further practical consideration relates to where there are changes to individuals remuneration during the performance period. In cases where an employee changes role or becomes part-time after an LTIP is awarded, their fixed pay will be reduced and could lead to a breach of the variable remuneration cap when the LTIP vests.

- There are potential unintended consequences of the cap not applying on vesting. For example, an employee may leave before vesting. Another scenario might include where the LTIP provides that vesting does not occur until after an individual's retirement.

- The inverse could also be true if fixed pay was to increase during that period which would create larger cap limit which could be back-filled by the bonus award. This risks circumvention of the pay-for-performance principle.

- A further consideration relates to how discounting will be applied to an LTIP if the valuation is undertaken at vesting.

- Institutions may cease to use LTIPs as a viable incentive due to the complexities explained above which further reduces the perceived value to employees.

We recommend that paragraph 120 be amended to value LTIPs for the purposes of calculating the fixed/variable ratio cap at grant.

With respect to paragraph 121, it is important not to inadvertently capture investments in vehicles that have no features of variable pay. By way of example, certain employees may be given the opportunity to invest in a firm's funds. This is at the discretion of the employee, utilising individual's post-tax monies, and there is no guarantee on the performance of the fund. Any preferential terms for employees are typically minimal such as waiving the minimum investment threshold.

The payments received by an employee in respect of such funds should properly be treated as investment income as they would be for any other investor unless there are reasons to conclude that such payments have been made by way of avoidance. This is an assessment that should be made by national regulators in particular cases.

Similarly where employees receive dividends on instruments comprising deferred remuneration, as is normal, those dividends should not be counted as part of variable remuneration.

Q 9: Are the requirements regarding allowances appropriate and sufficiently clear?

Whilst the requirements are clear they will be difficult to apply. For instance we find the requirement in paragraph 124 c for a role based allowance to be paid to any other staff-member fulfilling the same role in order to be classified as fixed remuneration to be unrealistic. There is no reason why individuals performing a similar role should be paid the identical allowance. Differences in seniority, decision making capacity, and complexity of the individual's role can all explain differences between role based allowances in similar roles. Furthermore it may be difficult to identify 'comparable' roles because across an organisation many roles are unique.

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

Yes although we note that for the purposes of the bonus cap, retention bonuses are spread pro rata over their life. This is inconsistent with the treatment of deferred bonuses and LTIPs, which are valued upon vesting, or as we would prefer, to reflect actual market practice, upon grant.

There may be occasions, for instance in relation to the restructurings, where a retention bonus is required to encourage key members of staff to stay with the business for a particular period of time. Such payments are not performance related and should therefore be counted as fixed, not variable, remuneration.

We are not clear why retention bonuses should be valued on an actuarial basis. This requirement would unnecessarily complicate the valuation process and introduce a concept which is not employed elsewhere in the remuneration guidelines.

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

No.

Firms invariably have a business wide policy on severance that applies to all individuals which should continue to apply and not be over-ridden by the remuneration policy guidelines.

These over-arching firm-wide policies will typically be written to apply to no-blame dismissal where severance payments are made by reference to pre-defined criteria but may distinguish between payments made for:

- Departures arising because of performance issues
- Redundancies resulting from a change in business strategy/circumstances
- Payments made as a result of litigation settlements

We think that the guidelines articulated in 13.2 need further refinement to take account of these different circumstances, for instance by excluding the payment of settlement amounts from potential litigation from the calculation of either fixed or variable amounts the payment of settlement amounts.

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

Placing the requirement on all institutions to monitor its staff to ensure they are not hedging their potential exposures to a downward adjustment in their remuneration is administratively burdensome. Larger institutions often have an in-house trading desk to be used for staff market transactions so will be able to track such activity. These are most unlikely to exist in smaller institutions. It should be sufficient to place an obligation on staff of institutions of whatever size to confirm that they will not undertake personal hedging activities.

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

We think that EBA is creating very significant additional administrative burdens by requiring ratios for different categories of staff to be set in advance. Practically, where an institution expects (but does not know for certain) to pay variable remuneration in excess of 100% it would seek approval for the maximum permissible 2:1 ratio and then adjust it downwards, depending on particular circumstances including the total size of the variable pay pool. So the ratio which would actually apply to any individual will only be known once the amount of variable pay has been determined. Setting different ratios for different groups of employees in advance removes flexibility, which contradicts the EBA and industry's expectation that a remuneration policy should be highly flexible, including the possibility that no variable compensation would be paid.

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

Yes the requirements are comprehensive and we agree with the requirement to use risk adjusted measures throughout the firm.

Q 15: Are the provisions on deferral appropriate and sufficiently clear?

The provisions are sufficiently clear but raise the possibility of deferral for longer than the 3 to 5 year period currently required by CRDIV. We caution that further extending the deferral periods for senior managers when already 60% of their variable pay is deferred for 5 years may not bring the prudential benefits that the EBA expects. A consequence of extended deferrals may be an increase in fixed pay, to compensate for the perceived diminution of the deferred portion of pay. Such increases in fixed pay should be considered counter-prudential, as it will limit the ability of firms to appropriately risk-adjust individual compensation.

Q 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.

With respect to paragraph 255, we understand the EBA's view that institutions should not construct deferred instruments with disproportionate interests arising during the deferral period. However where interest or dividend-equivalents are aligned with commercial rates and/or receipts available to other market investors, there should be no prohibition on paying equivalent amounts to employees.

Paying dividend equivalents on deferred shares and LTIPs is normal market practice and helps to align employees and shareholders. Dividends are generally "rolled up" and only paid out on the shares that actually vest at the end of the vesting period, limiting the risk of payment for failure.

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

The issues of retention and deferral should be considered cohesively as recognised in para 261 of the draft guidelines. We see no reason to require extended retention periods given that the five year deferral period is already lengthy and the guidelines require a one year retention period, which applies to all instruments including those that are not deferred.

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

Yes this reflects the current situation in the UK which we support. We are also supportive of the same requirements being applied to all EU firms in the interests of a common approach to malus and clawback.

Where the ex-post risk adjustments are made the amount clawed back from the employee should be the vested amount net of relevant income tax and employment taxes. The tax payments made by the employer at the time of vesting should be off-settable by the employer against its total tax bill in the year in which clawback is applied.

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

Yes.

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

Yes.

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

We are in broad agreement with the analysis although it will be difficult for our members to assess the actual impact until the revised guidelines have been in place for at least a year.

Q 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.

Our members have not provided us with information in response to this question which addresses just one of the many regulatory change initiatives that they are currently implementing.

Responsible executive

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