

Consultation response

Draft RTS on classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of the CRD

29 October 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the consultation on *Draft RTS on classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of the CRD (EBA/CP/2013/32)*. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We provide below our over-arching response to the consultation, which is followed by a discussion of a number of important issues.

Over-arching comments

AFME believes that the final RTS should not necessitate the creation of instruments specifically for the purposes of variable remuneration. Indeed, the EBA states its agreement with that principle on page 12 of its consultation, specifically recognising the additional burden associated with specific instruments for variable remuneration. However, we believe that many of the proposals in the draft RTS will make it very difficult to use the same instruments issued to external investors.

In particular, we believe that the specification in the RTS of additional criteria for instruments to be used for variable remuneration will make it difficult to use the already-issued instruments. AFME's preferred approach is to cross-refer to existing criteria in the CRR and the proposed Bank Recovery and Resolution Directive (BRRD), and not to augment those criteria in this RTS. Indeed, there is an argument that this is the approach contemplated in the Level 1 text, which requires the RTS to specify "the classes of instruments that satisfy the conditions in point (I)(ii) of paragraph 1". If the intention were that new criteria should be created in this RTS the Level 1 text could have referred to 'criteria for instruments that satisfy the conditions'. The reference to 'classes of instruments' could imply classes whose criteria are defined elsewhere (e.g., in the CRR).

We believe that the RTS should set out a framework under which already-issued instruments can be used for remuneration purposes, on the following basis:

- Given the array of existing market instruments there should not be a necessity to create new instruments purely as a vehicle to deliver pay to employees. The instruments should be awarded as far as possible under market conditions, in terms of mechanisms of conversion/write-down/write-up, triggers and distributions, to ensure that employees are treated equivalently to external investors;
- The framework should promote simplicity in terms of operational implementation, including the possibility to have a unique remuneration plan in a consolidated Group context;
- To the extent that such instruments are typically destined for institutional investors and that there is not a mature retail market, institutions must be able to ensure the liquidity of the instruments for their employees at the end of the deferral and retention periods.

No requirement to use non-equity instruments

For the avoidance of doubt, we do not read the Level 1 text as creating a requirement to use non-equity instruments for variable remuneration. There is no widespread use of non-equity instruments as there is no obvious advantage to using them in terms of risk alignment or influencing employee behaviour compared to other remuneration vehicles already used by institutions. In the market, such hybrid instruments are generally called at face value unless a trigger event has occurred.

As such, an award in the form of shares or share equivalents or even deferred cash with a write-down (or “malus”) mechanism linked to the level of the CET1 capital ratio of the institution would be simpler to implement, more easily understandable for employees, and achieves the same risk alignment objective. It would also indirectly contribute to the reinforcement of own funds in case of write-down.

Given all of the above considerations, there should be flexibility as to the use of such instruments for remuneration purposes. Institutions should be able to assess the suitability of using such instruments for remuneration purposes under the control of their supervisor, taking into account all relevant considerations, including a cost/benefit assessment of implementation. The absence of operational and legal constraints for using such instruments should not compel their use.

Trigger points and write-down

The specifying of trigger levels for conversion/write-down in the RTS, although with the flexibility to be higher, is too rigid and will bias towards instruments specifically created for remuneration purposes rather than using those available in the market. For example, if credit conditions for a particular institution dictate that a Tier 2 instrument with a trigger point of 7% is more optimal, the requirement for a trigger point no lower than 8/8.5% would require a bespoke instrument to be created, which would impose additional costs on the firm, as well as activating other requirements of the RTS such as the cap on distributions.

The inclusion of such additional triggers has an immediate detrimental effect:

- The capital structure would have added complexity, creating less transparency and potentially additional volatility in the capital management process of the institution;
- A potential decrease in financial stability, as earlier triggers writing-down remuneration instruments will have a signalling effect to the market of trouble in a bank, which could become self-prophetic;
- Employees would be treated significantly worse than external investors holding *pari passu* instruments;

- Maintenance of these unusual triggers requires an ongoing additional process and infrastructure – including external disclosure, as it affects the capital structure – leading to significant operational burden;
- Fungibility with other market-placed instruments, which enhances secondary market liquidity post the vesting period, is not possible.

A key aspect of the proposals in the draft RTS is the interpretation of the requirement in CRD Article 94(1)(l)(ii) that these instruments “adequately reflect the credit quality of the institution as a going concern”. We disagree that interpretation of that provision should lead to additional trigger mechanisms over and above those in place in the CRR and very soon in the BRRD (which, crucially, both ensure instruments reflect credit quality):

- Instruments with an AT1 host already contain in accordance with CRR Articles 52 and 54 a contractual trigger that will lead to a write-down or conversion into CET1 when the CET1 ratio reaches a certain trigger level;
- Instruments with both AT1 and Tier 2 hosts are “relevant capital instruments” and hence subject to capital write-down at the “point of non-viability” in accordance with BRRD Article 51.

The ability to write-down an instrument at the “point of non-viability”, which could be prior to the entry into resolution, allows regulatory intervention in a going concern. In general, however, we believe that it would be wrong to be overly focused on the ‘going concern’ aspect of the Level 1 text. In a going concern situation it is generally expected that coupons and principal on non-equity instruments would be fully paid. This is not the intention of the Level 1 text, which seeks to ensure that the value of the instruments for employees reduces as a firm’s credit quality deteriorates. Absent a market price to reference for variable remuneration awards (as liquid markets will not necessarily exist for all levels and tenors of a bank’s capital structure) EBA’s proposals in the RTS represent an attempt to estimate required levels of write-downs for given capital levels. This approach is too prone to errors in estimating credit quality and we do not believe it is appropriate, especially when a detailed mechanism for determining the ultimate value of all relevant instruments will soon exist in the BRRD.

We therefore propose that instruments that qualify as own funds under the CRR or are relevant capital instruments under the BRRD should be able to be used for the purpose of variable remuneration, with institutions free to use those instruments that fit best with their capital structure and ongoing capital planning process.

Coupon cap

We do not believe that the cap on coupons, as proposed in the RTS, is appropriate. The proposal for an inflation-linked cap is problematic as market-issued instruments are not issued at a spread over inflation. Therefore, to link instruments to inflation may not adequately reflect market conditions for comparable instruments.

Further, a cap of 6% over inflation may not adequately allow for the credit position of an institution. Accordingly, either a bank will be able to issue instruments at market rates below the cap or otherwise a bank will unlikely issue instruments to employees at all. The proposed cap unduly favours (i) banks with a better credit standing and (ii) instruments more senior in the capital structure.

For this reason, banks should be required to have defensible market comparisons and be able to demonstrate based on existing traded capital instruments what the relevant prices and spreads are. A cap should only apply for instruments that cannot be shown to reflect market conditions.

If a cap is unavoidable, it would be more appropriate to base it on a credit index, adjusted for instrument- and issuer-specific creditworthiness. The calibration would need to distinguish between:

- AT1, Tier 2 and other instruments,
- ratings and spreads applicable to the issuer, and
- the currency in which capital instruments are issued to employees.

Application within groups

It is unlikely that there will be a broad market issuance of parent-company issued instruments that are tied to the credit quality of the EU institution, as proposed in the RTS for third-country firms. Thus, third-country firms wishing to use such instruments will need to create them specifically for the purposes of remuneration. Given the general desire to use instruments that have a broad issuance and a liquid secondary market that facilitates employee redemption, this limitation appears counter-productive. In large, globally interconnected institutions, particularly those with parent-company guarantees in place, the narrow application of the proposed regulations does not appear to fit with a more realistic view of how credit quality should be assessed or reflect how firms structure their capital.