Response from the Italian Banking Association
to the EBA consultation paper

Draft Guidelines

On the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU

18 January 2014

POSITION PAPER

2013

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Preliminary remarks

The Italian Banking Association (ABI) welcomes the opportunity to comment on the draft Guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU (henceforth, "the Directive").

As stated in the Directive, if implemented by the Member State, the discount rate can be applied to the variable remuneration of **staff whose professional activities have been identified as having a material impact on the institution's risk profile**, for the purpose of calculating the ratio between variable and fixed remuneration. The discount rate can only be applied to variable remuneration paid in instruments that are deferred for five or more years. There is no obligation for the institution to make use of it.

ABI agrees with EBA's basic choices on the factors relevant to the calculation of the discount rate, but there is some feeling that the guidelines do not provide the best means of incentivising long-term deferral structures due to a lack of practicality, and complexity. This is due to the discount depending heavily on external factors and the resulting volatility makes it difficult to explain and not reliable enough to be used in real life compensation strategies. As an alternative, the regulator could decide on a fixed discount table of at least 25% if certain criteria for deferral and retention periods and / or structures are met.

ABI believes that a higher discount factor will better enable employees to understand the true incentive value of deferred compensation subject to retention over a long period.

The Directive provides (article 94(1)(m)) that *a substantial portion, and in any event at least 40%, of the variable remuneration component is deferred over a period which* ***is not less than three to five years*** *and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question*. Therefore, even though the Directive states (art. 94(1)(g)(iii)) that the discount factor should be applied to the variable remuneration *provided it is paid in instruments that are deferred for a period of not less than five years*, in ABI's opinion it would seem appropriate, for a transitional period, to allow a deferral of three years to be considered enough for the application of the new provisions, in order to allow businesses to adapt their systems of remuneration.

In ABI's opinion, it would be expedient to simplify quantification of the parameters used to calculate the discount rate. In particular, in the context of institutions or banking groups that operate in multiple countries, it is necessary to allow the use of a unique discount factor. ABI suggests that the basic factors be determined with reference to the country of the parent company in the case of a group, or to the country where the company is headquartered in the case of a bank that operates in multiple countries.

This would simplify the administrative burden on companies and ensure equal treatment among entities belonging to the same banking group (therefore avoiding disputes with employees treated differently within the same institution/group).

Finally, we know the guidelines will apply for the purpose of calculating the ratio between the variable and fixed components of total remuneration awarded for performance and service from 2014 and onwards. However, the consultation period ends on 18 January 2014 and, in accordance with its mandate, EBA must publish the guidelines by 31 March 2014. As the banks will publish their remuneration policies for 2014 at the beginning of 2014, they will likely need to define them before the guidelines are finalized. Therefore, they should be allowed to use a discount rate for the variable component of 2014 remuneration that is determined on a best efforts basis, even if not perfectly compliant with the guidelines.

Response to the Consultation questions

Title II – Requirements regarding the discount rate for variable remuneration

1. Variable remuneration which can be discounted

5. Institutions can discount up to a maximum of 25%, or a lower percentage prescribed by national law, of total variable remuneration. Only variable remuneration which is deferred for at least five years and is paid in equity or debt-instruments or instruments linked to such instruments which are eligible for the purposes of variable remuneration in accordance with Article 94(1)(l) of Directive 2013/36/EU should be discounted. This includes parts of the deferred variable remuneration that vest during the deferral period. Variable remuneration cannot vest faster than on a pro-rata basis. Retention periods are taken into account within the calculation of the discount rate, as set out in section 2.4.

6. The amount of variable remuneration which can be discounted should be calculated on the basis of the total nominal amount of variable remuneration as set out in the EBA's Guidelines on Remuneration Policies and Practices.

Q1: Is the scope of variable remuneration which can be discounted sufficiently clear?

Yes, it is clear.

2. Elements included in the calculation of the discount rate

7. The discount rate should include the following four factors: inflation, interest rate for EU government bonds, an incentive factor linked to the use of long-term deferred instruments and an incentive factor linked to the use of additional retention periods as set out in the following paragraphs of this section. For paragraphs 8 to 10 the most recently available data should be used when remuneration is awarded.

8. For remuneration awarded in a Member State one of the following should apply:

a. if the remuneration is paid in the currency issued by the Member State where the staff member mainly works, the factor for inflation is the average annual rate of change for the HICP published by Eurostat for this Member State;

b. if the remuneration is paid in a currency issued by another Member State or a third country, institutions should use equivalent official statistical data available for *the country issuing the currency or should use the HICP rate applicable for the Member State in which the staff member mainly works.*

9. For remuneration awarded in a third country the following should apply:

a. if the remuneration is paid in a currency issued by a third country, institutions should use equivalent official statistical data available for the country issuing the currency or should use the HICP rate applicable for the EU parent institution;

b. if the remuneration is awarded in a currency issued by an EU Member State, institutions should use the HICP rate applicable for the EU parent institution.

Q2: Is the suggested factor to consider inflation appropriate?

Eurostat does not publish forecast values for inflation, so which value should be used as indicator for evaluations? From the examples included in the consultation paper, it would seem that reference should be made to the latest available value for inflation at the time when the variable remuneration is awarded, and then left unchanged over the five-year period. Is this the correct interpretation?

It would be expedient to simplify quantification of the parameters used to calculate the discount rate. In particular, in the context of institutions or groups that operate in multiple countries, it is necessary to allow the use of a unique factor in order to simplify the administrative burden on companies, and ensure equal treatment among workers within the same group/institution.

In ABI's opinion it would be appropriate to use the inflation rate of the country of the parent company in the case of a group, and the inflation rate of the country where the company is headquartered in the case of a bank that operates in multiple countries.

Alternatively, ABI proposes using an average European inflation rate, published by the EBA or Eurostat, in view of the joint supervision of equality and equal conditions.

10. The average interest rate for long-term EU government bonds is the average yield on a government bond with a residual maturity of around ten years, as published by Eurostat.

Q3: Is it appropriate to consider the rate for EU government bonds within the discount rate as a proxy for the opportunity costs of deferred remuneration and for inflation risk?

The text of the proposed guidelines is not clear about whether the rate to be considered is that relating to each State or the European average.

Should EBA mean the values for each State, we confirm our proposed simplification in terms of referring to the values of the country of the parent company, or the country where the company is headquartered.

11. The incentive factor for deferred variable remuneration paid in instruments deferred for five years is ten percent. The factor should increase by two percentage points for each additional full year of deferral.

Q4: Is the incentive factor for the use of long-term deferred variable remuneration appropriate?

ABI proposes using an objective measure represented by an average European inflation rate, published by the EBA or Eurostat.

For each year of deferral the measure could be twice the average European inflation rate.

Alternatively, ABI proposes increasing the incentive factor for the use of long-term deferred variable remuneration to 15%, it means 3% for each year of deferral.

The incentive factor for a retention period which follows a deferral period of at least five years is two percent for a retention period of at least two years. The factor should increase for each additional full year of retention by one percentage point.

Retention of vested instruments is an important element in the design of the long-term incentive structure of variable remuneration. Longer retention periods create an incentive for the employees for prudent behaviour even after the awarded remuneration has vested, and links the variable remuneration to the performance of the institution, which is influenced by decisions on risks taken in the past. By imposing longer retention periods, remuneration is better aligned with the long-term interest of the institution.

Q5: Is an additional incentive factor for the use of retention periods for long-term deferred instruments appropriate?

The consultation paper proposes an incentive factor for retention that is substantially lower than the incentive factor for deferral, and the exponent of the proposed discounting formula does not take the retention period into account (only the vesting period).

ABI proposes inclusion of the retention period in the discounting formula.

ABI also proposes using an incentive factor for each year of retention that is higher than the implicit annual incentive factor for the long-term deferral of variable remuneration, since it is additional to the deferral period.

In the consultation paper, application of the discount rate is limited to financial instruments that are deferred for at least five years.

Accordingly, when transitioning from variable remuneration paid in financial instruments deferred for 3 years to that paid in instruments deferred for 5 years, a discount factor is envisaged in order to encourage the use of instruments that are deferred for a longer period.

This discount factor is a function of the annual rate of inflation, the yield on long-term EU government bonds and an incentive factor for variable remuneration paid in instruments deferred for five years. This discount rate is believed to represent the benefit of transitioning from 3 to 5 years of deferral, i.e. the advantage deriving from an additional two years of deferral.

ABI believes that the benefit to employees of adding a retention period of one year must be at least equal to that recognized annually for increasing the number of years of deferral.

This means that for each year of retention, the annual incentive factor should be at least equal to the half the discount rate.

ABI further observes that this would represent an incentive for deferrals of longer than 5 five years consistent with that recognized for 5-year deferrals.

Example

1) Factor for inflation: 2.0%

2) Factor for EU government bonds: 3.0%

3) Incentive factor long term deferral: 10.0%

1)+2)+3) is 15.0%

Incentive factor for retention is 15.0%/2=7.5% for one year.

3. Calculation of the discount rate

13. Institutions should calculate the applicable discount rates for different parts of variable remuneration which are subject to different deferral, vesting and retention arrangements and apply the discount rates accordingly. Institutions should use the applicable deferral and retention periods documented within their remuneration policy.

14. The applicable discount rate equals one divided by the sum of one plus the four factors set out in section 2, raised to the power of the number of years of the vesting period, as shown in the formula below. The vesting period is the period after which the variable remuneration vests. For this purpose the vesting period *should be rounded to the lower full integral number. For pro-rata vesting, institutions may also use a present value formula as described in the Annex*

Q6: Is the calculation of the discount rate sufficiently clear?

The calculation of the discount rate is sufficiently clear.

4. Application of the discount rate

15. The discount rate should be applied to the variable remuneration of an individual staff member.

16. The discount rate should be applied to a maximum of 25% of the variable remuneration or a lower value prescribed by national law paid in instruments that are deferred for at least five years.

17. Institutions should calculate:

a. the sum of all components of variable remuneration which are awarded to an individual staff member;

b. the amount of (a) which is paid in instruments and deferred for a period of not less than five years; and

c. the amounts in (b) for which different discount rates apply.

18. In order to calculate the discounted variable remuneration the applicable discount rate should be applied by multiplying it with the respective part of variable remuneration.

19. For the purpose of calculating the ratio between the variable and the fixed component of remuneration, the total variable remuneration is the sum of all discounted amounts of variable remuneration and the non-discounted variable remuneration.

Q7: Is the application of the discount rate sufficiently clear?

In points 15 and 16 it would be appropriate to specify that the variable remuneration considered is that awarded to an individual staff member, as indicated in point 17.

5. Documentation and transparency

20. Institutions should document the calculation and use of the discount rate.

21. Institutions should keep a record of the fixed and variable components of remuneration awarded to a staff member, the parts of variable remuneration paid in instruments which are deferred for five years or more, the applied discount rate and the ratio between the variable and fixed component of total remuneration.

22. Institutions are required, in accordance with Article 16 of Regulation (EU) No 1093/2010/EU, to report, in a clear and detailed way, whether they comply with these guidelines. Institutions should provide information on the *discount rates together with the disclosures required regarding the remuneration policy under Article 96 of Directive 2013/36/EU and Article 450(1)(d) of Regulation (EU) No 575/2013. In particular, institutions should disclose the following on a country by country basis:*

a) the use of the discount rate;

b) the extent to which the discount rate is used (the maximum being its application to 25% of the total variable remuneration or a lower value depending on national law);

c) the number of identified staff to whom the discount rate applies; and

d) the average of the applied discount rate.

Q8: What additional costs would be triggered by the documentation and transparency requirements?

There are two kinds of cost related to the documentation and transparency requirements:

- one-off costs of implementing the recording and reporting mechanism;
- annual costs of recording and reporting.

Implementation costs include training the staff of the HR department, as well as creating the procedures and software needed for identification of the relevant data and documents and their storage.

Ongoing costs include preparing the required reports (compliance with the guidelines by the institution and disclosure, on a country by country basis, of actual application of the discount rate to variable remuneration). The costs of internal control and approval procedures should also be taken into account.

As mentioned, these costs could be significantly reduced by applying a unique discount factor at institution/group level.

Q9: Is the example 1 sufficiently clear and helpful to understand the application of the guidelines?

Example 1 is sufficiently clear and helpful to understand the application of the guidelines.

Q10: Is the example 2 sufficiently clear and helpful to understand the application of the guidelines?

Example 2 is sufficiently clear and helpful to understand the application of the guidelines.

Q11: Is the example 3 sufficiently clear and helpful to understand the application of the guidelines?

Example 3 is sufficiently clear and helpful to understand the application of the guidelines.

Q12: Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

Whilst we generally agree with the impact analysis of the proposals, there is some feeling that the guidelines do not provide the best means of incentivising long-term deferral structures due to a lack of practicality, and complexity. This is due to the discount depending heavily on external factors and the resulting volatility makes it difficult to explain and not reliable enough to be used in real life compensation strategies. As an alternative, the regulator could decide on a fixed discount table of at least 25% if certain criteria for deferral and retention periods and / or structures are met.