BANKING STAKEHOLDER GROUP

EBA CONSULTATION CP/2015/03 ON DRAFT GUIDELINES ON SOUND REMUNERATION POLICIES UNDER ARTICLE 74(3) AND 75(2) OF DIRECTIVE 2013/36/EU AND DISCLOSURES UNDER ARTICLE 450 OF REGULATION (EU) NO 575/2013

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, June 4th, 2015

General comments

The BSG welcomes this consultation on the EBA's Guidelines on sound remuneration practices. The events of the 2008 financial crisis and subsequent misconduct issues have demonstrated the negative impact of inappropriate incentive structures and remuneration policies. Given the importance of incentive structures, the BSG strongly supports the application of remuneration guidelines which promote sound and effective risk management and align the interests of senior management and material risk takers with shareholders and customers.

However, the BSG's view is that remuneration should not follow a "one-size-fits-all" approach and should take into consideration the size, structure and activities of an institution. We would give particular emphasis to the incentive structures and remuneration packages faced by bank staff involved with the sales process to retail customers. In our response we make the following recommendations:

- The guidelines should require remuneration policies to be aligned with the interests of customers and be aimed at preventing and mitigating all forms of conduct risk. Remuneration committees should be responsible for assessing whistleblowing arrangements and be provided with all information about any concerns raised.

- Shareholders should be provided with full and comprehensive details of all the metrics and measurements which will be used to determine the award of variable remuneration and the performance against those metrics when variable remuneration is awarded. "Independent" reviews of remuneration policies and practices should be published.

- The principle of proportionality should be applied including the ability for neutralisations in appropriate circumstances.

- Discretionary pension payments made as part of severance payments should be considered variable remuneration.

- Presiding over or failing to prevent unethical or non-compliant behaviour should result in a significant reduction of a staff member's variable remuneration. The requirements should also be clarified to make it clear that participating in unethical or non-compliant behaviour should result in the full removal and/or clawback of all variable remuneration.

- Retention requirements should not be negated simply because an employee leaves an institution.

- It is also important to stress that the EBA cannot interfere with pay agreed in collective agreements. This is pointed out in in CRD 4, Recital 69.[1] An explicit reference to this Recital should therefore be included in the Guidelines.

Replies to Questions

Q01. Are the definitions provided sufficiently clear; are additional definitions needed?

Yes, in general, the definitions provided are sufficiently clear. It might be helpful to clarify the definition of 'proportionate' regular pension contributions and whether this definition covers pension contributions which are a significant proportion of salary.

Q02. Are the guidelines in chapter 5 appropriate and sufficiently clear?

There is also the need for additions to the guidelines to reflect the need for remuneration policies to be aligned with the interests of customers and be aimed at preventing and mitigating all forms of conduct risk. The guidelines should be amended to require remuneration policies to:

- "take account of all risks, including **conduct and** reputational risks **such as** the risks relating to the mis-selling of products"
- "**take account of possible litigation and customer redress provisions and occasions where these crystallise should result in malus and/or clawback of variable remuneration**"

Q03. Are the guidelines regarding the shareholders' involvement in setting higher ratios for variable remuneration sufficiently clear?

The provisions regarding shareholders involvement are clear. However, to aid shareholders in making these decisions the guidelines should ensure that shareholders are provided with full and comprehensive details of all the metrics and measurements which will be used to determine the award of variable remuneration and the performance against those metrics when variable remuneration is awarded. However, even with these guidelines we do not have much confidence that shareholders will exercise appropriate oversight of variable remuneration. As was noted in the Financial Times "senior staff at leading asset managers also benefit from the same culture of pay excess as the executives they pass judgement upon. So it is questionable whether they can be relied upon to hold those executives to account in line with the expectations of shareholders, company employees and the general public".[2]

[1] CRD 4, Recital 69: "The provisions on remuneration should be without prejudice to the full exercise of fundamental rights guaranteed by Article 153(5) TFEU, general principles of national contract and labour law, Union and national law regarding shareholders' rights and involvement and the general responsibilities of the management bodies of the institution concerned, and the rights, where applicable, of the social partners to conclude and enforce collective agreements, in accordance with national law and customs."

[2] FT, "Executive pay has become dysfunctional", 1st June

Q04. Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?

Yes, the guidelines regarding remuneration policies and group context are clear, but they should be expanded in the following areas:

- Remuneration committees should ensure that the remuneration system takes into account all types of risk including conduct risk,
- The remuneration committee should also be responsible for assessing the effectiveness of whistleblowing arrangements regarding the possible negative impacts of inappropriate variable remuneration processes,
- The committee should also be provided with all whistleblowing notifications from members of staff highlighting any issues raised about variable remuneration,
- The "independent" review of remuneration policies should also examine these issues.

To aid shareholders in making decisions about variable remuneration the results of any "independent review" of remuneration policies, practice and processes should be published and provided to shareholders. This should include any recommendations made and the remedial action plan approved by the remuneration committee.

Q05. 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 important to stress that by far the greatest proportion of employees in the financial sector do not receive excessively large bonuses or other kinds of variable remuneration which gives rise to systemic issues. Also, it is not unusual that variable remuneration in a bank is used only for staff at or above the "identified staff" level.

As a basic principle, the possibility for collective bargaining should not be hampered by the inclusion of too vast a number of employees, including those in middle management functions which are not immediately concerned with risk taking. This is an issue of proportionality, especially in small or medium-sized institutions which do not have a significant market activity.
For example, in Belgium there has been a case of a minor financial institution where the guidelines on remuneration were interpreted so broadly that all professional and managerial staff were asked to sign an accord in which they agreed to a clawback procedure. This was in terms of an interpretation by the bank itself of the Belgian law which implements European legislation. After consultation with a trade union and through that trade union's research department who had contacted the National Competent Authorities (Ministry and Supervisor), the bank agreed to narrow down the application of those rules.

While the interpretation itself is too broad, both with respect to the scope of European and of Belgian legislation, it shows the need to provide a clear indication of scope.

There are also examples of very small financial institutions with one or a few employees that have to appoint risk and compliance officers and report detailed information on, for example, remuneration rules to the supervisory authorities. This is all together a huge administrative burden for very small financial institutions.

The new approach to the principle of proportionality is based on the assumption that the CRD IV does not provide for any explicit provision that allows the so-called neutralisation. In contrast to this, we understand that, inter alia, Recital 66 CRD IV allows for such neutralisation. In fact, the wording of this recital indicates that waiving certain remuneration principles in respect of certain institutions (based on the proportionality principle) would be allowed.

Similar to that, Art. 92(2) CRD IV states that "Competent authorities shall ensure that, […] institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities". Art. 94(1) CRD IV further holds that "the following principles shall apply in addition to, and under the same conditions as, those set out in Article 92(2)".

According to Art. 74(1) CRD IV, institutions shall have robust governance arrangements, which include, amongst other things, "remuneration policies and practices that are consistent with and promote sound and effective risk management". Art. 74(2) CRD IV specifies that the "arrangements, processes and mechanisms referred to in Art. 74(1) CRD IV shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities". In short, in our view, also Art 74 CRD IV clearly advocates a broad application of the proportionality principle in connection with the remuneration policies.

Also historical arguments mirror that the proportionality principle, and even neutralisations, go hand in hand with the EU's remuneration policies. In its CRD III proposal (COM(2009) 362 final, 13 July 2009), the European Commission itself held that "the proposal allows firms the flexibility to comply with the new obligation and high level principles in a way that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities. This approach is

likely to minimise the up-front and on-going compliance costs for firms, and was therefore preferred over an alternative of requiring a strict and uniform compliance by all firms, irrespective of their size, with the principles set out in Commission Recommendation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial services sector." In fact, CRD III already contained very similar provisions on proportionality to the ones in the currently applicable CRD IV: compare Recital 4 CRD III and Recital 66 IV as well as Art. 22 CRD III and Art. 74 CRD IV.

Furthermore, the European Parliament, in its Resolution on remuneration of directors of listed companies and remuneration policies in the financial services sector (7 July 2010) stated that "compensation systems should be proportionate to the size, internal organisation and complexity of financial institutions and should reflect the diversity between different financial sectors such as banking, insurance and fund management" (para. 11).

Finally, we would like to refer to the 2010 CEBS Guidelines on remuneration policies (paras. 19 et seqq.), which do not only speak generally about proportionality, but also about the possibility to neutralise certain requirements (para. 20).

Consequently, we believe that the principle of proportionality and the possibility to neutralise are rooted in the CRD IV text, applying to the chapter on remuneration policies.

Q06. Are the guidelines on the identification of staff appropriate and sufficiently clear?

It would be easier to understand the Guidelines if the RTS on identification criteria (Commission Delegated Regulation (EU) N° 604/2014) were clearly referenced in the text or attached in an annex to the Guidelines.

Q07. Are the guidelines regarding the capital base appropriate and sufficiently clear?

Yes, the guidelines regarding the capital base are appropriate and sufficiently clear.

Q08. Are the requirements regarding categories of remuneration appropriate and sufficiently clear?

Yes, the requirements regarding categories of remuneration are appropriate and sufficiently clear. However, the position of signing-on bonuses – especially where these are received to replace variable remuneration lost from leaving a previous role or institution - should be clarified.

Q09. Are the requirements regarding allowances appropriate and sufficiently clear?

Yes the requirements regarding allowances are appropriate and sufficiently clear.

Q10. Are the requirements on the retention bonus appropriate and sufficiently clear?

Yes the requirements on the retention bonus are appropriate and sufficiently clear.

Q11. Are the provisions regarding severance payments appropriate and sufficiently clear?

The Guidelines should make it clear that any discretionary enhancement to pension benefits which is awarded as part of a severance payment should be considered as variable remuneration and be subject to the bonus cap.

The list of situations which should be considered as a failure of individual staff should be expanded to include a situation where "The identified staff were responsible for management of an area of an institution and this area suffered a material failure of risk management which led to losses or reputational damage to the institution". The existing list would enable a member of senior management of an institution to receive a severance payment in a circumstance where they presided over significant misconduct but did not directly participate in it.

Q12. Are the provisions on personal hedging and circumvention appropriate and sufficiently clear?

Yes, the provisions on personal hedging and circumvention are appropriate and sufficiently clear.

Q13. Are the requirements on remuneration policies in section 15 appropriate and sufficiently clear?

The guidelines should also clarify that presiding over or failing to prevent unethical or non-compliant behaviour should result in a significant reduction of a staff member's variable remuneration. The requirements should also be clarified to make it clear that participating in unethical or non-compliant behaviour should result in the full removal and/or clawback of <u>all</u> variable remuneration. It has been reported that a trader who was found by an internal investigation to have manipulated LIBOR was allowed to keep his bonus to discourage him from discussing his conduct externally.[3]

Q14. Are the requirements on the risk alignment process appropriate and sufficiently clear?

The guidelines state that institutions should provide a "sufficient level of transparency" around risk alignment decisions. However, the guidelines do not state the purpose of this transparency and whether this transparency should just be for internal purposes or for supervisors and shareholders. Our preference would for the purposes of the transparency to be to provide sufficient information to shareholders.

[3] http://www.thetimes.co.uk/tto/news/uk/crime/article4458704.ece

Risk-sensitive performance should not incentivise excessive risk taking, the mis-selling of products or any other form of conduct risk. There is also the concern that as “operational risk” capital has proved to be inadequate, relying on returns on risk-adjusted capital might not properly take into account the operational risk of an institution or business line. Risk sensitive performance criteria should not be solely reliant on “adjusted” forms of “profit”, “return on capital” or “economic profit”. Banks can have a tendency to publish measures of “adjusted” profits which exclude numerous costs such as legacy business lines or misconduct costs and to award significant amounts of variable remuneration to staff based on these “adjusted” levels of profit.

The guidelines should make it clear that risk adjustments should be undertaken in circumstances where a staff member is responsible for a material failure of risk management and fails to prevent unethical or non-compliant behaviour.

There must be an element of judgment involved in the risk alignment process and it should be made clear that no matter what performance is on the ‘quantitative’ criteria, there could be a significant reduction in variable remuneration.

The guidelines should also make it clear that risk alignment should apply to every aspect of variable remuneration received during a specific time period. For example if a risk adjustment is applied to a staff member’s annual bonus then an equivalent risk adjustment should also be applied to any Long-Term Incentive Plan (LTIP) covering the same period.

Finally, the list of circumstances where institutions should make qualitative *ex-ante* risk adjustments should be expanded to include occasions where there have been costs of misconduct or customer redress within the institution or business line.

Q15. Are the provisions on deferral appropriate and sufficiently clear?

The guidelines should make it clear when pro-rata vesting is allowed or whether a five year deferral period means that staff have to wait for five years before receiving any of their variable remuneration.

Q16. 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.

We do not have any comments to make in response to this question.

Q17. Are the requirements regarding the retention policy appropriate and sufficiently clear?

The guidelines on the retention policy should make it clear that retention requirements or guidelines on the levels of shareholdings should not be removed or negated when an employee leaves an institution.

Q18. Are the requirements on the ex post risk adjustments appropriate and sufficiently clear?

Additions should be made to the criteria requiring *ex post* risk adjustment to include occasions where the lack of oversight from a member of staff contributed to the regulatory sanction. *Ex post* risk adjustment should also occur where there are significant provisions for litigation or customer redress within an institution or business unit.

Q19. Are the requirements in Title V sufficiently clear and appropriate?

Yes, the requirements in Title V are sufficiently clear and appropriate. It is very important that any exceptional government support of an institution results in significant malus and clawback of variable remuneration.

Q20. Are the requirements in Title VI appropriate and sufficiently clear?

We do not have any comments to make in response to this question.

Q21. Do institutions, considering the baseline scenario, agree with the impact assessment and its conclusions?

We do not have any comments to make in response to this question.

Q22. 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.

We do not have any comments to make in response to this question.

Submitted on behalf of the EBA Banking Stakeholder Group

David T. Llewellyn
Chairperson