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August 21, 2013

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Re: EBA/CP/2013/11, Draft Regulatory Standards, on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile under Article 90(2) of the proposed Capital Requirements Directive

To the European Banking Authority:

The Compensation Working Group of the Institute of International Finance (IIF) welcomes the opportunity to comment on the consultation paper on the draft regulatory technical standards (RTS) for the definition of material risk-takers for remuneration purposes. The IIF broadly supports the overall objectives of the proposed RTS, and it recognizes the importance of harmonizing criteria for identifying material risk-takers and establishing a level playing field across the European Union (EU).

Problematic Timing. Despite the important goal of harmonization, the timing of implementation of the RTS and related remuneration standards required by the Capital Requirements Directive (CRD IV) presents a number of challenges. The planned release for the standards is not until March 31, 2014, and yet firms will be required to apply these standards to compensation earned during the full 2014 calendar year. This will undoubtedly raise many complications for firms in contract negotiations with employees and for the development and application of their compensation policies at the start of the year. As it stands, there is a substantial risk that compensation arrangements, policies and agreements with employees may be subject to doubt, renegotiation, or legal conflicts between contractual commitments and the requirements of the new standards. Aside from such difficulties, there is the risk that the strongest employees may be given an incentive to go to firms not covered by CRD IV, if they are not confident in the arrangements that banks make with them.

An additional timing problem arises from the fact that many European firms will not have a chance to consult with their shareholders on adjusting the ratio applicable to variable pay until their annual general meetings, which in many instances are held in May. Not knowing, at the outset of the year, whether shareholders will approve a revision of the ratio will likely affect how management determines fixed pay.

Given these considerations, it would make sense to defer the mandatory application of the RTS, and the other remuneration standards required by CRD IV, until 2015 (i.e., to the start of a

complete compensation cycle for the majority of market participants) in order to allow time for management to consult appropriately with shareholders, plan policies, and make and communicate compensation decisions in an orderly way.

Adequately defining risk-takers. With respect to some of the more substantive parts of the proposal, the approach taken in the proposed RTS does not adequately meet the requirements for identifying *material* risk-takers in covered institutions. The likely effect of the RTS, instead, will be to capture an entire set of employees for whom the standards were never intended. The IIF is concerned, in particular, with: i) the use of pay levels as a proxy for risk-taking; ii) the broad scope of the RTS, as compared to the intentions of CRD IV; and iii) the effects that the RTS will have on the operations of European firms outside the EU and their ability to function competitively in other markets.

The quantitative criteria for determining material risk-takers in many cases could vastly expand the number and types of employees¹ to which the RTS would apply, without any consideration of the actual risks posed by those employees' activities.² The assumption on which the proposal is based is that pay levels somehow mirror risk-taking. However, as with many broad generalizations, this assumption simply does not hold in practice. Pay rates vary greatly across institutions and jurisdictions, based on differences in compensation practices, real exchange rates, and other factors, and do not provide meaningful insight into the risks created by employees. For example, two employees creating equal risk may receive different levels of compensation, depending on their home jurisdictions, their seniority, or the parts of the business in which they work; or alternatively, two employees receiving equal compensation could be very different in their capacity to affect an institution's risk profile.³ The potential mismatch between pay and risk-taking is especially evident in Articles 3(2)(a), (b), and (c) of the proposal.^{4,5} To the extent that compensation is determined to be indicative of some level of risk creation, it is recommended that Article 3(2) apply as an initial filter to determine affected staff but that additional screening be used, as well, to determine whether specific staff members initially captured are in fact material risk-takers.⁶

¹ See footnote 3, *infra*.

² Indeed, Paragraph 26 of the Impact Assessment indicates that the EUR 500,000 absolute pay threshold, in Article 3(2)(c), was based entirely on the anticipated number of staff members it would capture, without citing evidence that this pay level was commensurate with any particular level of potential risk-taking.

³ An example of this would be a commodities trader who is identified as a risk-taker by virtue of his risk-taking capabilities, who also happens to have the same total compensation as, say, a director of the Information Technology division.

⁴ These sections require that employees be designated material risk-takers if: (a) their variable remuneration exceeds EUR 75,000 or 75% of fixed pay; (b) their total gross remuneration is equal to or greater than the lowest remuneration of any other designated risk-taker; or (c) their total remuneration exceeds EUR 500,000. These apply to high-performing employees, irrespective of their risk creation, or to low-risk employees in divisions with relatively high compensation levels. Clause (b) is particularly problematic, as it establishes a floor above which all employees are determined to be risk-takers, regardless of the actual risks posed by their activities. In some of these cases, a junior employee with the potential only for minimal risk creation would be captured under the RTS. Only clause (d), which applies to the top 0.3% of staff on the basis of gross remuneration, seeks to apply the standards proportionately across banks and jurisdictions, but even this may capture substantial numbers of non-risk-takers.

⁵ Even the assumptions in Articles 3(2)(a) and (b), which potentially could be overcome to the extent an institution can "demonstrate that the staff member has in fact no material impact on the institution's risk profile" (as described in the executive summary), seems inappropriate and will add additional compliance burdens with little or no benefit.

⁶ There appears to be no reason to treat Articles 3(2)(c) and (d) differently than Articles 3(2)(a) and (b) in terms of the application of Article 4.

In addition, the scope of staff captured by the RTS extends beyond what is envisioned under CRD IV and does not conform to the intent of the political discussions that led to the agreement of that text. Article 90(2) of CRD IV specifies that the EBA develop technical standards that identify “categories of staff whose professional activities have a *material impact* on the institution’s risk profile” (emphasis added). Article 88(2) also limits the focus of the standards to staff that are senior management or whose professional activities have a *material impact* on an institution’s risk profile. It is clear that the standards were meant to be limited to employees whose activities have a “material impact” on the firm’s risk profile. The various quantitative thresholds provided for in the proposed RTS, however, do not adequately reflect this “material impact” test, and as noted above, there does not appear to be any necessary link between pay thresholds and material risk-taking. Greater emphasis should be placed on the “material impact” aspect that was stipulated for by CRD IV.⁷

From a competitive standpoint, the impact of the proposed RTS on European banks could be quite severe and will likely place them at a significant disadvantage relative to non-European Economic Area (EEA) banks in markets outside the EU. The proposal, in effect, will strain the ability of European banks to offer competitive compensation and retain key talent in non-EEA markets and to retain highly talented European employees who have either the geographic or industry mobility (e.g., auditors, risk managers, lawyers) to move to firms not covered by CRD IV. This will limit the capability of these banks to compete internationally, and the likely result will be that these banks will reduce their operations abroad. Given this, it is foreseeable that these banks will become more dependent solely on the strength of their domestic markets and, as a result, will ultimately become more brittle.

Again, the IIF supports the efforts of the EBA in attempting to establish a uniform set of standards for identifying material risk-takers for remuneration purposes. The timing of implementation, however, poses several issues that should be addressed. In addition, there is a concern that the approach used in the proposal does not adequately identify material risk-takers. Instead, it casts a wide net over a set of employees that likely poses no actual risk to their firm. The approach taken, of equating pay with risk-taking, ought to be reconsidered and revised before the RTS is implemented. Should you have any questions, please do not hesitate to contact Alec Oveis (aoveis@iif.com).

Sincerely,



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⁷ Extending the scope of Article 4 to all of Article 3(2), rather than limiting it to Articles 3(2)(a) and (b), would help alleviate the problems mentioned. However, this would still yield significant numbers of staff for initial review under Article 4, creating operational difficulties around conducting a meaningful review and imposing an administrative burden on banks and supervisors alike that could be eliminated by adjusting points (a) and (b) to better target *material* risk-takers.