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Committee of European Banking Supervisors (CP42@c-ebs.org)

Re: CEBS Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)

We appreciate the opportunity to comment on your Consultation Paper (CP) on remuneration policies and practices, from the perspective of our research on executive remuneration in Europe and on the international principles for sound compensation practices at financial institutions.

In our paper ***"Economics, Politics, and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks"*** (*ECGI Law Working Paper No. 169/2010*, available at: http://www.clfge.org/publications.html; forthcoming *Vanderbilt Law Review*, spring 2011) we analyse post-crisis compensation reforms and banks' compensation practices before and after the financial crisis, with the aim of assessing the need for regulating compensation in the financial sector. We advocate principle-based regulation, flexible enough to allow for innovation and diversity in executive pay structures while preventing excessive risk taking, and we reject a one-size-fits-all approach.

Our response to your CP mainly concerns the principle of proportionality, particularly your interpretation of the circumstances for neutralization of specific CRD requirements. Your document rightly emphasises the importance of proportionality in accordance with CRD III,[1] to be applied to governance, risk alignment and transparency of compensation. As stated in paragraph 19 of your CP, "the effect of the proportionality principle is that not all institutions have to give substance to the remuneration requirements in the same way and to the same extent. Proportionality operates in both ways: some institutions will need to apply more sophisticated policies or practices in fulfilling the requirements; other institutions can meet the requirements of the CRD in a simpler or less burdensome way." Additionally, you state in paragraph 20 that the application of proportionality may lead to complete neutralization of some requirements. Your guidelines require that institutions resorting to neutralization explain the rationale for the same.

[1] See in particular Recital (4) CRD III: "[…] The principles recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities. In particular, it may not be proportionate for investment firms referred to in Articles 20 (2) and (3) of Directive 2006/49/EC to comply with all of the principles. […]," and Annex V, Section 11, Directive 2006/48/EC, 23: "When establishing and applying the total remuneration policies, […] credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and complexity of their activities: […]."

Nonetheless, it is our impression that Annex 2 of your CP, which gives a breakdown of each CRD requirement and the corresponding clause for neutralization, constrains the flexibility of proportionality, by disabling neutralization for most of the requirements. In our view, if neutralization is disabled, institutions have no alternative to full compliance with the respective requirements. Therefore, it is unclear to what extent you would still allow institutions, under the principle of proportionality, to bypass certain requirements through explaining the reasons for non-compliance.

Furthermore, for some requirements for which neutralization is allowed, we respectfully suggest a wider application of the neutralization clause. Given that a global playing field in compensation practices is important, in our response we also consider for a comparison the corresponding international standards issued by the Financial Stability Board (FSB) and the US Federal Reserve guidelines on compensation.[2]

CRD requirement (paragraphs 121-130, CEBS) *A substantial portion, which is at least 50 % of any variable remuneration shall consist of an appropriate balance of:* i. *shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed credit institution, and* ii. *where appropriate, other instruments within the meaning of Article 66, paragraph 1a, point a), where applicable that adequately reflect the credit quality of the credit institution on an ongoing concern.* *These instruments are subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. Member States or their competent authorities may place restrictions on the types and designs of these instruments or ban certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in line with point (i) and the portion of the variable remuneration component not deferred*.

Your guidelines allow for neutralization only in the case of non-complex institutions not publicly-traded that do not have alternatives for equity-based variable remuneration. We would object that a similar scope for neutralization is too narrow and should be extended to all credit institutions, including complex and publicly traded ones. Setting a 50% obligatory minimum threshold for equity-based pay can raise problems for any type of bank. In our above cited paper, we argue that incentives derived from equity-based compensation depend on the individual executives' portfolio of securities of their respective institution. In support of this, we analyse several recent studies showing that, in the case of executives holding substantial equity stakes in their companies, stock-based compensation could aggravate the incentive alignment problems. Consequently, we respectfully suggest that the requirement for equity-based pay should allow for some flexibility in the proportion of instruments as part of total variable pay, taking into consideration managers' equity holdings in their firms. In addition, we suggest that the decision of the precise equity-based structure should be left to the board of the institution, which has specific knowledge of the managers' portfolio of their respective firm securities.

Although we do not fully agree with the FSB approach in setting a minimum threshold for the equity-based pay portion, we note that the FSB standards allow for more flexibility than your

[2] Financial Stability Forum, *Principles for Sound Compensation Practices* (April 2009), Financial Stability Board, *Principles for Sound Compensation Practices. Implementation Standards* (September 2009); Federal Reserve System, *Guidance on Sound Incentive Compensation Policies* (June 2010).

guidelines as to the minimum proportion of equity-based pay of executive variable remuneration, by suggesting this threshold rather than mandating it.[3]
FSB, Standard 8: "A substantial proportion, *such as more than 50%*, of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk."

US regulation also allows for more flexibility in the proportion of equity-based pay, referring to "*a significant portion* of the incentive compensation to be paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period."[4]

CRD requirement (paragraphs 114-120, CEBS)
A substantial portion, which is 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. Remuneration payable under deferral arrangements vests no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount is deferred. The length of the deferral period is established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

For this requirement your guidelines similarly allow for neutralization only in the case of non-complex institutions not publicly-traded that do not have alternatives for equity-based variable remuneration. As with the previous requirement, we would object that a similar scope for neutralization is too narrow and should be extended to all credit institutions, including complex and publicly traded ones. The strict requirements for deferment, such as the minimum percentage (40-60%) of variable remuneration and the minimum time of deferral (3-5 years) appear too rigid; we believe that this is an area which should be left to banks' boards to decide upon. We suggest that the proportion should be dependent on the sensitiveness of pay to risk outcomes, also taking into consideration circumstances for risks that may materialize within a shorter timeframe. In addition, the decision of the equity-based structure should be left to the board of the institution, which should have specific knowledge of the risk tolerance of the individual institution.

The FSB standards appear to allow for more flexibility in adapting the thresholds to each individual institution circumstances.[5]
FSB, Standard 6: "A substantial portion of variable compensation, *such as 40 to 60%*, should be payable under deferral arrangements over a period of years. These *proportions should increase significantly along with the level of seniority and/or responsibility*. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, *for instance above 60%*."
FSB, Standard 7: "The deferral period described above *should not be less than three years*, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis."

[3] *Ibidem*.
[4] *Ibidem*.
[5] *Ibidem*.

US regulation also leaves room for adjusting deferral policy to risk outcomes. [6]
"*The amounts paid are adjusted* for actual losses or other aspects of performance that are realized or become better known only during the deferral period. […] To be most effective, the deferral period should be *sufficiently long* to allow for the realization of a substantial portion of the risks from employee activities."

Further assessment regarding imposing thresholds for incentives

We take this opportunity to further emphasize some results of our recent research, which would further support the above suggestions for not enforcing a certain threshold for the amount of long-term incentives. Our analysis of forty large European banks finds that, before the crisis, banks already had a fairly balanced mix of short-term and long-term incentives; this result does not differentiate banks that received government support from the ones that did not. This leads to our suggestion that regulators – in addition to enforcing and strengthening prudential requirements for credit institutions – could follow a softer approach to compensation standards by limiting themselves to recommending institutions which structures would best curb excessive risk taking. Our suggestions are supported by the results of several recent empirical studies, which do not find evidence that credit institutions that had a better alignment of executives' interests with the shareholders' interests performed better during the crisis, or that short-term incentives led banks to undertake excessive risks.

Our recent research also finds that firms' compliance with regulation is higher with respect to core principles and lower with respect to specific standards. This trend reflects a more general resistance to detailed regulation of pay structures, which may be too rigid and hinder the efficient adjustment of compensation contracts. This could have negative effects on the EU financial sector. Enforcing certain thresholds for deferment of incentive pay or for the portion of equity-based pay would make it difficult for EU credit institutions to keep and attract managerial talent, particularly from countries that adopt a more flexible approach or from firms that are not subject to regulatory constraints (such as hedge funds and private equities). Imposing a formulaic approach to remuneration would set limits to the variable part, which may force institutions to set aside a higher proportion of their earnings for the annual fixed pay.

Conclusions

By definition, proportionality implies case-by-case implementation and no standardization, therefore its application calls for judgments from banks, when applying the rules and adapting them to their specific characteristics and risk, and from supervisors, when reviewing and assessing remuneration practices according to risk. We believe that, as long as banks are able to demonstrate that the methodologies they have developed to adjust variable remuneration to risk and performance are appropriate to their specific circumstances, the remuneration policies can be appropriately adopted and the proportionality principle can function properly. On the contrary, mandating pay structures would hamper the flexibility of compensation arrangements, which in fact need to be adjusted to individual firms (according to their circumstances) and managers (also in light of their personal portfolios of their banks' securities). Therefore, in our opinion, regulation of bankers' pay should be restricted in scope and flexible enough to allow for diversity and innovation.

[6] *Ibidem*.

Thank you for considering our comments. Please do not hesitate to contact us if we can be of further assistance.

Respectfully submitted,

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