Joint Response to European Commission Consultation on Capital Requirements Directive (CRD) and Remuneration

Introduction

The London Investment Banking Association (“LIBA”), the Securities Industry and Financial Markets Association (“SIFMA”), and the International Swaps and Derivatives Association (“ISDA”) are pleased to respond to the consultation on this working document.

We would like to highlight the following general principles supported by our associations on remuneration in the financial sector, as generally reflected in our previous responses to the EC and CEBS.

- The industry recognises that more can be done to ensure that remuneration incentives are better aligned with effective risk management.

- Remuneration incentives can best promote growth and stability if they:
  - are aligned with the interests of shareholders and the long-term profitability of the firm;
  - align individual risk-taking with the risk appetite of the firm;
  - to the extent possible, reflect the riskiness of the particular business line against which the remuneration is awarded and the time horizon over which profits will be realised.

- We believe that regulatory principles on remuneration policies will best facilitate those outcomes by remaining high-level and outcome-focused in a manner similar to the principles issued by the Financial Stability Board and endorsed by the G20. They should avoid undue prescription on matters where firms reasonably could adopt different approaches. Firms should be allowed flexibility as to how the principles are applied, provided they can demonstrate the appropriate application.

- While remuneration policies are a commercially differentiating factor for firms, the industry recognises the need for prudential oversight on the question of whether or not individual firms’ remuneration policies are consistent with good risk management given the firm’s business and overall risk tolerance.
• However, structures and practices are commercial issues determined by firms individually, in particular their remuneration committees, and, ultimately, by shareholders. Determinations should be executed with support from control functions (risk management, compliance and human resources) with sufficient independence to provide the management information necessary to manage remuneration risk.

• It is particularly important that increased regulatory oversight of remuneration structures does not remove legitimate commercial differentiation, inadvertently increase remuneration costs, or create the unintended effect of reducing the incentives on remuneration committees and shareholders to provide proper oversight of remuneration practices.

• The financial services industry operates in a global and highly competitive market. Many firms operating in Europe have global remuneration policies that are set outside of Europe. Without a co-ordinated international approach, reform will only have a limited effect. It will be difficult for individual countries to take forward regulatory changes that do not take account of regulatory progress on remuneration at the international level.

• Equally, it will be important to ensure consistent implementation by Member States of any EU-wide initiatives. On this, we would further note that significant costs will be incurred in the process of implementing new remuneration policies, particularly where new compensation structures are required, and will need to be implemented in every Member State in which a firm has a presence. For each Member State, significant due diligence on local legal and tax implications will be required, adding further to the overall costs to the firm.

General

Our initial view from a regulatory capital perspective is that we agree with a Pillar 2 based approach. Such an approach requires a firm to assess whether additional capital is required and will stimulate dialogue between the firm and its supervisor.

Third country groups may have globally consistent remuneration policies and procedures that are applied to entities across the group, including entities that are regulated inside the EU. An EU-specified Pillar 2 approach should therefore be sufficiently flexible to allow firms to leverage internal capital assessments carried out at the highest consolidated level in the group. The principles set out in Annex V should accommodate remuneration policies and procedures developed globally in line with supervisory guidelines in other third country jurisdictions.

Particular Concerns:

1. In recital point 4, the Commission proposes: "In reviewing remuneration policies and practices and assessing their potential impact on risk management...".

   We suggest this phrase should be refocused on the implementation of the changes to the Capital Requirements Directive (CRD) and away from an enforcement stage review of remuneration policies.

   We suggest that the point be redrafted to read: "In determining their approach to implementing the CRD provisions on risks arising in connection with remuneration policies, competent authorities should have due regard...".

2. In recital point 5, the Commission proposes that "competent authorities should also be able to impose financial or non-financial penalties..."

   We suggest that the point be redrafted to read "competent authorities should also be able to impose capital requirements...". The proposals relate to the Capital Requirements Directive and should be focused on capital requirements, not other means of constraining risk.
We are also unclear as to the meaning of "non-financial" penalties and whether "financial penalties" refers directly to capital requirements, both of which points are addressed by the redraft above.

We would also make the following points on the setting of remuneration principles as set out in Annex V, point 16:

1. Sub-bullet 1: We agree with this principle.

2. Sub-bullet 2: We agree with this principle on the proviso that the Commission and regulatory bodies of Member States recognize that the (global) management body of an institution with a non-EU based parent company may be based outside of the EU.

3. Sub-bullet 3: We agree with this principle. It is also important to acknowledge that the remuneration of these individuals will also need to be set in the context of the overall labour market for these groups of individuals, and we suggest that this Principle be set in this context. In addition, it will be important to avoid unintended consequences. Risk and compliance functions should have sufficient independent oversight of the teams they supervise; however, not to the detriment of sufficient involvement to ensure a consideration of risk and compliance is built into the way the business is done. Otherwise these functions may become purely the way problems are identified rather than preventing them from occurring in the first place.

4. Sub-bullet 4: We support the spirit behind this principle but suggest it should cover bonus pools only – i.e., the reference to “bonuses” should be removed: in practice, the meaningful focus for risk adjusted flexible remuneration will be on bonus pools rather than individual bonuses as taking risk measures such as cost of capital and liquidity risk into account on an individual basis is impossible. Further, we suggest the principle be redrafted to allow for judgement on the level of granularity of the calculation. A non-formulaic approach may be more suitable for some institutions. In practice, it is unrealistic and immaterial in terms of risk management for the bonuses of most individuals to be calculated using risk-adjusted measures at an individual level and there is a risk that undue firm and supervisor time could be taken up with this exercise. Instead, firms should be expected to determine a relevant and practical level of input to a bonus pool calculation for reasonably sized groups of individuals that support specific products (i.e., where a cost of capital calculation is feasible). Accordingly, we suggest the principle be redrafted as follows:

“The measurement of performance used to calculate bonus pools includes an appropriate adjustment for current and future risks, as determined by the credit institutions, and takes into account the cost of the capital employed and the liquidity required as appropriate.”

5. Sub-bullet 5: We generally support the principle that there should be an appropriate balance between fixed and flexible remuneration as a contribution to managing remuneration risk. However, if firms are properly aligning bonus pools with the risk of the underlying business, then regulators do not need to take a view on the fixed / flexible balance. Ideally, firms should determine their own approach to this matter with due regard to an appropriate balance across senior employees and market pay, with supervisors taking a particular view only in the event that a firm is not delivering good risk management in remuneration more generally. Accordingly, we suggest the principle be redrafted as follows:

“Fixed and variable components of remuneration should be appropriately balanced so that the fixed component represents an appropriate proportion of the individual's total remuneration, as determined by the credit institution, to allow a fully flexible bonus policy, with the ability to pay no bonus if appropriate.”

We would further note in this context that losses either in the firm as a whole or in a particular business unit do not necessarily dictate a nil bonus. There may be very legitimate reasons to award individuals or groups of individuals bonuses in such circumstances as performance on non-financial
measures or skills deployed that contained the loss or a new growing business where profitability is not expected in the first few years.

6. Sub-bullet 6: The Commission should allow firms discretion on the proportion of the bonus to be deferred together with the form, length of deferral and applicability as long as firms can demonstrate that appropriate risks are managed. The Commission should provide that firms should set (and be able to explain) criteria for deferral rates and periods, thus allowing firms to choose graduated deferral rates where appropriate (e.g., by setting higher deferral rates for senior or more highly paid employees as they are more likely to be taking risk decisions than junior, less well-paid employees). It is well accepted that there are diminishing returns from long vesting periods (of, say, more than three years) and employees are likely to discount to close to zero such deferred long-term payments, thus reducing the incentive to manage risk appropriately. Accordingly, we suggest the principle be redrafted as follows:

“Payment of part of a significant bonus, irrespective of the form in which it is to be paid, is deferred for a period which is appropriate for the nature of the business in which the individual is engaged and its risks.”

7. Sub-bullet 7: We are generally supportive of this principle; however, firms should be allowed sufficient flexibility in their approach to linking the deferred part of any bonus to future performance. Guidelines should not be prescriptive to allow firms to take account of the significant legal and tax issues around deferral (and particularly forfeiture arrangements) across different jurisdictions. Accordingly, we suggest the principle be redrafted as follows:

“Payment of the deferred part is linked to the future performance of the firm, as determined by the firm, and, to the extent practicable, to the performance of the division or business unit of the individual.”

8. Sub-bullet 8: We agree with this principle.

9. Sub-bullet 9: We agree with this principle.

We remain at your disposal should you have any questions or require clarification on any of the points raised in our response. We look forward to maintaining a dialogue with you on this important topic and thank you for your consideration.

Kind regards,

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cc: Claire Bury – European Commission  
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