ABI Position Paper on the Basel Committee consultation paper “Range of Methodologies for Risk and Performance Alignment of Remuneration”

December 2010

POSITION PAPER

Introduction to the ABI Position Paper

ABI welcomes the Basel Committee's contribution to the development of sound practices for risk-adjusted remuneration at a technical level.

ABI supports the approach which aims to enhance institutions understanding of different methodologies without setting prescriptive guidelines, allowing banks to develop practices most appropriate for their own risk profiles and business characteristics.

ABI would strongly recommend that any further regulatory evolution of the Basel Committee's document not establish a more prescriptive approach which would be detrimental to the firm's approach to sound risk and remuneration practices and may produce distortive systemic effects.

However we would like to express a number of general considerations regarding the implications that different degrees of alignment with such methodologies by the countries concerned and/or their different levels of adoption by the banks in a given national system might have.

Also taking into account the very recent CEBS publication of the final version of the "Guidelines on Remuneration Policies and Practices" (confirming a rather restrictive interpretation of CRD III), with which European banks are expected to align from 2011, we hope that the same firm approach, as with the metrics indicated in the Basel paper, is imposed upon all banks and finance sectors, both EEA and non-EEA. This to avoid a competitive gap between international players (in effect, it seems that the final version of the CEBS paper does not completely clear the field of potential implementing differences even within the EEA).

In addition we would like to draw attention to the following aspects:

Flexibility

ABI hopes that the regulators at all levels assess these risks and guarantee a "flexible" approach to prevent distortion and competitive advantages in a global field already sufficiently aggressive.

The external guidelines should not be prescriptive and should leave the institution the flexibility to decide on the specific parameters/metrics to be used to design incentive systems so to link performance measures with the firm's objectives. Distortion, rigidity and complexity should be avoided as unintended side effects. Especially for international Group, it is important to have the flexibility to address the topic at Group wide level, while any prescriptive hint from any Regulator could jeopardize the Group overall approach.

Time to Implementation

It must also be noted that though institutions may agree with the concept , philosophy and spirit of the guidelines. However practical impediments may delay full implementation in the immediate term. These may be linked to the

granularity and frequency of data collected (i.e. collection at Branch, Transaction level) as well as the ability and flexibility of backbone systems to cut data in the form required. Where possible Institutions should be given the time and the opportunity to identify a roadmap to develop the resources required to obtain and analyse data required.

In any case, regulations should not act retroactively, that is they should not be applied to items (i.e. bonus) accrued in years during which the standards established in the document had not been set yet.

Executive summary

D. Identified issues affecting the effectiveness of risk alignment methodologies

Risk and performance measurement - Point 34 - page 6

Relative external measures: We note that reference to relative external measures is primarily to market measures (e.g. share price) and would clarify that external metrics may also be used as an approach to measure operational performance and sustainable value creation via benchmarking and ranking versus market peers on a broad range of financial and non financial measure. We suggest takes into consideration that "market" indicators are not the only parameters used in evaluating relative performance, since comments on strengths and weaknesses are currently misleading.

Adjusting remuneration for risks

Point 35 – page 7

"Risks taken need to be estimated (ex ante) or risk outcomes observed (ex post).'

With a view to matching the spirit of the regulatory guidance, it is believed that the assessment of the extent of the risk should be conducted both ex-ante, e.g. by introducing return on risk-adjusted capital (RORAC) objectives, and ex-post, in a certain deferral period assessing unexpected risk outcomes, e.g. on new business and/or products and/or scenarios.

Point 38 – page 8

"Deferral is more effective when deferred remuneration can only be adjusted downward."

It is considered that the review of risk measures taken ex-post during the deferral period, e.g. as a consequence of "distortion" or discrepancies discovered in the assessment methodologies used or emerging as unexpected market conditions or portfolio structural characteristics arose (both upward and downward adjustments), are difficult to implement in terms of producing effects on bonus calculations, particularly given the current regulatory restrictions (labour and tax laws). We feel a stricter, more prudential approach to risk assessment would be better, with ex-post adjustment options limited to exceptional cases.

1. General issues

1.2. Conditions for effective risk alignment methodologies

Integrating the remuneration process in risk management - Point 55 – page 11

"This would notably ensure that internal control units, particularly independent risk management units, could play a key role to validate and/or verify the measures used and the remuneration process."

The role assigned to the risk management unit seems to be an alternative to the validation stage of risk-based metrics applied to remuneration processes, or at a later verification stage, at the time of their application.

Regarding the standard institutional role given to risk management units in (i) defining, (ii) validating, (iii) implementing and applying risk assessment methodologies, we ask whether action by such units in all three of the stages indicated can be consistent with the spirit of the regulations, coordinated and shared with units involved in incentive system definition and management and in goal planning.

1.4.2. Employees

The paragraph 1.4.2. (65) of the consultation paper identifies members of the staff whose professional activities have a material impact on the bank's risk profile. ABI supports this approach. However, the following paragraphs (66-68) include the possibility of expansion to other staff where appropriate.

This takes the Basel Committee's sensible approach to identifying risk-taking staff to absurd lengths. The FSB envisages that institutions should apply a special remuneration policy to a comparatively small group of staff. By broadening the interpretation of "*the staff whose professional activities have a material impact on the bank's risk profile*", this special focus is lost; beside it could lead to a definition that is likely to cover all employees at most banks. This not only flies in the face of the original intention of the FSB and the CRD but would in addition place a significant administrative burden on banks for no justifiable reason.

As for the staff involved, ABI believes that principles could be considered at EU and International level to address possible weaknesses in remuneration practices but considers that those principles should remain high-level and should be restricted to managerial functions, risk and financial control personnel and material risk-takers. As high-level principles in this area are targeted to adequately address risks for the financial institution, only those functions and categories of leading managerial personnel whose decisions

could potentially lead to expose the financial institutions to financial risks linked to the performances of market instruments, should be taken into account.

ABI therefore holds the opinion that not all employees and activities within a financial institution should be addressed by these principles which should not interfere with national collective agreements.

1.5. Proportionality in the application of the rules

Though referring to the principle of proportionality (§ 69-83) and differentiating the main drivers for applying the related content, in outlining the characteristics of remuneration schemes identifiable from business practices and the possible inefficiency of methods used to create incentives in line with risk-assumption prudence, the paper gives examples that can be applied in general cases, and only by medium-large banks.

For example, with particular reference to the deferral and ex-post adjustment formats, it is felt that these involve application profiles sufficiently complex to render them inappropriate for use in cost-benefit terms by smaller intermediaries.

1.5.2. Proportionality between institutions

Size and complexity of the institution

The inapplicability of remuneration formats involving a mix of cash and shares or share-linked instruments for cooperative banks should be made more explicit (§ 78), and in doing so also introduce a specific reference to the inapplicability of “implicit” forms of ex-post adjustment.

2. Inputs for the determination of remuneration

2.1. Performance measurement

2.1.1. Types of performance measures

Absolute and relative measures **-** Point 93 - page 20

"Relative benchmarks may lead to positive outcomes also because relative improvement is significant, even if performance measures remain in the bottom range. In this case the effort to progress is recognized and assessed together with relative positioning."

The link with relative performance measures and procyclical behaviours is not clear.

Internal and external measures - Point 94 - page 20

In some situations market measures can be distorted: should a firm be badly managed, so as to become an easy take-over target, its price could move up even though its profitability is collapsing.

In spite of their shortcomings, in the long run, market measures tend to reflect the true value of the business: the more appropriate use would be for long time incentives.

2.2. Incorporating risks in the remuneration process

2.2.1. Completeness of risk capture

Measure of inherent vs actual risks - Point 101 – page 22

"In considering risk, it is important to utilise measures of inherent, rather than residual risk, where inherent is meant to indicate the magnitude of risk prior to the application of corporate controls, …".

Regarding the application of risk-adjusted metrics to Operations top managers (Organisation and IT Systems), the use of operational value-at-risk (OpVaR) measures that also include the impact of mitigation linked to control system and insurance cover access investments is crucial, as such measures in effect qualify as risk mitigation elements, functional and useful to achieving objectives in line with the bank's risk appetite.

2.2.4. Balance between ex ante and ex post adjustments

Points 112, 113 and 114 – page 24

“Deferral practice & risk adjustments”

The capacity of IT systems used in “monitored” risk management processes, in particular for multi-year periods with cumulative risk results and in attributing such results directly to specific managers, clashes with the dynamics that characterise financial exposure and credit portfolios in terms of both new exposures and changes to existing exposure management policies, changes which in the long term could have affected different persons in a scenario of successive risk takers.

This context makes fair allocation ex-post to specific persons extremely difficult.

We therefore feel that it would be more practical to apply surcharges from the outset and in ex-ante quantitative adjustments that also take into consideration extreme and/or prudential stress elements (as also referred to in Case 3, paragraph 3.2.3 ‘Specific quantitative risk adjustments’). In this way it would also be possible to ‘limit’ the deferral period to a multi-year but not excessively long period that might ‘violate’ the spirit on which the incentive systems are based (specifically, the certainty of receiving the bonus, fair timing of the payment and the positive effect of the incentive in terms of forward-looking good behaviour).

3. Ex ante risk adjustments

3.1. General comments

Points 139 and 140 – page 29

“… most likely there will be a need for the firm to rely on informed judgments to estimate risks and risk outcomes.”

“Discretionary adjustments by the board sit as an overarching adjustment tool.”

We feel that to ensure that risk assessment models are recognised and accepted by the risk takers, room for qualitative assessments (informed opinions) and discretional assessments (corporate body adjustments) are to be specifically defined with clear, demarcated boundaries, preferably tracing back to assessments in a general or specific context but which are objective and suitably formalised.

3.2. Quantitative risk adjustments

3.2.1. Funds transfer pricing adjustments

The ex-ante risk alignment methodologies that focus in particular on the definition/calibration of fund transfer prices between treasuries and other business units, targeting correct assessment of collective and individual performance through the allocation of interest rate risk and especially liquidity and credit risk, do not appear to apply to banks as a whole, particularly small banks (§ 142-144).

3.2.2. Valuation Adjustments

Point 145 – page 31

"Some firms adjust the valuation of individual positions or cohorts of positions for characteristics that …"

It is felt that the adjustments considered in financial instrument portfolio assessment have to be consistent with the fair value policy applied at accounting stage, to avoid the introduction of "parallel" metrics that are difficult to reconciliate.

3.2.3. Specific quantitative risk adjustments

The contents referring to quantitative risk adjustments (§ 146-151) – and related examples – often mention a risk management methodology framework centred on measures/indicators for which the level of confidence expressed by smaller banks is often such as to advise against immediate use in their remuneration and incentive systems.

Point 147 – page 32

"The cost of capital of a given unit is estimated as the product of (a) the participation percentage of the unit on the overall economic capital; (b) the regulatory capital allocated to the unit; (c) the cost of capital of the firm"

ABI believes that the second factor in the formula indicated in the example has to envisage the total regulatory capital rather than the regulatory capital allocated to the individual management unit. In this case, however, the formula would be used to identify/quantify the regulatory component applying to the specific unit based on the % weighting of the related economic absorption on total absorption. The end purpose of this approach appears to be unclear, as the regulatory capital of that unit, the capital on which the cost would then be measured and paid, could be more easily defined by a bottom up approach (regulatory capital can in fact be

measurable/measured at individual position level and then aggregated to obtain the target/desired management level, or in the case in question to the business unit considered).

3.3.1 Specific qualitative risk adjustments

Point 154 – page 33

"A common good practice …. is through the use of balanced scorecards that explicitly include risk and control considerations such as … internal control breakdowns"

It is believed that the inclusion of qualitative risk adjustments represented by penalties resulting from internal control unit verifications (e.g. audit reports) cannot qualify as automatic action on bonus systems in that, in some/many cases, the results reported by such units could refer to shortcomings that cannot be managed (or only partly managed) directly by the risk takers (in particular, budget restrictions dedicated to such areas and overall internal trade-off assessments, that inhibit the availability of such leverage and mean their use by risk takers is not fully efficient and time to market).