Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Chris Barnard
Germany

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Your Ref: Comment letter on Consultative Document
- Range of Methodologies for Risk and Performance Alignment of Remuneration

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on Range of Methodologies for Risk and Performance Alignment of Remuneration. I will first make some general comments, and then discuss some more detailed points.

Transparency, communication and governance

It is absolutely necessary that institutions have in place clear and transparent remuneration policies. These should be communicated and disclosed to all stakeholders, including investors and shareholders, regulators and internally within the institutions. It is also necessary to have strong, independent governance structures in place, including the establishment of a remuneration committee, and processes to ensure that the institutions' remuneration policies are appropriate and that they are being complied with.

Risk and performance adjustments

It is clearly appropriate that variable remuneration should take account of the risks being taken on by employees, and the risk-adjusted performance thereon. If employees meet performance targets by taking on excessive risk, then this potentially endangers the solvency of institutions, and effectively rewards luck, which is unacceptable. I would suggest that risk adjustments to variable remuneration should be based on a genuine economic risk-based capital model. Please note this last point. Any risk adjustments made will only be effective and appropriate if based on a market-consistent risk-based model which covers the term of the risks taken on. An example of an inappropriate model would be to base risk adjustments solely on arbitrary

judgements, for example credit ratings published by a rating agency. An example of a good model would be the Solvency II model which is expected to come into force for EU domiciled insurance companies in 2013.[1]

As a principle, all variable remuneration should be based on achieved performance in some way. Guaranteed variable remuneration is a contradiction in terms, and should be prohibited.

Proportionality and link to performance

There should be a clear link between the variables used to measure risk, determine risk adjustments and performance, and the seniority of and influence that employees have on said risk and performance. Ideally, all variable remuneration should relate to areas within the control and responsibility of employees.

Deferral of variable remuneration

Variable remuneration should be paid out in instalments over a minimum period of 1-5 years after award, depending on the term of the risks taken on. The important remuneration principle to uphold here is that employees receive a salary for doing their job, and should only receive bonuses for risk-adjusted outperformance, and one can only reasonably measure risk-adjusted outperformance over a period that is consonant with the run-off of the risks taken on. It is also important that employees who have outperformed should actually receive their bonuses, i.e. that their bonuses should represent accrued earnings, and any deferral of payment is exactly that – just deferment. This would mitigate the need for such things as "golden handshake" and "golden parachute" payments, which should be prohibited in my opinion. Similarly, severance pay should be limited to redundancy and payment for the duration of a notice period.

More comments on the consultative document

Para 37. Agreed. It is difficult to capture bad-tail risks and long-term risks within a remuneration model. Any ex ante risk adjustment should employ a prospective model which captures the full run-off of risks, and appropriate stresses and shock scenarios to quantify potential bad risk outcomes.

Para 38. 2nd bullet point: long term incentives which have been earned in accordance with the accrual and vesting concepts used should be paid regardless of whether the employee is still in the institution or not. This would mitigate the need for "golden handshakes" elsewhere.
4th bullet point: I am not sure that a one-sided risk adjustment is fair, although I accept it might be more practicable. Employees who outperform by taking on less risk than expected may have less incentive to control their risk taking in the future.

Paras 46 and 47. I agree that the recent financial crisis has highlighted the need to control excessive risk-taking, however one of the main problems was that the risk capital

[1] For example please see the latest QIS 5 technical specifications, EC, 5 July 2010.

methodologies used and the measurements therein were so poor. I would strongly recommend to couple remuneration and incentive principles with introducing a more complete and market-based risk-based capital methodology and supervision of institutions. As a minimum, institutions should be able to recognise that they are actually taking on excessive risk in the first place.

Para 52. Agreed. Institutions should establish Remuneration Committees as best practice in this arena.

Para 77. Agreed. Size and complexity could be linked to measures of systemic risk, such as whether an institution is "too big to fail", or "too interconnected to fail".[2]

Para 82. Accepted. However, in general I would suggest that regulators keep an eye on the level of risk-taking in institutions, or perhaps define principles and guidelines on what is meant by "excessive" risk-taking.

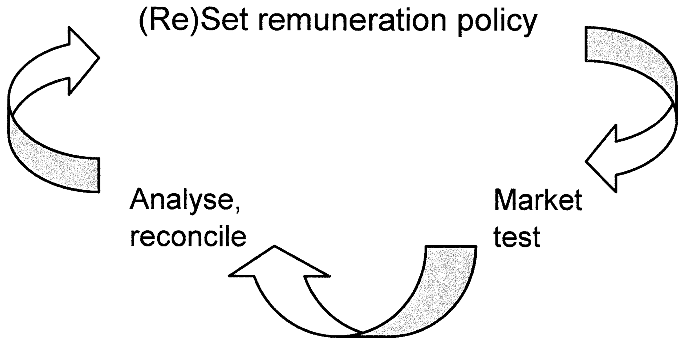
Para 90. Agreed. Discretionary adjustments should not be arbitrary. They should always be reasonable and rational.

Para 112. Again, I agree with your commentary on bad-tail risks. These should be quantified by considering potential worse case scenarios, stresses and shocks, and I agree that deferral would better capture the true cost of such risks.

Para 120. This is a big problem with current market practice. The issue is: if everyone follows the market, who sets the market? Attempts to match the pay levels of competitors inevitably lead to highly escalating remuneration packages.

Para 157: Institutions should be able to reconcile how final outcomes compare to initially expected outcomes by means of a movement analysis. For example: initially expected outcomes, plus or minus any changes in remuneration policy, plus or minus any experience adjustments, plus or minus any variances due to ad hoc or discretionary features should equal final outcomes.

Institutions should also monitor and control the expectations and outcomes of their remuneration policy by using a control cycle technique as follows:



[2] The FSB also identifies systemic risk by three criteria: size, interconnectedness and substitutability.

Para 171. As I have already commented, employees should receive their "earned" deferred or unvested remuneration at the end of the vesting period, regardless of whether they are still employees at that date, if they have earned the remuneration originally as employees of the institutions in question. Deferred remuneration should be exactly that – deferred. This would mitigate the need for such things as "golden handshakes".

Yours faithfully

C.R. Barnard

Chris Barnard