INSTITUTE OF INTERNATIONAL FINANCE

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IIF Views on Basel Committee consultative document *Pillar 3 disclosure requirements for remuneration*

The Institute of International Finance welcomes the opportunity to comment on the Basel Committee's consultative document *Pillar 3 disclosure requirements for remuneration*. In the aftermath of the recent global financial crisis there has been a significant increase in the scrutiny applied to how financial firms compensate their employees, and appropriately so. In the past three years, there has also been significant international progress on compensation reform, by regulators as well as by the financial services industry. A global regulatory framework for compensation reform was set out in the FSB *Principles for Sound Compensation Practices*, later elaborated in the September 2009 *FSB Implementation Standards*. The Institute was among the forerunners in these efforts, issuing its Principles on Compensation in the report by the Committee on Market Best Practices in July 2008. In 2009 and 2010, the Institute also conducted surveys of industry practices and published reports on the progress being made by global wholesale banks in reforming their compensation practices in line with global principles and standards through, inter alia, proper alignment with risk, deferrals and clawbacks.[1]

The Institute's response to the Basel Committee's new standards on compensation disclosure is part of an overall effort to foster improvement of industry practices consistently with the FSB Standards. The Institute fully supports the objective behind the Pillar 3 requirements to ensure that compensation practices are appropriately aligned with sound risk management. In this regard, the Board of Directors of the Institute recently called for the disclosure of clear and comprehensive information on compensation policy in its November 2010 *Statement on Compensation Reform in the Financial Services Industry*.

Insofar as the Pillar 3 requirements build on the existing FSB principles by providing shareholders and the markets with clear and useful information on compensation in a globally consistent manner, and serve the Pillar 3 objective of facilitating market discipline, the Institute supports the Basel Committee's efforts. However, the extent to which the Basel guidelines increase the scope and level of detail of the information subject to public disclosure may not be useful or may create issues around the risk of misinterpretation especially by the markets.

Given the fact that national jurisdictions are currently taking different approaches to remuneration disclosure, at least in terms of coverage and level of detail, it is a challenge for firms to converge on a globally acceptable standard. This comment letter is a synthesis of the views held by the Institute's members and does not necessarily reflect the detailed critiques that many firms may have on the consultative document.

1 IIF & Oliver Wyman. *Compensation in Financial Services: Industry Progress and the Agenda for Change*, March 2009 & *Compensation Reform in Wholesale Banking 2010*, September 2010

General Issues

The Institute endorses most of the "Qualitative" aspects of the disclosures, as well as many of the "Quantitative" disclosures, though remains to be convinced that a productive disclosure framework needs necessarily the detail that the Basel Committee proposes. A key issue that stands out in our view is that the costs and benefits of the quantitative disclosure requirements need to be carefully calibrated and possibly reconsidered. Harmonization around the format and content of disclosures is desirable in order to encourage common transparency and disclosure standards, but overly prescriptive requirements demanding finely-detailed disclosure across a wide range of different firms would not enhance transparency and may actually be counter-productive. In this way some of the proposed detail requirements seem to go beyond the capital-related purposes of Pillar 3.

Over-Disclosure. There is a real danger that certain specific requirements (see below) in the new guidelines may be subject to different interpretations, thus possibly creating confusion as opposed to increasing transparency. It is important to avoid additional quantitative disclosures that are of questionable usefulness, or whose relevance to sound governance and to the purposes of Pillar 3 is not clearly articulated. In particular, the requirement to disclose at levels beyond aggregate information and senior management will create a mass of quantitative information of questionable usefulness to shareholders and the market and that may also raise privacy concerns.

Disclosure to Public v. Disclosure to Supervisors. The Institute believes that the Basel Committee needs to reconsider carefully the allocation of disclosure items to Pillar 3 or to Pillar 2 supervision, especially where disclosure to regulators rather than disclosure to the public is likely to be more effective in discouraging excessive risk-taking. In this regard, it should consider allocating some of the more detailed disclosure requirements to supervisors under Pillar 2.

Application for Banking Groups: Although mention is made on the disclosure of all information on a single site, the consultative document does not specify whether Banking Groups can disclose remuneration on a consolidated basis. While the CRD Pillar 3 remuneration disclosure rules under EU legislation make clear that disclosure may be made at the EU consolidated level, it is not clear this will be the case for non-EU headquartered banks. The multiplication of remuneration reports for numerous subsidiaries will create significant difficulties for worldwide Banking Groups, and for small subsidiaries could reveal confidential information. We would therefore suggest that the Basel Pillar 3 requirements should reflect the BCBS's comments in paragraphs 13 to 15 of its Compensation Principles and Standards Assessment Methodology (dated January 2010). These comments make it clear that the FSB Principles and Standards should be applied at the group level and that the "home country" supervisor should be responsible for evaluating the banking group's compensation policies.

This approach should apply equally to FSB Standard 15 and disclosure generally, so that banking groups can satisfy worldwide disclosure obligations through a single disclosure in the "home country". Almost invariably this is the country where a bank's shares are listed and where stakeholders will naturally expect disclosure.

Proportionality. The document should consider proportionality in setting down disclosure requirements for certain firms. The degree of disclosure should depend, in part, on the size, systemic importance, business mix, and complexity of the firm. The FSA Remuneration Code,

updated in December 2010, offers a useful example, creating four “tiers” of firms with differing minimum expectations of compliance for each group. We would encourage incorporating some version of this approach to help generate comparable and potentially more useful disclosure outcomes in a globally consistent manner.

Implementation. More careful consideration needs to be given to the implementation of these standards than is currently reflected in the paper. As the regulatory framework develops over the coming years, the Committee may wish to consider a gradual implementation of the new disclosure standards with proper sequencing that takes into account the results of consultations with stakeholders and an ongoing assessment of the usefulness of the new information in the context of the enhanced governance framework and Pillar 3 objectives. Care also needs to be taken that the guidance offered in the document is implemented consistently across jurisdictions.

Useful and Effective Disclosure

As noted in the 2010 IIF Board Statement, the industry agrees that “disclosure policies should ensure that clear and comprehensive information concerning basic compensation policies is issued in a timely manner” in order to allow shareholders and other stakeholders to engage in the compensation debate, and the IIF membership is currently taking steps to do just that. Appropriate disclosure should include adequate description of the governance safeguards including information on the work of the remuneration committee, the development and approval policies of the remuneration committee, insight into the creation of the remuneration policy, and information on the link between pay and performance including risk alignment of compensation and the use of clawback and deferrals.

Keeping these comments in mind, the Institute endorses generally Provisions (a) through (f), and some of the “Quantitative” aspects, of the “Key Disclosures” section as the basis for an effective disclosure regime. More specifically, the following issues could be usefully addressed by banks in their public reports:

- The decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the scope of the remuneration policy, and the use of external consultants;

- General explanation of how the firm links compensation and performance, including how the policy takes into account longer-term performance;

- A succinct and qualitative discussion of the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;

- General qualitative information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

- The main parameters and rationale for any variable component scheme;

- Quantitative information on remuneration, including:
    - Senior management (executive officers) remuneration for the financial year, broken down into fixed and variable and the forms used.

These disclosures are consistent with the FSB Principles of 2009 and reflect sound practices of firms across jurisdictions. If supervisors require further elaboration of the qualitative topics, or more detailed information on the quantitative results, they have the authority and are free to request them in the regular supervisory process. We believe that these general disclosures strike an appropriate balance between giving shareholders and other stakeholders the information they need to monitor the board's actions and policies on compensation while at the same time protecting the reporting firm from undue adverse market reaction or from disclosing confidential or market sensitive information.

Appropriate Levels of Disclosure

The Institute's reservations about the proposed disclosure regime relate mainly to some of the rather detailed quantitative requirements.

Adequate disclosure to shareholders may not always be served simply by an increase in the volume of data or its level of detail. As the Committee is well aware, information overload can often be overwhelming and counterproductive and would not serve the purposes of sound disclosure. This is why there is an emphasis on "materiality" with respect to disclosure aimed at shareholders. Alternatively, comprehensive and detailed information disclosed to supervisors does not pose such problems and, in any event, is essential for the discharge of supervisors' responsibilities. Furthermore, regulators have recognized the heightened market sensitivity of some of the information that the Basel Committee requires to be disclosed to the public. For example, the FDIC has acknowledged that some public disclosures could create competitive concerns and it therefore pledged to keep the remuneration information required to be disclosed to regulators confidential[2]

We therefore see a distinction between compensation disclosure to "facilitate constructive engagement by all stakeholders... in particular shareholders", which should be clear, concise and comprehensible, on the one hand, and additional compensation disclosure and analysis that is made available to regulators as part of the ongoing monitoring and supervisory process, on the other. Disclosure at the level of detail required by the consultative paper in certain instances, including Provision (h) regarding "numerical value of risk adjustments", may have little quantitative relevancy to shareholders and therefore should appropriately be made to supervisors under Pillar 2.

An important point with regard to the usefulness of the data to shareholders and to markets is comparability among firms and across jurisdictions. Disclosure of some of the proposed measures – Provision (i) requiring the disclosure of the total amount of adjustments to reflect weak performance metrics – is generally firm-specific and may not be meaningful for comparative purposes and would be difficult to evaluate outside of the kind of Pillar 2 discussion a supervisor can have with the particular firm. Banks use different methodologies to calculate bonus pools in consideration of key risks and apply different mixes of ex-ante and

[2] FDIC "Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements" February 7, 2011

ex-post risk adjustments, coupled with the exercise of judgment in most cases, that address the unique business models and strategies of each firm.

The requirement to break down much of the quantitative information into the three categories of *senior management, other material risk takers, and financial control staff* raises concerns as well. Every institution will have a different interpretation of what the three categories mean depending on the bank's titling conventions, business and organizational model, and department names and conventions. The first group clearly identifies a limited number of individuals who have a significant influence over the risk strategy and performance of a firm. This group has an easily identifiable and stable population, and its members are the decision-makers accountable to shareholders. Comprehensive disclosure in this case is both necessary and appropriate.

Depending on definition, however, the other two groups (material risk takers and financial and risk control staff) could cover a significant number of staff with varying responsibilities at different levels within the organization and variable over time, especially with the inclusion of “financial and risk control” staff. The disclosed information will not be comparable across firms or even across similar-sized firms and the standard would not meet its objective to "allow meaningful assessments by market participants of compensation practices" through greater convergence of compensation disclosure. Both the total numbers of these employees and detailed information on their compensation is unlikely to be useful to shareholders and market analysts when trying to compare compensation systems across firms. Again, an appropriate supervisory discussion might cover whether the scope of risk-based compensation within a firm has been determined appropriately, and if not what steps firms would need to take to remedy the situation.

Comparisons among different global firms can also be distorted depending on their business focus and the geographical areas of operation. Moreover, as each firm will need to come up with its own definitions of variable and fixed compensation and of material risk takers and other critical categories, detailed disclosure with respect to these categories will make apples-to-apples comparison become exceedingly difficult.

Provision (i) asks for the number and total amount of remuneration adjustments performed during the financial year to reflect weak performance metrics. This type of disclosure would not be meaningful at the individual remuneration level, where remuneration decisions are made by many individual managers to address specific individual performance issues.

Members are also concerned that the current level of disclosure mandated could raise confidentiality issues. To the extent that more detailed and specific information is required, such information would be more usefully provided to supervisors without necessarily disclosing to the public.[3] Examples:

- If firms must disclose by type of employee envisioned by the Basel Committee, many measures, such as the total number of sign-on bonuses or severance payments may be small and will raise privacy concerns for the few non-executive level individuals who will qualify;

[3] If issues of interpretation of the FSB guidelines arose, they could be dealt with by supervisory guidance clarifying such guidelines without expanding their scope.

- The aspects of Provision (c) requiring detailed disclosure in relation to the measures used to take account of current and future risks and how these measures are linked to the banks' overall risk management framework. The requirements in respect of this are at a level of detail that most firms may struggle to articulate without revealing sensitive information, and in any case are highly unlikely to be meaningfully comparable across firms;

- The second bullet of Provision (d) requires disclosure of main performance metrics for individuals - it is not clear which group or types of individuals this applies to or whether this is expected to be a general overview. An individual's specific performance metrics would normally include objectives related to business growth initiatives, customer engagement strategies, employee retention and development, to name a few, which would be commercially sensitive and unique to each bank and underlying business unit, and should not be disclosed publicly;

- The material demanded by the third bullet point of Provision (j) is likely to be sensitive to firms and to the employees, and to be somewhat misleading – there are many reasons for performance adjustments and the total number may not be a useful piece of information or indicative of sound compensation practices;

- Any attempt to disclose the risk adjusted return of specific business or activities or the level of capital adequacy, such as the disclosure of internal charges for economic capital as mentioned in the footnote to Provision (h), should qualify as sensitive and confidential. Firms are fully comfortable revealing such information to supervisors, as this falls under their mandate to ensure firms are promoting prudent risk taking. But to have this information available to other firms and the general public may give away too much of a bank's internal data.

Clarifications

It would be helpful to have further information regarding the following issues:

- Provision (d): is this requirement a high-level overview of how individual performance is measured, or does it call for disclosure of exactly how performance measurement is done (e.g. CEO/GEB performance measurement)? If the latter is the case, such a requirement would go above and beyond sound disclosure practices and would necessitate too-detailed disclosure;

- It is unclear whether the quantitative disclosures set out in Provisions (i) through (k) refer to compensation values or accounting values. More guidance is needed on the basis of reporting;

- Avoidance of Duplications: It would be helpful to provide explicitly in the paper the possibility for firms to incorporate, by reference, the entries corresponding to the Pillar 3 disclosure tables to the disclosures made elsewhere (for instance in the annual report or the compensation report).

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Compensation has become a very sensitive topic in the public realm, so it is important to balance the potential benefits with the possible costs of disclosure of remuneration practices.

Moreover, Pillar 3 disclosures should only advance Pillar 3 goals. Many of the most problematic disclosures are difficult to understand in the context of these goals, and they could be dropped from the proposed guidelines, or perhaps moved to supervisory guidance, to the benefit of all concerned.

Again, we appreciate the opportunity to comment on this important and timely consultation paper and would be happy to provide further comments or industry input as needed on these issues. We also stand ready to meet and discuss the topic at greater length. Should you have any questions, please feel free to contact us at any time.

Very truly yours,

George T. Abed
Senior Counsellor and
Institute of International Finance
Tel: + 1 202 857 3644
Cell: + 1 202 758 7395
Fax: + 1 202 293 1639
Email: gabed@iif.com

George Abed
+1.202.857.3644 – gabed@iif.com