25 February 2011

Basel Committee on Banking Supervision

Bank of International Settlements

Via email: baselcommittee@bis.org

Dear Committee Members

CONSULTATIVE DOCUMENT: PILL AR 3 REQUIREMENTS FOR REMUNERATION DISCLOSURE

I thank you for the opportunity to comment on the proposed reforms outlined in the discussion paper released on 27 December 2010. I note the two stated policy imperatives behind the proposals:

- "Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders, including in particular shareholders" (per Paragraph 94 of the supplemental Pillar 2 guidance 2009); and
- The need to ensure greater comparability of disclosed information by way of promoting greater convergence in disclosure regimes (per FSB Peer Review Report on Compensation 2010).

A detailed list of disclosures, classified as qualitative and quantitative follows, with the annex including suggested tabular disclosures.

Good disclosures or good remuneration practices?

The first comment I offer is a recommendation that the Committee be clear on what the ultimate end goal of these and other remuneration regulatory initiatives is: namely, that banks adopt appropriate remuneration practices that encourage the right kind of behaviour and performance from their employees (thus contributing to the bank's overall performance*)*. The second comment I offer is that mandating disclosures alone cannot change remuneration practices if no sanction exists within the regulatory framework for poor practices, only non-disclosure; or if there are no real levers within the system that the stakeholders can pull to ensure practices change from poor to good.

The differing variety of banks subject to these proposed disclosure requirements means that the identity of the pertinent stakeholders will differ. Thus the levers that might exist for ensuring good practices will also differ and depend on the nature of banking supervision within the jurisdiction; the local banking laws; the local corporate laws (including financial reporting obligations and shareholder rights to appoint and remove directors, and any voting rights on remuneration); whether the bank is listed on a stock exchange and subject to market-based scrutiny and discipline; the extent of institutional investor (and hence proxy adviser) scrutiny and engagement.

I attach to this email an article on the regulated remuneration cycle[1] as one method of analysis of the framework of rules on remuneration. The paper describes a model to analyze the regulatory framework for a 'say on pay' jurisdiction (but can be easily translated into other jurisdictions).

Within a jurisdiction, the 'rules' for remuneration practices (as distinct from disclosure of those practices) might be in the form of 'best practice principles' rather than laws, and their 'enforcement' might not be a legal sanction (eg a fine), but some other kind of lever. The paper argues that the synergies between the remuneration practice rules, and the engagement and voting practices of institutional shareholders are key to achieving the practices described. Translating this to supervision of banking remuneration (assuming no external shareholder monitoring), the local translation of the FSB *Principles for Sound Compensation Practices* will be achieved if supervisory monitoring and enforcement activity is linked to enforcing these practice rules.

The quality of the rules for remuneration practice is also important. Some of the FSB *Principles* may well have been translated into 'rule-like' statements: eg 'must have a remuneration committee of independent directors'. The 'must haves' are easy to monitor: taking the example given, a bank either has such a committee or it does not (because it has no remuneration committee, or because it has a remuneration committee, but not all the directors are independent). It is the more loosely worded principles that are difficult to monitor because they potentially allow (and arguably appropriately so) a variety of practices to exist. Paradoxically, as Julia Black notes, such principles can be interpreted as rules and applied inflexibly, undermining the flexibility of practices desired.

The Committee should consider what steps it can and should take to inform supervisors of the need to consider this broader framework, framing their local adoption of the disclosure requirements to facilitate the synergies described.

Extent of disclosures

The third comment I offer is that the list of key disclosures in paragraph [11] is long and somewhat detailed (although not meant to be exhaustive as indicated by 'should include'), with the result that a bank seeking to comply with the requirements noted (as a minimum) will have to make an extensive (ie long) remuneration disclosure.

We have some experience in Australia of this situation with listed companies because our remuneration report disclosure requirements found in the *Corporations Act 2001* (Cth), s 300A and in the *Corporations Regulations 2001* (Cth), reg 2M.3.03 are also very detailed. There is a broad consensus here that the disclosures are too long, although there is also evidence from ISS and Guerdon Associates (remuneration consultants) of non-compliance with the legal requirements, which suggests that more detail alone does not necessarily mean better disclosure practices.

[1] Sheehan (2009) 'The Regulatory Framework for Executive Remuneration in Australia', *Sydney Law Review* 31: 273-308.

Busy stakeholders may not be able to spend the time necessary to analyze extensive disclosures. Thus they are likely to focus only on a few elements that are easy to identify and to understand. Banks, on becoming aware of this, might adopt a template form of disclosure that facilitates this activity. There is nothing wrong with templates per se, but if the disclosures end up as a series of boilerplate statements, they start to become less meaningful, if not meaningless.

The Committee should consider whether there is merit in somehow distinguishing between the various disclosure requirements by reducing the list of 'should include' disclosures while retaining the overall headings (or topics) and a reduced list of 'should include' disclosures.

Disclosure of the pay for performance link

Finally, I note that paragraph 90 of the Supplementary Pillar 2 Guidance requires disclosure of the link between remuneration and performance (paragraph 90). The recent Ontario Securities Commission report on its review of listed company remuneration disclosures indicated extensive non-compliance with the requirements for disclosures relevant to establishing this link.

The difficulty with the pay-performance link disclosure requirements is the way in which companies interpret the 'commercial-in-confidence' carve-outs. I personally would expect that companies highlighting their performance against key performance indicators or measures in their public statements (including financial reports) should be able to say how remuneration outcomes relate to these. However, this is not necessarily so in practice.

Given that the Committee is making changes that will be implemented via national banking laws or regulations, and monitored by banking supervisors, it should consider whether some kind of non-public disclosure of sensitive information might enable this key stakeholder to confirm that the link exists and is appropriate. In other words, there may be scope for recommending that some disclosures are public and some are non-public and in confidence to the relevant regulator. I appreciate that this outcome may disappoint some other stakeholders. However, they may also be able to create pressure to improve the public disclosures of the link.

Please contact me if you require further clarification of any of these comments.

Yours sincerely

Dr Kym Sheehan
Lecturer
Sydney Law School
The University of Sydney

p: +61 2 9351 0493
e: kym.sheehan@sydney.edu.au