



The ABI's Response to FINMA Consultation on Remuneration in Financial Services

Introduction

The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's stockmarket and hold substantial portion of European equities, including major holdings in the Swiss market. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. As a representative of a major part of the European financial services sector we welcome the opportunity to respond to this paper.

Executive Summary

It is axiomatic that remuneration structures within any company should not provide incentives to take inappropriate risks. However, we do not believe that the regulators' role should extend into the operational management on every financial services company. The regulators' remit in this area should be, in line with the core aim of good regulation, to focus on systemic risks that threaten the stability of the system, and in this regard on those firms that are evidently systemic in nature.

Those companies that are not systemic should not be subject to such regulation, and instead reliance should remain on the normal methods of corporate/management control, including non-executive/supervisory directors, shareholders and, relevant risk management and other regulation protecting clients and/or customers.

Whilst, as the paper notes, there is a high degree of inter-linkage within financial services, this does not mean that every firm is systemic. For example, although an asset manager may have a number of relationships with a brokerage that is part of a major investment bank, this does not make the asset managers systemic. Where relationships pose counter party risks that are systemic in nature, this is of course a matter of concern for the regulators. However, the appropriate way to understand and monitor such risks is through appropriate regulatory monitoring.

Given these facts, we agree with the Financial Stability Board that the best way forward would be for relevant regulators in each jurisdiction to identify those entities that are systemic and apply proportionate controls and

appropriate monitoring of their activities. Other financial services may wish to adopt any proposals as a matter of best practice. This should include ensuring that remuneration structures do not provide incentives to take inappropriate risks.

Specific Comments

Increasing awareness

As stated in the executive summary we do not believe the proposals should be extended to all financial services firms. The proposals seek to address the issue of inappropriate remuneration practices posing a systemic risk but not all firms give rise to it. For example, neither insurance nor asset management pose the systemic threat that the banking sector does.

Although there is widespread debate across the globe regarding remuneration structures and practices across the corporate sector, this is focused on the manner in which shareholders have sought to solve the agency problem. The way in which owners incentivise management, reward long-term performance and align interests is not a matter for the regulator unless it poses a systemic threat.

Risk awareness is a fundamental behavioural aspect of all employees. Rather than increasing employees' risk awareness, as suggested in the paper, we believe that remuneration should be structured so that it does not inhibit or hinder such behaviours. Further, we believe that abiding by legal and compliance requirements is a minimum expectation and a failure to do so should be a matter of disciplinary action, not a way to determine levels of remuneration. Therefore, such basic risk awareness and management should be a gateway into the system that determines remuneration, rather than something which influences or determines its levels.

We do not understand the contention that high-risk activities must result in lower variable remuneration than lower risk ones. The level of reward payable as a result of any activity is part of the risk/reward calculation that is the basis of any business activities. The focus therefore must be on understanding the risk, including its tail, when determining the level of award. Artificial constraints in this area will result in perverse outcomes, including vastly increased fixed costs (salaries) for high-risk activities which will not prevent or mitigate inappropriate risk taking, but instead will undermine the financial services sector business model which will, if these proposals are enacted, be unable to adapt to the economic cycle.

Variable Remuneration

We agree that restrictions or blanket bans on variable remuneration (bonuses) is not a good idea. In our view, remuneration structures should be in line with the relevant performance and risk horizons. This means that a

one-size-fits-all model cannot be adopted both across the market and within individual firms, where many different business activities may be undertaken. Similarly, economic profit is one measure that may be appropriate, but it may be difficult to apply at all times in all areas of financial services. For example, fund managers are rewarded for managing client money effectively and therefore any contribution the firm's economic profit is indirect as there is no proprietary trading and limited use of company capital. Any move to economic profit as a basis of reward would therefore sever a clear performance link and as a result potentially harm clients.

Long-term orientated awards

We agree that remuneration should incentivise behaviours that create long-term sustainable value creation. We believe that directors, who are in effect stewards of the company, should define a remuneration policy that is aligned with this aim. We also agree that care must be taken in the use of such targets such as turnover growth. We further believe that unrealised gain should not be rewarded, but instead that payment should only be made when the gain crystallises. The overriding emphasis should not be on profit at any price, but on quality profit at a reasonable price.

We agree that more deferral is desirable; the amount of time for this deferral should be in line with the relevant risk horizons. Whilst there may be some value in linking deferred awards to ongoing performance, this performance should be related to that which is relevant to how the award was earned. For example, if the award was the result of desk or divisional performance, the ongoing measurement should not relate to the overall corporate entity. Doing so would risk unfairly penalising the recipient for matters out of their control or rewarding them further even if their own performance was not good. We would also caution against the overuse of shares in deferral schemes. The use of shares dilutes existing shareholders and as large value discounts are applied by participants in such schemes this can lead to them demanding much larger awards to compensate for the use of shares. We would also note that at companies such as Lehmans and Bear Stearns, many staff, including the "risk takers", were significant holders of stock and this did nothing to promote sound risk management. Indeed, it may be argued that the unlimited upside and limited downside characteristics of shares and the volatility of equity markets creates an imbalance in the perceived risk/reward calculation.

Transparency

We agree that disclosure of individual employees' remuneration is not the way forward, although directors' remuneration should be disclosed in relation to their responsibilities to shareholders as their agents.

With an increase in remuneration transparency there is a danger that this will lead to a degree of pay inflation as firms seek to remain competitive. To

guard against this, remuneration committees and human resources departments must avoid unnecessary ratcheting up of pay and chasing medians. One reason this may happen is because of over-reliance on external benchmarking and perceived market rates.

Keeping competition balanced

Although we recognise that there is a need to ensure a level playing field for firms where possible, we do not believe this should result in regulatory creep into areas that it is not necessary to regulate. As stated previously, we recognise that counter party risks, financial complexity and other factors mean that risk and its location are not understood. However, a better way to address this is through better regulation and market transparency, rather than misdirected regulation of remuneration.