October 31, 2014

Comments on the PRA and the FCA's Consultation Paper
"Strengthening the alignment of risk and reward: new remuneration rules"

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultation paper "Strengthening the alignment of risk and reward: new remuneration rules" released on July 30, 2014 by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).
We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the rules.

[General Comment]

It is understood that international discussions have been initiated on remuneration arrangements that may incentivise excessive risk taking activities by financial institutions as well as responsibilities of senior managers. In response, measures to be taken are being considered at a jurisdiction level.

While recognising the necessity of remuneration rules, the proposed rules may increase the difficulty in attracting competent talent to the UK financial industry, which would lead to an uncompetitive environment for the UK, both internationally and within the EU. The proposed rules, in combination with a cap on variable pays set out in the Capital Requirements Directive IV (CRD IV), may result in a further increase in fixed pay which is not subject to malus and clawback. This would eventually limit banks' ability to recoup remuneration through clawback and malus. A substantial amount of regulatory reforms have been undertaken for bankers' remuneration; however outcomes of these reforms have not yet been fully analysed. Given this, reforms, including those rules proposed in this Consultation Paper, may entail a risk of producing unintended consequences. Accordingly, it is respectfully requested to postpone a new reform, or to further review such reform, until the impact analysis is completed.

In implementing the proposed rules, it is also requested to exclude expatriates from the scope of these requirements taking into account double taxation and legal risks arising from a difference in jurisdictions. Since, generally, the deferral and clawback periods are longer than the durations of expatriate's stay, cases where expatriates receive

variable pay after transferring to other country would increase. Such situation may lead to an increase in risks discussed above. Consequently, imposing more enhanced requirements than those set forth in the current Remuneration Code should be avoided.
On the other hand, we are in support of retaining the same level of minimum thresholds that are specified in the current Remuneration Code in Appendix 4 Draft supervisory statement on Remuneration. If these proposed rules would be implemented, it is respectfully requested to ensure that these minimum thresholds are applied to both senior managers and material risk-takers at the same level as those defined in the current Code.

The Specific Comment section below provides our responses to each question in the Consultation Paper.

[Specific Comment] (Our responses to the questions in the CP)
2. Deferral period of remuneration

Question 1: Do you agree with the principle of introducing a two-level approach for deferral, with longer deferral for senior managers?

(Our response)
We are basically in agreement with a proposed two-level approach. However, such approach should be introduced as guidance, as opposed to mandating through the regulation. Additionally, expatriates should be excluded from the scope of this requirement.

(Reason)
We understand the necessity of applying a longer deferral period of remuneration for senior managers, relative to material risk takers. Since, however, the application of a two-level approach is not consistent with requirements in other jurisdictions, it is considered more acceptable to introduce such requirements in the form of guidance rather than regulation.

Question 2: Do you agree with extending the deferral period to seven years for senior managers?

(Our response)
Our view is that, essentially, firms should be allowed to determine the deferral period by aligning to their own risk horizon based on their risk profiles. Since ex-post risk adjustment is sufficiently ensured by measures such as payments in the form of equity

or clawback, we are not in support of the proposal to excessively extend the current deferral period of three to five years. As an alternative, the deferral period should be set as five years, with a two-year retention period. Additionally, expatriates should be excluded from the scope of this requirement.

(Reason)
We agree that senior managers should be subject to a longer deferral period. However, a seven year deferral period does not necessarily be consistent with all firms' risk horizon, and hence firms should be able to determine the deferral period in line with their risk horizon based on their risk profile.
The extension of a deferral period for seven years should be reviewed in light of buy-outs proposed in the Consultation Paper. A deferral period which is longer than currently required would result in a greater number of, and larger amount of, buy-outs, which would lead to loss of talent from the UK. Additionally, since the proposed longer deferral period may result in time discounting of variable pay due to a potential future reduction in the amount of remuneration, the payment of remuneration would be shifted to fixed pay which are not subject to malus and clawback. These consequences may result in malus and clawback not being substantially functioning, thereby undermining the effectiveness of malus and clawback when material errors and other incidents may occur.
On the other hand, ex-post risk adjustment is fully ensured through payments in a form of equities or newly introduced clawback and other measures. It is therefore considered that the current extension period is sufficient to allow firms to make risk adjustment, and the seven-year extension of deferral period is excessive when compared to other jurisdictions.
In view of these, if firms are not allowed to defer remuneration in alignment with their risk horizon, as an alternative, we propose to set a five-year deferral period, with the two-year retention period. Under this approach, remuneration for senior managers will be vested within five year, during which banks can suspend payments, and hence malus can be applied according to the banks' internal process.
Expatriates should be excluded from the scope of this requirement as the extension of deferral period for seven years is considered to be excessive when compared to other jurisdictions, thereby reducing incentive of competent talent to work in the UK. Additionally, since, generally, the durations of expatriate's stay is shorter than seven years, the double taxation risk may increase after senior managers being transferred to other country.

Question 3
Do you agree with introducing an additional requirement that no deferred variable remuneration should vest earlier than the third anniversary of award for senior managers?

(Our response)
We do not agree with the proposal. The period should be one year as prescribed in the current Code, as opposed to three year. In particular, expatriates should be excluded from the scope of this requirement.

(Reason)
Consistent with the reason provided in Question 2, the requirement “the third anniversary” may not necessarily be in line with the risk horizon of all firms. Bonus pools are conservatively set based on risk adjusted measures, and tail risk is already factored into bonus pools for each business-unit. The third anniversary may also result in employees further discounting the total value of remuneration at the time of award, and may result in a competitive disadvantage for attracting employees to the UK.
Awards for senior managers are already subject to the seven-year clawback period newly introduced and hence firms can recover awards through this clawback. Therefore, there is no substantial need for not vesting the deferred variable remuneration earlier than the third anniversary of award.
Additionally, for the same reason as raised in Question 2, expatriates should be excluded from this requirement.

Question 4
Do you agree that five years is an appropriate minimum requirement to apply to all other MRTs, bearing in mind the range of roles covered?

(Our response)
We do not agree with the minimum requirement of five years. Firms should be allowed to determine the deferral period by aligning to their own risk horizon based on their risk profiles. Additionally, expatriates should be excluded from this requirement.

(Reason)
Consistent with the reason provided in Question 2, this requirement may not necessarily be in line with the risk horizon of all firms. Consequently, firms should be able to determine the deferral period in line with their risk horizon based on their risk profile.
The extension of the deferral period for five year at a minimum as opposed to current three to five years would lead to higher buy-outs, resulting in loss of talent from the UK.

This would undermine the effectiveness of malus applied by firms. Therefore, an extension period which is longer than the currently defined period should not be set.
Additionally, for the same reason as raised in Question 2, expatriates should be excluded from this requirement.

3. Clawback

Question 6 Do you agree with the proposal to introduce a requirement to provide for a possible extension of the clawback period of up to three years for Senior Managers if there are outstanding investigations underway at the end of seven years?

(Our response)
We do not agree with the proposal to include this requirement in the Remuneration Code. Rather, guidance should be provided with regard to this proposed possible extension. Additionally, expatriates should be excluded from this requirement.

(Reason)
It is a market practice to suspend variable pay and deferral payments whilst an internal or external investigation is carried out. Firms therefore should be allowed to continue with this approach through a market practice, and the three year extension of the clawback period should not be included in the Code. The reason for this is because of the perceived time value discounting of remuneration by employees at the time of award. It would also limit banks' ability to continue the suspension of remuneration should the investigation period exceed the three year time horizon.
Guidance has not been provided on how the use of the 10 year clawback would work if the investigation is commenced after the seventh year from the date of grant. For example, if an investigation were to commence eight years after the date of grant of an award, the senior manager would have satisfied the seven year clawback limit per the bank's policies. In such a case, it is unclear whether the PRA and FCA expect banks to retrospectively apply the extension of clawback. If the PRA and FCA expect such extension, this would require further clarity in regards to how this requirement would be implemented from an employment law perspective.
Given this, it is respectfully requested that guidance is provided by the PRA and FCA in regards to its expectations on applying the extension rather than including this as a requirement in the Code.
Additionally, expatriates should be excluded from the scope of this requirement for the following reason. Given that expatriates relocate across multiple countries once in several years, if an expatriate moves outside of the UK and provides services in other

country, cases where banks will apply clawback might increase if the clawback period would be extended. In such a situation, laws governing such cases would not be limited to laws of the UK. Moreover, depending on a jurisdiction to which an expatriate is relocated, there may be a mandatory requirement that may not permit the application of clawback.

4. Buy-outs

Question 8 What do you see as the advantages and disadvantages of the approaches identified above?

(Our response)

We do not support the approaches Banning Buy-outs, Maintaining Unvested Rewards and Applying Malus while support the approach Reliance on Clawback.

(Reason)

- Banning buy-outs

This would impair the competitiveness of attracting talent to the UK, leading to a UK talent being attracted to poaching by other institutions outside of the UK. Therefore, we would not recommend this approach. Additionally, since buy-outs by competitors are established as a market practice in the labor market, this approach might in effect pose a limitation on job transfer within the UK financial market.

- Maintaining unvested awards

As in the case of banning buy-outs, we do not recommend this approach since this would result in UK talent being attracted to poaching by other institutions outside of the UK as buy-outs would not be required on their part. There would also be conflicts of interests for the employee as they would have been vested interest in the performance of their previous employer due to their unvested awards even after changing their job. If the equity awards were converted to cash to limit this conflict, then the link to the long-term interests of the bank's shareholders through the use of equity instruments would be removed.

- Applying malus

The application of malus by an employee’s previous employer would give rise to a number of practical issues. For example, harmonization of conflicting interests between the previous and current employers and exchange of employees’ information. These efforts might necessitate the PRA and FCA to act as an arbitrator between the two

institutions. It would also be difficult to apply malus in cases where the employee has moved to a non-financial services institution which is not regulated by the PRA and FCA. Given this, it is considered impracticable for an employee's previous employer to apply malus unless specific guidance or supervisory methodologies are established.
In relation to Question 6, in cases where the labor law of Japan is applied to expatriates, since such law prohibits an employer from entering into a pre-indemnification agreement with its employees, a legal framework needs to be established to apply malus to remuneration paid by other institutions.

- Reliance on clawback

We are supportive of this approach as this is already required under the recently released clawback policy statement.

Question 9 What views do you have on the potential options for addressing the disadvantages of particular approaches?

(Our response)
For ban on buy-out and maintenance of unvested awards discussed in Question 8, we have no view on a potential option that addresses the disadvantages noted in Question 8. The application of malus requires clear guidance from regulatory and legal perspectives.

Question 10 What are the relative merits of pursuing the different approaches and any alternative approaches that might be identified?

(Our response)
No further regulation is required as this is addressed through the recently released clawback rules.

6. Risk adjustment

Question 11 Do you agree with the proposal to require firms to use the above approach to ensure that the measure of profit used for determining variable remuneration is based on prudent valuation?

(Our response)
We are not in agreement with this proposal.

(Reason)
The current Remuneration Code stresses the importance of risk adjustment in measuring an institutions' performance. There are a number of risk-adjustment techniques, and we are supportive of the PRA's current stance on allowing banks to use the approach which is most appropriate for them. We also support further guidance from the PRA and FCA on the use of risk adjustment. However, we are opposed to regulation which limits banks' ability to use the approach which is most appropriate in light of their business model, strategy and risk profile.
If the PRA and FCA, as their individual supervisory approach, require individual banks the use of measures that are most suitable for them, we support such approach.

Question 12
Do you agree that there should be a rule that simple revenue or profit-based measures may not be relied on to determine variable remuneration at aggregate or individual level, except as part of a balanced and risk-adjusted scorecard?

(Our response)
We do not agree with this proposal.

(Reason)
Firms require flexibility in determining an approach for bonus pool calculations in a manner that is reflective of business model and strategic objectives. Accordingly, firms should be allowed to proactively exercise business judgment, for example, on how to combine multiple business indicators to measure performance.