HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

20 November 2014

Mark Carney
Chair, Financial Stability Board

Dear Mark,

I am increasingly concerned by recent developments that appear to be driving up fixed compensation in the banking industry. This trend is bad for financial stability and bad for rebuilding trust in the financial system. Fixed remuneration cannot easily be cut when a bank faces financial distress, nor can it currently be made subject to claw-back in cases of serious mis-conduct. I think this issue requires serious examination.

We all agree on the policy objective here: to ensure bankers' pay is kept under control, is at risk to performance, and can be properly clawed back if there is wrongdoing or poor performance. In 2009, the Financial Stability Board's *Principles for Sound Compensation*, which the UK implemented in full, set out that a "substantial proportion of compensation should be variable". More recently, the Parliamentary Commission on Banking Standards highlighted in its report *Changing Banking for Good* that "there are distinct advantages to a significant proportion of banking remuneration being in variable rather than fixed form". Andrew Bailey has consistently argued that higher fixed compensation increases risks to financial stability by raising a bank's fixed cost base and reducing its ability to adapt to difficult trading conditions. He has argued cogently the case for putting a meaningful amount of pay at risk.

The government has pursued a number of policies to deliver that objective, including requiring firms to put in place policies so that they are able to reduce or cancel deferred bonus payments when subsequent information on poor performance comes to light. From January 2015, firms will also be able to claw back bonuses that have been paid out to employees, where sufficient information on past poor performance comes to light.

However, as you set out so clearly in your 2014 Monetary Authority of Singapore Lecture, we now face the prospect in Europe of an increasing proportion of bankers' remuneration being paid as fixed compensation, not subject to claw-back and effectively guaranteed even if the bank is facing financial distress. As you noted, this is an unintended consequence of the 'bonus cap' provisions in the EU's Capital Requirements Directive.

That is why the UK has consistently opposed the measure. As I said at a meeting of European finance ministers in March 2013, the government's concern "is that this may have a perverse effect, it may undermine responsibility in the banking system rather than

promote it" by pushing salaries up, making it more difficult to claw back bankers' bonuses when things go wrong, making it more difficult to ensure that the banks and bankers pay when there are mistakes, rather than the taxpayer. That, unfortunately, is what has started to happen.

It now looks clear that there are minimal prospects for success with our legal challenge, so we will no longer pursue it. But that should not stop us from pursuing our objective of ensuring a system of remuneration that encourages responsibility instead of undermining it.

Given the global nature of the banking industry, I believe that remuneration standards should apply globally. The UK, as a member of the Financial Stability Board (FSB), therefore strongly supports the FSB's ongoing work to monitor and report on the implementation of the *Principles for Sound Compensation* and to assess the impact of those standards in ensuring sound risk-taking by financial institutions.

As part of that work, I believe there is a need for careful consideration of how, in jurisdictions such as the EU where the balance of banking remuneration has shifted towards fixed remuneration, compensation schemes can still achieve the objective of supporting sound risk taking. For example, I was interested by some of the ideas floated by President William Dudley of the New York Federal Reserve which would increase accountability by putting more of senior bankers' remuneration at risk.

The ongoing FSB work is uniquely placed to undertake this process of monitoring and review and the UK will continue to offer that work its full support. In addition, I will ask the Fair & Effective Markets Review to consider this issue as part of its work on responsibilities, governance and incentives. As set out in its recent Consultation Document, incentives play a critical role in the Fixed Income, Currency and Commodity Markets. Ensuring that firms incentivise employees to behave in the right way is essential to restoring public trust in financial markets.

GEORGE OSBORNE