



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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Paschal Donohoe TD
Minister for Finance and Public Expenditure and Reform
Department of Finance
Upper Merrion Street
Dublin 2
D02 R583

30 May 2019

Re: Review of the Irish Government's Bank Remuneration policy

Dear Minister

I write in respect of your letter of 4 April 2019 requesting the Central Bank of Ireland's ("the Central Bank's") observations on the review of the Irish Government's Bank Remuneration policy, which applies specific restrictions on the remuneration practices of Allied Irish Banks plc, the Governor and Company of the Bank of Ireland and permanent tsb (the "impacted banks").

As articulated at the Joint Committee on Finance, Public Expenditure and Reform on 26 March 2019, we view this as a matter for the Government (including as shareholder) and the wider Oireachtas in the first instance.

The Central Bank serves the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy. Essential to this is a sustainable banking sector that functions effectively, and is well-managed and well-regulated. Since the crisis, many of the contributory



weaknesses in the regulatory and supervisory frameworks have been addressed. Banks (and other financial institutions) are now required to hold more and better quality capital, be more sustainably funded, better governed and more strongly equipped to deal with difficulties as they emerge.

Pre-crisis, there were no restrictions on how variable remuneration was awarded, the form it took, and the period over which it was paid. Since then, in tandem with the enhancements to the wider regulatory and supervisory frameworks, remuneration requirements have also been significantly strengthened. In particular the Capital Requirements Directive (“CRD”) IV, which was transposed in Statutory Instrument 158 of 2014 (European Union (Capital Requirements) Regulations 2014), includes specific provisions with respect to longer-term incentivisation, malus and clawback. These provisions seek to ensure greater alignment of risk and reward and encourage behaviours that are more closely aligned with the institution’s overall corporate governance framework, corporate culture, risk appetite and the related governance processes.

Reviews of remuneration policies and practices form part of the Central Bank’s supervisory engagement programme with institutions; this includes ensuring that remuneration policies and practices comply with relevant regulatory requirements and are appropriately implemented.

With regard to the total compensation limit of €500,000 (“the cap”), we acknowledge that the cap may limit the recruitment pool for senior leadership positions in these banks. At the same time, the level of pay is not the only factor that motivates qualified individuals to apply for leadership roles in these significant institutions that play an important economic and societal role. Indeed, recent recruitment rounds indicate that it is possible to appoint qualified individuals to accept senior roles in these organisations.

A greater current and future risk, in our view as supervisor, may arise with respect to restrictions relating to staff in critical functions underneath this level. These staff perform essential roles in supporting the banks to deliver on their mandates, including their regulatory and compliance obligations and their commitments to their customers.



The affected banks are competing for talent not just with other banks, but also with professional services and technology firms. There is a risk of losing staff in critical functions or with specialist skills in the areas of IT, risk, compliance and related functions to firms that are not subject to the remuneration restrictions. These difficulties may become more pronounced as competition for talent in the from the United Kingdom's decision to leave the European Union. As you are aware, Brexit has led to a significant number of financial institutions establishing a presence in Ireland in order to continue to service European Union clients. These financial institutions are likely to offer more flexible and attractive remuneration structures than those currently available in the impacted banks.

Against this background and taking account of the more stringent European remuneration regulations now in place, we believe there may be merit in allowing more enhanced flexibility with respect to remuneration for such staff. In particular, and if executed effectively, variable pay can support and incentivise behaviours that are consistent with positive consumer outcomes, the execution of the banks' business and risk strategies, corporate values, and long term interests, including guarding against excessive risk-taking.

The incorporation of variable pay into remuneration packages would also allow banks the flexibility to vary their costs in line with economic circumstances or business needs. If banks enter a downturn with a high fixed salary cost, the options available to reduce costs are more limited than if variable pay were in place. Any variable pay structure would have to be well-designed, consistent with European regulatory requirements and aligned to reinforcing a positive culture and good consumer outcomes.

From a sustainability standpoint, the Irish domestic banks have returned to profitability, albeit at relatively subdued levels. However, risks remain both from a prudential and conduct perspective. The banks need to continue to drive forward essential changes in order to build a resilient and trustworthy banking sector that sustainably serves the needs of the economy and its customers over the long term. These necessary changes include, inter alia:

- resolving the legacies of the crisis; most notably non-performing loans remain at elevated levels and make the banks highly vulnerable to future economic shocks; these



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need to continue to be resolved in a manner that ensures the fair treatment of financially-distressed borrowers;

- addressing vulnerabilities in their business models and developing sustainable strategies which reflect the changing operating environment; and
- reshaping culture, particularly a consumer-focused culture, which remains underdeveloped.

We do not have evidence that the remuneration restrictions are having a material effect on the pace or effectiveness of remediation of the aforementioned issues in these banks. In this context, it is worth noting that we continue to see similar governance and risk management issues, and underdeveloped cultures, in firms that are not subject to the additional restrictions imposed on these banks.

Finally, it is our view that enhancing flexibility with respect to remuneration will not in itself be a solution to the challenges within the affected banks. More must be done to better build pipelines of talent. There needs to be more ambition with respect to enhancing diversity, including targets and measures. Improving levels of diversity in the banking system, particularly at senior levels, will expand the talent pool and should help to deliver the necessary cultural improvements, improve decision-making and reduce the risk of groupthink. More consideration is also required on the overall composition and functioning of the executive management layer when making appointments, and barriers to changed behaviours need to be identified and eliminated.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Philip Lane".