



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**



Economic and Monetary Affairs

Employment and Social Affairs

Environment, Public Health and Food Safety

Industry, Research and Energy

Internal Market and Consumer Protection

**Workshop on Banks'
Remuneration Rules (CRD III):
Are they implemented and do
they work in practice?**

WORKSHOP



**DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

BANKS' REMUNERATION RULES (CRD III) ARE THEY IMPLEMENTED AND DO THEY WORK IN PRACTICE?

WORKSHOP

30 JANUARY 2012, BRUSSELS

Abstract

In 2010 the European Parliament adopted 'CRD III' (i.e. Directive 2010/76/EU amending the Capital Requirements Directives) which included some of the strictest rules in the world regarding bankers' bonuses. These rules took effect in January 2011. After one year of application, the ECON Committee felt that the time has come to check if these tough new rules on bonuses are properly implemented and have indeed effectively transformed the bonus culture and ended incentives for excessive risk-taking.

This workshop on the Implementation of Banks' Remuneration Rules (CRD III) seeks to gather information on the state of play of implementation, in particular diverging application and the effects thereof, and will try to gain views as to the efficiency of the new framework for bankers' bonuses. The views of the European Commission, as well as the current work of the Financial Stability Board (FSB), the European Banking Authority (EBA) and scientific experts in the area are properly taken into account for this evaluation.

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JANUARY 2012

PE 464.465

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Isabelle VAILLANT, Director, Cluster Regulation, European Banking Authority (EBA)

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PROGRAMME OF THE WORKSHOP



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

**WORKSHOP: Banks' Remuneration Rules (CRD III):
Are they implemented and do they work in practice?**

- Programme -

30 January 2012, European Parliament, Brussels

Room ASP 1G2; 15.00 - 17.30 hrs, Interpretation: DE, EN, FR

| | |
|---------------------------------|---|
| 15.00 - 15.15 h | Welcome and Introduction: Arlene McCARTHY, ECON Vice-Chair and rapporteur for CRD III in 2010 |
| Keynote speech | Michel BARNIER, Commissioner, European Commission, Directorate General Internal Market & Services |
| 15.15 - 16.15 h | <u>Presentation Session:</u> Have Member States properly implemented the remuneration rules of CRD III? Are banks complying with the rules? Are there differences in implementation in practice? |
| | Opening remarks by Arlene McCARTHY, ECON Vice-Chair |
| Guest speakers: | |
| Simonetta IANNOTTI | Member of the Secretariat, Financial Stability Board (FSB) <ul style="list-style-type: none">• The FSB Principles and Standards on Compensation Practices: Outstanding work to achieve full implementation and a level playing field |
| Isabelle VAILLANT | Director, Cluster Regulation, European Banking Authority (EBA) <ul style="list-style-type: none">• Overview of the implementation of remuneration rules (CRD III) and CEBS/EBA Guidelines on Remuneration Policies and Practices (2010) and outcome of EBA consultation |
| Maria Cristina UNGUREANU | Research Fellow, University of Genoa, Genoa Centre for Law and Finance <ul style="list-style-type: none">• Bankers' pay in EU banks after CRD III: Application of the rules in the EU and analysis of the effects |
| Kern ALEXANDER | Professor, University of Cambridge <ul style="list-style-type: none">• Practical implementation of CRD III remuneration rules in the U.K. - issues and results |
| Sony KAPOOR | Managing Director, Re-Define <ul style="list-style-type: none">• CRD III Remuneration Rules: Implications, limitations, lessons learned and the way forward |
| 16.15 - 17.20 h | <u>Discussion - Questions & Answers</u> |
| 17.20 - 17.30 h | Closing remarks by Arlene McCARTHY, ECON Vice-Chair |

CURRICULA VITAE OF SPEAKERS

Michel BARNIER

Having been active from an early age in the pro-Europe wing of the Gaullist movement, Michel Barnier was appointed in 1993 Minister for the Environment and would go on to be Minister for European Affairs (1995-1997), Minister for Foreign Affairs (2004-2005) and Minister for Agriculture and Fisheries (2007-2009). In 1999 he resigned from national office to take up his post, alongside Romano PRODI, as European Commissioner for regional policy and institutional reform. In 2009 he led the presidential majority's campaign in the European elections and was the head of the French Delegation of the EPP Group in the European Parliament. He was then proposed as European Commissioner by the President of the Republic Nicolas SARKOZY and took up his post, alongside José Manuel BARROSO, as Member of the European Commission responsible for Internal Market and Services.

Simonetta IANNOTTI

Simonetta Iannotti joined the FSB Secretariat in January 2010. Her main fields of activity are the policy development and financial reforms on systemically important financial institutions, compensation structures and macroprudential frameworks. She represents the FSB in the Basel Committee Task Force on Compensation and in the Macroprudential Working Group. She was responsible for the FSB Second thematic review on compensation. Prior to joining the FSB, she worked at the Bank of Italy, first in the area of Macroprudential Analysis and then in Supervision, responsible for supervisory methodologies on Internal Economic Capital models and stress testing within Pillar II. She represented the Bank of Italy in the Basel Committee Risk Management and Modelling Group (RMMG).

Author of several articles on banking, her main research interests included the study of bankfirm relationships, risk management and regulation. Simonetta holds a PHD in Banking and Regulation from Università La Sapienza, Rome.

Isabelle VAILLANT

Ms Isabelle Vaillant was recently appointed as Director of the Cluster Regulation of the European Banking Authority (EBA) where she took office on 1 October, 2011. Before that date, she was Head inspector for on-site examinations at the French Financial Markets Authority. Ms Vaillant was on secondment from the Banque de France where she spent most of her career holding several positions including Deputy Director of the European and International Relations Directorate (2007- 2010), Head of the Large International Credit Institutions Supervisory Department (2005-2006), Head of the International Regulation Department (2001-2005), Head of the European Regulation Division (1996-2005), etc. Ms Vaillant graduated from the Institut d'Etudes Politiques de Paris (Sciences Po - Paris Institute of Political Studies) and completed a postgraduate MSc in Economics and Econometrics at the Nanterre University Paris X. She published several research papers in English and French on different topics including *Foreign currency risk in Eastern European banking sector (2009)*; *How to efficiently reconcile FSAPS and article IV (2008)*; *Emergency Liquidity Assistance and the backing of supervisory function by central banks (2001)*; *Banks' preparation for the Euro (1998)*; *Banking crisis, resolution or liquidation (1996, Revue Banque et Stratégie)*, etc.

Maria Cristina UNGUREANU

Maria Cristina is independent consultant in corporate governance, research fellow at the Centre for Law and Finance (Genoa), academic member of the European Corporate Governance Institute (Brussels) and visiting lecturer at the University of Pavia. Prior to her research activity she worked in investor relations and corporate communication in London and Johannesburg.

Her areas of research and knowledge include corporate governance, financial services regulation and investor relations. She holds a Bachelor Degree in Economics, a Masters Degree in International Relations and a PhD in Finance from the University of Iasi, Romania.

She is author of several papers on executive remuneration, corporate governance and European financial integration. She is often invited at international conferences and seminars to present on these topics.

Kern ALEXANDER

Kern Alexander holds the Professorial Chair in Law and Finance at the University of Zurich and is also Senior Research Fellow in Financial Regulation at the Centre for Financial Analysis and Policy, University of Cambridge. In 2011, he was appointed Specialist Adviser to the UK Parliament's Select Committee on the Draft Financial Services Bill. He is also a Member of Expert Panel on Financial Services for the European Parliament. He is the author of numerous academic articles and several books on banking and securities law and international economic and financial regulation. His academic articles have been published in peer-reviewed journals, including the *Journal of International Economic Law*, *Journal of Corporate Law Studies*, the *European Business Organization Review*, and the *Journal of Banking*. He is co-author with John Eatwell of *Global Governance of Financial Systems: the International Regulation of Systemic Risk* (Oxford University Press, 2005), which identified weaknesses in bank capital regulation and systemic risk in the OTC markets before the 2007 financial crisis. He is also the author of *Economic Sanctions: Law and Public Policy* (Macmillan, 2009) and *Law Reform and Financial Markets* (with N. Moloney; Elgar, 2011). In addition to academic publications, he has co-authored major reports commissioned by the European Parliament entitled 'Financial Supervision and Crisis Management in the EU' (2007), 'Clearing and Settlement in the EU' (2009), and 'Crisis Management, Resolution Regimes, and Solidarity Mechanisms in the EU' (2010). He has given oral and written evidence to the House of Commons Treasury Committee and the House of Lords Select Committee on Economic Affairs and to the European Parliament Committee on Economic and Monetary Affairs on topics ranging from EU and UK banking and financial law and regulation to the international law of economic sanctions. He was educated at Cornell, Oxford, Cambridge and London universities. He was educated Cornell University, University of Cambridge and University of Oxford.

Sony KAPOOR

Sony Kapoor's career spans working in the financial sector, with civil society and on public policy across several countries. As Managing Director of Re-Define, an economic and financial think tank that advises policy makers in the EU and internationally, he is deeply involved in finding a solution to the on-going economic and financial crises.

Mr Kapoor is known for his work on financial regulation, economic governance, crisis management and international development. In his personal capacity he is the chairman of the Banking Stakeholder Group of the European Banking Authority, a member of the expert panel of the Crisis (CRIS) committee of the European Parliament and a Visiting Fellow at

the London School of Economics. He is also a consultant to several governments and EU institutions.

Mr Kapoor has previously worked in investment banking and derivative trading for institutions including ICICI (International Credit and Investment Corporation of India), Lehman Brothers and Aquila Energy Limited. He left the financial sector in 2003 to work on reforming the financial system and improving public policymaking.

He has also worked extensively on international development, including during a stint as a strategy adviser to the Government of Norway. He co-founded the International Tax Justice Network, served on the boards of several NGOs, ran development economics at Christian Aid and was a strategy adviser to both Oxfam Novib and Jubilee USA. He was also a development finance consultant for the World Bank and United Nations as well as for governments in Europe and the developing world.

He has testified as an expert witness on international finance at the European Parliament, the US Congress, the Bundestag and other parliaments, and conducted seminars and lectures at various finance ministries, central banks, universities, multilateral institutions and the European Commission. His comments and analysis of the crisis are often picked up by publications such as the Financial Times & the Wall Street Journal and media outlets such as the BBC, Reuters and Bloomberg.

Mr Kapoor holds a Chemical Engineering degree from the prestigious Indian Institute of Technology, an MBA from the Faculty of Management Studies (University of Delhi), one of India's leading business schools and an MSC in International Finance from the London School of Economics.

KEYNOTE SPEECH BY MICHEL BARNIER, COMMISSIONER

Published on Commissioner Barnier's webpage:

<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/48&format=HTML&aged=0&language=FR&guiLanguage=en>

1. PRESENTATION BY SIMONETTA IANNOTTI



The FSB P&S on compensation:

Outstanding work to achieve full implementation and a level playing field

**EU Parliament workshop: Banks' Remuneration Rules (CRD III):
Are they implemented and do they work in practice?**

Simonetta Iannotti, FSB, Member of Secretariat
30 January 2012



Overview of the Financial Stability Board (FSB)

Established: April 2009

Chairperson: Governor Mark Carney (Bank of Canada)

Membership: Authorities responsible for financial stability (ie treasuries, central banks and financial supervisory agencies) of 24 jurisdictions

+

International standard setting bodies, IFIs and central bank committees related to market infrastructure

Location: FSB Secretariat is hosted by the Bank for International Settlements (BIS) in Basel, Switzerland.



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Compensation Roadmap

G20 endorsed the FSB Principles for sound compensation practices (London, April 2009) and their **Implementation standards** (Pittsburgh, September 2009)

BCBS/IAIS incorporated the Principles into supervisory guidance; IOSCO incorporated the Principles into disclosure guidance

Periodic review of implementation mandated to FSB

First review March 2010

G20 Toronto 2010: Maintain reform momentum
Countries to fully implement Principles and Standards by end 2010
FSB to undertake ongoing monitoring

Second review October 2011, with Assessment Criteria, presented to G20 FM&CBGs

G20 Summit 2011: Implementation monitoring

- Ongoing FSB monitoring on compensation practices
- Set up of bilateral complaint handling process

3



The First peer review on compensation

Published in March 2010, 1st Thematic Peer Review done by the FSB

Main observations:

- Progress and movement towards convergence across jurisdictions; first changes taking place in major firms
- Still early in the process and effective implementation far from complete
Gaps, different in approaches, technical difficulties
- Consulting firms review shows financial firms as responsive
- More work needed in some areas: **risk and performance alignment and disclosure**
- More evidence needed on changes in industry practices to complete judgment on the adequacy of ongoing efforts – **Second Review Mandated to FSB**

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The Second peer review on compensation

- **Published in October 2011, shortly before G20 Cannes Summit**
- **Relevant authorities and firms in FSB member countries have made good progress in implementing the Principles and Standards**
 - A total of 13 of 24 jurisdictions (7 more) have implemented all P&S; 5 have implemented all but one or two standards; remaining jurisdictions still in the process (all EMEs)
 - **Of the firms, 20 identified as large internationally active are most advanced; their compensation practices appear *on average* broadly consistent with P&S.**
 - These are located in jurisdictions that moved earlier, and were given priority in supervisory action: ***Implementation efforts do make a difference!!***
- **Despite these strides, more work is needed:**
 - A) To achieve full implementation by national authorities
 - B) To address concerns over level playing field issues, particularly in pay structures (St. 6-9); guarantees (St. 11); hedging (St. 14); identification of material risk takers

“Achieving lasting change within firms is a long term challenge that requires sustained commitment”

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The Second peer review: Close up on EU implementation

In the EU, convergence towards a rules-based regulatory approach following the implementation of the Capital Requirements Directive (CRD) III

- France, Germany, Italy, the Netherlands, Spain, and the UK are all among the 13 FSB jurisdictions that have achieved full implementation
- The 6 FSB members of the EU have incorporated the numbers in Standards 6 to 9 as minimum requirements. Other jurisdictions (Australia, Canada, Hong Kong, Japan, US) have interpreted the numbers in Standards 6 to 9 as examples rather than minimum requirements and allowed firms more flexibility, taking account of differences in their business models and risk profiles.

There are some differences in the proportionality approach:

- All 6 FSB Members of the EU regulate or plan to regulate compensation practices at all firms
- Germany Italy UK have also adopted a tiered approach that differentiates firms on the basis of their systemic importance
- All 6 FSB Members of the EU apply their frameworks to material risk takers and control staff at all levels of a firm; in Germany and Italy, smaller institutions have more discretion in how they extend these rules below the level of top executives

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All 6 FSB members of the EU had planned horizontal supervisory reviews for 2011



The Second peer review: Close up on firms' assessment

- Firms have made better progress in **governance structures** to oversee the compensation system's design and operation; 62 percent of the firms have broadly implemented the P&S
 - For firms with gaps, of relevance is an insufficient level of independence of the remuneration committee and little involvement of risk and compliance functions in the process,
- In **pay structures**, large internationally active firms have made more progress (higher numbers and less variation across firms). Numbers are similar for firms headquartered in North America and Europe
- Also good progress has been achieved in the areas of **no hedging** and **golden parachutes**
- More gaps in the area of **alignment of compensation** with performance; only half of the firms in the sample having broadly implemented the related P&S
- **Disclosure** is the area where most progress is needed; 26 percent broadly implemented the P&S

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The Second peer review: Recommendations

1 - Full implementation by national authorities

- Proportionality criteria clearly specified

2 – Addressing level playing field concerns

- Bilateral supervisory exchanges and complaint handling process
- To inform scope and intensity of FSB monitoring

3 – Ongoing implementation monitoring

- The FSB to undertake ongoing monitoring and public reporting on the implementation of the P&S
- To consider scope and appropriate timing for a follow-up peer review on compensation practices
- and any decision to issue additional FSB guidance on the interpretation of the definition of MRT

4 – Supervisory cooperation

- Supervisory networks to be used to exchange information to enhance the effectiveness and consistency of implementation. Focus on evolving practices in the areas of risk adjustment and performance alignment

5 – Effective governance of compensation

- Supervisors to ensure full adherence by significant firms to the key requirements in the area of effective governance of compensation.

6 – Disclosure

- Supervisors to ensure compliance by significant firms to Basel Committee's Pillar 3 disclosure requirements for remuneration from 1 January 2012.

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FSB: Renewed focus on implementation monitoring

G20 Summit 2011, agreed on the FSB to establish

- **Coordination framework for implementation monitoring**

*We agree to intensify our monitoring of financial regulatory reforms, report on our progress and track our deficiencies. To do so, we endorse the **FSB coordination framework for implementation monitoring**, notably on key areas such as the Basel capital and liquidity frameworks, OTC derivatives reforms, compensation practices, G-SIFI policies, resolution frameworks, and shadow banking.*

- **Ongoing monitoring and public reporting on compensation practices**

*We reaffirm our commitment to discourage compensation practices that lead to excessive risk taking by implementing the agreed FSB principles and standards on compensation. While good progress has been made, impediments to full implementation remain in some jurisdictions. We therefore call on the FSB to undertake an **ongoing monitoring and public reporting on compensation practices** focused on remaining gaps and impediments to full implementation of these standards and carry out an **on-going bilateral complaint handling process to address level playing field concerns of individual firms**. Based on the findings of this ongoing monitoring, we call on the FSB to consider any additional guidance on the definition of material risk takers and the scope and timing of peer review process.*

9



References

- **Principles for sound compensation practices**

http://www.financialstabilityboard.org/publications/r_0904b.pdf

- **Implementation standards**

http://www.financialstabilityboard.org/publications/r_090925c.pdf

- **First Thematic Peer Review on Compensation Practices**

http://www.financialstabilityboard.org/publications/r_100330a.pdf

- **2011 Follow up Peer review**

http://www.financialstabilityboard.org/publications/r_111011a.pdf

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FSB FINANCIAL STABILITY BOARD

Background slides

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FSB FINANCIAL STABILITY BOARD

FSB Country membership

| | | |
|--------------------|--------------------|------------------------|
| <u>Australia</u> | <u>Hong Kong</u> | <u>Singapore</u> |
| <u>Canada</u> | <u>Italy</u> | <u>Switzerland</u> |
| <u>France</u> | <u>Japan</u> | <u>United Kingdom</u> |
| <u>Germany</u> | <u>Netherlands</u> | <u>United States</u> |
| <u>Argentina</u> | <u>Indonesia</u> | <u>Saudi Arabia</u> |
| <u>Brazil</u> | <u>Korea</u> | <u>South Africa</u> |
| <u>China</u> | <u>Mexico</u> | <u>Spain</u> |
| <u>India</u> | <u>Russia</u> | <u>Turkey</u> |
| <i>FSF members</i> | | Total = 24 + <u>EU</u> |
| <i>G20 members</i> | | |

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FINANCIAL
STABILITY
BOARD

Objectives of the FSB

- **The FSB is an international body to co-ordinate the work of national financial authorities and international standard setting bodies**

to

- **Promote global financial stability**
 - Coordinate regulatory supervisory and other policy development and implementation
 - address vulnerabilities

The Financial Stability Board (FSB) is established to coordinate at the international level the work of national financial authorities and international standard setting bodies (SSBs) in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In collaboration with the international financial institutions, the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.

- FSB Charter, Article 1

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Mandate of the FSB

Original mandate (1999):

- assess vulnerabilities affecting the financial system, identify and oversee action needed to address them
- promote coordination and information sharing among authorities responsible for financial stability
- monitor and advise on market developments
- Advise on and monitor best practice in meeting regulatory standards

Broadened mandate – in addition (2009):

- Collaborate with IMF, including by conducting Early Warning Exercises
- Undertake joint strategic reviews of the policy development work of the international standard setting bodies
- set guidelines for and support supervisory colleges
- contingency planning for cross-border crisis management (particularly for systemically important firms)

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FSB Policy priorities

1. **Implementing the SIFI framework, including resolution**
 - Extension to Domestic SIFIs, global insurance companies and global non banks
 - Resolution Key Attributes: assessment methodology and thematic review
 - G-SIFI resolvability assessments, RRP, cross-border cooperation agreements
2. **OTC and commodity derivatives market reforms, including Global Legal entity identifier (LEI)**
3. **Shadow banking**
 - Framework for monitoring
 - Regulatory action in 5 areas
4. **Other reform areas**
 - CRAs
 - Consumer protection
 - Accounting standards convergence
5. **Implementation monitoring**
 - Country and thematic peer reviews
 - Monitoring of national implementation of agreed g20/financial reforms
6. **FSB resources and governance**

Source: *The G20 Cannes Summit* (<http://www.g20-g8.com/g8-g20/g20/english/for-the-press/news-releases/cannes-summit-final-declaration.1557.htm>)

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The FSB Principles for Sound Compensation Practices

Principles for effective governance in compensation

- The firm's board of directors must actively oversee the compensation system's design and operation
- The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended
- Staff engaged in financial and risk control must be independent, have appropriate authority and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm
- See also BCBS [Principles for enhancing corporate governance](#), October 2010

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FSB FINANCIAL STABILITY BOARD **The FSB Principles for Sound Compensation Practices**

Principles for effective risk-alignment of compensation

- Compensation must be adjusted for all types of risk
- Compensation outcomes must be symmetric with risk outcomes
- Compensation payout schedules must be sensitive to the time horizon of risks
- The mix of cash, equity and other forms of compensation must be consistent with risk alignment

See also BCBS [Range of methodologies for risk and performance alignment of remuneration](#), May 2011

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FSB FINANCIAL STABILITY BOARD **The FSB Principles for Sound Compensation Practices**

Principles for effective oversight and stakeholder engagement

- Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action
 - Now review to be conducted in PII

See BCBS [Enhancement to the BII Framework](#), July 2009

- Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders

See BCBS [Pillar 3 Disclosure requirements for remuneration](#), July 2011

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FSB Implementation standards

Motivation and Focus

- Detailed specific proposals on compensation governance, structure and disclosure to strengthen adherence to the FSB Principles for Sound Compensation Practices.
- Focus on areas where progress is needed:
 - Independent and effective board oversight of comp. policies → Remuneration committee
 - Linkages of total variable compensation pool to overall performance of the firm and need to maintain a sound capital base
 - Compensation structure and risk alignment (deferral, vesting, clawbacks)
 - Limitations on guaranteed bonuses
 - Enhanced public disclosure and transparency of compensation
 - Enhanced supervisory oversight of compensation

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**FINANCIAL
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Second thematic review: close-up on pay structure

20 Large internationally active firms, averages

| | Number of employees | Variable Compensation | | | | |
|---|---------------------|-------------------------|--------------------|-----------------------------------|---|--------------------------------------|
| | | % of total compensation | % that is deferred | Deferral period (number of years) | % awarded in shares or share-linked instruments | % subject to ex post risk adjustment |
| A. Most senior members of the executive board | 10 | 81 | 74 | 4 | 68 | 64 |
| B. Other members of the executive board | 7 | 78 | 67 | 4 | 61 | 62 |
| C. Other senior executives | 50 | 80 | 63 | 3 | 58 | 55 |
| D. Other employees whose individual actions have a material impact on the risk exposure of the firm | 704 | 76 | 59 | 3 | 52 | 48 |
| E. The most highly paid employees not covered above | 37 | 89 | 57 | 3 | 54 | 51 |

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2. PRESENTATION BY ISABELLE VAILLANT



ECON Workshop: Banks' Remuneration Rules (CRD III):
Are they implemented and do they work in practice?

Brussels, 30 January 2012
Isabelle Vaillant
Director Regulation

EBA
European
Banking
Authority

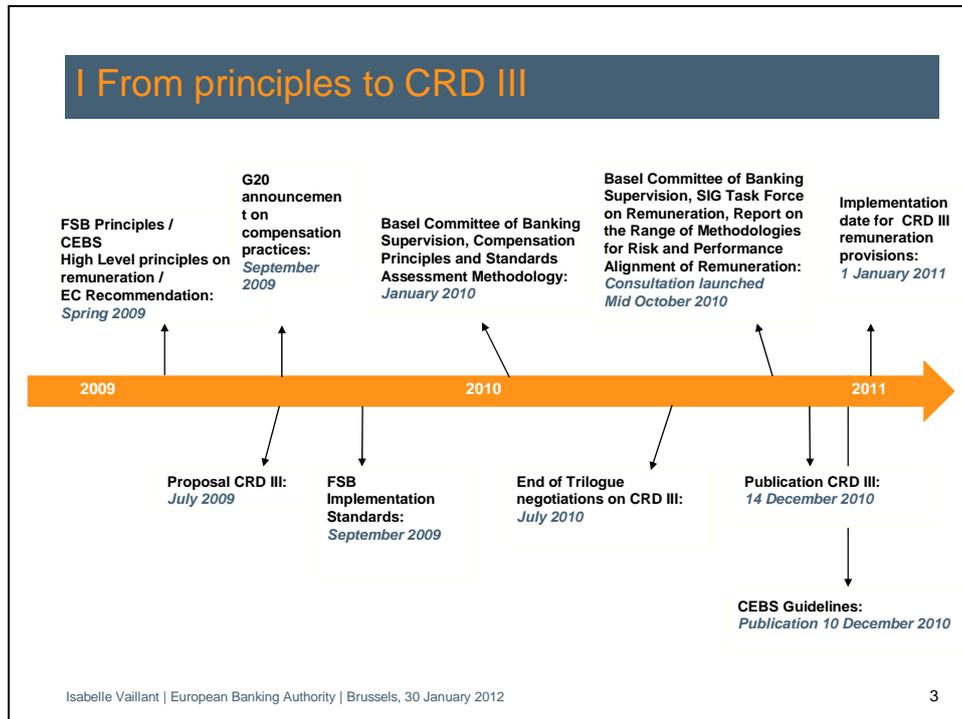
European System of Financial Supervision

Outline

- I. CRD III and Guidelines on remuneration policies and practices
- II. Implementation study: Preliminary findings
- III. Guidelines for data collection on bank remuneration practices

Isabelle Vaillant | European Banking Authority | Brussels, 30 January 2012

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- ### I Structure of CRD III remuneration provisions
- Published 14 December 2010 in the Official Journal
 - Recitals state intention to address the potentially detrimental effect of poorly designed remuneration structures on the management of risk and control of risk-taking behaviour by individuals
 - General legal basis: Art. 22 CRD
 - Annex V CRD: actual remuneration provisions (points 23 and 24)
 - Annex XII CRD: transparency provisions
 - Main purpose: Establishment of risk-based remuneration policies and practices, aligned with the long-term interests of the institution → Avoidance of excessive risk taking
- Isabelle Vaillant | European Banking Authority | Brussels, 30 January 2012 4

I Mandate for the EBA

The Committee of European Banking Supervisors shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in points 23 and 24 of Annex V.

→ Broad but limited at the same time:

CEBS Guidelines document is all-encompassing with its own logic, but constrained by clear level 1 decisions

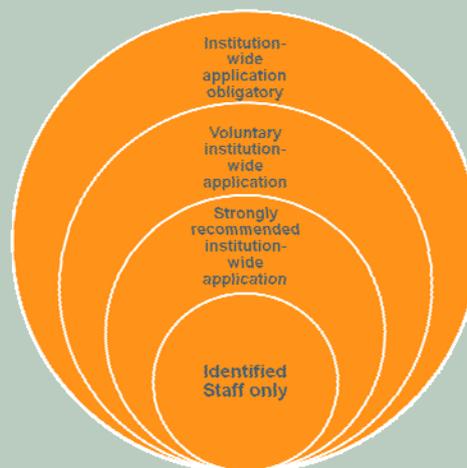
→ Aims at creating a level playing field within EU while keeping flexibility at the same time

I Summa divisio

- Common introductory outlines
- Distinction between:

- Three blocks:

- Governance
- Risk alignment
 - General requirements
 - Specific requirements
- Transparency



II Preliminary Findings of the Implementation study

- Launched in November 2011
- Two main areas examined:
 - (i) How did legislators and supervisors implement the guidelines in their legislative frameworks?
 - (ii) How are the principles of the GL supervised in practice?
- Around 90 questions divided into three blocks:
 - (i) General aspects of implementation,
 - (ii) specific implementation questions,
 - (iii) implementation of specific principles.
- Plus: numerical information for a sample of banks that represents at least 60% of total assets or the 20 largest institutions in one Member State.

Isabelle Vaillant | European Banking Authority | Brussels, 30 January 2012

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II Areas where satisfactory progress has been achieved

General aspects of implementation:

- Guidelines were implemented swiftly by all NSAs except for two due to delays in the legislative process regarding CRD III transposition.
- In all countries, the guidelines are part of the Supervisory Review Process.

Specific aspects of implementation

- Governance of remuneration:
 - Good implementation of the governance requirements has been observed
 - Remuneration committees broadly set up
 - Management body in its supervisory function involved in determination of remuneration schemes.
- Risk alignment: The setting up of multi-year frameworks, including deferral periods, is now widespread.

Isabelle Vaillant | European Banking Authority | Brussels, 30 January 2012

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II Critical areas which need further supervisory work

Scope of application

- No substantive exemptions at national level to the application of the guidelines, HOWEVER
- Considerable variations in terms of application of the guidelines beyond the scope of the CRD and proportionality, e.g. application on insurance undertakings and/or no thresholds for application of proportionality.
- Identified risk takers: Large variety of criteria for this internal exercise is applied, e.g. Case-by-case decisions without fixed criteria, salary thresholds, position in the organisation.
- Number of risk takers differs considerably between Member States, with a clear tendency towards low numbers.
- Substantial threat to the effectiveness of the EU supervisory reforms on remuneration.

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II Critical areas which need further supervisory work

Techniques for risk alignment

- Net profits and, to a lesser extent, risk adjusted performance parameters are used for setting-up bonus pools, HOWEVER
- Lack of consistence with parameters used for risk management purposes.
- Range of possibilities for discretionary judgements and a lack of transparency how they are applied.
- Criteria for ex-post risk adjustments tend to lack back testing character with regard to the initially measured performance.
- Observed ratios variable to fixed tend to be high and criteria for their determination not always transparent and plausible.

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II Critical areas which need further supervisory work

Preliminary conclusions:

Satisfactory implementation in legal and supervisory frameworks.

HOWEVER

Further supervisory guidance needed in the following areas:

- (i) Identification of Risk Takers,
- (ii) Scope of application beyond CRD,
- (iii) Determination of variable vs. fixed remuneration.

II Critical areas which need further supervisory work

Preliminary conclusions (2)

More advanced industry practices necessary in the areas of:

- Ex-ante and ex-post risk measurement techniques and linkage with risk taker's performance measurement and compensation,
- Alternative share plans,
- Usage of hybrid Tier 1 instruments.

III Guidelines for data collection on bank remuneration practices

- CRD III introduced two new tasks for the EBA:
 - (i) Benchmarking of remuneration trends and practices at Union level,
 - (ii) disclosure of the number of high earners on an aggregate Member State level.
- Both tasks require data collection in a harmonized fashion – to be facilitated by two guidelines.

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III Guidelines for data collection on bank remuneration practices

- Guidelines publically consulted July – September 2011.
- Comments mostly technical in nature; relating to scope of application, level of consolidation, award periods and date of first remittance.
- Guidelines will be published beginning of February.
- Date of first data remittance June 2012, relating to fixed and variable remuneration awarded for the 2010 and 2011 performance years.

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3. PRESENTATION BY MARIA CRISTINA UNGUREANU

Bankers' pay in EU banks after CRD III: Application of the rules in the EU and analysis of the effects

Maria Cristina Ungureanu

*Genoa Centre for Law and Finance
European Corporate Governance Institute*

*European Parliament
Workshop Implementation of CRD III remuneration rules
Brussels, 30 January 2012*

1

Transposition

Legislation through amendments to existing national laws
or / and
New regulations issued by financial supervisors

Generally follow the text of the CRD III

Some variation in implementation:

- Timing
- Proportionality
- Design

2

Transposition

| | UK | FR | IT | ES | NL | BE | LU |
|---------------------|--|---|--|---------------------------------------|---|--|--|
| Decree | | Decree of 13 December 2010 amending Regulation No. 97-02 on the internal control of credit institutions | | | Decree on Controlled Remuneration Policy (Jan '11) | Royal Decree of 22 February 2011 approving the CBFA Regulations and amending the Banking Law | |
| Law | | | | The Sustainable Economy Act (Mar '11) | | | |
| Regulation Circular | FSA, Remuneration Code (Revised) (Dec '10) | | Bank of Italy, Supervisory measures concerning the remuneration and incentive practices of banks (Mar '11) | | DNB, Regulation on Controlled Remuneration Policy (Jan '11) | Regulation of CBFA of 8 February 2011 on sound remuneration policies in financial institutions Circular CBFA_2011_05 on sound remuneration policy | Circulars CSSF 10/496 and CSSF 10/497 (Dec '10) Circular CSSF 11/505, Details relating to the application of the principle of proportionality (Apr '11) |

Undergoing research (as at December 2011)

3

Transposition

| | AU | DE | SW | DK | FI | RO | PL |
|---------------------|--|--|--|--|-------------------------------------|--|---|
| Decree | | Ministry of Finance, Ordinance on Remuneration in Financial Institutions (Oct '10) | | | | | |
| Law | Amendment to the Banking Act (Dec '10) | Amendments to the German Banking Act 2010 | | Bill on remuneration policies in financial (Nov '10) Amendment to the Danish Financial Business Act | | | Amendment to the Banking Act and the Act on Trading in Financial Instruments (Apr '11) |
| Regulation Circular | | BaFIN, Regulation on the Supervisory Requirements for Institutions' Remuneration Systems (Oct '10) | Swedish FSA, Regulations following the implementation of directive CRD III (Feb '11) | | Finnish supervision release 62/2010 | National Bank of Romania, Amendment to the Regulation 18/2009 concerning the management of credit institutions' activities | Banks: Resolution by Financial Supervision Authority Brokers: Regulation by the Ministry of Finance |

Undergoing research (as at December 2011)

4

Proportionality

Credit institutions and investment firms may apply the provisions in different ways according to size, internal organisation and the nature, scope and complexity of their activities

UK

4 tiers, each subject to decreasing minimum expectations of compliance:

- 1, 2 - credit institutions and broker dealers with significant banking activities
 - 3 - small firms that may occasionally take risks
 - 4 - no-risk firms
- 3 & 4 may neutralise the rules on deferral, performance adjustment and retained shares

Neutralisation for identified employees if:

- individual total remuneration < GBP 500,000, and
- individual variable remuneration < 33% of the individual total remuneration

5

Proportionality

Germany

Full adoption:

- Institutions with the average total assets of the previous three fiscal years \geq EUR 10 billion, and
- The importance of the institution is confirmed in a self-conducted complex risk analysis

Italy

Full adoption:

- Larger financial institutions – i.e. with consolidated asset value of at least EUR 40 Billion
- Risk employees:
 - earnings above EUR 200,000/year, or
 - variable part exceeding 20% of the total remuneration

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Proportionality

Luxembourg

Allowing proportionality for:

- Banks:
 - Total assets do not exceed EUR 5 billion; and
 - The global capital requirement to cover risks < EUR 1,562,5 million
- Investment firms: Net result of their activities is lower than 20% of the global net result before taxation
- Employees: Variable remuneration < EUR 100,000

Netherlands

- Generic provision – concerning investment firms

7

Variations

UK

- **Deferment:** GBP 500,000 the amount of variable remuneration triggering the 60% deferral requirement

Italy

- **Retention period:** 2-year retention period applying to the upfront part of variable remuneration paid in financial instruments

Germany

- **Deferment:** additional requirements - at least 50% of the deferred element must be subject to the continuing sustainable development of the bank

Austria

- **Deferral period:** minum 5 years

8

Variations

Belgium

- **Deferment:** 50% of variable remuneration with 25% being deferred for a two year period and 25% for a period of at least three years
Variable remuneration < 25% of total gross remuneration need not be deferred

Netherlands & Romania

- **Timing:** rules apply only as from 2011 onwards

Did not apply to:

- Remuneration due on the basis of contracts concluded before January 1 2011 and awarded after this date
- Remuneration awarded for services provided in 2010 and not yet paid by January 1 2011

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Implementation issues

- Temporal differences in implementation --- 'first mover disadvantage'
- One-sided implementation --- 'country disadvantage'
- More onerous rules for banks --- 'industry disadvantage'
- Differences in application of the proportionality principle --- complexity of global compensation schemes at international banks
- Employment law issues: malus and clawback

e.g. Austria, Belgium, France, Germany, Italy

- Q1: right of the employee to refuse amendments to an existing contract
- Q2: right of a financial institution to claim reimbursement of remunerations paid in breach of CRD III

Answers depend on

- The legal nature of the implementation instruments; reaction of national legislators

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Adoption by banks

Research: 34 Banks FTSEurofirst 300 - market capitalisation

| | | | | | | | | | | | |
|----|----|----|----|----|----|----|----|----|----|----|----|
| UK | IT | ES | FR | SW | CH | DE | AU | BE | NO | DK | GR |
| 5 | 5 | 4 | 4 | 4 | 3 | 2 | 2 | 2 | 1 | 1 | 1 |

Variation in progress among banks

- More progress – UK, CH, FR, IT
banks in countries with early implementation of the global standards
- Slow progress – AU, ES, GR
banks in jurisdictions at an early stage of implementation

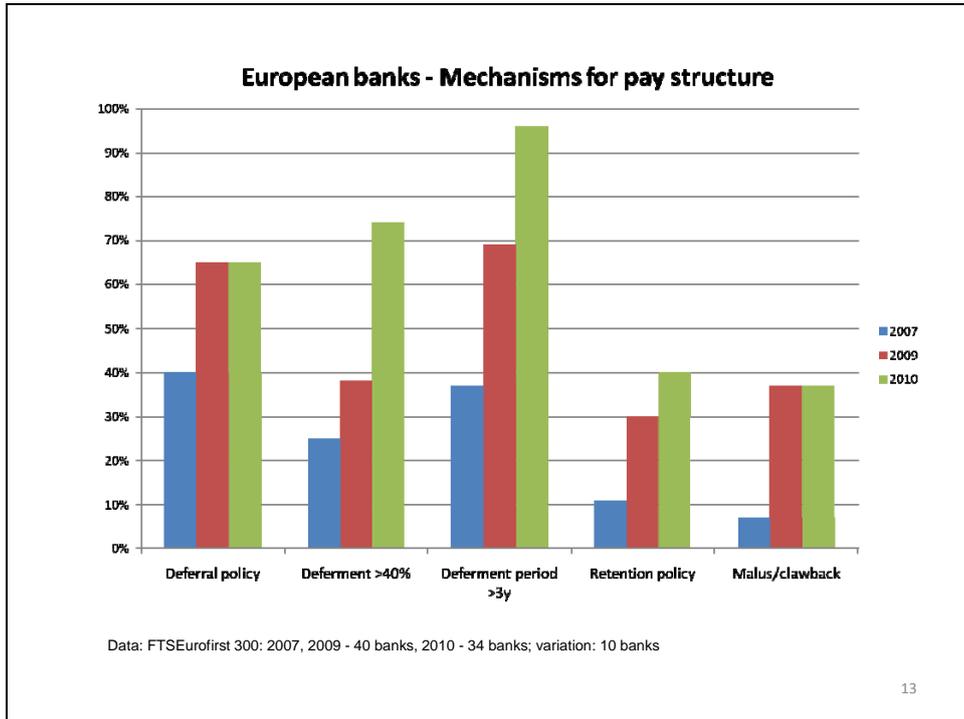
Nature of transposition (decree/law/regulation) does not seem to influence

Application of risk considerations by the banks that reviewed pay policies

- Incorporating economic profit, return on risk weighted assets
- Involvement of risk & control functions
- Clawback still at low levels

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| Area | Criteria | Incl. UK | Continental Europe |
|------------------------|----------------------------------|----------|--------------------|
| RemCom | RemCom existence | 94% | 93% |
| | RemCom - majority independent | 69% | 66% |
| | Risk function in the process | 51% | 44% |
| Remuneration structure | Cash+bonus + LTIP | 69% | 65% |
| Remuneration policy | Deferment Y/N | 66% | 66% |
| | Deferment > 40% | 74% | 41% |
| | Deferment > 3y | 96% | 59% |
| | Equity/Instruments > 50% | 31% | 24% |
| | Retention period | 40% | 31% |
| | Malus / clawback | 37% | 28% |
| Disclosure | Consolidated remuneration report | 63% | 59% |
| | Remuneration policy | 89% | 89% |
| | Individual disclosure | 71% | 69% |



Disclosure

Assessment based on disclosure in Annual Reports – limits

Generally, no significant improvement in disclosure comparing to previous years

- Italy-exception, improved considerably
 - UK, Swiss banks still best performers
 - Austrian, Portuguese, Greek banks: lowest range - no individual disclosure
- UK top 5 banks: disclosure of five highest paid senior executives in addition to that of executive directors (Project Merlin)

Research complemented with reports from the Authorities (field research)

- FED – Horizontal Review: 16 US operations & 9 US operations of EU banks
 - FSB – Thematic Review: a wider spectrum, including large and smaller institutions from across all continents
- Similar results

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Conclusions

- Implementation in practice reflects the pace of national transposition and the degree of international activity of each bank
- A certain degree of convergence has been achieved – general principles
- Variations may enhance the complexity of remuneration policies, particularly at cross-border banks
- However, harmonization of compensation rules is not always beneficial
 - Introducing rigidity in pay structures
 - Depriving boards of the possibility to experiment new arrangements
- Banks should consider the reforms as an opportunity to rethink their compensation design

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Related research

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- Guido Ferrarini & Maria Cristina Ungureanu, *Lost in Implementation: The Rise and Value of the FSB Principles for Sound Compensation Practices at Financial Institutions*, Revue Trimestrielle de Droit Financier, N. 1-2, May 2011, pp. 60-65; runner-up ICFR-Financial Times Research Prize 2010
- Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks*, 64 Vanderbilt Law Review, 2011, 431-502
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- Guido Ferrarini, Niamh Moloney & Maria Cristina Ungureanu, *Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe*, 10 Journal of Corporate Law Studies 73, 2010, 73-118

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4. PRESENTATION BY KERN ALEXANDER



**Universität
Zürich**^{VZH}
Rechtswissenschaftliches Institut



Cambridge
Finance

Practical implementation of CRD III remuneration rules in the UK – *issues and results*

European Parliament Workshop on
the Implementation of the CRD III
Remuneration Rules

Professor Kern Alexander
30 January 2012

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Main points

Objectives of remuneration regulation

UK bank remuneration regulation pre-CRD III

UK bank remuneration regulation post-CRD III

Difficulties and challenges

Related issues

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Finance

Objectives of remuneration regulation

1. *Reduce principal-agent problem – asymmetric information. Enhanced shareholder monitoring and complete contracts to control bankers' excessive risk-taking and enhance firm performance*
2. *Public policy concerns of taxpayer subsidies to financial firms (ie., bailouts) that encourage failed business and risk management. Subsidies create moral hazard to encourage greater risk-taking than what is socially optimal.*
3. *Social and political backlash at huge salary differentials and big bonuses – ,Occupy the City', ,Occupy Wall Street'*

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Cambridge
Finance

UK bank remuneration regulation

UK remuneration regulation pre-CRD III inadequate but 2009 Code and FS Act 2010 provided adequate regulatory and legal basis for reforms

CRD III focuses attention on agency problems and excessive risk-taking. But rules on bonuses too prescriptive and will lead to much higher compliance costs for EU/UK firms and competitive problems with non-EU firms in attracting personnel.

Increased complexity of CRD III may lead to regulatory capture and limit market disclosure

Role of shareholder stewardship?

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| | |
|---|---|
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| <h2>UK remuneration regulation pre-CRD III</h2> <p>European Commission Recommendations (2009)</p> <p>FSA Remuneration Code 2009 – implemented into FSA Handbook through Part 4 powers.</p> <p>Financial Services Act 2010 – FSA statutory powers to require disclosure Regulate the way banks pay employees Recover deferred and undeferred compensation (malus & clawback)</p> | |
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| | |
|--|---|
|  Universität Zürich ^{VZH} Rechtswissenschaftliches Institut |  |
| <h2>CRD III – key areas for UK</h2> <p>Align remuneration with effective risk management</p> <p>Prescriptive rules-based regime for bonus controls – 50%, 40%/60% rule.</p> <p>Performance-based measures over time as risk materialises and bonus adjustment rules</p> <p>Enhanced corporate governance (ie., independent remuneration committees) and proportionality</p> <p>Covers most EU-based financial firms and overseas branches and EU subsidiaries of non-EU groups</p> | |
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UK remuneration regulation and CRD III FSA Revised Remuneration Code 2010 –

Principle 12 ‘remuneration structures’
Reluctant adoption of 50%, 40%/60% rule
Critical of CEBS interpretations

Proportionality principle
De minimis rule
4 classifications of firms – application
intensity depends on firm size, nature of
risks, and market inter-connections

Performance adjustment – *malus* and clawback

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Challenges of implementation for UK

CRD III remuneration requirements – especially rules-
based bonus structures - increase **complexity**

Difficult for shareholders and stakeholders to
comprehend complicated rules.

Limits effective disclosure to the market, thereby
reducing shareholder protection and weakens risk
management. Lack of disclosure of pay bands

***Unintended effect of increasing excessive risk-
taking and undermining firm performance***

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Shareholder stewardship and moral hazard

Role of large bank shareholders encouraging excessive risk-taking

Limited liability structure creates moral hazard for shareholders to pressure the board/executives to approve greater risk-taking and reward it with lavish bonuses. Prior to crisis, greater leverage increased risk-adjusted returns on equity (ROE) (25% for some large banks). New metrics on performance needed.

Limitations on limited liability?
New culture of shareholder stewardship?

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5. PRESENTATION BY SONY KAPOOR

Improving Remuneration Practices in the Financial Sector CRD III – Implications, Limitations, Lessons learnt & the way forward

Sony Kapoor

Managing Director

Re-Define

European Parliament Workshop on Implementation of CRD III Remuneration Rules
Brussels, 30 January 2012

1

Implications: Objectives addressed! Success?

- Reduce incentives for excessive risk-taking (3/10)
- Reduce incentives for socially harmful activities (2/10)
- Make compensation structures fairer (3/10)
- Conserve capital for financial institutions (1/10)
- Allow a firm to better manage costs through the cycle (2/10)
- Align incentives with interests of shareholders, stakeholders or society (1/10)

2

Implications: Performance of CRD III Provisions?

- Align remuneration to risk (4/10)
- Capital retention (1/10)
- Limits on upfront cash bonuses (8/10)
- Deferment & claw back (5/10)
- At least 50% in shares or similar instruments (5/10)
- Bonuses capped to salary (1/10)
- Limits to bonuses in bailed out banks (3/10)
- Bonus like pension covered (Too soon to tell)
- Transparency & benchmarking of pay (2/10)
- Corporate governance reforms (4/10)

3

Limitations: How can such high bonuses be payable?

- Scalability of financial activities
- Implicit and explicit subsidy provided by society
- Complexity and opacity of financial activities
- Lack of competition in the financial services industry
- A fundamental mis-understanding between risk and loss
- Behavioural economic explanations

4

Limitations: How are these bonuses generated?

- Taking on excessive leverage
- Business line diversification
- Expansion of trading books
- Growth of structured products
- Churning in trading
- Too many LBOs and M&A deals
- Riskier assets
- Taking on excessive maturity mis-match
- Writing options

5

Lessons: Understanding incentives

- Deal A: 80% chance of \$50 million profit & 20% chance of \$100 million loss
- Deal B: 80% chance of \$100 million profit & 20% chance of \$300 million loss
- The expected value of deal A and deal B both is \$20 million but they have a very different risk profile. Deal B poses a much greater risk for the bank.
- Now imagine that the trader was entitled to 25% of the profit he generated (a smaller percentage is more likely but 10% - 20% is not uncommon for star traders).
- Let us further assume that he would get fired in case the bank lost money on the deal – usually the worst outcome that can befall a trader.
- So from the traders point of view Deal A = 80% chance of \$12.5 million bonus (25% of \$50 million profit) and a 20% chance of zero compensation. Deal B = 80% chance of \$25 million bonus and 20% chance of getting fired and hence zero compensation.
- For the trader, Deal A has an expected value of \$10 million and Deal B has an expected value of \$20 million. He will almost always choose Deal B.
- Because, part of the downside of the trader's decisions is borne not by him personally but by the firm, he will almost always choose to load the firm up on risk so as to maximize his personal bonus payment.
- The closer the links of the bonuses to profit generated, the less the risk adjustment, the lower the base salary as a component of the total compensation the more excessive risk the trader has an incentive to take compared to what might be optimal for the firm.

6

Lessons: Understanding Incentives

- Now let us look at the shareholder perspective
- Let us assume that a bank has a share capital of \$100 million. Let us say it faces the same decisions as the trader
- Deal A: 80% chance of \$50 million profit & 20% chance of \$100 million loss
- Deal B: 80% chance of \$100 million profit & 20% chance of \$300 million loss
- Typically, investment bank shareholders get about 50% revenue earned in the form of dividends with the rest distributed amongst employees.
- The pay-off for Deal A = $0.5 \cdot (0.8 \cdot \$50 \text{ million} - 0.2 \cdot \$100 \text{ million}) = \$10 \text{ million}$.
- For deal B, it is important to consider that because of limited liability bank shareholders are only liable for the amount their shareholder capital which is \$100 million. So the most they can lose is \$100 million not \$300 million. The calculation will then take the form Deal B = $0.5 \cdot (0.8 \cdot \$100 \text{ million} - 0.2 \cdot \$100 \text{ million}) = \$30 \text{ million}$.
- Thus bank shareholders would prefer to do Deal B despite the fact that the deal is much more risky for the firm. Crucially, the \$200 million of excess losses will be borne by the financial sector outside the firm.

7

Lessons: Understanding Incentives

- Bank employees get the upside, in the form of bonuses, of the excessive risks they load on to the firms they work for. Their personal downside is limited to being fired, the equivalent of zero compensation. The downside instead falls within and outside of the firms they work for.
- Bank shareholders typically reap about 50% or so of the excess returns that the banks they own generate because of excessive risk taking by their employees. The downside of shareholders is limited to the amount of share capital they own since they have limited liability. The rest of the downside risk is borne by other stakeholders in the firm, such as bondholders; by other financial firms and by the real sector.
- The financial sector as a whole benefits completely from excessive profits generated by excessive risks taken but faces only part of the downside since a significant proportion of the costs fall on the real sector of the economy.
- Several levels of asymmetries exist, which work together to ensure that financial sector actors – employees, shareholders, firms and other stakeholders all have incentives to take on excessive risks and earn rents at the cost of the rest of the economy.

8

Way forward: Limiting the upside

- Limit bonuses and other forms of variable compensation to a small fraction of the fixed compensation say between 10%-50%. This would significantly reduce the asymmetry between the upside and downside faced by bankers because of their actions.
- Put an absolute cap on compensation, multiple of the average worker's salary 20 – 40 times.
- Impose a much higher tax on bonuses in excess of a certain amount, say Euro 25,000.
- Limit firm compensation in terms of percentage of revenue to say 25% of firm revenue on a 3 year rolling average basis.
- Make banks factor externality posed by employee behaviour when calculating bonus amounts.
- Impose a higher discount factor on the firm's compensation decisions as the overall level of risk in a firm and in the financial system increases.

9

Way forward: Limiting the upside

- Get the supervisor to ensure that bonuses are paid on a risk adjusted basis only where the adjustment needs to be done for 1) increased firm level risk 2) contribution to systemic risk 3) contribution to risk for the real economy.
- Impose penalty capital /liquidity requirements for firms with irresponsible compensation policies.
- Impose an industry wide moratorium on bonuses while firms are expected to replenish and build up their capital to the new levels expected under Basel III. This takes care of the collective action problem and allows authorities to limit bonuses more easily even after the moratorium expires.
- Introduce limits on the year on year growth of the bonus pool consistent with the growth levels seen in the real economy.
- Calculate bonuses only after the maturity of the deal the bonus has been paid for

10

Way forward: Increasing the downside

- Force bankers to put their bonuses into an escrow account for the duration of a business cycle – at least ten years.
- Introduce claw back provisions, linked to losses experienced in the firm or the broader financial system that may be attributable to excess risk taking.
- Introduce strict civil and maybe even criminal penalties for negligence of duty in case employees are found to have taken on excessive risks that were personally beneficial but harmful for the society at large.
- Introduce provisions against employees fired because of irresponsible risk taking so they are not able to work in the financial sector again.
- Link bonuses to subordinate debt? Cocos?
- Introduce personal liability?

11

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N.B. The references given on slide 12 and 13 are repeated with hyperlinks at the end of this presentation.

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Thank You

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Practical implementation of CRD III remuneration rules in the UK – issues and results

NOTE

Abstract

The Capital Requirements Directive III attempts to align bank remuneration practices with effective risk management and prudential regulation. The UK has adopted a Revised Remuneration Code to implement the requirements of CRD III. Questions remain, however, regarding how far these regulatory reforms go in protecting the financial system and society against excessive financial risk-taking. CRD III is premised on the notion that there are agency problems in the remuneration practices of financial institutions. CRD III provides a prescriptive rules-based approach to regulating bonuses for senior executives and risk traders that creates complexity and limits effective disclosure to the market. Moreover, it does not address the moral hazard in limited liability corporate structures which incentivises shareholders to influence bank managers to take excessive risks. CRD III will probably do little to control excessive financial risk-taking and may also undermine the competitiveness of the EU and UK banking sector in globalised financial markets.

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LIST OF ABBREVIATIONS

| | |
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| 2009 Code | FSA Remuneration Code 2009 |
| 2010 Code | FSA Remuneration Code 2010 |
| CRD III | Capital Requirements Directive III |
| FSA | UK Financial Services Authority |
| FSMA | UK Financial Services and Markets Act 2000 |
| FS Act | UK Financial Services Act 2010 |

EXECUTIVE SUMMARY

The structure of bank compensation was often designed to create incentives for traders to book short-term profits based on excessively risky behaviour which had the effect of increasing systemic risk in the financial system and weakening the bank's medium and long-term prospects. Shareholders failed to provide adequate stewardship over bank senior management and risk-takers by allowing them to be compensated based on short-term revenue, rather than longer-term profitability. The EU Capital Requirements Directive III seeks to align the remuneration practices of banks and financial firms with effective risk management and prudential regulation. It does so largely with a prescriptive rules-based regime that attempts to reduce the agency problems in financial firm bonus practices that can lead to excessive risk-taking and poor firm performance.

The paper analyses the main issues related to the UK's implementation of CRD III's variable remuneration requirements and discusses how these requirements may affect risk management and prudential regulation. Part 1 reviews the UK legislative and regulatory initiatives before adoption of CRD III, including the FSA's 2009 Remuneration Code and its overriding principle to link bank remuneration to effective risk management. It also discusses the relevant provisions of the UK Financial Services Act 2010 that authorise the FSA to regulate financial firm remuneration by restricting how bonuses are paid and adjusting remuneration based on firm performance. Part 1 also compares the UK's largely principles-based variable remuneration (bonus) requirements to the more prescriptive rules-based requirements of CRD III and shows how the FSA is implementing the CRD III requirements. Part 2 discusses some of the unintended effects of CRD III that may undermine its overall effectiveness. UK implementation of CRD III may result in remuneration rules becoming more complex, thereby making it more difficult for shareholders and other stakeholders to monitor financial institution's remuneration practices. This limits effective disclosure by making remuneration more opaque and exacerbating agency problems. Moreover, the paper argues that CRD III does not address the moral hazard problems created by limited liability corporate structures in financial institutions that incentivise shareholders to influence managers and risk traders to take excessive balance sheet risks at the expense of creditors, depositors and customers. Part 2 then charts a path forward for UK remuneration regulation under the new UK supervisory regime. Although CRD III addresses some of the important agency problems in financial firm remuneration, its prescriptive nature and limited jurisdictional application to EU-based financial groups may lead to circumvention, greater risk-taking, and a loss of competitiveness for the EU and UK financial sector.

1. UK REMUNERATION REGULATION BEFORE AND AFTER CRD III

Major weaknesses in corporate governance at UK banks and financial institutions contributed significantly to the financial crisis. Specifically, the structure of bank compensation at UK banks created incentives for senior managers and traders to book short-term profits based on taking excessive risks that not only weakened the bank's medium and long-term prospects but also increased systemic risk in the financial system. The predominant business ethos in the banking industry was based on generating higher revenues that led to higher cash bonuses that contributed to weaker bank performance at the expense of bank customers, depositors and long-term shareholders. UK policymakers and regulators failed to understand how the compensation arrangements of banks and other financial institutions drove excessive risk-taking and undermined effective risk management.

1.1. UK legislative and regulatory initiatives on bank remuneration before CRD III

In recent years, several studies have shown that executive compensation at the largest FTSE 100 companies and large UK banks and financial companies has increased at alarming levels.¹ Even at the Royal Bank of Scotland – one of Britain's largest banks which is 84% owned by the UK taxpayer - which collapsed in 2008 under the leadership of Sir Fred Goodwin, the RBS Board is considering whether to approve a £1 million bonus for its CEO Stephen Hester for 2011 that is in addition to his £1.2 million annual salary.² As UK economic growth stagnates in 2011, executive pay in FTSE 100 companies increased on average by 49% compared with just 2.7% for the average employee.³ These gaps in remuneration between senior executives and the average employees of UK companies are extraordinary and have created a public backlash which is causing British politicians to look closely at whether high pay awards in the private sector should be restricted.

Bank remuneration arrangements were identified as playing a significant role in contributing to excessive risk-taking by senior management and risk traders prior to the recent crisis. At the time, there was no express UK statutory authority for the Financial Services Authority to impose restrictions on the compensation practices of UK regulated institutions. Although the FSA had discretionary authority to impose requirements on regulated firms, including controls on compensation, as part of their Part 4 authorisation conditions under the Financial Services and Markets Act 2000, it followed a principles-based regulatory approach that deferred to the discretion of management to decide remuneration structures and other risk controls so long as regulatory objectives appeared to be met. Firm remuneration structures were viewed by the FSA to be a matter for managerial discretion and contract law between firms and their employees.

In November 2009, Sir David Walker published his review of UK bank corporate governance which contained, among other things, proposals on compensation standards for UK banks and financial firms.⁴ The Walker Review adopted 11 principles on remuneration that cover roles and responsibilities of remuneration committees, skills and experience of members, responsibility for approving and reviewing remuneration policy;

¹ See THE HIGH PAY COMMISSION 2011, pp. 8–9.

² See *Financial Times Leader*, (20 Jan. 2012).

³ THE HIGH PAY COMMISSION 2011, p. 9.

⁴ Sir David Walker, *The Walker Review* (26 Nov. 2009) chap. 7 (compensation practices).

risk management input into the remuneration process; and incentive structures for *'high-end'* employees. Of particular importance was its proposal for retention periods for the vested benefits of senior executives and *'high-end'* employees.⁵ The Walker Review's principles influenced⁶ the FSA's development of a Remuneration Code (the 'Code') in 2009,⁷ which was later revised in 2010 to take account of changes brought about by CRD III.

The FSA's 2009 Code was designed to provide a flexible principles-based approach for developing remuneration structures that enhanced firm performance whilst achieving regulatory objectives. For instance, Principle 8 addressed remuneration structures for *'code staff'* of financial firms by providing legally non-binding guidance for how firms and their code staff should be classified in remuneration policies and the metrics used to assess their performance. FSA consultations revealed general satisfaction with the principles-based approach for classifying firms and their staff into risk categories before applying remuneration disciplines, but some firms expressed dissatisfaction with the lack of clarity regarding compliance and lack of consistency regarding firms posing similar risks.⁸ In 2010, the FSA adopted a Revised Remuneration Code containing more specific criteria for assessing remuneration policies that were aimed at implementing the more prescriptive rules-based requirements of CRD III.

Before the Revised Code was adopted, the UK Parliament enacted the Financial Services Act 2010,⁹ which reinforced the 2009 Code's key principles. Sections 4 to 6 of the Act contain a number of provisions concerning bank remuneration. The Act authorised the Treasury to adopt secondary legislation that delegated new powers and duties to the FSA to devise and enforce minimum standards on remuneration at regulated firms, including requiring firms to disclose remuneration-related matters. The FS Act 2010 also contained two provisions that required the Treasury to delegate powers to the FSA to prohibit employees (or groups of employees) from being remunerated in specific ways. Remuneration contracts that breach prohibitions or restrictions on types of remuneration adopted by the FSA under its Code can be rendered void. The other provision empowers the FSA to require the 'recovery of any payments made, or other property transferred' if such transfers are pursuant to contracts that are rendered void or which breach compensation requirements under the Code.¹⁰

1.2. The FSA Remuneration Code and CRD III implementation

CRD III generally requires that financial sector remuneration be aligned with effective risk management. It is premised primarily on the idea that there are agency problems in financial firm remuneration structures that incentivise managers and risk-takers to take excessive financial risks that reduce shareholder value and undermine financial stability.

⁵ Ibid. It states '[e]xecutive board members and 'high end' employees should be expected to maintain a shareholding or retain a portion of vested awards in an amount in line with their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee'

⁶ For example, the Walker Review's recommendation on retention of vested benefits influenced the FSA to adopt a similar approach in the 2009 Code (Principle 8) and the FSA Handbook.

⁷ The FSA Code was initially adopted based on the Financial Stability Board's 2009 'Sound Principles on Compensation' that sets forth principles for states to regulate pay and bonuses in order to prevent firm compensation structures from encouraging excessive risk-taking.

⁸ The Financial Services Authority, Policy Statement, (December 2010). The FSA found that '[i]n last year's [2009] implementation process, we found that the rules and guidance on remuneration structures presented the most challenges and so, following issuance of a supervisory framework to firms in December 2009, we are now proposing additional guidance [in 2010 pre-CRD III] on these key aspects.'

⁹ The Financial Services Act 2010 received the Royal Assent on 8 April 2010 and became effective on 8 June 2010.

¹⁰ The FINANCIAL SERVICES AUTHORITY (FSA) 2010a, nos. 2.4-2.6.

CRD III creates prescriptive rules that limit the cash element of upfront bonuses to a maximum of 30% of the total bonus, while limiting the cash element of large upfront bonuses to 20%. At least 50% of the total bonus must be paid in shares or equivalent instruments, and this should be applied equally to the deferred and non-deferred portions of the bonus. This means a banker receiving a £100k bonus could receive an upfront cash payment of £30k, but that would have to be matched (50/50) with £30k in upfront shares that would have to be retained over a period of time (not yet determined by the European Banking Authority). The deferred portion of the £100k bonus (£40k) could be received equally in cash (£20k) and shares (£20k) on a pro rata basis over a 3 year period beginning not before the third year following the receipt of the upfront bonus. This 50%, 40%/60% formula aims to link bonus payments to longer term firm performance.

Earlier, the FSA had taken the view that the reference in CRD III to the 50% requirement applies to variable remuneration as a whole. According to the FSA, firms should have had the discretion to decide whether shares could form part of the non-deferred payment, part of the deferred element, or a mixture of both. The EU Parliament Rapporteur, Arlene McCarthy MEP, however, interpreted the 50% requirement as applying equally to both the deferred and the non-deferred portions of the bonus. CEBS issued an interpretative guideline agreeing with the Rapporteur's interpretation.

The FSA has now implemented into the Revised Code and regulatory rules the CEBS/Parliament interpretation that the 50% variable remuneration rule should be applied equally to both the deferred and non-deferred portions of variable remuneration.¹¹ The FSA, however, has stated that the 50% rule would increase compliance costs because of the rule's complexity and that it would adversely affect UK competitiveness on a global basis because it might make it more difficult for British firms to compete for talented personnel.¹²

The FSA has adopted the following provisions in its Handbook, which implement, in its view, the main requirements of the CRD III variable remuneration rules.

'(1) A firm must not award, pay or provide a variable remuneration component unless a substantial portion of it, which is at least 40%, is deferred over a period which is not less than three to five years.

(2) Remuneration under (1) must vest no faster than on a pro-rata basis.

(3) In the case of a variable remuneration component:

(a) of a particularly high amount, or

(b) payable to a director of a firm that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities; at least 60% of the amount must be deferred.

[...]

(6) £500,000 is a particularly high amount for the purpose of (3)(a).

(7) Paragraph (6) is without prejudice to the possibility of lower sums being considered a particularly high amount.'¹³

Regarding subsections (3)(a) and (6) above, the FSA interpreted the CRD III requirement that 60% of a substantially high bonus must be deferred to mean that all bonuses in

¹¹ The FINANCIAL SERVICES AUTHORITY (FSA) 2010b, *Revising the Remuneration Code. Feedback on CP10/19 and final rules*. PS 10/20. No 1.22-1.24.

¹² FINANCIAL SERVICES AUTHORITY (FSA) 2010b, nos. 1.27.

¹³ The FSA Handbook, SYSC, nos. 19A.3.49.

excess of \$500,000 paid to code staff must be subject to 60% deferral. The FSA also allows discretion for firms to consider whether lesser amounts should be considered as 'particularly high' taking account, for example, whether there are significant differences in the levels of variable remuneration paid to code staff within a firm. FSA expects firms to have a 'firm-wide policy on deferment, subject to a *de minimis* rule, which includes a rising proportion of deferment according to the amount of variable remuneration.¹⁴

The FSA recognises the CRD III principle of linking remuneration to instruments, such as shares, that reflect firm performance. For firms that are unable to issue shares, however, such as mutuals or building societies, the FSA observes that complications arise because of the difficulty issuing appropriate alternatives to shares and share-linked instruments. Moreover, the increased use of shares and equivalent instruments as part of variable remuneration may affect the bank's ability to comply with regulatory capital requirements. Principle 6 of the FSA's Revised Code addresses this by stating 'that the total variable compensation paid by the firm to all staff' should not 'limit its ability to strengthen its capital base'. Moreover, increased use of shares in variable remuneration may also significantly dilute existing shareholders, which may affect shareholder rights under EU company law.¹⁵

1.1.1. Retention periods

Regarding the portion of shares or share-equivalent instruments issued as upfront payment, CRD III requires firms to establish a retention programme stipulating minimum transfer retention periods. This is not the same as deferral: Retention periods apply to non-cash bonuses paid upfront or deferred awards that have vested. The FSA provides an example of how this would work: '*if the level of deferral is greater than or equal to 50% of variable remuneration, the firm can choose to issue the full deferred proportion as shares and this would meet the proposed share-based requirement. However, if the deferred shares amount to less than 50% of variable remuneration (e.g. 40% deferred), the remaining required portion (e.g. 10% upfront) should be allocated in shares or share-equivalent instruments and subject to a retention period.*'¹⁶

The FSA believes that firms should have flexibility to adopt retention periods that are proportionate to the type of risks they face and has criticised any proposals to establish prescriptive retention periods and suggests that the market should decide as follows:

'Retention period – CRD3 states that variable remuneration issued in shares or other instruments should also be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the firm. The CEBS guidelines do not specify a minimum retention period. However, CRD3 provides that the minimum retention period should be sufficient to align incentives with the longer term interests of the institution.' (FINANCIAL SERVICES AUTHORITY (FSA) 2010b, nos. 2.50)

CRD III also requires that bonuses paid as exceptional pension payments must be held in shares or equivalent instruments whose value is linked to the underlying value of the firm's shares and profitability. Banks are required to establish binding bonus-to-salary ratios with regulatory approval and remuneration committees whose membership consists wholly of outside, independent directors. Each financial firm must publish the details of its salaries and bonuses in order to enhance transparency for shareholders and

¹⁴ The FSA Handbook, SYSC 19.3.47R (2) a)(d).

¹⁵ Ibid. The FSA also observed that it wants to be satisfied that the instruments firms use to meet this requirement are eligible as Tier 1 capital requirements.

¹⁶ FSA Consultation paper (July 2010).

provide benchmarks for regulators to monitor how remuneration affects firm risk-taking and performance.

1.1.2. Scope of application

The FSA relied on the Financial Stability Board's 2009 recommendations that financial sector compensation regulation should only apply to large banks and investment firms. Accordingly, the FSA 2009 Code applied only to a limited number of large joint-stock company UK banks and financial firms. CRD III, however, expands the scope of application to all banks, building societies, and investment firms to which the Market in Financial Instruments Directive applies. In the Revised 2010 Code, the FSA has now expanded its scope of application to over 2,500 regulated financial firms in the United Kingdom.¹⁷

The Code's intensity of application to these firms, however, will depend on the firm's size, the nature of risk-taking, and complexity and inter-connectedness of the firm or institution in financial markets. In this regard, the FSA considers the proportionality principle – mandated by CRD III - to be important in determining the precise application of CRD III's more prescriptive rules-based framework to these firm's remuneration policies.

1.1.3. *De minimis* rule and the proportionality principle

The FSA will apply a *de minimis* exclusionary rule for determining what type of variable rate bonuses should be excluded from its disciplines. The FSA's 2009 Code and its supervisory framework specified that a *de minimis* exclusion would apply to its deferral requirements for code employees who earned under £500,000 per annum and whose bonuses were less than 25% of total remuneration. This was part of the FSA's approach to proportionality. Under the 2010 Code and Handbook, the FSA has expanded its *de minimis* rule to exclude code staff whose total remuneration is equal to or less than £500,000 and whose bonuses are less than 33% of total remuneration from the rules covering: deferral, performance adjustment, proportion of remuneration paid in shares, and guaranteed bonuses.¹⁸

1.1.4. Performance adjustment

CRD III requires that firms should be able to make adjustments to the unvested deferred amounts of an individual's variable remuneration, provided that the firm communicates beforehand its intention to the employee. This ex post 'performance adjustment' should reflect actual firm performance as it materialises over time, and may, as a result of poor firm or individual performance, lead to a reduction in the deferred unvested award. The objective is to develop incentives where high-end risk-takers are focused on longer-term firm performance and are accountable to shareholders. Firms are required to design and implement performance adjustment schemes to establish a credible, effective link between the individual's remuneration and the future riskiness of the activities already undertaken.

The FSA distinguishes between ex post adjustments to deferred variable remuneration that have not yet vested (known as 'malus') and ex ante adjustments to variable remuneration that is already vested, but which the individual agrees in advance to repay (known as 'clawback') if certain conditions occur. The FSA's performance adjustment powers are codified in section 6 of the FS Act 2010, which provides that the FSA can '*render void any provision of an agreement that contravenes a prohibition or restriction*

¹⁷ See FSA Handbook, Prudential Sourcebook for Banks, Building Societies and Investment Firms.

¹⁸ FSA Handbook, SYSC 19.3.6. FSA Consultation Paper, (July, 2010), para. 3.79.

on remuneration under the Act and 'provide for the recovery of payments made, or property transferred, in pursuance of a void provision.' The FSA has specified conditions under which it will exercise this power, but only in relation to code staff, for both ex ante and ex post performance adjustment¹⁹ and to impose restrictions on guaranteed bonuses.²⁰ CRD III has led the FSA to give more precision to its clawback powers by providing in the FSA Handbook that where it exercises its 'voiding powers' for a particular contract, the regulated firm *'will be obliged to recover payments made or property transferred to the individual'*, and that *'[a] payment made in breach of [the] rule would be void and must be recovered.'*²¹

¹⁹ See FSA Handbook (deferral arrangements), SYSC 19.3.46R.

²⁰ See FSA Handbook (guaranteed bonuses), SYSC 19.3.38R.

²¹ FSA Handbook, SYSC 19 Annex 1 5R and SYSC 19 Annex 1 7R. In situations where the firm is unable to clawback cash or property the Handbook further states that the '[f]irm would be restricted from making further variable remuneration awards to the individual in respect of the same performance year unless they have legal advice that the award complies with the Code.'

2. CRD III – UNINTENDED CONSEQUENCES AND CHALLENGES

2.1. UK bank compensation trends

Despite the UK's regulatory and legislative reforms, senior executive pay – both fixed and variable compensation - continues to grow rapidly – particularly at banks and other financial institutions – out of proportion to the growth of average wages of UK workers and even mid-level employees in the UK financial services sector. In 2011, the most senior executives at Barclays earned 75 times more than the average compensation of a Barclays' employee.²² Barclays' 75 to 1 ratio was considerably higher than its ratio in 1979 in which the most senior executives earned only 14.5 times more than the average compensation of a Barclays' employee. Between 1979 and 2011, senior executive compensation at Barclays has risen by 4,899.4% – from £87,323 to a staggering £4,365,636.²³

2.2. CRD III challenges: complexity and disclosure

The regulation of remuneration in the financial sector has contributed to increasing complexity in compensation packages. Despite the FSA's objective of more transparency in relation to executive pay, it has become more difficult for shareholders and other stakeholders to understand the criteria and rules that determine executive and senior management compensation at financial institutions and firms. This has resulted in a situation where only relatively few individuals with technical insight are able to understand what an executive is being paid. Indeed, the UK High Pay Commission has observed that *'despite legislation designed to increase transparency in relation to executive pay, the issue remains murky to say the least.'*²⁴ This has had the unintended effect of limiting or reducing transparency in compensation practices in the financial sector.

Enhanced disclosure also remains a challenge under the CRD III and FSA Code. Indeed, the requirement of disclosure is an important part of CRD III, but according to Sir David Walker disclosure is not enough. Sir David has observed that *'while the European Union's new Capital Requirements Directive is highly prescriptive on other areas of bank remuneration, it does not require disclosure of high-end salary bands.'*

According to Sir David, this has resulted in shareholders of EU financial firms ignoring the big picture issue of how many senior bank managers and risk-takers fall into certain high-end salary categories, yet imposing very prescriptive regulatory provisions on remuneration as a whole. It is argued that *'if shareholders took a closer and more broadly based interest in remuneration, the regulatory pendulum would not need to swing so far.'* (Walker, 2010) The right amount of disclosure would make the other requirements of CRD III unnecessary. Indeed, by disclosing bands of remuneration, shareholders and stakeholders would have the ability to compare and benchmark remuneration patterns and to have more relevant information about the type of compensation for those higher paid senior managers and risk takers whose performance has the greatest impact on the bank's risk profile and long-term performance.

Disclosure requirements which vary from country to country (as they do in the EU) will limit and restrict the ability of shareholders and regulators to compare the type and level

²² UK THE HIGH PAY COMMISSION 2011, pp. 8–9.

²³ Ibid.

²⁴ THE HIGH PAY COMMISSION 2011, p. 41.

of compensation between similar banking institutions. They may also lead to regulatory arbitrage. In the case of the UK, the requirement for banded disclosure for UK banks and the non-EU foreign subsidiaries of UK-controlled banking groups does not also apply to non-UK based banks, which creates a regulatory cost advantage for foreign institutions *vis-a-vis* their UK competitors. This could also lead to higher executive turnover at UK institutions with the unintended consequence that UK institutions would adopt much higher remuneration – both fixed and variable – *'as a defensive retention measure.'* (WALKER 2010)

As discussed above, CRD III requires that 50% of the non-deferred and deferred bonuses be paid in shares, and that the deferred portion can only be paid in cash on a pro rata basis over a 3-to-5 year period. The UK High Pay Commission, however, criticised this requirement on variable pay and instead recommended that bonuses should consist only *'of shares, the value of which is determined by the remuneration committee, with a five-year initial holding period and then a timed vesting of 20% each year as the preferred option. Although other performance-related-pay options are available, we feel this is the simplest way of linking the interests of the executive to the shareholder. This simplification could also act to limit tax evasion and avoidance.'*²⁵

2.3. The Way Forward – the role of shareholder stewardship?

The CRD III and FSA Code have not adequately addressed the substantial moral hazard problem in the limited liability corporate structures of banks and certain investment firms that creates an incentive for shareholders to encourage management and risk traders ('code staff') to take excessive risks. Prior to the crisis, large institutional shareholders and board members were often complicit in decisions by senior management that led to excessive risk-taking, which put depositors' and customers' money at great risk. Many of these investors did not consider themselves to be stewards of the company's long-term profitability and performance, but rather were focused on the firm's short-term revenues and risk-adjusted return on equity. Shareholders stood to lose only the value of their equity investment, but could potentially reap huge gains if bank management took greater risks by, for instance, increasing leverage.

The alignment of interests between large institutional shareholders who were seeking greater risk-adjusted returns on which they could trade profitably over the short-term and senior management and risk traders who were pressured by large shareholders to take greater risks to increase short-term revenues while being rewarded with lavish cash bonuses created moral hazard that eventually caused the financial system to collapse. This type of moral hazard problem is not addressed by CRD III and the FSA Code.

The two new UK regulators - the Prudential Regulatory Authority and the Financial Conduct Authority – will have an opportunity to address these problems when they begin exercising their powers in early 2013. It is suggested that they exercise their powers to ensure that remuneration in the financial sector is linked to the long-term profitability of regulated financial firms, while ensuring effective risk management in those firms that protects other stakeholders in society against the social costs of excessive risk-taking. In doing so, the regulators should require that directors have the knowledge and incentives to question the firm's business and risk models and how they affect not only earnings and shareholder returns but also the impact of the firm's risk-taking on the broader financial system. However, the code should also require that bank management instil a new cultural ethos in bankers that emphasises sustainable investments and a duty of care to protect customers' interests. Also, effective shareholder stewardship requires not

²⁵ THE HIGH PAY COMMISSION 2011, p. 48.

only an alignment of interests between shareholders and senior executives and risk-takers, but also an alignment between shareholders and other stakeholders in society, such as customers, depositors, and employees.

CONCLUSION

The financial crisis demonstrates how bank and financial sector remuneration practices led to risky business models and excessive risk-taking, thereby resulting in bank failures and state bailouts. UK policymakers responded to these concerns by adopting the 2009 Compensation Code which set forth a principles-based regime requiring greater disclosure and the alignment of remuneration policies with effective risk management and long-term firm performance. The Financial Services Act 2010 reinforced the FSA's legal powers to require enhanced disclosure of remuneration practices, restricting how bonuses are paid, and allowing firms to 'clawback' money or property already paid to code staff who are in breach of performance adjustment rules. The FSA Revised Code 2010 aims to implement the CRD III remuneration requirements. CRD III creates a prescriptive rules-based regime for bonus structures and related remuneration practices. The FSA reluctantly agreed to implement the CRD III's bonus requirements with respect to the 50% and 40/60% rule on the grounds that it would increase compliance costs and weaken UK competitiveness. CRD III has attracted much criticism on the grounds of complexity that would lead to less effective disclosure. Moreover, CRD III fails to address the moral hazard problem inherent in the limited liability structure of most large financial institutions that incentivise excessive risk-taking at the expense firm performance. The new UK supervisory regime will continue to face substantial challenges in implementing CRD III.

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Background on the implementation of CRD III remuneration rules

NOTE

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Abstract

Remuneration packages offered by large financial institutions can encourage employees to take risks, and this is believed to be one of the causes of the global financial crisis of 2007-2008. Consequently, G20 leaders took the initiative to address the supervision of companies' remuneration policies. This initiative was, in turn, supported by international supervisory bodies, such as the Financial Stability Board (FSB), who issued recommendations accordingly. Building on this and the de Larosière report, the European Commission proposed enhanced rules and increased supervision for executive compensation in the EU. Directive 2006/48/EC was subsequently amended by what became known as the Capital Requirements Directive III or 'CRD III'.

JANUARY 2012

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EXECUTIVE SUMMARY

The existing structure of executive remuneration packages has encouraged excessive risk-taking by employees. This has been acknowledged as one of the main drivers of the crisis.¹ Moreover, despite financial uncertainty in the financial sector, CEOs and traders of some troubled banks received generous bonuses and other financial benefits, which provoked massive public indignation. In order to tackle this issue, a new legal framework has been established, both at EU and global level.

On 29 February 2009, the High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, issued its Report stating *inter alia* the need to revise remuneration policies.² A few days later in London, G-20 leaders endorsed the Financial Stability Forum's (FSF, now Financial Stability Board, FSB) *Principles for Sound Compensation Practices*. The initiative was strongly supported at EU level and in April 2009, the Committee of European Banking Supervisors (CEBS, now European Banking Authority, EBA) published their *High Level Principles on Remuneration Policies* and the European Commission issued its *Recommendations on remuneration policies in the financial services sector*.

Pursuing further the aim of establishing a strengthened legal framework for supervision of remuneration structures, the Commission adopted its proposal for amending Directive 2006/48/EC regarding new remuneration rules in July 2009, which was adopted by Council and European Parliament in November 2010. In the meanwhile, the Basel Committee on Banking Supervision (BCBS) published the *Compensation Principles and Standards Assessment Methodology* to guide supervisory bodies in reviewing financial institutions' compensation policies and assessing their compliance with the FSB principles and standards. Supplementary *Guidelines on Remuneration Practices* were issued by CEBS (now EBA) in December 2010.

In November 2011, the FSB presented the latest peer report on implementation and efficiency of the new remuneration rules. The FSB peer review claims that the changes in corporate culture and managerial behaviour will have visible results in the long term. According to the findings, certain shortcomings of the remuneration principles were discovered, and the FSB has already provided financial institutions with new recommendations on implementation.

At EU level the Commission is in charge of reviewing the rules on remuneration policy regarding their efficiency, implementation and enforcement. The relevant articles should be examined taking into account developments on international level including any further proposals from the FSB. This should be done via a review which is due by 1 April 2013.

¹ Danthine Jean-Pierre, speech: *After the crisis – improving incentives in the financial sector*, 20 May 2011.

² All documents mentioned in this background note are linked in the reference part at the end.

1. GENERAL OVERVIEW: THE STRUCTURE OF EXECUTIVE REMUNERATION

As a general rule, CEO remuneration³ is often composed of 20% base salary and of 80% performance-based pay. Executive compensation is not only about cash and stocks, but it also includes executive benefits and perquisites. The composition of executive pay is presented in table 1.

Interestingly enough, there are certain differences in European and US compensation schemes for executive staff. According to the study '*Executive Compensation Controversy: A Transatlantic Analysis*' by M. Conyon, European CEOs receive in general:

- 50% of their annual pay in the form of cash salary (compared to 30% in the USA)
- 19% of annual pay in form of equity and stock pay (compared to 46% in the USA)
- 75% of their annual pay in salaries and bonuses, however, bonuses depend less on shareholder return, accounting performance, or sales increase.

Table 1. Structure of executive remuneration

| Basic elements of executive compensation |
|---|
| Salary (base payment) for the core role and responsibilities of the day-to-day running of the organisation |
| Short-term incentives or bonuses for meeting annual performance objectives |
| Long-term incentive payments for meeting performance objectives to be achieved for a two- to five-year period. |
| Restricted stock awards as an incentive to assure the executives are strongly aligned with the interests of shareholders. |
| Stock options and stock appreciation rights for increasing share price and increasing the shareholders' returns. |
| Supplemental executive retirement plans , which may keep the executive whole (that is, make up the difference) or better from a tax regulation |
| Insurance plans (ex. golden parachute) that provide a source of retirement income and a richer death benefit to the executive's family. |
| Paid expenses (perquisites) and other compensation for various programs or negotiated deals; can include some very large amounts for items such as loan forgiveness, special insurance programs, relocation expenses, etc. |

Source: Table based on the article '*Executive Compensation*' by Bill Coleman

³ In this document, the terms 'remuneration' and 'compensation' are considered as being synonymic and imply all kinds of assets received by executives of a company for their services. It is worth noting that EU institutions commonly use the term 'remuneration', while 'compensation' is used by international organisations (FSB, BCBS) and in the USA.

The Financial Times has published data on CEO total pay of the world's biggest banks in 2008-2010. More than half of these banks either were bailed out, or benefited from other state aid tools (asset relief, guarantee schemes, etc.). However, not all of them adjusted their remuneration policy according to the financial state of the bank (table 2).

Table 2. Executive Total Pay in 2008-2010

| Bank | Total pay, USD | | | Change, % | |
|--------------------------------|----------------|---------------------------|------------|-----------|-----------|
| | 2008 | 2009 | 2010 | 2008-2009 | 2009-2010 |
| Wells Fargo | 9 041 087 | 18 756 172 | 17 568 387 | 107,5 | -6,0 |
| Credit Suisse | 2 640 569 | 17 684 443 | 11 807 725 | 569,7 | -33,0 |
| Deutsche bank | 2 033 342 | 13 280 770 | 8 548 380 | 553,1 | -19,0 |
| Royal Bank of Scotland | n/a | 10 036 855 | 11 537 346 | n/a | 15,0 |
| BVVA | 7 819 725 | 8 954 596 | 8 070 985 | 14,5 | -10,0 |
| HSBC | 16 781 061 | 8 850 592 | 8 980 695 | -47,3 | 1,0 |
| Unicredit | 15 979 470 | 6 012 236 | n/a | -62,4 | n/a |
| Intesa Sanpaolo | 4 479 075 | 5 298 943 | 5 048 351 | 18,3 | -5,0 |
| Lloyd Banking group | 9 235 174 | 4 976 605 | 8 367 953 | -46,1 | 68,0 |
| Barclays | 9 244 674 | 1 751 403 | 5 945 946 | -81,1 | 239,0 |
| Societe Generale | n/a | 1 552 526 | 2 323 917 | n/a | 50,0 |
| BNP Paribas | 5 726 857 | (1 453 740)* 3 435 108 | 3 530 624 | -74,6 | 3,0 |
| JPMorgan Chase | 35 716 101 | 1 265 708 | 20 776 324 | -96,5 | 1 541,0 |
| Morgan Stanley | 1 235 097 | 939 241 | 14 854 049 | -24 | 1 481,5 |
| Goldman Sachs | 40 946 646 | 862 657 | 14 114 080 | -97,9 | 1 536,0 |
| Citigroup | 38 237 437 | 128 751 | n/a | -99,7 | n/a |
| Bank of America Merrill | 9 003 467 | 32 171 | 1 220 234 | -99,6 | 142,9 |

Source: Financial Times 2010 and 2011. Compilation of figures derived from interactive graphic: Bank CEO pay 2009,⁴ 2010.⁵

Note: For each CEO, total annual pay includes base salary, cash bonuses, the grant-date value of stock and option awards, and certain other benefits. The data was collected from the annual report of each company.

* The figure for the CEO of BNP Paribas was revised in 2011.

This is why, when the global financial crisis started, executive remuneration, especially in the financial sector, became the subject of massive public attention and scrutiny. It was generally acknowledged that 'unwisely' designed remuneration policies in financial institutions - especially at large banks - were a key contributing factor to the global financial crisis, as they encouraged excessive risk-taking that was inappropriate to the loss-absorption capacity of credit institutions and of the financial sector as a whole.⁶ In order to address this issue, certain measures regarding strengthening of the prudential oversight on the executive remuneration were undertaken.

⁴ Bank CEO Pay 2009, Financial Times newspaper, 22 August 2010.

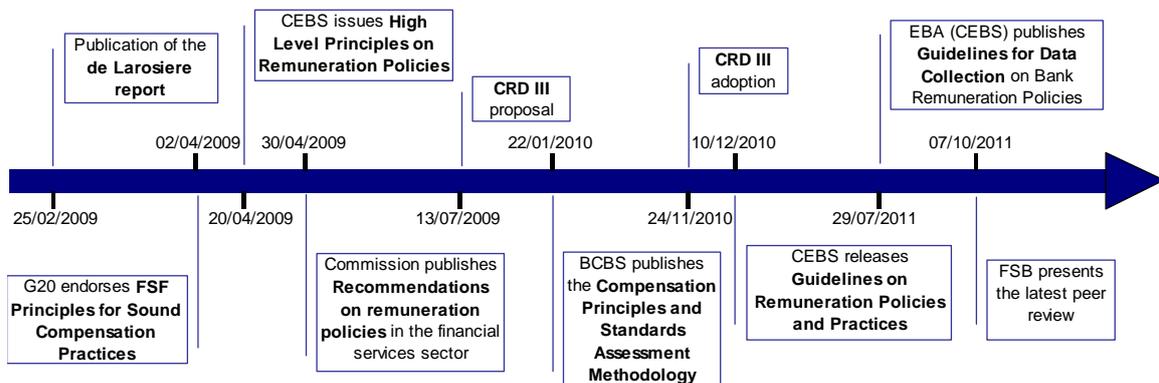
⁵ Bank CEO Pay 2010, Financial Times newspaper, 14 June 2011.

⁶ Guidelines on Remuneration Policies and Practices, CEBS, point 1.

2. ESTABLISHMENT OF THE LEGAL FRAMEWORK

The creation of the new legal framework on remuneration policies started in the early spring of 2009. This initiative has been taken at both global and national level; including by G-20, BCBS, and FSB. Within the European Union, the Commission, EBA and national supervisors are involved.

Timeline 1: Establishment of the legal framework - Main events



2.1. Global Level

2.1.1. G-20

First decisive measures regarding stricter regulation on remuneration policies were taken by the G-20 leaders on 2 April 2009 in London where the *Declaration on Strengthening the Financial System* was adopted. Besides the decision to improve the quality, quantity, and international consistency of capital in the banking system, the Declaration claims calls for the creation of sustainable compensation schemes through implementation of the *Principles on Sound Compensation Practice* developed by the Financial Stability Forum.⁷

2.1.2. Financial Stability Forum (FSF) / Financial Stability Board (FSB)

Given the issue of incentives towards excessive risk taking that may arise from the ill conceived compensation rules, the objective of the FSF's *Principles on Sound Compensation Practices* is to promote prudent remuneration policies through adjusting compensations according to all types of risk, risk outcomes and the time horizon of risk. Any compensation scheme must work along with other management tools in pursuit of prudent risk taking.

The Principles for Sound Compensation Practices apply to large financial institutions, and they are crucial for significant, systemically important firms. Given the importance of the Principles, they are to be implemented by financial institutions. The implementation and adherence will be reinforced through supervisory reviews and intervention at the national level.

⁷ The Financial Stability Forum (FSF) is the predecessor of the Financial Stability Board (FSB) that has been established upon the G-20 Leaders Summit in April 2009. 'The FSB is an international body that has been created to coordinate the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It aims to bring together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.' The FSB includes all G-20 major economies, FSF members, and the European Commission; information taken from <http://www.financialstabilityboard.org/cos/wssb.htm>.

Box 1. FSF Principles for Sound Compensation Practices (April, 2009)**'- Effective governance of compensation:**

1. *The firm's board of directors must actively oversee the compensation system's design and operation.*
2. *The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended*
3. *Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.*

- Effective alignment of compensation with prudent risk taking:

4. *Compensation must be adjusted for all types of risk*
5. *Compensation outcomes must be symmetric with risk outcomes.*
6. *Compensation payout schedules must be sensitive to the time horizon of risks.*
7. *The mix of cash, equity and other forms of compensation must be consistent with risk alignment.*

- Effective supervisory oversight and engagement by stakeholders:

8. *Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.*
9. *Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.'*

In October 2011 the FSB published a peer review of the recommendation implementation by member countries and organisations. The peer review found that supervisory authorities and financial firms in FSB member jurisdictions have made good progress in implementing the *Compensation Principles and Standards Assessment Methodology*, as many national authorities have adopted the necessary legislation, supervisory control has strengthened, and the governance of compensation schemes at firms has improved. However, it was stated that more work is required to fully implement the principles and standards by individual national authorities, to address concerns regarding possible competition distortions in the market for highly skilled employees, and eventually achieve sound compensation practices.

Given the purpose of achieving lasting change in behaviour and culture within firms, the peer review stresses that more time is needed to develop common supervisory understanding; besides the implementation process of new compensation policies has to be effective and consistent. Regardless the full implementation of compensation principles by some companies, it was concluded to be too early for evaluation of their effectiveness in with regard to firms' behaviour and risk-taking incentives of employees.

In view of the findings of the peer review, the FSB has set out certain recommendations on advancement in the implementation of the Principles and Standards by both national supervisory authorities and financial companies.

Box 2: List of FSB recommendations⁸

'Recommendation 1 - Full implementation by national authorities

(a) All FSB member jurisdictions should finalise the implementation of the P&S. Jurisdictions should undertake actions, including legislation where needed, to eliminate any impediments to full implementation.

(b) Proportionality in the implementation of the P&S may be justified by the business model and risk profile of the institution. FSB member jurisdictions should clearly define in national regulations or supervisory guidance the specific criteria supporting the application of the principle of proportionality. In addition, jurisdictions should proactively ensure that proportionality remains appropriate and does not give rise to regulatory arbitrage as a result of market developments and emerging risks.

(c) National authorities should periodically report to the FSB on the nature of any significant impediments and proposed actions to address them as well as on the specific criteria supporting the application of proportionality in their jurisdiction. This reporting will form part of the FSB's ongoing monitoring of the implementation of the P&S.

Recommendation 2 – Addressing level playing field concerns

National supervisors should work bilaterally to verify and, as needed, address specific level playing field concerns raised by their respective institutions, particularly with regard to the implementation of Standards 6-9, 11 and 14. The nature of the concerns, the actions taken to address them via supervisory cooperation and the outcomes should be reported at least annually to the FSB and should inform the scope and intensity of its ongoing monitoring of the implementation of the P&S.

Recommendation 3 – Ongoing implementation monitoring

The FSB should undertake ongoing monitoring and public reporting on the implementation of the P&S as part of its coordinated framework for monitoring the implementation of agreed G20/FSB financial reforms. This monitoring should focus on remaining gaps and impediments to full implementation by member jurisdictions as well as on the actions taken by relevant parties in response to this report's recommendations. Based on the findings from the ongoing monitoring, the FSB should consider the scope and appropriate timing for a follow-up peer review on compensation practices as well as any decision to issue additional FSB guidance on the interpretation of the definition of material risk takers.

Recommendation 4 – Supervisory cooperation

Supervisory cooperation in the area of compensation practices should be stepped up. Greater efforts need to be made to include remuneration on the agenda of supervisory colleges and to enhance home-host supervisory cooperation and coordination for significant, cross-border financial institutions. In order to enhance the effectiveness and consistency of implementation of the P&S, supervisors should use appropriate supervisory networks to exchange information on the interpretation and technical implementation of the P&S in their jurisdiction, including with respect to the definition of material risk takers. They should also discuss evolving firm practices, especially in the areas of risk adjustment and performance alignment.

Recommendation 5 – Effective governance of compensation

Supervisors should ensure that all financial institutions deemed significant for the purposes of the P&S take immediate steps to align their practices with the key requirements in the area of effective governance of compensation. Particular attention should be given to the independence and expertise of the institution's remuneration committee, to the independence of risk and compliance functions in the compensation process, and to evidence of real cultural change within the institution.

Recommendation 6 – Disclosure

Supervisors should ensure that all financial institutions deemed significant for the purposes of the P&S comply with the Basel Committee's Pillar 3 disclosure requirements for remuneration from 1 January 2012.'

⁸ 2011 Thematic Review on Compensation, 7 October 2011, FSB.

2.1.3. Basel Committee on Banking Supervision (BCBS)

In January 2010 the Basel Committee on Banking Supervision (BCBS) issued its *Compensation Principles and Standards Assessment Methodology*. The purpose of the Methodology is two-fold: first, to guide supervisors in reviewing compensation practices and assessing their compliance with the FSB Principles for Sound Compensation Practices and their implementation standards; and second, prevent possible competition distortions and to provide supervisory approaches in promoting prudent remuneration rules at significant financial institutions. The assessment methodology defines supervisory review framework with regard to the three issues addressed by the FSB Principles:

- (i) effective governance of compensation,
- (ii) effective alignment of compensation with prudent risk-taking, and
- (iii) effective supervisory oversight and engagement by stakeholders.

The BCSB provides various approaches for each of the FSB Principles and Standards; as well the assessment methodology advises supervisors on information that could be used in conducting examinations.

2.2. EU Level

2.2.1. European Commission

On 25 February 2009, the High Level Group on Financial Supervision in the EU chaired by Jacques de Larosière issued its Report giving recommendations for reforming the European financial supervision and regulation. In this report, special attention is paid to executive compensation, and it is stated that '*compensation incentives should be better aligned with shareholder interests and long-term profitability*'. Therefore, the structure of financial sector compensation schemes should be based on the following principles (Recommendation 11):

- *'The assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle;*
- *The same principles should apply to proprietary traders and asset managers;*
- *Bonuses should reflect actual performance and not be guaranteed in advance.'*

Moreover, it was advised that '*supervisors should oversee the suitability of financial institutions' compensation policies, require changes where compensation policies encourage excessive risk-taking and, where necessary, impose additional capital requirements under pillar 2 of Basel 2 in case no adequate remedial action is being taken.*'⁹

On 30 April 2009, following the initiative of the G-20 leaders and the conclusions of the de Larosière report, the European Commission adopted its '*Recommendations on remuneration policies in the financial services sector*'.

In July 2009, the European Commission issued a proposal for a directive amending the Directive 2006/48/EC regarding strengthening of prudential regulation of the compensation structures and enabling supervisory authorities to impose capital 'sanctions' on financial institutions the remuneration policies of which are found to generate unacceptable risk.

The proposed Directive (CRD III) was adopted on 24 November 2010.

⁹ Report of the de Larosière Group, p.31.

2.2.2. The European Parliament

On 7 July 2010, the European Parliament issued its resolution on remuneration of directors of listed companies and remuneration policies in the financial services sector (2010/2009(INI)). The European Parliament strongly supported the initiative taken by the Commission and the FSB. The resolution was adopted by 594 votes to 24, with 35 abstentions.

Briefly, the resolution supports the ideas that:

- supervisory bodies should take a decision on creation of a remuneration committee within a credit institution or a listed company, and that they should do so with regard to its size, internal structure, complexity and the nature of its activities;
- the remuneration committee determines the remuneration policy of a financial institution or a listed company, and it must have access to the subject matter of contracts;
- compensation packages should be aligned with adequate risk-taking and have balanced structure;
- remuneration schemes should be reasonable with regard to the size, internal organisation and complexity of credit institutions;
- supervisory bodies should be empowered with the right of prudential oversight, including penalties for non-observation; stakeholders should more involved in endorsement of bonuses.

2.2.3. The European Banking Authority (EBA)

The predecessor of the European Banking Authority (EBA), i.e. the Committee of European Banking Supervisors published on 20 April 2009 a set of *High-level Principles for Remuneration Policies* (HLP). Based on FSF Principles, the HLP pursued the same objective, i.e. optimisation of remuneration policies.

The scope of the HLP covers and focuses on:

- remuneration policies applying throughout an organisation,
- key aspects including the alignment of company and individual objectives;
- governance with respect to oversight and decision-making;
- performance measurement;
- and forms of remuneration.

Following-up on the HLP, the new EBA was tasked to issue guidelines on sound remuneration policies which had to comply with the principles included in the amended Annex V of CRD. From Q4 2009 until Q1 2010, EBA conducted a comprehensive study on the implementation of the HLP,¹⁰ both by national supervisors and by financial institutions. The main findings were used as input for the guidelines and were officially published on 11 June 2010.

The Guidelines on Remuneration Policies and Practices were issued by EBA in December 2010. The objective of the guidance is to guarantee proper application of the new approaches to remuneration policies in the financial sector, and to prevent anti-competitive behaviour amongst financial firms, especially with a view to keeping claims on proportionality - both from supervisors and institutions. The EBA guidelines addressed not

¹⁰ Report on national implementation of CEBS High-level principles for Remuneration Policies, June 2010.

only executive remuneration policies in institutions, but also the everyday remuneration rules and procedures through which the policy is implemented.

A further step in regulating executive compensations was taken on 28 July 2011, when EBA published two consultation papers on guidelines for data collection on bank remuneration practices.¹¹ The consultation was closed on 2 September 2011. According to EBA results, respondents supported the proposed Guidelines and appreciated that they were developed based on the international standards issued by the FSB. It was mentioned that the crucial issue during the crisis was not a lack of legislative rules '*but a lack of effective implementation of these rules*'.¹²

2.2.4. Review

According to Article 156 of the Directive 2006/48/EC, '*by 1 April 2013, the Commission should review the principles on remuneration policy with particular regard to their efficiency, implementation and enforcement, taking into account international developments including any further proposals from the FSB and the implementation of the FSB principles in other jurisdictions including the link between the design of variable remuneration and excessive risk-taking behaviour.*'

¹¹ Consultation Paper 'Draft on Remuneration data collection exercise regarding high earners' and Consultation Paper Draft 'On the remuneration benchmarking exercise', 28 July 2011.

¹² EBA Guidelines on Internal Governance, 27 September 2011, p. 5 point 12.

3. THE AMENDING DIRECTIVE 2006/48/EC (CRD III)

3.1. Proposal of the Commission (CRD III)

The final proposal COM(2009)0362 was released on 13 July 2009. Apart from the new rules on compensation policy, the proposal also included changes to legislation on trading books and securitisation provisions.

The stated objectives of the proposed amendments to the CRD concerning remuneration were:

- *'to impose a binding obligation on credit institutions and investment firms to have remuneration policies and practices that are consistent with and promote sound and effective risk management, accompanied by high level principles on sound remuneration;*
- *to bring remuneration policies within the scope of the supervisory review under the CRD, so that supervisors would be able to require the firm to take measures to rectify any problems that they might identify;*
- *to ensure that supervisors may also impose financial or non-financial penalties (including fines) against firms that fail to comply with the obligation'.*

The proposed obligation should apply to remuneration for staff whose professional activities have a material impact on the risk profile of the bank or investment firm and for those individuals who take decisions that may affect the level of risk assumed by the institution.

According to assessment conducted by the European Commission¹³, the impact of the proposed amendments to remuneration policies would be the following:

- credit institutions and investment firms will have remuneration policies that are consistent with effective risk management;
- the rate of compliance by credit institutions and investment firms will increase;
- credit institutions and investment firms will get the flexibility to comply with the new obligation and high level principles in a way that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities;
- minimisation of the up-front and on-going compliance costs for firms.

According to the results of public consultation (from 29 April until 6 May 2009), the majority of respondents expressed support for the principle that remuneration policies within the banking sector which should be consistent with sound and effective risk management, and were of the view that this should be brought within the scope of supervisory review under the CRD.¹⁴

CRD III introduced two tasks for national supervisory authorities as well as for the EBA, relating to data collection on remuneration practices. In summary, the tasks are:

- collection of aggregate quantitative information on remuneration (broken down by business areas) and

¹³ Commission Staff Working Document Accompanying document to the Proposal for a Directive amending Capital Requirements Directive on trading book, securitisation issues and remuneration policies, Impact Assessment SEC(2009) 974 final of 13 July 2009.

¹⁴ Commission Proposal for Directive COM(2009) 362 final, 13 July 2009, p. 4.

- collection of information on the number of individuals per credit institution in pay brackets of EUR 1 million and above.

To support these two tasks the EBA, after discussion with its Banking Stakeholder Group, is proposing two guideline documents for a common approach across the EU on remuneration data collection, via templates to be used by financial institutions for reporting to their national supervisors.

3.2. Adoption of the amending directive

Directive 2010/76/EU (amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies) was adopted 24 November 2010.

According to this Directive, the CEBS/EBA shall adopt guidelines on sound remuneration policies. Also, national prudential oversight bodies are in charge of checking whether the remuneration policies and practices are consistent with sound risk management given the nature of the firm's business. In case of breach of legislation, the supervisory body in charge has a right to apply financial and non-financial sanctions:

- qualitative measures (requirement for the firm to rectify the situation by changing its remuneration structure to reduce the inherent risk)
- quantitative measures (requirement for the firm to hold additional own funds against the risk) to address those problems.

The relevant provisions regarding remuneration (including the amendments made to the Directive) are copied in the Annex to this document.

4. IMPLEMENTATION OF CRD III REMUNERATION RULES IN MEMBER STATES

As stated in Article 3 of the Directive, the ultimate transposition date of the new remuneration rules was 1 November 2011. According to information contained in the Eur-Lex system,¹⁵ all Member States have implemented their new legislation on compensation policies. This information is also confirmed by the EBA.¹⁶

According to the Hausmann study,¹⁷ in most Member States the new remuneration rules are implemented in two different approaches: first, revision of corporate law, second, amendment of legislation on financial markets. While legal acts enforced by the supervisory bodies are binding, '*regulation of the financial markets sector is often effected by non-statutory circulars of supervisory authorities following a 'comply or explain' approach*'.¹⁸ As said by Y. Hausmann, '*the national initiatives which have so far been undertaken to implement the international reform [...] differ both as to the scope of application of the new or envisaged provisions as well in regard to the implementation of selected core principles in the area of governance of compensation, alignment of compensation with prudent risk-taking and enhanced external disclosure of remuneration policies*'.¹⁹

Box 3: Experience of the United Kingdom

The United Kingdom

In the UK, the Financial Service Authority (FSA) played the leading role in the adoption and implementation of the new remuneration rules. The Remuneration Code (published by the FSA on 12 August 2009) and the Walker Review on Corporate Governance in UK Banks and Other Financial Institutions (issued by the UK Treasury Department on 26 November 2009) were the main regulatory initiatives, accompanied by various policies and guidelines of associations and private bodies.

*In order to finalise the incorporation of the CRD III provisions regarding executive remunerations into UK law, on 17 December 2010 the FSA Remuneration Code was revised. It came into force on 1 January 2011.*²⁰

*It is worth noting, that In the UK the regulation of the remuneration policy is one of the priorities of the current Prime Minister. According to the Prime Minister's announcement, the shareholders are to be empowered by having a straight vote on executive compensations. They would have to endorse salary packages and - more importantly - bonuses, instead of just having advisory votes as nowadays.*²¹

Source: Hausmann Y., Bechtold-Orth E., 2010.

¹⁵ National Execution Measures of Directive 2010/76/EU.

¹⁶ Compliance table: Guidelines on Internal Governance (GL44), 9 January 2012.

¹⁷ Hausmann Y., Bechtold-Orth E., 2010.

¹⁸ Hausmann Y., Bechtold-Orth E., 2010.

¹⁹ Hausmann Y., Bechtold-Orth E., 2010.

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ANNEX: DIRECTIVE 2006/48/EC, RELEVANT PROVISIONS IN REGARD TO REMUNERATION

Article 22

1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management.

[...]

3. Home Member State competent authorities shall use the information collected in accordance with the criteria for disclosure established in point 15(f) of part 2 of Annex XII to benchmark remuneration trends and practices. The competent authorities shall provide the Committee of European Banking Supervisors with that information.

4. The Committee of European Banking Supervisors shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in points 23 and 24 of Annex V. The guidelines shall take into account the principles on sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector.

The Committee of European Banking Supervisors shall, *inter alia*, ensure the existence of guidelines to:

(a) set specific criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration within the meaning of point 23(l) of Annex V;

(b) specify instruments that can be eligible as instruments within the meaning of point 23(o)(ii) of Annex V that adequately reflect the credit quality of credit institutions within the meaning of point 23(o) of that Annex.

The Committee of European Securities Regulators shall cooperate closely with the Committee of European Banking Supervisors in ensuring the existence of guidelines on remuneration policies for categories of staff involved in the provision of investment services and activities within the meaning of point 2 of Article 4(1) of Directive 2004/39/EC.

The Committee of European Banking Supervisors shall use the information received from the competent authorities in accordance with paragraph 3 to benchmark remuneration trends and practices at the Union level.

5. Home Member State competent authorities shall collect information on the number of individuals per credit institution in pay brackets of at least EUR 1 million including the business area involved and the main elements of salary, bonus, long-term award and pension contribution. That information shall be forwarded to the Committee of European Banking Supervisors, which shall disclose it on an aggregate home Member State basis in a common reporting format. The Committee of European Banking Supervisors may elaborate guidelines to facilitate the implementation of this paragraph and ensure the consistency of the information collected.

Article 136

1. Competent authorities shall require any credit institution that does not meet the requirements of this Directive to take the necessary actions or steps at an early stage to address the situation. For those purposes, the measures available to the competent authorities shall include the following:

[...]

(f) requiring credit institutions to limit variable remuneration as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base;

[...]

Article 156

By 1 April 2013 the Commission shall review and report on the provisions on remuneration, including those set out in Annexes V and XII, with particular regard to their efficiency, implementation and enforcement, taking into account international developments. That review shall identify any lacunae arising from the application of the principle of proportionality to those provisions. The Commission shall submit its report to the European Parliament and the Council together with any appropriate proposals. In order to ensure consistency and a level playing field, the Commission shall review the implementation of Article 54 with regard to the consistency of the penalties and other measures imposed and applied across the Union and, if appropriate, shall put forward proposals. The Commission's periodic review of the application of this Directive shall ensure that the way it is applied does not result in manifest discrimination between credit institutions on the basis of their legal structure or ownership model. In order to ensure consistency in the prudential approach to capital, the Commission shall review the relevance of the reference to instruments within the meaning of Article 66(1a)(a) in point 23(o)(ii) of Annex V as soon as it takes an initiative to review the definition of capital instruments as provided for in Articles 56 to 67.

Annex V**11. REMUNERATION POLICIES**

[...]

23. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities:

(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;

(b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest;

(c) the management body, in its supervisory function, of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;

(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

(e) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

(f) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in point (24) or, if such a committee has not been established, by the management body in its supervisory function;

(g) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial and non-financial criteria are taken into account;

(h) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

(i) the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;

(j) *guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment;*

(k) *in the case of credit institutions that benefit from exceptional government intervention:*

(i) *variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;*

(ii) *the relevant competent authorities require credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the credit institution within the meaning of Article 11(1);*

(iii) *no variable remuneration is paid to the persons who effectively direct the business of the credit institution within the meaning of Article 11(1) unless justified;*

(l) *fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component. Credit institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration;*

(m) *payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;*

(n) *the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required. The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;*

(o) *a substantial portion, and in any event at least 50 %, of any variable remuneration shall consist of an appropriate balance of:*

(i) *shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non-listed credit institution, and*

(ii) *where appropriate, other instruments within the meaning of Article 66(1a)(a), that adequately reflect the credit quality of the credit institution as a going concern. The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (p) and the portion of the variable remuneration component not deferred;*

(p) *a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to 5 years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question. Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;*

(q) *the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;*

(r) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution. If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of 5 years in the form of instruments referred to in point (o). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (o) subject to a five-year retention period;

(s) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

(t) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive. The principles set out in this point shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

24. Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity. The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The Chair and the members of the remuneration committee shall be members of the management body who do not perform any executive functions in the credit institution concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.

Annex XII part 2: Information on remunerations to be provided

15. The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices of the credit institution for those categories of staff whose professional activities have a material impact on its risk profile:

(a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

(b) information on link between pay and performance;

(c) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;

(d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

(e) the main parameters and rationale for any variable component scheme and any other non-cash benefits;

(f) aggregate quantitative information on remuneration, broken down by business area;

(g) aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution, indicating the following:

(i) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;

(ii) the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;

(iii) the amounts of outstanding deferred remuneration, split into vested and unvested portions;

(iv) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;

(v) new sign-on and severance payments made during the financial year, and the number of beneficiaries of such payments; and

(vi) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

For credit institutions that are significant in terms of their size, internal organisation and the nature, scope and the complexity of their activities, the quantitative information referred to in this point shall also be made available to the public at the level of persons who effectively direct the business of the credit institution within the meaning of Article 11(1).

Credit institutions shall comply with the requirements set out in this point in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to Directive 95/46/EC.



POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**

Banks' Remuneration Rules (CRD III): Are they implemented and do they work in practice?



Monday
30 January 2012

15.00 - 17.30 hrs

Room:
Altiero Spinelli
1G2

Committee on Economic and Monetary Affairs

Participants needing a badge must register providing name, date of birth, nationality, passport or ID number before 25 January 2012 to karine.gaufilet@europarl.europa.eu and to poldep-economy-science@europarl.europa.eu

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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