CEBS Guidelines on remuneration policies and practices

Public hearing

29 October 2010 - London

CEBS

Committee *of* European Banking Supervisors

Plan

- Broader international framework for the CEBS Guidelines
- CRD III background
- Structure and outlines of the guidelines
- Three blocks:
  - Governance
  - Risk alignment
  - Transparency

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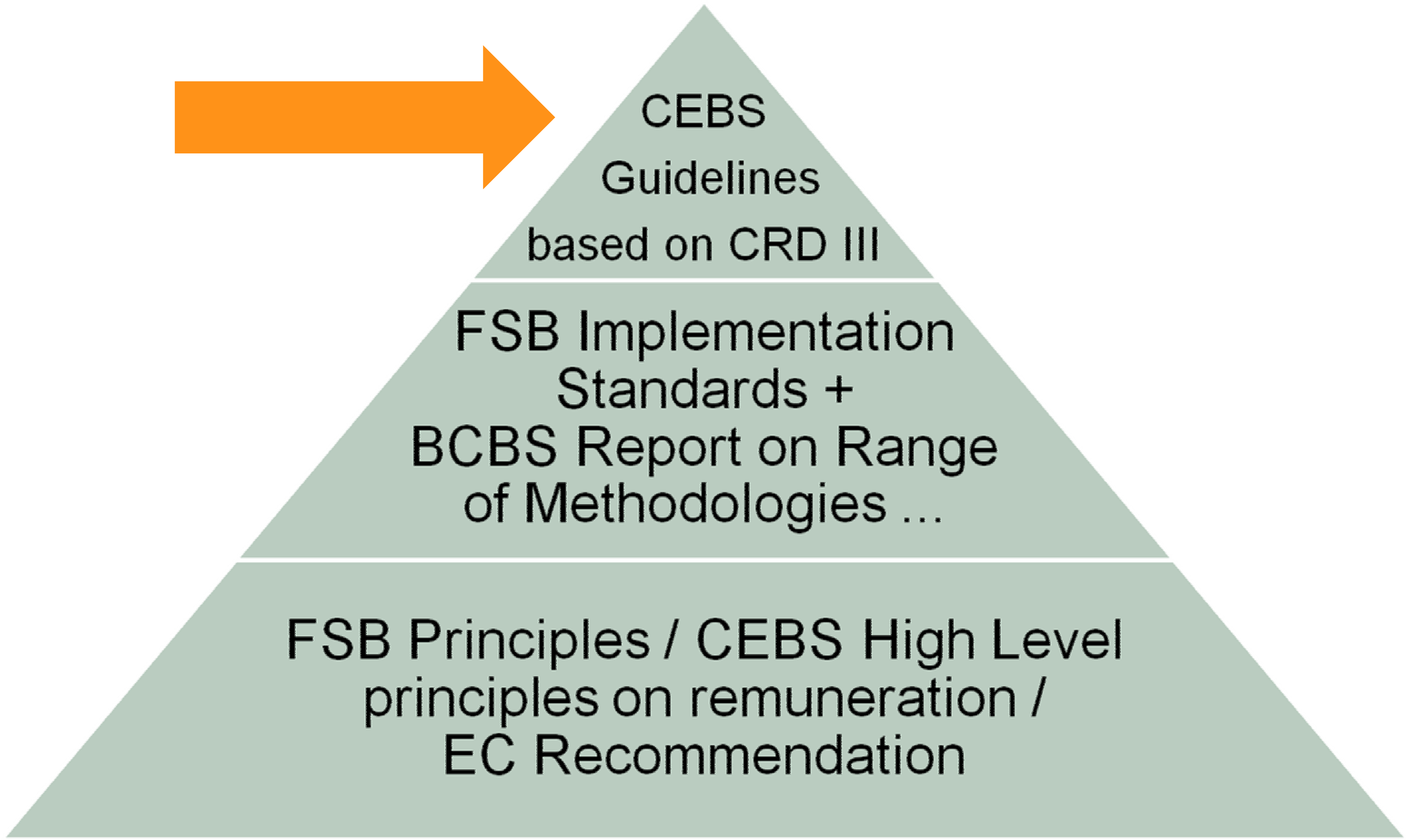
From Principles to Guidelines



Timeline

2009

2010

2011

FSB Principles / CEBS High Level principles on remuneration / EC Recommendation:
Spring 2009

Proposal CRD III:
July 2009

FSB Implementation Standards:
September 2009

Basel Committee of Banking Supervision, Compensation Principles and Standards Assessment Methodology:
January 2010

End of trilogue discussion CRD III:
July 2010

Basel Committee of Banking Supervision, SIG Task Force on Remuneration, Report on the Range of Methodologies for Risk and Performance Alignment of Remuneration:
Consultation launched Mid October 2010

Publication CRD III:
Expected for November 2010

CEBS Guidelines:
Publication in December 2010

Implementation date for CRD III remuneration provisions:
1 January 2011

Comparison between ongoing CEBS and Basel consultations

CEBS Guidelines		Basel Range of Methodologies Report
Content is aligned	=	
primarily normative (level 3)	≠	primarily descriptive
all credit institutions and investment firms	≠	major international banking institutions
all-encompassing	≠	focused on risk alignment

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Genesis CRD

- Proposal: July 2009 → based on FSB Principles / CEBS High Level principles on remuneration / EC Recommendation
- Position of European Council: November 2009 → additions based on FSB Implementation Standards
- Amendments by European Parliament in first reading (rapporteur Arlene McCarthy)

  - very strict vision
  - time pressure to deliver a strong political message

Implementation CRD III

“*The laws, regulation and administrative provisions necessary to comply with point 1 of Annex I shall require credit institutions to apply the principles therein to (i) remuneration due on basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date and to (ii) remuneration awarded, but not yet paid, before the date of effective implementation in each Member State,* ***for services provided in 2010****.*”

→ Balance between legal certainty and effectiveness of new legislation

→ Change of legislation was known and could be prepared for

Structure of CRD III remuneration provisions (1/2)

- Recitals
- Art. 22 CRD: general legal basis
- Annex V CRD: actual remuneration provisions (points 23 and 24)
- Annex XII CRD: transparency provisions
- Different explicit references to proportionality

→ Long lists, no self-evident structure, “open” proportionality

Structure of CRD III remuneration provisions (2/2)

Art. 22: "*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.***"

→ This positioning in the CRD makes clear that remuneration is part of *internal governance* and as such integrated in Pillar 2 (ICAAP and SREP)

Mandate of CEBS

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

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Summa divisio

- Common introductory outlines
- Distinction between:

- Three blocks:
  - Governance
  - Risk alignment
    - General requirements
    - Specific requirements
  - Transparency

Outlines: scope of application (1/2)

Institutions:

- Credit institutions
- Investment firms (with reference to investment services and activities within the meaning of point 2 of art. 4 (1) MiFID)

Remuneration:

- All forms of payments or benefits made directly by, or indirectly but on behalf of institutions within scope, in exchange for professional services rendered by staff
- All remuneration is either variable or fixed
- Monetary and non (directly) monetary benefits

Outlines: scope of application (2/2)

Identified Staff :

→ Material impact on risk profile is decisive for each category

→ Institution must determine its own scope of Identified Staff

•*Executive members of the credit institution or investment firms' corporate bodies, depending on the local legal structure of the institution*

•*Senior Management responsible for day-to-day management*

•*Staff responsible for independent control functions*

•*Other risk takers*: materiality criteria:

- highest proportion variable to fixed
- absolute threshold of total remuneration
- impact on results and/or balance sheet

•*Other employees whose total remuneration takes them into the same remuneration bracket as senior managers and risk takers*

Outlines: proportionality

- Proportionality applies in principle to ALL remuneration provisions
  - Proportionality within the financial sector, amongst different kinds of institutions
  - Proportionality within the Identified Staff, amongst different (sub)categories of staff
- Proportionality can lead to complete NEUTRALISATION of some requirements:
  - Remuneration committee
  - Variable remuneration in instruments
  - Deferred variable remuneration
  - Retention periods

Outlines: group context

"*These principles are applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.*"

Objective: Application of requirements in a consistent manner across group entities to prevent distortions and arbitrage opportunities within the group; prevention of entities created to facilitate the avoidance of the requirements of this Directive.

Mode of operation

EEA parent → **Remuneration policies apply to all subsidiaries and branches, including non-EEA**

Non EEA parent → **Remuneration policies apply to staff who performs services/duties for an EEA-based institution**

Outlines: measures

- Financial and non-financial penalties or other measures (art. 54 CRD)

- Art. 136 CRD:
  - Protection of capital base has priority above paying out variable remuneration
  - Qualitative measures
  - Pillar 2 *capital add-on* based on art. 22 is possible

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Block 1: Governance (1/2)

- "*Management body in its supervisory function*": adopts and periodically reviews the remuneration policy and is responsible for its implementation
- Avoidance of conflict of interests: decisions on remuneration package of members of the management body in its management function must be taken by the members of the management body in its supervisory function
- Close and ongoing cooperation with internal control functions

Block 1: Governance (2/2)

- Remuneration Committee (RemCo):
  - Comprised of non-executive directors, majority of which should be independent
  - Supports and advises the management body in its supervisory function in all remuneration related aspects
  - Assesses how the principle of risk alignment is implemented
  - Obligation to establish RemCo can be neutralized
- Control functions:
  - Remuneration must be independent from the performance of the business units they control
  - Remuneration of senior officers of risk management and compliance function is directly overseen by RemCo

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Block 2: Risk alignment / general (1/3)

Basic principle applicable to all institutions:

remuneration policies and practices, including pension policy, must be in line with prudent risk taking

- No encouragement to excessive risk-taking
- Consistency with sound and effective risk management
- Long-term interests and values must be taken into account
- Remuneration is part of capital and liquidity planning and must be in line with strengthening capital and liquidity base

Block 2: Risk alignment / general (2/3)

EU-specific: discretionary pension benefits

- *“enhanced pension benefits granted on a discretionary basis by a credit institution to an employee as part of that employee’s variable remuneration package”*
- in case of retirement: pay-out in the form of "point (o) instruments" with a five year retention period
- in case of leave before retirement: benefits must be held by the institution in the form of "point (o) instruments" for a five year deferral period

Block 2: Risk alignment / general (3/3)

General prohibitions:

- No guaranteed variable remuneration, unless exceptional and limited to the first year of employment
- No personal hedging
- No rewarding of failure in case of severance payments
  - E.g. "two years fixed remuneration" reference in EU Commission's Recommendation
  - Good practice to apply deferral in such cases

Block 2: risk alignment / specific (1/7)

Variable versus fixed remuneration

- Fully flexible remuneration policy
- Appropriate balance between fixed and variable
  - Institutions must set and document explicit maximum ratio(s) on the variable component in relation to the fixed component
  - Balance will depend on different factors

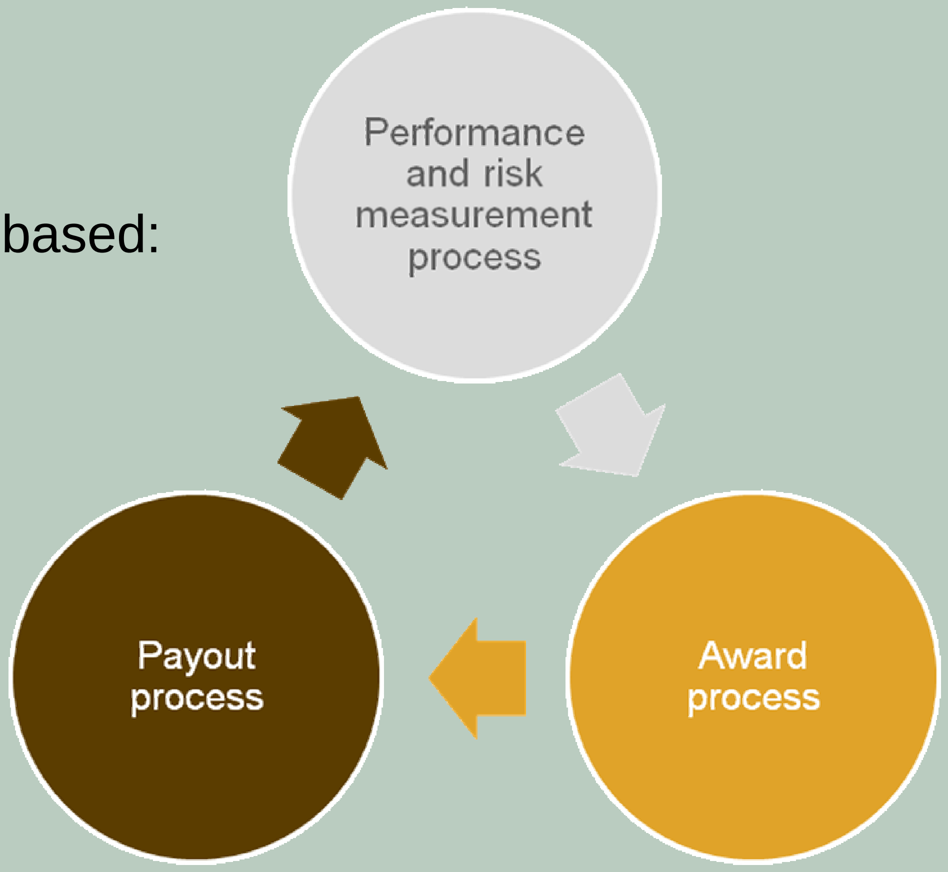
Block 2: Risk alignment / specific (2/7)

Risk alignment is an ongoing, embedded process, not a one time inevitability

- total time horizon is decisive
- formulae-based vs. judgment-based:

checks and balances must

be included in the process



Block 2: Risk alignment / specific (3/7)

Performance and risk measurement: setting of risk-based objectives and evaluation of day-to-day performances against these objectives

- Qualitative vs. quantitative measures
- Different levels: individual, business unit or institution
- Internal vs. external measures
- Relative vs. absolute measures

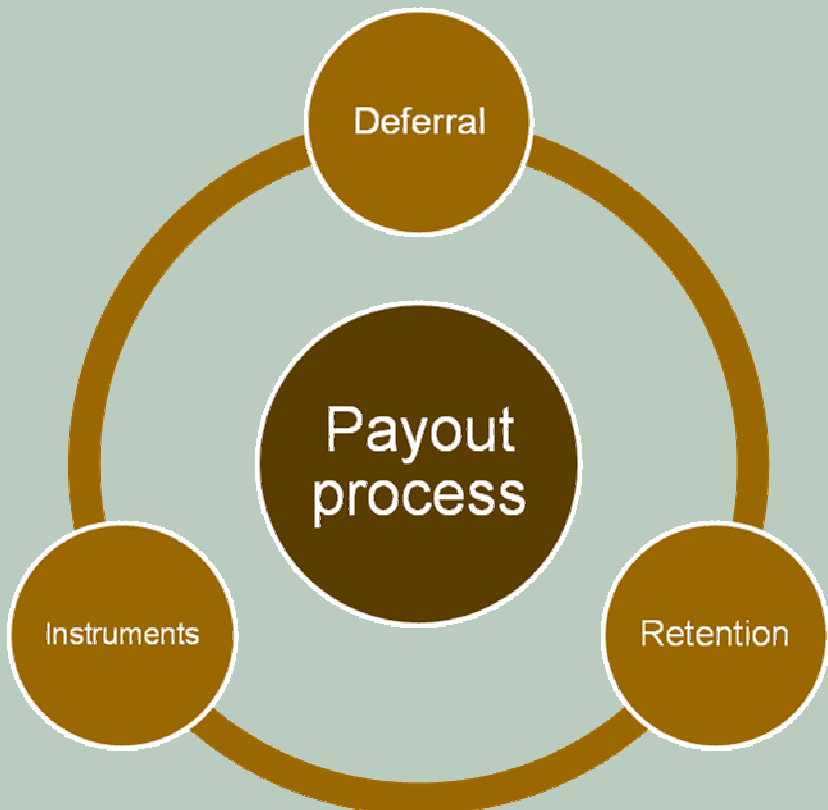
Block 2: Risk alignment / specific (4/7)

Award process: setting and allocation of bonus pools with explicit risk adjustment

- *Top down* vs. *bottom up* approach
- *Ex ante* vs. *ex post*
- All kinds of risks
- Including the cost of capital and liquidity
- Profit-based pools are a minimum; existing internal models in the institution can be integrated as a more advanced form of risk adjustment

Block 2: Risk alignment / specific (5/7)

Payout process: three main elements:



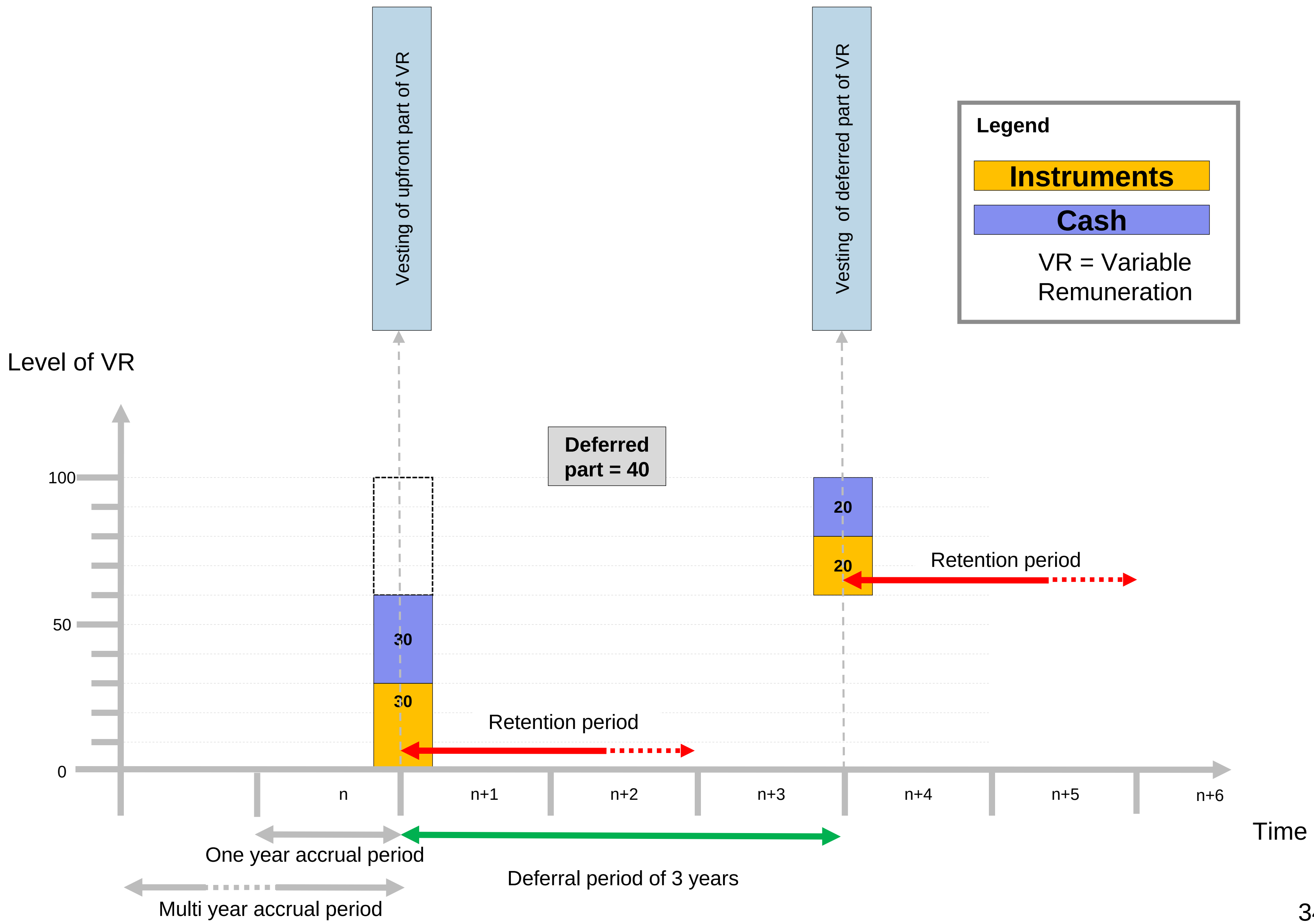
Block 2: Risk alignment / specific (6/7)

- Deferral: = postponed vesting
  - 40 to 60% of the variable component must be deferred
  - over a period which is not less than three to five years
- Retention periods:
  - Linked with element "instruments"
  - Independent of deferral periods
  - Institution must set and document their own minimum periods
  - Explain the difference between “upfront” and “deferred” situation

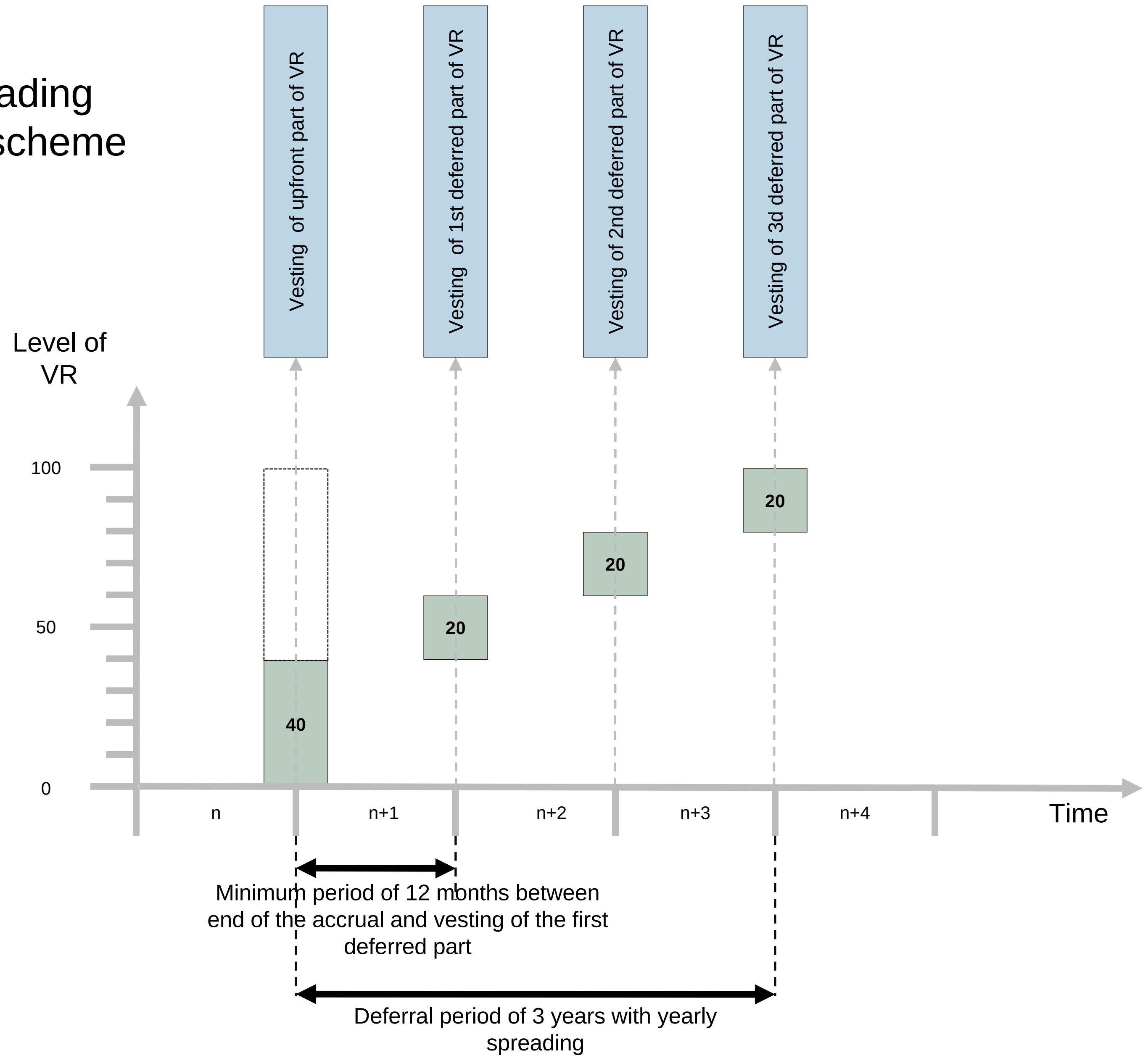
Block 2: Risk alignment / specific (7/7)

- Instruments:
  - 50 % of variable component should consist of instruments
  - point (o) is EU specific
    - Broader than just shares or share-linked instruments: also hybrid tier 1 instruments within the meaning of art. 66 (1a)(1) CRD
    - Ratio between instruments and cash applies to both the upfront and deferred part of the variable remuneration to avoid big upfront cash variable remuneration

Accrual vs. deferral vs. retention



Pro rata spreading in a deferral scheme



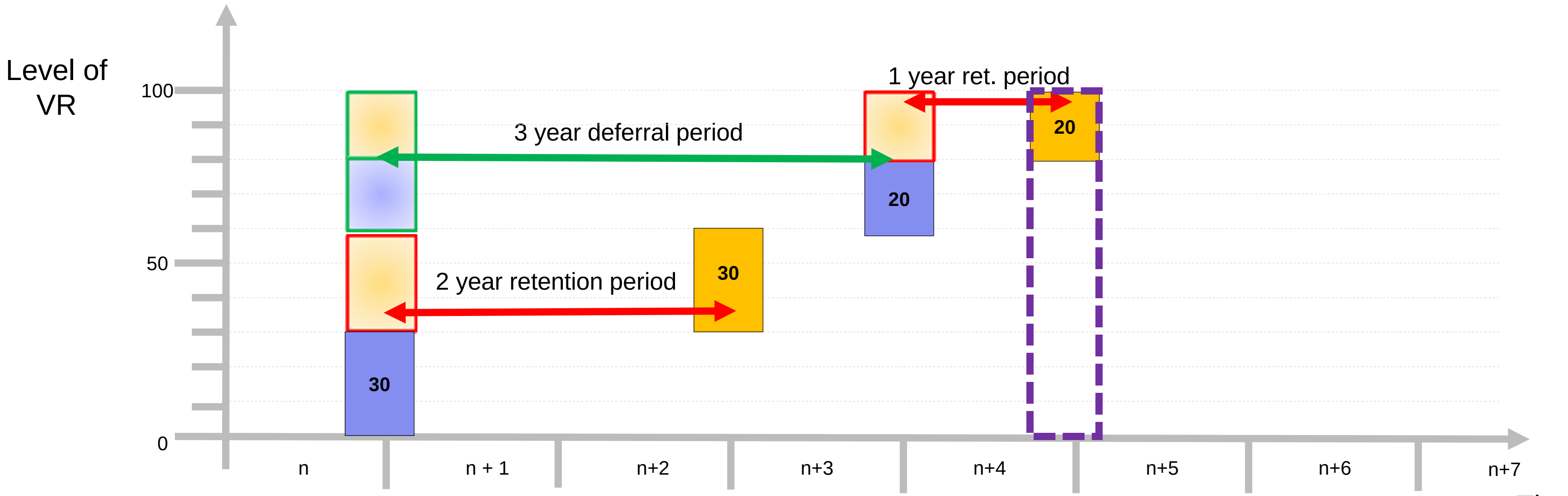
Roll-over effect of long term application of point (o)
Case: 40 % deferral, 50 % instruments, three year deferral period, two year retention period upfront, one year retention period for deferred instruments

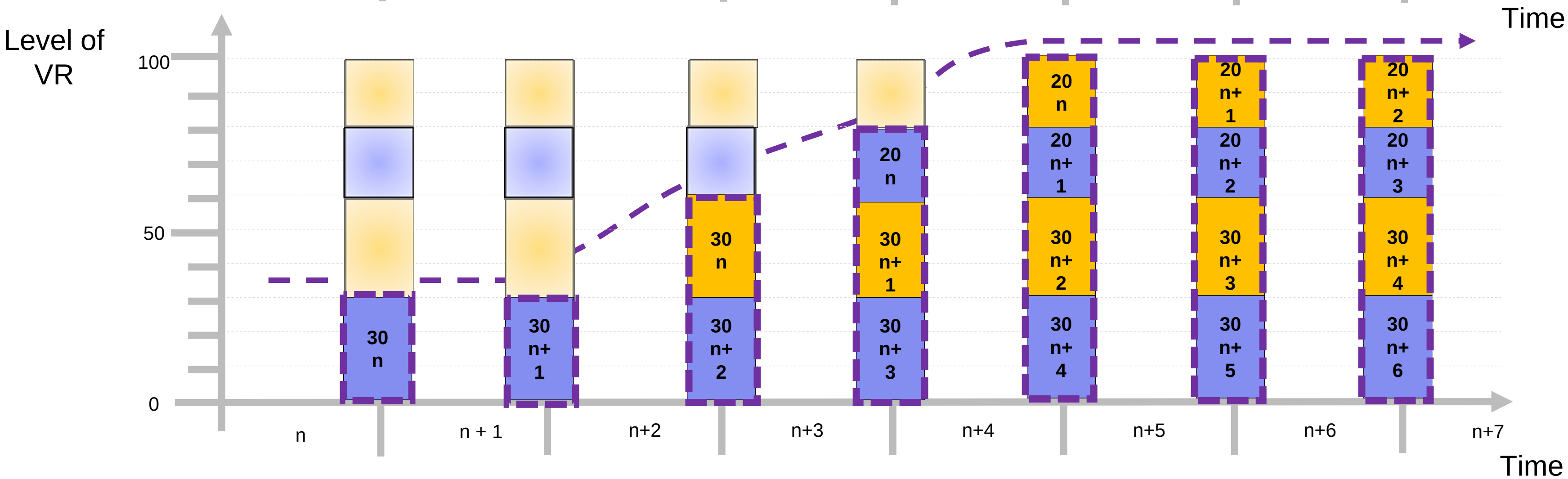
Legend

Instruments

Cash

VR = Variable Remuneration





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Block 3: Transparency (1/2)

- Part of “Pillar III disclosure”, enshrined in annex XII, part 2 of CRD
- May take form of a separate report or may be part of the annual report
- Mainly information on the remuneration of Identified Staff, but also a limited general component
- Will be the basis for benchmarking studies

Block 3: Transparency (2/2)

- Content:
  - Basic characteristics of the remuneration policy
  - Composition and mandate of RemCo
  - Link between pay and perfomance
  - Parameters and rationale for variable remuneration
  - Aggregate quantitative information broken down by business area
  - Aggregate quantitative information broken down by senior management and risk takers
    - Amounts of remuneration for the financial year, split into fixed and variable
    - Form of variable remuneration (cash/shares/other instruments)
    - Outstanding deferred remuneration
    - Sign-on and severance payments
    - Amounts of deferred remuneration awarded
  - For significant institutions: aggregate quantitative information at the level of directors

Next steps

- Consultation until 8 November 2010
- E-mail: CP42@c-ebs.org
- CEBS decision will be taken on 9-10 December 2010
- CRD III / Guidelines must be implemented by 1 January 2011

Thank you!