German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA's consultation on *draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013.*

Question 1: ***Are the definitions provided sufficiently clear; are additional definitions needed?***
We would like to ask the EBA to clarify the definition of "any other person acting on behalf of the institution". From our point of view, this definition should not include e.g. advisors, attorneys, etc.

Question 2: ***Are the guidelines in chapter 5 appropriate and sufficiently clear?***

It should be clarified whether the term "remuneration policy" in the Draft Guidelines refers to general remuneration principles or to a physical document entitled "Remuneration Policy". Depending on the context, the wording of the Draft Guidelines currently appears to mean both general principles and a physical document containing detailed rules. The meaning of the term "remuneration policy" should be defined accordingly and its use adapted to reflect the context of the Guidelines in each case.

Pursuant to para. 12 of the Draft Guidelines, "where variable remuneration is awarded such awards should be based on the institution's, business unit's and staff's performance". This requirement corresponds to Art. 94(1)(a) CRD IV providing that "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 institution". The latter requirement (i.e. that variable remuneration must also be based on the overall results of the institution), however, is only applicable to identified staff, i.e. staff whose professional activities have a material impact on the institution's risk profile. There is no good reason why a requirement which is specifically applicable to identified staff should apply to all staff. While the risk takers' professional activities have an impact on the institution's risk profile, this will, by definition, not be the case regarding the rest of the staff. When considering that performance criteria should include achievable objectives and measures on which the staff member has some direct influence, linking variable or performance-related remuneration to the performance of the institution is understandable in the case of identified staff, while in the case of the rest of the staff it is not. Some staff members may not even have significant influence on the performance of the business units they work for. Consequently, the extension of the scope of Art. 94(1)(a) CRD IV is not compatible with the principle of proportionality. Therefore, and in line with Annex 1 of the Draft Guidelines, Art. 94(1)(a) CRD IV should only be applicable to identified staff. There is no reason to even recommend its application to all staff.
In addition to this, para. 12 could be interpreted in a way that every variable remuneration for all staff has to be performance related. Since Art. 94 (1) (a) CRD IV implies that variable remuneration does not necessarily have to be performance related ("where remuneration is performance related […]"), the wording in para. 12 is too general and should be adjusted.

Paragraph 14
Given that the supervisory body is responsible for adoption of and compliance with the remuneration policy, such policy should not contain any detailed requirements. Instead, the remuneration policy for which the supervisory body is responsible should merely contain general principles of the institution's remuneration policy and remuneration practices, without any detailed application rules. Anything else would overstretch the functions and duties of the supervisory body.

With this in mind, we consider it necessary that institutions should be able to delegate the implementation of application rules to the appropriate responsible level within the institution (e.g. to the management and business support function level).

Paragraph 23
It is not up to a remuneration policy to determine individual role, function or position descriptions.

***Question 3:* Are the guidelines regarding the shareholders' involvement in setting higher ratios for variable remuneration sufficiently clear?**

We would like to comment on para. 32, which states that […] "the approval of an institution's remuneration policy and, where appropriate, decisions relating to the remuneration of members of the management body (or other identified staff), may be also assigned to the shareholders' meeting". […]

We are not convinced that having a remuneration policy that has to be agreed upon in the shareholders meeting would be the right way to go. In our opinion, the purpose of the annual shareholders' meeting is to decide on the most important issues of the company as set forth by law (especially the company's act). The decision-makers have made a decision on what issues should be brought to the attention of the shareholder and, indeed, we believe that this list is extensive and conclusive. The purpose of the shareholders' meeting is not to mingle into the daily business of the company, which is rather the task of the management board. The approval and say on certain policies, which includes also remuneration policies, is clearly an operative business and it contains many technical and administrative procedures.

Hence, in our opinion, it would not be appropriate to bring remuneration policies to the attention of the shareholders because dealing with the content of these technical and administrative procedures would not serve their purposes. The remuneration of the management and supervisory board is reported anyway to the shareholder through the corporate governance report, which will also be distributed to each shareholder in the shareholders' meeting. This report includes the basic mechanism of the boards' remunerations. In conclusion, we do not regard it necessary and useful to report in the shareholders meeting on certain policies, such as remuneration policies.

Remuneration Committee

Paragraph 39
All significant institutions at individual, parent company and group level are required to establish a remuneration committee. We believe that, with due regard the principle of proportionality, establishment of a remuneration committee at group level should also be permissible, particularly where institutions base their business operations on cross-company line organisation.

Paragraph 44
The requirements for the role of the remuneration committee should respect existing national legislation and regulation. That goes particularly for countries with a two-tier system of corporate governance and thus with a separation between the management body and the supervisory body. The operational/control functions assigned to the remuneration committee under para. 44 are impracticable in a two-tier system.

With regard to point “a”, the remuneration committee plays an important role in determination of remuneration policies and compliance with the rules, but it cannot be given the job of reviewing the salaries and variable remuneration of all risk takers. This would impose an unduly heavy workload on the remuneration committee and lead to restricted performance of its other statutory functions.

Question 4: ***Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?***

Paragraph 63

Pursuant to para. 63 of the Draft Guidelines “the consolidating institution must ensure that subsidiaries within the group which are not themselves subject to the CRD, apply the group-wide remuneration policies to all staff and the requirements of Article 92(2), 93,and 94 of CRD at least to those staff members whose professional activities have a material impact on the group’s risk profile.” This shall also include “subsidiaries which are not in the scope of prudential consolidation” (c.f. p. 11 of the Draft Guidelines).

Pursuant to Art. 92(1) CRD IV institutions shall apply the remuneration principles at group, parent company and subsidiary level. Under Art. 109(2) CRD IV parent undertakings and subsidiaries subject to the CRD IV shall meet the obligations set out in Art. 74 et seqq. CRD IV on a consolidated or sub-consolidated basis. Also, parent undertakings shall implement the relevant arrangements, processes and mechanisms also subsidiaries which are not subject to the CRD IV.

While the scope of the group-wide remuneration policy under CRD III was restricted to undertakings that came within the group of prudential consolidation (c.f. para. 27 CEBS Guidelines), the Draft Guidelines extend the scope of application of the group-wide remuneration policy to all subsidiaries within the accounting scope of consolidation and without any possibility to exempt subsidiaries. This, however, is disproportionate.

The purpose of Art. 92(1) CRD IV is to ensure that the remuneration principles are coherently observed on a group-wide basis. This aims at preventing that remuneration is paid through vehicles or methods that facilitate the avoidance of the remuneration requirements contained in the CRD IV. The focus of Art. 109(2) CRD IV is primarily directed at the effective management of risks. Risk management at group level shall include all risks of the entire group, irrespective of whether they are caused by subsidiaries which are subject to the CRD IV or not (covering e.g. risks arising from special purpose vehicles or from the area of “shadow banking”). Nevertheless, allowing institutions to exempt certain subsidiaries from their group-wide remuneration policy is appropriate where the subsidiary has no relevant impact on the group’s overall risk profile and the subsidiary is not used for purposes of circumventing the remuneration requirements of the CRD IV. Where these conditions are satisfied, the subsidiary’s inclusion in the group-wide remuneration policy is not required from the perspective of sound and effective risk management. Also, their inclusion would lead to significant upfront and ongoing costs which are not justified when measured against the benefit in terms of the regulatory objective. This is in particular true where institutions have subsidiaries that are not part of the regulatory consolidation group because they provide services unrelated to the banking business, such as IT services. For those subsidiaries that compete with similar service providers which are not part of a banking group, it would be a significant competitive disadvantage if they had to apply the remuneration rules designed for banks that conflict with the market standards outside of the regulated financial services business. It therefore must remain possible for national authorities to exempt certain subsidiaries from the application of the group-wide rules.

The EBA should make clear that the term "institutions" as used in the Draft Guidelines covers only institutions that are directly subject to application of CRD IV and should confirm that the identification of risk takers at individual level is designed to identify those staff members whose professional activities may have a material impact on the risk profile at group level. The EBA should also make clear that the CRD IV-specific risk orientation of remuneration is only to be applied to staff members whose professional activities have a material impact on the risk profile at group level and that the requirement to apply the CRD IV provisions on remuneration does not apply to the variable remuneration of subsidiaries within a group which are subject to separate sectoral or national regulations.

Question 5: ***All respondents are welcome to provide their comments on the chapter on proportionality, with particular reference to the change of the approach on 'neutralisations' that was required following the interpretation of the wording of the CRD. In particular institutions that used 'neutralisations' under the previous guidelines for the whole institution or identified staff receiving only a low amount of variable remuneration are asked to provide an estimate of the implementation costs in absolute and relative terms and to point to impediments resulting from their nature, including their legal form, if they were required to apply, for the variable remuneration of identified staff: a) deferral arrangements, b) the pay out in instruments and, c) malus (with respect to the deferred variable remuneration). In addition those institutions are welcome to explain the anticipated changes to the remuneration policy which will need to be made to comply with all requirements. Wherever possible the estimated impact and costs should be quantified, supported by a short explanation of the methodology applied for their estimation and provided separately for the three listed aspects.***

The German Banking Industry Committee would appreciate applying a broad interpretation of the CRD IV in order to keep the possibility of neutralisations, which were in line with previous guidelines, for the whole institution and for categories of staff. There are a significant number of small institutions which do not have any complex business strategy and pay lower amounts of boni or no bonus at all. These institutions should still have the possibility to apply a full neutralisation of pay-out under consideration of their complexity, risk profile, risk appetite, etc.
It should also not be overlooked in this context that the CRD IV provisions on remuneration are, in their entirety, too complex. They thus urgently need to be simplified. The existing provisions ultimately force institutions to first identify an unduly large number of staff members as risk takers and then demonstrate where necessary in a second step that the purported material impact on the institution's risk profile does not exist.

The new approach to the principle of proportionality is based on the assumption that the CRD IV does not provide for any explicit provision that allows the so-called neutralisation. In contrast to this, the German Banking Industry Committee understands that, *inter alia*, Recital 66 CRD IV allows for such neutralisation. In fact, the wording of this recital indicates that waiving certain remuneration principles in respect of certain institutions (based on the proportionality principle) would be allowed.

Similar to that, Art. 92(2) CRD IV states that "Competent authorities shall ensure that, [...] institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities". Art. 94(1) CRD IV further holds that "the following principles shall apply in addition to, and under the same conditions as, those set out in Article 92(2)".

According to Art. 74(1) CRD IV, institutions shall have robust governance arrangements, which include, amongst other things, "remuneration policies and practices that are consistent with and promote sound and effective risk management". Art. 74(2) CRD IV specifies that the "arrangements, processes and mechanisms referred to in Art. 74(1) CRD IV shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities". In short, in our view, also Art. 74 CRD IV clearly advocates a broad application of the proportionality principle in connection with the remuneration policies.

Also historical arguments mirror that the proportionality principle, and even neutralisations, go hand in hand with the EU's remuneration policies. In its CRD III proposal (COM(2009) 362 final, 13 July 2009), the European Commission itself held that "the proposal allows firms 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. This approach is likely to minimise the up-front and on-going compliance costs for firms, and was therefore preferred over an alternative of requiring a strict and uniform compliance by all firms, irrespective of their size, with the principles set out in Commission Recommendation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial services sector." In fact, CRD III already contained very similar provisions on proportionality to the ones in the currently applicable CRD IV: compare Recital 4 CRD III and Recital 66 IV as well as Art. 22 CRD III and Art. 74 CRD IV.

Furthermore, the European Parliament, in its Resolution on remuneration of directors of listed companies and remuneration policies in the financial services sector (7 July 2010) stated that "compensation systems should be proportionate to the size, internal organisation and complexity of financial institutions and should reflect the diversity between different financial sectors such as banking, insurance and fund management" (para. 11).

Finally, we would like to refer to the 2010 CEBS Guidelines on remuneration policies (paras. 19 et seqq.), which do not only speak generally about proportionality, but also about the possibility to neutralise certain requirement (para. 20).

Consequently, we believe that the principle of proportionality is rooted in the CRD IV text, applying also to the chapter on remuneration policies.

At any rate, to the German Banking Industry Committee it is clear that the main interpretative guideline of any legal act should be the text of this act itself. In the present case, Recital 66 CRD IV is very helpful as it refers to the legislator's intention and explains its purposes. It holds that "the provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles."

Therefore, we conclude that the wording of CRD IV allows not to apply some of its principles regarding remuneration to some institutions (investment firm, for instance: "In particular…"), as far as it would not be proportionate to ask them to comply with all those principles. Thus, one could derive a neutralisation principle directly from CRD IV, in particular from Recital 66**. This view is also strongly supported by a legal opinion of the law firm *Freshfields Bruckhaus Deringer*, which we have attached to this comments.**

EBA's interpretation of the CRD has a significant impact on institutions. Under the CEBS Guidelines proportionality operated both ways in the sense that some institutions were required to apply more sophisticated remuneration policies and practices, while other institutions could meet the remuneration requirements in a simpler or less burdensome way. By contrast, under the Draft Guidelines proportionality operates only one-way: upwards. All institutions, even small and non-complex ones, will have to apply the minimum standards for all identified staff, the level is raised for significant institutions (far) beyond the minimum standards.

The omission of neutralisations would lead to disproportion between institutions and would hit small institutions comparatively hard – demanding extraordinary organisational efforts from them (human resources for execution, purchasing and handling of remuneration software, etc). In the light of these burdensome implications of a changed view on proportionality, especially small and non-complex institutions which do not extensively rely on variable remuneration or only pay low amounts of variable remuneration could also be pushed to completely withdraw from the use of variable remuneration. This would partly be accompanied by an increase of fixed remunerations in order to cushion competitive disadvantages. Given the fact that the EBA itself sees variable remuneration as an important element of cost flexibility for institutions (p. 15 of the consultation paper), we would very much welcome in this context if the EBA considered differences between investment banks, retail banks, promotional banks and non-bank subsidiaries regarding their risk profile and the amount of their bonus payments.

Additionally, we consider that the stricter application, following the interpretation of the EBA's legal service, would not lead to the effects strived for. On the one hand this interpretation rather establishes a stiffness in the risk adjustment system of variable compensation. The German Banking Industry Committee believes that the interpretation of the proportionality principle should not be understood as a technique to avoid the application of an article, but rather as a way to simplify its implementation and impact. In this regard, we understand that the fact that all professionals included in the identified group should receive their variable remuneration with deferred payment and in instruments could generate undesirable situations; mainly in relation to identified staff who only receives a low amount of variable remuneration or whose boni represent a small percentage of their remuneration and raises a conflict of external competitiveness, both of which would be counterproductive to the objectives of the regulation itself.

Moreover, we understand that one of the main objectives of the deferral is to effectively implement the risk-aligned malus policies and the ex-post adjustments; in addition to moving the market risk of the shares to professionals as an aggregate interpretation of the results and market risks assumed by the bank. According to this approach, for low amounts of boni or for bonus amounts which weigh little in relation to the total remuneration of a professional, the effect of deferring it three years and to pay 50% cash and 50% in other instruments – with the consequent decrease in taxes – generate small monetary amounts that are often neither really relevant for the professional nor for the purpose of the regulation to achieve its objectives.

The CEBS Guidelines expressly prohibit applying lower numerical requirements for identified staff but did foresee the possibility of 'neutralising' entirely the specific requirements with numerical criteria for certain members of staff (c.f. para. 20 and 26 CEBS Guidelines), EBA considers itself to be bound to change this approach and thus to require the application of the aforementioned requirements to all identified staff – even those receiving only a low amount of variable remuneration. This, however, is not compatible with the principle of proportionality. If the amount of variable remuneration is low in absolute terms, the requirements relating to deferral, payout in instruments and ex-post risk adjustment cannot be applied in a sensible manner as it would mean deferring and converting into instruments (potentially very) small amounts. The application of these requirements would lead to significant costs which are disproportionate in relation the benefit in terms of the regulatory objective. Ultimately, the requirement to defer amounts tends to lead to an increase in total remuneration as employees attribute less value to remuneration that is deferred. If variable remuneration is used only to a small extent, it is unlikely that such small amount of variable remuneration will create incentives for excessive risk-taking. It is therefore not required from the perspective of prudent risk-taking to make small amounts of staff members' variable remuneration subject to the strictest requirements.

For example, for a professional whose fixed remuneration is EUR 160,000 with a bonus target of 25% (EUR 40,000), with an award scheme of 60% upfront (EUR 34,000), the deferral of the 40 % (EUR 16,000) in three years would result in € 5,333 annually, 50% (EUR 2,667 in shares and EUR 2,667 in cash). Taxes (for instance, 35%) would also still apply to these EUR 2,667, regardless of the change in the share price, the final yield would be EUR 1,733 (cash and stock totalling EUR 3,466). On the whole, this would be only around a 2% of his salary. So it seems understandable that the professional would not focus his efforts, especially on results aligned with the risk profile in the long term, but rather in achieving a promotion which would become economically more important.

For all these reasons, the German Banking Industry Committee believes that, without undermining the objectives of the remuneration policies, it would be positive for the financial sector if the EBA considered the option of keeping CRD III's interpretation of the proportionality principle in CRD IV and developing quantitative criteria for its application in order to lessen the asymmetry of interpretations.

For example, we would appreciate the application of a (materiality) threshold at the European level, approved by the EBA, with regard to neutralisation.
We therefore request in particular the following specific exceptions or neutralisation options:

- General neutralisation of institutions with total assets of less than EUR 15 billion.
- Neutralisation of staff members where the total remuneration of an individual staff member does not exceed EUR 300,000 (provided no other EBA or 'RTS on identified staff' criteria apply).
- No application of deferral rules, commitments to award shares or share-based instruments and retention periods for certain staff members where the variable remuneration does not exceed an amount of EUR 100,000.
- Right to make discretionary award of variable remuneration (bonuses) under the following conditions:
    1. Payments are made after the close of the respective business year;
    2. Staff have no legal claim to such payments, which are awarded in each case at the institution's discretion;
    3. The caps on variable remuneration in proportion to fixed remuneration are adhered to;
    4. The fixed remuneration of the respective staff member or manager does not exceed EUR 670,000 annually and the total remuneration does not exceed EUR 2 million annually.

Indeed, we would welcome more guidance on the amount and percentage of boni on the fixed remuneration that should be considered as a minimum. Above this minimum, it would be mandatory to pay with deferral and instruments. This nominal amount could be considered as a reference to establish a common framework within the EU or internationally, and then each institution could adapt it to the reality of each country, using indices based on purchasing power parity.

Question 6: Are the guidelines on the identification of staff appropriate and sufficiently clear?

According to para. 85, the annual self-assessment for identifying risk takers should be based not only on the qualitative and quantitative criteria set out in the RTS on identified staff but also on additional institution-specific criteria. These additional criteria must, moreover, be disclosed by institutions (para. 294). The requirement to apply such additional criteria is neither necessary nor appropriate in our view. Thanks to their detailed qualitative and quantitative identification criteria, the RTS on identified staff ensure that all relevant risk takers are identified. In particular, they cover all relevant types of risk. These additional criteria are a completely indefinite opening which leave each user of standards on their own. The resulting time and work involved, more precisely the process of developing and documenting criteria, is entirely disproportionate.

In respect of branches of credit institutions (para. 107), our practical experience has shown us that branches and subsidiaries (not only those located in third countries) which identified their staff according to the criteria laid down in the RTS on *criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile* (RTS on Categories of Staff) had to identify almost their entire staff because of the small scope Identification at individual level produces a disproportionately high number of identified staff whose professional activities have no material impact on the risk profile of the group as a whole. In our view, a consolidating institution can, moreover, only identify those risk takers group-wide whose professional activities may have a material impact on the risk profile of the group as a whole.

According to our estimation, this should not be the objective of the aforementioned RTS. Therefore, we would like to ask the EBA to review its wording in para. 107 to the extent that small and not complex branches and subsidiaries should not be subject to the scope of application in the same way as other, more complex, institutions. The principle of proportionality needs to be respected. In particular, we refer to Art. 3(4 et seqq.) RTS on Categories of Staff.

In addition, the identification of risk takers that subsidiaries in other EU countries are required to perform under national legislation should be carried out by the institutions themselves without involving the parent company.

With regard to the identification of risk takers, it does not appear feasible in our view to continuously update the self-assessment in the course of a year. The self-assessment is a result of the annual identification process and is based on an annual risk analysis, i.e. the risk-taker criteria. On the basis of this risk analysis, staff transfers and recruitments within a year are already continuously monitored today to determine whether the relevant staff members fulfil the risk-taker criteria.

Question 11: Are the provisions regarding severance payments appropriate and sufficiently clear?

12.3 Discretionary pension benefits

The EBA should make clear that components of retirement income which are acquired under general, transparent rules not directly at the discretion of the institution and which are based on contributions from certain portions of variable remuneration will not be counted as discretionary pension benefits.

13.2 Severance pay

If severance payments are also generally to be subjected to the full requirements for variable remuneration, the EBA should, in our view, explain how risk adjustment of severance payments based on a detailed, final contractual agreement and a waiver by staff members of all claims against the institution is to be carried out.

EBA should take into account that under national labour law severance payments would generally be considered as a form of compensation for damages (loss of job) rather than remuneration.

143 (a) stipulates that severance payments should not be awarded "where there is an obvious failure which allows for the immediate cancellation of the contract or the dismissal of staff". Based on this example, it is impossible to determine with any legal certainty in which cases severance payments are not permissible. Whether the failure of a staff member warrants immediate dismissal is something that can only be clarified on a legally binding basis by a labour court verdict. In fact, this is the reason why the situation described under para. 143 (a) commonly leads to settlements in case of potential or actual labour disputes. Severance payments are indispensable for institutions as they enable the participants to avoid a lengthy labour dispute, the outcome of which is often uncertain. It should therefore be made unequivocally clear that severance payments agreed under a court settlement are always permissible. The same should apply to severance payments that are agreed to avert a legal dispute before a labour court, even if failure of staff cannot be verified/proven at the time of the settlement. It should also be clarified that the provisions on severance pay do not apply to staff members whose professional activities do not have a material impact on an institution's risk profile.

Question 15: Are the provisions on deferral appropriate and sufficiently clear?

Although para. 230-245 do not differentiate between all staff and identified staff, the EBA based its more detailed questionnaire of 26 March 2015 (addressed to some selected institutions and organisations) on the assumption that deferral and pay out in instruments apply to identified staff only. To avoid misunderstandings, it should therefore be clarified that only remuneration for identified staff is subject to these stringent provisions.

Paragraph 234

As stated above in connection with the proportionality principle, we believe that the rules on deferral, etc., should not apply if the variable remuneration does not exceed a specific amount. Application of the rules on retention from the very first euro of variable remuneration would impose an unreasonable extra administrative burden because the professional activities of staff members receiving low variable remuneration usually have no material impact on the bank's overall risk profile. The annual payout of relatively low amounts of variable remuneration stipulated under the deferral rules means that variable remuneration can virtually no longer unfold any positive incentive effect.

Paragraph 236

Pursuant to para. 236 of the Draft Guidelines "significant institutions should in any case apply, at least for members of the management body in its management function and senior management, deferral periods of at least five years or longer".
Art. 94(1)(m) CRD IV requires that a substantial portion of the variable remuneration component shall be deferred over a period which is not less than three to five years and be properly aligned with the nature of the business, its risks and the activities of the staff member in question. First, there is no basis in the

wording of Art. 94(1)(m) CRD IV that would allow the EBA to establish specific requirements for significant institutions. In contrast to Art. 95(1) CRD IV, which sets out a specific requirement applicable to significant institutions only, namely to establish a remuneration committee, such specific requirement is not contained in Art. 94(1)(m) CRD IV. Furthermore, the purpose of the deferral requirement is to enable the institution to adjust the variable remuneration over time as the outcomes of the staff member's actions materialize. Thereby, part of the remuneration can be adjusted for risk outcomes over time through ex-post risk adjustments. The length of the deferral period should therefore depend on the specific activities of the staff member, the nature of the specific business and the risks connected therewith. Accordingly, the length of the deferral period should depend upon the circumstances of each individual case. A deferral period of at least five years or longer is unlikely to correspond to the specifics of the individual case. Finally, it has to be considered that the deferral of variable remuneration is only one means for aligning remuneration with prudent risk taking. Proper risk alignment of remuneration depends on many factors which must not be regarded independently of each other. Therefore, a deferral period of five years may be appropriate in some cases, in other cases not, depending on the structure of the overall remuneration package.

Question 16: Are the provisions on the award of variable remuneration in instruments appropriate and sufficiently clear?

Paragraph 248(a)

Para. 248s of the Draft Guidelines states that under Art. 94(1)(l)(i) CRD IV only shares (and no share-linked instruments) should be used by listed stock corporations. The only explanation that EBA gives for this requirement is that, as the RTS on instruments applied only to instruments under Art. 94/1)(l)(ii) CRD IV, it were appropriate to set out guidelines on shares and share-linked instruments in order to ensure that they are appropriate for the use as part of variable remuneration and do not lead to a circumvention of the relevant CRD provisions (c.f. para. 110 of the Draft Cost-Benefit Analysis / Impact Assessment).

Pursuant to Art. 94(1)(l) CRD IV a substantial portion, and in any event at least 50 % of any variable remuneration shall consist of a balance of the following: (i) shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution; [...]. The reason for the proposed requirement for institutions to award part of the variable remuneration in the form of shares or share-based instruments is setting long-term incentives. These long-term incentives can also be set using share-based instruments. As regards the wording of this provision, can clearly be interpreted so that both instruments are considered as alternatives. Both instruments are rather to be considered as alternatives. This was also the view of the CEBS (see there, para. 124). Considering that there were no substantial changes introduced by CRD IV in this respect, there is no good reason why the CEBS's view should not be valid any more. Also, when looking at the purpose of remunerating staff in instruments, there is no convincing argument why listed stock corporations should not be allowed to award e.g. phantom shares instead of shares. The basic purpose for remunerating staff members in instruments is to put them into an owner-like position in order to align their interests with those of the stakeholders, especially of the owners. Furthermore, the final payout will depend partly on market prices due to fluctuations during the deferral and retention period (implicit risk adjustment). Both purposes, the aligning of interests and the implicit risk adjustment are served and satisfied equally well by shares and phantom shares. Therefore, phantom shares are equally appropriate for the use as part of variable remuneration. There is no reason why the use of phantom shares should lead to a circumvention of the respective CRD provisions. In addition, it must be noted that using physical shares can lead to various difficulties for the affected institutions, e.g. under securities or stock corporation laws. Also from a practical perspective, physical shares have disadvantages with a much higher administrative burden attached to it. In practice, it may for example prove almost impossible to hold the relevant shares in European custody accounts on behalf of US employees of the affected institutions due to applicable restrictions under the FATCA and other rules.

This means that there are basically no further valid arguments for excluding listed stock corporations from the use of share-based instruments. In contrast, a remuneration scheme based on a commitment to award physical shares is highly complex and cost-intensive.
All institutions, irrespective of their legal form, should therefore be entitled to use share-based instruments. When it comes to catering to shareholders' interests, share-based instruments support the same objectives as shares, they are easier to handle and less costly.

For some institutions, which are non-stock corporations, non-cash instruments including instruments based on cash, whose value is based on the market price of ownership rights, do not make any sense. A reference to a market price is not possible if there is no market. The fair value is defined according to IFRS, however, German institutions apply national standards only. The obligation to create instruments for remuneration purposes only would result in a disproportionate burden and extraordinary costs while at the same time the effect on the ex-post-risk-assessment compared to cash-payment would be very limited.

Question 17: Are the requirements regarding the retention policy appropriate and sufficiently clear?

Pursuant to para. 264 of the Draft Guidelines „large (including significant) and complex institutions should at least for the management body and senior management consider at least one of the following in order to align the variable remuneration to the risk taken: (a) setting for the upfront awarded instruments a retention period at the length of the combined deferral and retention period for deferral instruments; (b) defer a significant higher portion of the variable remuneration paid in instruments for these staff members."
Under Art. 94(1)(l) CRD IV instruments shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the institution. First, there is no basis in the wording of this provision that would allow special requirements for significant institutions, or for "large" or "complex" institutions. With regard to "large" or "complex" institutions, the terms are framed so vaguely, that is not even possible to clearly identify such institutions. As regards the substance, para. 264 of the Draft Guidelines further reduces the amount of variable remuneration that is available upfront for affected staff members. When considering the length of the retention period under option (a), comprising a deferral period of at least three to five, or even more (see Q 15 above), years plus an appropriate retention period, it is fair to say that the "upfront awarded instruments", in practice, cannot even be characterized as an "upfront" payment any more. The likely effect of this is an increase in the total remuneration, as a compensation for this disadvantage. Finally, the only justification brought forward by EBA to justify such long retention periods for upfront awarded instruments is to ensure a more harmonized approach, and particularly, to ensure that the minimum standards to be used are harmonised (see para. 108 and 111 of the Draft Cost-Benefit Analysis / Impact Assessment). With regard to retention periods, however, there are no minimum standards that could be harmonised. What is to be considered an appropriate retention under Art. 94(1)(l) CRD IV depends upon the circumstances of the individual case. A retention period for

upfront awarded instruments of up to five years, or even more, does not seem appropriate and is not compatible with the principle of proportionality.

Question 18: Are the requirements on the ex post risk adjustments appropriate and sufficiently clear?

Under para. 270 of the Draft Guidelines “institutions should use at least the initially used performance and risk criteria to ensure a link between the initial performance measurement and its back testing”. Under Art. 94(1)(n) CRD IV the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus and clawback arrangements. While the CEBS Guidelines required institutions to ensure that there is a link between the initial performance measurement and the back-testing, (see there, para. 135), the EBA Draft Guidelines introduce an additional obligation in this respect, namely to use at least the initially used performance and risk criteria. If this would mean that every institution within the process of assessing performance ex post must carry out a complete re-evaluation of the initial performance and risk measurement, then such requirement would be disproportionate, especially for small and non-complex institutions.

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Freshfields Bruckhaus Deringer

Memorandum

From
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To
Die Deutsche Kreditwirtschaft

Date
1 June 2015

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EBA Guidelines on sound remuneration policies and the principle of proportionality

I. Facts and question

On 4 March 2015 the European Banking Authority (***EBA***) launched a consultation on its draft Guidelines on sound remuneration policies[1] (***EBA Guidelines***). The EBA Guidelines have been developed on the basis of Art. 74 (3) and 75 (2) of Directive 2013/36/EU[2] (so-called *Capital Requirements Directive IV* – ***CRD IV***) and are intended to ensure the common, uniform and consistent application of the remuneration requirements set out in Art. 92 to 95 CRD IV and to provide guidance on disclosures under Art. 96 CRD IV and Art. 450 of Regulation (EU) No 575/2013[3] (so-called *Capital Requirements Regulation* – ***CRR***).

The EBA Guidelines are intended to replace and repeal the Guidelines on Remuneration Policies and Practices which were developed by the EBA's predecessor, the Committee of European Banking Supervisors[4] (***CEBS Guidelines***) on the basis of the relevant provisions of Directive 2010/76/EU[5] (so-called *Capital Requirements Directive III* – ***CRD III***). In contrast to the CEBS Guidelines, which allowed for the proportionate application of the remuneration requirements to small and non-complex institutions (so-called 'neutralisation'

[1] European Banking Authority, Consultation Paper, Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013, EBA/CP/2015/03, 4 March 2015.

[2] Directive 2013/36/EU of the European Parliament and the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervisions of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176 of 27 June 2013, p. 338.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176 of 27 June 2013, p. 1.

[4] See Committee of European Banking Supervisors, Guidelines on Remuneration Policies and Practices, 10 December 2010.

[5] Directive 2010/76/EU of the European Parliament and the Council of 24 November 2010 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, OJ L 329 of 14 December 2010, p. 3.

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of certain remuneration requirements), the EBA Guidelines foresee a revised approach to the application of the principle of proportionality which can be summarized as follows:

> "Based on a preliminary legal analysis of the remuneration principles set out in Art. 92 to 94 CRD, *the approach to the application of the principle of proportionality has been changed compared to the 2010 CEBS Guidelines with respect to the possibility to 'neutralise' some of those principles* such as the deferral of variable remuneration, the pay out in instruments and the application of malus and clawback. *The CRD does not provide for any explicit provision that allows for such waivers.* The CRD IV allows for some flexibility to adapt the concrete manner and extent of the application of these rules to the size, internal organization and nature, scope and complexity of institutions' activities. *The requirements have, however, to be applied at least at the minimum thresholds set by the CRD IV. The principle of proportionality cannot lead to the non-application of these rules.* For the purposes of legal certainty, the EBA has asked the European Commission for its view on the application of the principle of proportionality and whether it would be possible to allow waivers on the basis of the CRD and received the *European Commission's interpretation that the remuneration requirements have to be applied without exemptions and exceptions to all institutions.*"[6]

The European Commission's interpretation that (all) the remuneration requirements set out in Art. 92 to 94 CRD IV have to be applied without exemptions and exceptions to every institution is summarised in the EBA Guidelines as follows:

> "The EBA received confirmation from the EU Commission on the *reading that Articles 92 and 94 CRD apply to all institutions, without any distinction,* pointing beside others to the following aspects: *the general principles as implicitly referred to in the introductory part of Article 92(2) CRD can in no way justify the non-application of one or the other rule contained in that provision, or indeed in Article 94(1) CRD.* This applies in particular to the provisions referring to the deferral arrangements, the pay-out in instruments and the application of malus. Such provisions lay down clear rules and leave no room for exceptions or exemptions."[7]

With regard to the interpretation of Art. 92(2) CRD IV, the European Commission sets out in more detail:

> "Articles 92 and 94 apply to all institutions, without any distinction. Article 92(2) clarifies in this context that *competent authorities shall ensure that institutions comply with these principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities.* This means that each of the relevant provisions has to be applied to each institution, while any discretion those provisions may leave Member States and competent authorities has to be exercised notably in competence with the principle of proportionality. This is

[6] See EBA Guidelines, p. 6. See more in detail: EBA, Letter to European Commission on proportionality, "Interpretation of the proportionality principle as set out in Article 92(2) of the Capital Requirements Directive – Remuneration policies", 8 January 2015; and European Commission, Response of European Commission re proportionality, "Interpretation of Article 92(2) of the Capital Requirements Directive – remuneration policies, JUST/A3/KKH/mg(2015)726410, 23 February 2015.

[7] See EBA Guidelines, p. 12.

> what Article 92(2) means when it stipulates that the "principles" referred to must be applied "in a manner *and to the extent* that is appropriate…"."[8]

The European Commission further refers to the exclusive competence of the co-legislators, the European Parliament and the Council:

> "However, it is neither for national competent authorities, nor indeed the EBA […] to decide that certain rules adopted by the co-legislators shall not apply. It is *exclusively for the co-legislators* to amend the existing rules, notably with a view to make further distinctions."[9]

In the context of proportionality, the EBA Guidelines refer to a resolution of the European Parliament:

> "In addition, the EBA took into account the European Parliament (EP) resolution of 3 July 2013 on reforming the structure of the EU banking sector. The EP besides others urges the Commission and the EBA 'to ensure full and comprehensive implementation of (…) the provisions on compensation and remuneration' (…)".[10]

Apparently, the EBA favors a proportionate application of the remuneration requirements particularly to small and non-complex institutions but considers itself as being bound by the European Commission's interpretation of the law:

> "The EBA is investigating which specific situations would justify the application of the proportionality principle to the various remuneration provisions in an appropriate manner and extent and is therefore seeking additional input from industry on the impact of the application of these principles to all institutions, particularly to small and non-complex institutions, and on the impediments for a full application as a starting point. *However, the EBA is of the view that such provisions could be 'neutralised' for certain institutions that do not extensively rely on variable remuneration and, if confirmed by further analysis, also for identified staff that receive only a low amount of variable remuneration.* To this regard, the Authority intends to send its advice to the European Commission suggesting legislative amendments that would allow for a broader application of the proportionality principle and is, therefore, asking all interested parties to provide input on this aspect that will be used to substantiate the EBA's opinion and to develop more concrete proposals."[11]

We were asked to analyze whether the European Commission's interpretation of the relevant provisions of the CRD IV is mandatory or whether there is still room for a proportionate application of the remuneration requirements in the sense that not all requirements have to be mandatorily applied to all institutions.

[8] European Commission, Response of EU COM re proportionality, "Interpretation of Article 92(2) of the Capital Requirements Directive – remuneration policies, JUST/A3/KKH/mg(2015)726410, 23 February 2015, p. 1 et seq.

[9] Ibid., p. 2.

[10] See EBA Guidelines, p. 12.

[11] See EBA Guidelines, p. 6.

II. Legal analysis

1. CRD IV requirements

When looking at the relevant provisions contained in the CRD IV, it can first be noted that the principle of proportionality, and thus, the proportionate application of the remuneration requirements to institutions, is well established.

Pursuant to Art. 74 (1) CRD IV, institutions shall have robust governance arrangements, which include, *inter alia*, remuneration policies and practices that are consistent with and promote sound and effective risk management. Under Art. 74 (2) CRD IV, the arrangements, processes and mechanisms referred to in Art. 74 (1) CRD IV shall be comprehensive and *proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities*,[12] whereby the technical criteria established in Art. 76 to 95 CRD IV shall be taken into account. Under Art. 74 (3) CRD IV, EBA shall issue guidelines on the arrangements, processes and mechanisms referred to in Art. 74 (1) CRD IV, *in accordance with Art. 74 (2) CRD IV.*

Further, pursuant to Art. 75 (2) CRD IV, EBA shall issue guidelines on sound remuneration principles which comply with the principles set out in Art. 92 to 95 CRD IV. Under Art. 92 (2) CRD IV competent authorities shall ensure that, when establishing and applying the remuneration policies for so-called risk takers (in the EBA's terminology: identified staff), institutions comply with the remuneration principles contained in Art. 92 (2) (a) to (g) CRD IV *in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities*. Pursuant to Art. 94 (1) CRD IV, the remuneration principles contained in Art. 94 (1) (a) to (q) CRD IV shall apply in addition to, and *under the same conditions as, those set out in Art. 92 (2) CRD IV.*

Further reference to the principle of proportionality is made in recital 66 of the CRD IV, setting out that "the provisions of this Directive on remuneration *should reflect differences between different types of institutions in a proportionate manner*, taking into account their size, internal organization and the nature, scope and complexity of their activities. *In particular it would not be proportionate to require certain types of investment firms to comply with all those principles*."

From recital 66 of the CRD IV it can be concluded that the CRD IV provides for the possibility, as a matter of principle, to waive certain remuneration principles with regard to certain institutions based on the principle of proportionality. This is also in line with the wording of CRD IV itself, since Art. 92 (2) CRD IV requires institutions to comply with the

[12] See also recital 54 of CRD IV: „In order to address the potentially detrimental effect of poorly designed corporate governance arrangements on the sound management of risk, Member States should introduce principles and standards to ensure effective oversight by the management body, promote a sound risk culture at all levels of credit institutions and investment firms and enable competent authorities to monitor the adequacy of internal governance arrangements. *Those principles and standards should apply taking into account the nature, scale and complexity of institutions' activities*."

remuneration principles only "*to the extent*" that is appropriate to their size, internal organization and the nature, scope and complexity of their activities.

This is clearly contrary to the aforementioned interpretation of the European Commission, according to which the remuneration requirements would have to be applied "*without exemptions and exceptions to all institutions*". Furthermore, since investment firms are only mentioned as an example in recital 66 ("*in particular*"), the possibility of waiving certain remuneration requirements is not confined to investment firms. Thus, there is, in principle, room for applying exemptions and exceptions also to (small and non-complex) credit institutions.

Based on this preliminary analysis, we note that the wording of the relevant provisions set out in the CRD IV allows for the interpretation that not all remuneration requirements have to be mandatorily applied to all institutions. When looking further at the legislative history of the remuneration requirements, the above conclusion gets an even stronger foundation.

2. Legislative history

a) Implementation of the FSB Principles and Standards

As set out in recital 62, CRD IV intends to implement international principles and standards at Union level. The relevant international principles and standards can be found in the Financial Stability Board's Principles for Sound Compensation Practices[13] and the respective Implementation Standards [14] (***FSB Principles and Standards***). These principles and standards were developed in reaction to the financial crises that began in 2007, and their aim was to enhance the stability and robustness of the financial system.[15] For this purpose, the FSB Principles and Standards were intended to apply to all "significant financial institutions", but they were meant to be "especially critical for large, systemically important firms".[16]

Against this background, it is not surprising that the principle of proportionality appeared on the agenda from the outset of the implementation process at European Union level. In its Communication "Driving European Recovery" of 4 March 2009, the European Commission announced a two-fold implementation strategy in respect of the FSB Principles, including the enactment of a non-binding recommendation and an amendment of the Capital Requirements Directive.[17]

[13] Financial Stability Forum, FSF Principles for Sound Compensation Practices, 2 April 2009.

[14] Financial Stability Board, FSB Principles for Sound Compensation Practices – Implementation Standards, 25 September 2009.

[15] FSB Standards, p. 1.

[16] FSB Principles, p. 1.

[17] European Commission, Communication for the spring European Council, Driving European Recovery, Volume 1, COM(2009) 114 final, 04 March 2009, p. 8.

b) Recommendation 2009/384/EC

As regards the non-binding recommendation, the European Commission considered two options, namely to restrict its scope to "significant, systemically important companies" or to opt for a broad scope covering "all financial institutions independent of their size". In the end, the European Commission opted for a broad scope for its recommendation, covering all financial institutions. However, according to the European Commission, *"for the sake of ensuring proportionality and in order to avoid unnecessary costs for the financial institutions of small size with a limited number of employees, Member States may take account of its size, scope of activities and complexity".*[18] Consequently, recital 11 of Commission Recommendation 2009/384/EC[19] sets out that the remuneration policy of a particular financial undertaking should also be *linked to the size of the financial undertaking concerned, as well as the nature and the complexity of its activities.*" Furthermore, it is set out in Section I para. 1.3 of Commission Recommendation 2009/384/EC that when taking measures to ensure that financial undertakings implement those principles, *Member States should take into account the nature, the size as well as the specific scope of activities of the financial undertakings concerned.*

In light of the above, the principle of proportionality, or the proportionate application of remuneration principles to financial institutions of a small size, works as a mechanism to counterbalance the application of remuneration principles on a broad basis, even though those principles were primarily developed to address significant, systemically important firms. This conclusion is of immediate interest also for the interpretation of the CRD IV and the EBA Guidelines since, pursuant to Art. 75 (2) sent. 2 CRD IV, the EBA's guidelines shall take into account the remuneration principles set out in Commission Recommendation 2009/384/EC.

c) Legislative process leading to CRD III

As regards the amendment of the Capital Requirements Directive, the European Commission applied the same considerations. Again, the European Commission considered the options of applying the remuneration principles to "all institutions irrespective of their size" ("policy option 4") or only to "systematically important undertakings" ("policy option 5"). While, according to the European Commission, option 5 underscored the fact that from the point of view of enhancing financial stability, risk-taking behavior of large firms is more pertinent, option 4 would be more effective with respect to contributing to objectives of protection of creditor interests and reducing pro-cyclicality of the financial system as it would reinforce risk management incentives for a broader scope of institutions. However, *"implications of*

[18] See European Commission, Commission Staff Working Document accompanying the Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and the Commission Recommendation on remuneration policies in the financial services sector, Impact Assessment, SEC(2009) 580, 30 April 2009, p. 45.

[19] Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial sector, OJ L 120 of 15 May 2009, p. 22.

option 4 for the compliance costs of small institutions would be mitigated by combining this option with option 2 that allows for a proportionate application of the relevant principles."[20] Policy option 2 foresaw that institutions should comply with the remuneration principles in a way that is appropriate to their size, internal organization and the nature and scope of their activities – in contrast to policy option 3 which required strict and uniform application of the remuneration principles.

In its proposal for the CRD III of 13 July 2009, the European Commission opted for policy options 2 and 4 and argued that the proposal "allows firms the flexibility to comply with the new obligation and high level principles in a way that is "*appropriate to their size and internal organization and the nature, scope and complexity of their activities. This approach is likely to minimize the up-front and on-going compliance costs for firms*" and was thus preferred over an alternative of requiring a strict and uniform compliance by all firms with the remuneration principles.[21]

During the subsequent legislative process, the CRD III remuneration principles underwent a fundamental change from high-level principles to much more detailed rules. This process was in line with the developments at international level, namely the supplementation of the high-level FSB Principles of 2 April 2009 with the more detailed FSB Standards of 25 September 2009. Against this background, it is evident that the question of proportionality gained even more importance in the course of the legislative process.

In its opinion of 12 November 2009, the European Central Bank (***ECB***) highlighted that "*when introducing international standards that primarily address significant financial institutions to Community law, which applies to all credit institutions (including small ones), the proportionality principle, as laid down in the Treaty, should be applied appropriately.*"[22]

The European Parliament equally addressed the principle of proportionality during the legislative process. In its resolution of 7 July 2010, the European Parliament welcomes the initiatives by the Commission and the FSB on remuneration policies but takes the view that "*the financial undertaking's size, and thus its activity's contribution to the systemic risk, should be taken proportionally into account when imposing additional regulation in matters*

[20] European Commission, Commission Staff Working Document, accompanying document to the Proposal for a Directive of the European Parliament and the Council amending Capital requirements Directive on trading book, securitization issues and remuneration policies, Impact Assessment, SEC(2009) 974 final, 13 July 2009, p. 34.

[21] European Commission, Proposal for a Directive of the European Parliament and the Council 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, COM(2009) 362 final, 13 July 2009, p. 5.

[22] European Central Bank, Opinion of 12 November 2009 on a proposal for a Directive of the European Parliament and the Council 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, OJ C 291 of 1 December 2009, p. 1, para. 5.

of remuneration policy and capital requirements on financial institutions."[23] Further, the European Parliament stressed that compensation systems should be proportionate to the size, internal organization and complexity of financial institutions.[24]

In line with these thoughts, the European Parliament proposed amendments to the European Commission's proposal for CRD III. In particular, a new recital 4a was proposed which set out that the principles on remuneration policy "should be applied consistently by Member States *in a manner and to the extent that is proportionate to the nature, scope, complexity and riskiness of the activities and the size and internal structure of the credit institution or investment firm concerned.*"[25] The justification given for this was that taking into account the constraints on small firms a proportionality test to the remuneration measures should apply. This should however be reviewed to ensure it does not lead to an unlevel playing field that could be exploited for the purpose of regulatory arbitrage.[26] Furthermore, the introductory part of Annex V, Section 11, point 22 of the Commission's CRD III proposal was amended so that credit institutions should not only comply with the remuneration principles in way but also "*to an extent*" that is appropriate to their size, internal organization and the nature, the scope and the complexity of their activities.[27] While it deemed necessary to establish strong minimum standards in order to avoid the risk of regulatory arbitrage,[28] the European Parliament's Committee on legal affairs proposed a new recital 5a which read as follows: "Payment of at least 40 % of the bonus should be deferred for an appropriate period. Payment of at least half of the deferred part of the bonus should be made in shares or share-linked instruments of the credit institution or investment firm, subject to the legal structure of the institution or firm concerned. In the case of non-listed credit institutions or investment firms, the payment should, where appropriate, be made in other non-cash instruments. *The principle of proportionality is of great importance in this context, since it may not always be appropriate to apply these requirements to small credit institutions and investment firms*".[29]

All the above mentioned proposed amendments are contained in the position of the European Parliament adopted at its first reading on 7 July 2010[30] and represent what was agreed during

[23] European Parliament, Resolution of 7 July 2010 on remuneration of directors of listed companies and remuneration policies in the financial services sector, OJ C 351 of 2 December 2011, 56, para. 1.

[24] Ibid., para. 11.

[25] European Parliament, Report on the proposal for a directive of the European Parliament and the Council 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, A7-0205/2010, 28 June 2010, p. 8

[26] Ibid., p. 9.

[27] Ibid., p. 49.

[28] Ibid., p. 80.

[29] Ibid., p. 106 et seq.

[30] See European Parliament, Position adopted at first reading on 7 July 2010 with a view to the adoption of Directive 2010/.../EU of the European Parliament and the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the

the trialogue negotiations between the European Parliament, the Council and the European Commission.[31] Accordingly, they are also included in the text of the CRD III that was finally adopted on 24 November 2010.

d) CRD III

Art. 22 (1) CRD III set out the general principle (now contained in Art. 74 (1) CRD IV) that every credit institution shall have robust governance arrangements, which include, *inter alia*, remuneration policies and practices that are consistent with and promote sound and effective risk management. In line with Art. 74 (2) CRD IV, pursuant to Art. 22 (2) CRD III, the arrangements, processes and mechanisms referred to in Art. 22 (1) CRD III shall be comprehensive *and proportionate to the nature, scale and complexity of the credit institution's activities*. Further, Annex V, Section 11, point 23 of the CRD III contained the remuneration principles applicable to so-called risk takers and set out in its introductory part that when establishing and applying the total remuneration policies, credit institutions shall comply with the remuneration principles in a way and *to the extent* that is appropriate to their size, internal organization and the nature, the scope and the complexity of their activities. This corresponds to Art. 92 (2) CRD IV and Art. 94 (1) CRD IV, respectively.

Comparable to recital 66 of CRD IV, recital 4 of CRD III set out that the principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities and, *in particular, that it may not be proportionate for investment firms referred to in Art. 20 (2) and (3) of Directive 2006/49/EC to comply with all the principles.* Furthermore, recital 9 of CRD III made reference to the specific requirements of deferring a substantial portion of the variable remuneration and of paying a substantial portion of the variable remuneration in instruments and highlighted that "*in that context, the principle of proportionality is of great importance since it may not always be appropriate to apply those requirements in the context of small credit institutions and investment firms.*"

In the light of this, and bearing in mind the legislative process leading to the CRD III, the relevant provisions in the CRD III allow, and even demand, the interpretation that not every remuneration requirement has to be mandatorily applied to all institutions. On the contrary, the wording of the introductory part of Annex V, Section 11, point 23 of the CRD III, namely that remuneration principles applicable to so-called risk takers shall be applied "*to the extent*" that is appropriate to the credit institution's size, internal organization and the nature, the scope and the complexity of its activities, purposefully leaves room for the interpretation that certain remuneration principles may not be applied at all, especially by

supervisory review of remuneration policies, EP-PE_TC1-COD(2009)0099. Recital 4 of the European parliament's positions is phrased differently and reads as follows: "*The principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities and, in particular, that it may not be proportionate for investment firms referred to in Art. 20 (2) and (3) of Directive 2006/49/EC to comply with all the principles.*"

[31] See Council of the European Union, Doc. 11749/10, 12 July 2010, p. 2.

small institutions. This interpretation is explicitly supported by recital 9 of the CRD III in respect of the deferral of variable remuneration and the payout in the form of instruments.

The CEBS' approach to proportionality corresponds to this interpretation. Pursuant to para. 19 of the CEBS Guidelines, the effect of the proportionality principle is that not all institutions have to give substance to the remuneration requirements in the same way *"and to the same extent"*. While the numerical minimum standards as regards the deferral of the variable remuneration and the payout in instruments are principally respected (see para. 19 of the CEBS Guidelines), the concept of 'neutralisation' as set out in para. 20 of the CEBS Guidelines enables small and non-complex institutions to put aside certain remuneration requirements, including those mentioned in recital 9 of the CRD III. Additionally, the concept of 'neutralisation' comprises remuneration requirements that are closely related, i.e. retention and ex-post risk adjustment. Bearing in mind that the remuneration requirements in the CRD III evolved from high-level principles to much more detailed rules during the legislative process (paralleling the development from the FSB Principles to FSB Standards), the non-application of certain requirements may indeed be regarded as the only effective means to take account of the principle of proportionality, since the detailed remuneration rules otherwise would leave little or no leeway for applying them in a way that is appropriate to the size, internal organization and the nature, the scope and the complexity of institutions' activities. The approach chosen by CEBS must therefore be considered as an appropriate application of the principle of proportionality, especially when considering that the concept of proportionality operates both ways: while some institutions will need to apply more sophisticated policies or practices in fulfilling the requirements, other institutions can meet the requirements of the CRD in a simpler or less burdensome way (see para. 19 of the CEBS Guidelines).

e) Legislative process leading to CRD IV

On 20 July 2011, the European Commission published its proposals for the so-called CRD IV package, comprising the CRD IV and the CRR. The Commission's CRD IV proposal contained new elements concerning provisions on sanctions, effective corporate governance and provisions preventing the overreliance on external credit ratings. The other elements of the CRD IV proposal, according to the European Commission, *"repeat existing legislation or are adaptions to the proposed CRR"*.[32] Therefore, while the European Commission in its CRD IV proposal rearranged the CRD III provisions on remuneration and divided them up into separate provisions of the CRD IV (Art. 73, 74 and Art. 88-91), the Commission did not introduce any substantive change of the provisions.[33] The only new remuneration-related

[32] See European Commission, Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2011) 453 final, 20 July 2011, p. 2.

[33] Consequently, the European Commission impact assessment merely refers to the CRD III, see European Commission, Commission Staff Working Paper, Impact Assessment, accompanying the Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions

features contained in the proposed CRD IV package include an additional disclosure requirement (see Art. 435 (1) (h) of the CRR proposal) and restrictions on distributions in connection with the new capital buffers (see Art. 131 of the CRD IV proposal).

The newly introduced disclosure requirement in relation to the number of staff receiving total remuneration of EUR 1 million or more goes back to requests *inter alia* made by the European Parliament in its resolution of 11 May 2011 on corporate governance in financial institutions.[34] In the same resolution the European Parliament acknowledges with regard to remuneration that *structural approaches differed among Member States*; in this respect the European Parliament encourages practices which strengthen corporate governance according to the legal form, size, nature, complexity and business model of the financial institution.[35]

In its survey on the implementation of the CEBS Guidelines of 12 April 2012,[36] also the EBA referred to divergences across jurisdictions in the extent to which the remuneration provisions can be neutralized and the ways in which that neutralization is achieved (making particular reference to three jurisdictions that operate tiered proportionality regimes, namely Germany, Italy and the UK). In this context the EBA elaborates that individual jurisdictions have taken the opportunity of "*the flexibility available to them through CRD III and the CEBS Guidelines*" to apply proportionality and the scope for neutralization in very different ways. According to the EBA, "*although all jurisdictions appear to be fully compliant with the legislations and guidelines*, the scope for flexibility of application has undoubtedly created outcomes whereby firms of comparable size could be treated differently for neutralization purposes depending on the jurisdiction within which they are based, including the need to meet less or more onerous requirements. There is thus scope for divergence related to the application of the proportionality principle. *Given the differences in the size and complexity of individual markets, a flexible approach to neutralization is desirable* although this should be balanced against the possible scope, albeit modest, for regulatory arbitrage."[37]

In the subsequent legislative process leading to CRD IV, although the topic of remuneration reappeared very prominently on the agenda (including the discussion about the introduction of a bonus cap), the principle of proportionality remained untouched. Even though different approaches in connection with the application of proportionality in the Member States were

and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, SEC(2011) 952 final, p. 93.

[34] European Parliament, Resolution of 11 May on corporate governance in financial institutions, OJ C 377 of 7 December 2012, para. 54.

[35] Ibid., para. 51.

[36] European Banking Authority, Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices, 12 April 2012.

[37] Ibid., p. 7 et seq.

publicly known, neither the European Parliament[38] nor the Council proposed any changes to the principle of proportionality. It appears that the topic was also not addressed during the trilogue negotiations in the beginning of 2013. Consequently, the CRD IV package that was finally adopted on 26 June 2013 does not contain any amendments in this respect.

f) CRD IV

Against this background, it must be concluded that the principle of proportionality contained in CRD IV fully corresponds to that contained in CRD III. The legislator consciously upheld the principle of proportionality and all related CRD provisions. In particular, Art. 92 (2) CRD IV in conjunction with Art. 94 (1) CRD IV (still) set out (as Annex V, Section 11, point 23 of the CRD III) that institutions shall comply with the remuneration principles in a manner "*and to the extent*" that is appropriate to their size, internal organization and the nature, scope and complexity of their activities. This addition, which was purposefully made during the legislative process leading to CRD III, allows for the non-application of certain remuneration requirements in accordance with the principle of proportionality. As set out above, this conclusion is explicitly supported by recital 9 of CRD III. The same must apply for CRD IV. The fact that recital 9 of CRD III is not contained in CRD IV does not allow any other conclusion, since it is common practice that not every recital of a Directive is also contained in the revised version of the Directive; rather the recitals of the revised Directive repeat the basic principles and address the points that were introduced in the course of the revision (as it is in the case of CRD IV). This, however, does not mean that the legislator's intention expressed in this recital is no longer valid. On the contrary, the legislator's intention expressed by recital 9 of CRD III was rather consciously upheld.

Therefore, the interpretation of the European Commission that "*the general principles as implicitly referred to in the introductory part of Article 92(2) CRD can in no way justify the non-application of one or the other rule contained in that provisions, or indeed in Article 94(1) CRD*"[39] is simply not correct. This interpretation ignores the interpretative leeway provided by these provisions as well as the legislator's intention expressed in recital 66 of CRD IV and recital 9 of CRD III. It is furthermore argued by the EBA that "*the requirements have, however, to be applied at least at the minimum thresholds set by the CRD IV*" and that "*the principle of proportionality cannot lead to the non-application of these rules*".[40] It is true that CRD IV sets out numerical minimum standards (as CRD III

[38] The European Parliament's report of 30 May 2012, which addresses the remuneration topic in many ways, does not make any reference to the principle of proportionality, see European Parliament, Report on the proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, A7-0170/2012, 30 May 2012.

[39] See European Commission, Response of EU COM re proportionality, "Interpretation of Article 92(2) of the Capital Requirements Directive – remuneration policies, JUST/A3/KKH/mg(2015)726410, 23 February 2015, p. 2; see also EBA Guidelines, p. 12.

[40] See EBA Guidelines, p. 6.

already did) and that these minimum standards have to be complied with. That means that there is "no partial proportionality" in the sense that an institution could, on the basis of proportionality, for instance defer only 30 % of the variable remuneration component instead of the minimum 40 % as set out in Art. 94 (1) (m) CRD IV. What is permissible, however, is to 'neutralize' or waive a specific remuneration requirement altogether. This possibility is explicitly foreseen in recital 9 of CRD III and was also acknowledged by CEBS: "*Where there are specific references to deferral levels or time horizons (the numerical criteria), proportionality cannot be applied between those levels and complete neutralization*".[41] Apparently, this was also the EBA's position until 2012 when the EBA held the view that all jurisdictions that e.g. operate tiered proportionality regimes "*appear to be fully compliant with the legislations and guidelines*" and take advantage of "*the flexibility available to them through CRD III and the CEBS Guidelines*" (see above). Bearing in mind that CRD IV did not introduce any changes as regards proportionality,[42] it is incomprehensible why Member States should be allowed to make use of the flexibility available to them under CRD III, but not under CRD IV.

Finally, the EBA's reference to the European Parliament's resolution of 3 July 2013 does not justify any other assessment. The European Parliament urged the Commission and the EBA "to ensure *full and comprehensive implementation* of the Capital Requirements legislative framework, with particular regard to the provisions on compensation and remuneration".[43] Even if this request for "full and comprehensive implementation" were understood as a statement relating to the application of the principle of proportionality, which is far from clear, it has to be reminded that CRD IV had already been adopted at this point in time. The position of the European Parliament, which, taken in isolation, has no binding effect, therefore neither has entered CRD IV nor can it be used for the CRD IV's interpretation. Any other understanding would ignore the position of the Council in its role as co-legislator.

Against this background, the EBA's primary aim, also as regards proportionality, appears to be the "*maximum possible harmonisation*".[44] Given the differences and the heterogeneity in the Member States' banking markets, such as in the very heterogeneous German banking market with many smaller institutions that have a conservative business model, especially with a focus on local retail and smaller to medium corporate clients, such maximum possible harmonisation is not required when measuring the costs and benefits involved against the legislative objectives and therefore affects the fundamental rights of small institutions.

[41] Committee of European Banking Supervisors, Feedback to the public consultation on CEBS's Guidelines on Remuneration Policies and Practices (CP42), 10 December 2010.

[42] This is implicitly acknowledged also by the EBA when enumerating the changes introduced by CRD IV and CRR and making no reference to the principle of proportionality, see EBA Guidelines, Section 6.1 (Draft Cost-Benefit Analysis / Impact Assessment), para. 5.

[43] See European Parliament, Resolution of 3 July 2013 on reforming the structure of the EU banking sector, (2013/2021(INI)), P7_TA(2013)0317, para. 20.

[44] EBA Guidelines, Section 6.1 (Draft Cost-Benefit Analysis / Impact Assessment), para. 12.

3. Legislative purpose and fundamental rights

As already set out above, the prudential regulation of remuneration practices goes back to the financial crisis that began in 2007 and principally aims at enhancing the stability of the financial system. From the perspective of financial stability, the risk-taking behavior of large, systemically important firms is of primary interest. Also the remuneration rules of the European Union are based on this assumption which is clearly expressed in recitals 1 and 4 of CRD III stating that "excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally" and that "excessive and imprudent risk-taking may undermine the financial soundness of credit institutions or investment firms and destabilize the banking system".

However, the European legislator, instead of focusing on the largest firms, opted for a broad scope of the remuneration requirements. In addition, the European legislator opted for a very strict implementation of the FSB Principles and Standards, implementing the FSB Standards "one-to-one" as minimum standards, and even going beyond that. Bearing in mind that the waiver of certain requirements, particularly the numerical minimum standards regarding the deferral and the payment in instruments, may indeed be regarded as the only effective means for applying proportionality, and taking into account that the contribution of small and non-complex institutions to systemic risk is low, it is justified, and in line with the legislative purpose, to allow those institutions to make use of such a waiver.

From an international perspective, the Basel Committee on Banking Supervision (***BCBS***) also highlights the importance of proportionality in the application of remuneration rules. According to the BCBS, proportionality is a key principle to consider for the implementation and supervision of the FSB Principle and Standards. A key rationale for proportionality is a proportionate relation between the benefit in terms of the regulatory objective to the costs caused coming with regulatory requirements and supervisory action. Therefore, to the extent that the implementation remains in line with the objectives and substance of the principles, the details can be adjusted.[45] In this context, the BCBS explicitly refers to proportionality between institutions, i.e. the different application of remuneration principles according to the size and complexity of institutions, their business models as well as their risk tolerance.[46]

When analyzing the relation between the benefit in terms of the regulatory objective to the costs caused by regulatory requirements and supervisory action, the application of all remuneration requirements, particularly the numerical minimum standards regarding the deferral and the payment in instruments, also to small and non-complex institutions is disproportionate. While applying these requirements effectively would lead to significant costs for small institutions where normally not very sophisticated remuneration and risk

[45] Basel Committee on Banking Supervision, Range of Methodologies for Risk and Performance Alignment of Remuneration, May 2011, para. 70.

[46] Ibid., para.75 et seqq.

management tools are used and the level of variable remuneration is low,[47] waiving these requirements would not endanger the achievement of the regulatory objective. Those small institutions still have to comply with the general requirement of having remuneration policies and practices in place that are consistent with and promote sound and effective risk management. Further, if variable remuneration is used only to a small extent, it is unlikely that this small amount of variable remuneration will create incentives for excessive risk-taking behavior. It is therefore not required from the perspective of prudent risk-taking to make this small amount of variable remuneration subject to the most burdensome requirements, especially when the requirements relating to deferral, payout in instruments and ex-post risk adjustment cannot be sensibly applied in an appropriate manner.[48] Moreover, there should be only limited scope for regulatory arbitrage, especially for small and non-complex institutions.

Finally, the approach of "maximum possible harmonisation" affects the fundamental rights of small and non-complex institutions, particularly the institutions' freedom to conduct their business and their right to property pursuant to Art. 16 and 17 of the Charter of Fundamental Rights of the European Union.[49] Subject to the principle of proportionality, limitations on the exercise of the rights and freedoms are only permissible if they are necessary and genuinely meet objectives of general interest. In the light of the foregoing, there is clear reason to doubt that a uniform application of all CRD IV remuneration requirements to all institutions, including small and non-complex ones, without any possibility to waive certain requirements, would meet this standard.

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[47] This is acknowledged also by the EBA, see EBA Guidelines, Section 6.1 (Draft Cost-Benefit Analysis / Impact Assessment), para. 46.

[48] See also EBA, Letter to EU COM on proportionality, "Interpretation of the proportionality principle as set out in Article 92(2) of the Capital Requirements Directive – Remuneration policies", 8 January 2015, p. 2: "*a waiver would appear justified for small and non-complex institutions, where only low amounts of variable remuneration are paid [...] Indeed, in these cases incentives to take excessive are practically non-existent; the level of risk which can be assumed by single risk takers is in most cases relatively low and cannot justify the application of ex-post risk adjustments to the variable remuneration, given the low absolute levels of bonuses.*"

[49] OJ C 83 of 30 March 2010, p. 389.