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High-level principles for Remuneration Policies

Introduction

1. The recent market turbulence has, amongst other things, highlighted the risks inherent in institutions having inadequate remuneration policies and structures. The absence of a coherent and adequate remuneration policy generates potential risks for a financial institution that need to be adequately analysed and contained. The following list of principles aims to address the most critical aspects to a well functioning remuneration policy, while recognising that the responsibility for the policy rests ultimately with the institution itself and, where applicable, the shareholders. The principles should be applied by all those institutions within the remit of CEBS and implemented before the end of Q3 2009. Institutions may allow for a transitional period following implementation, e.g. in order to take the necessary steps to renegotiate existing contracts.

Scope

2. In line with the CEBS's internal governance work, the guidelines are addressed both to regulators and regulated institutions. Within the institutions, the guidelines are intended to cover the entirety of the remuneration policy, including members of the management body, with special emphasis on senior employees and other risk-takers and risk-managers in the institution. The remuneration policy should include all levels of the organisation and all categories of employees.
3. The implementation of these guidelines and thus the exact form of an institution's remuneration policy should take account of its nature and scale and the complexity of its activities. The principles should be applied both at solo and group levels and be implemented in a proportionate way.
4. Further consideration will be given to how the supervisory review and evaluation process (SREP), which includes an assessment of all risks to an institution, can address those risks emanating from the remuneration policy. Within this process supervisors will consider the range of measures available under Pillar 2 to address and mitigate these risks.

5. The set of principles is as follows:

General

- i. The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should be adequately rewarded to attract skilled individuals.***

This principle is aimed at a key objective of an institution's remuneration policy: any policy should aim at aligning personal and company objectives with a view to the long-term. This must include the overall business strategy as well as other company values such as compliance culture, ethics, behaviour towards customers, measures to mitigate conflicts of interest, etc.. This also implies that remuneration policies should not encourage excessive risk taking. An institution should not reward individuals for taking risks in excess of the institution's risk tolerance and at all times give due consideration to the longer term.

Control functions (such as Risk Control, Compliance and Internal Audit) should be adequately compensated in accordance with their own objectives and not in relation to the performance of the business units they control.

Severance pay or pay related to other scenarios such as mergers and acquisitions should be related to performance achieved over time and be designed in such a way as not to reward failure.

- ii. The remuneration policy should be transparent internally and adequately disclosed externally.***

The remuneration policy should be accessible to all employees. The employees should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and transparent to the employee concerned.

Whilst respecting confidentiality, relevant information on the remuneration policy should be disclosed in a clear and easily understandable way to external stakeholders.¹

An institution should be able to clearly articulate its remuneration policy to its supervisory authority upon request. This could, for example, take the form of a remuneration policy statement which is subject to regular review.

¹ In particular, listed companies should apply the European Commission's Recommendation on 'fostering an appropriate regime for the remuneration of directors of listed companies' - <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0055:0059:EN:PDF>

GOVERNANCE

iii. The management body, in its supervisory function, should determine the remuneration of the management body in its management function². In addition the management body, in its supervisory function, should approve the principles of the overall remuneration policy of the institution and maintain oversight of their application. The implementation of the remuneration policy should be subject to central and independent review.

This principle addresses an institution's oversight and decision-making regarding pay and bonuses.

Ultimate oversight of the remuneration policy should rest with the institution's management body (supervisory function). One way of achieving this could be by setting up an independent Remuneration Committee or other relevant committees which report to the management body (supervisory function).

Centralised decision-making bodies will be better able to align individual remuneration packages with the company's overall performance.

Any policy should be subject to regular (at least annual) and independent internal review, with specific attention to preventing incentives for excessive risk taking and other adverse behaviours.

In addition to the management body's general responsibility for overall remuneration and its review, adequate involvement of the following is required:

- Control functions (such as Risk Control, Compliance and Internal Audit);
- Human Resources; and
- the shareholders, where applicable.

A commercial business unit should not be able to determine the remuneration of its control functions as this would create a potential conflict of interest.

MEASUREMENT OF PERFORMANCE AS A BASIS FOR REMUNERATION

iv. Where the pay award is performance related, remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors apart from financial performance should be considered. The

² For a definition of the management board in either its supervisory or management capacity, please refer to the definition provided on page 6 of GL03. The definition is designed to address both single and dual tier structures within the EU.

measurement of performance, as a basis for bonus awards, should include adjustments for risks and the cost of capital.

This principle targets the measurement of performance as the basis for the awarding of pay and bonuses. This may not be applicable to all categories of employees. The measurement of employees' performances is central to a good remuneration policy. Defining the pay award should not be a purely mechanical process based on measurable performance criteria, but should include the ability to exercise judgement.

Any performance measure should include variables relating to individual as well as collective performance (for example business unit, company and group performance). While the overall company and/or group performance is important, this does not mean that remuneration policies cannot vary in nature depending on the business unit to reflect the objectives of the specific area.

For individual performance measurement, while financial criteria may be one dimension in determining performance, other non-financial factors should also be considered such as skills acquired, personal development, compliance with the institution's systems and controls, commitment to the business strategies and its major policies and contribution to the performance of the team. Where it is appropriate, poor performance in the non-financial variables should override good performance in terms of profit generation, i.e. unethical or non-compliant behaviour cannot be compensated for by good financial performance.

Bonuses or bonus pools should be calculated using a measure of performance which is adjusted for risks (including liquidity risk) and the cost of capital. Where possible, this should be based on an institution's economic capital model. The aim of such an adjustment is to ensure that the longer term interests of the institution or group are fully taken into account, such as the sustainable growth and profitability prospects of the institution.

The remuneration of non-executive directors should not be linked to the financial institution's short term results, but take into account other factors, such as the time invested and their respective responsibilities.

FORM OF REMUNERATION

- v. There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure up-front cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.***

The relation between base pay and bonus should be of reasonable proportion. Employees should not have to rely on bonuses.

This principle addresses the form of the pay-out. Whilst cash pay awards may be appropriate for base pay, when bonus payments are of significant size the award should at least include a deferred component (for example company shares, options or other funds held in a trust or similar account) to take into consideration the risk horizon of the underlying performance. The deferred payment should therefore be linked to measures of future performance within a reasonable time horizon. In such a situation, it is desirable that these measures are risk adjusted as set out in principle (iv).

Big bonuses should not be awarded purely in up-front cash.

Whilst taking into account all legal and fiscal constraints, any up-front bonus payment should be subject to claw back if it is later established that it resulted from fraudulent activities.