



**Report on national implementation of
CEBS High-level principles for Remuneration Policies
June 2010**

TABLE OF CONTENTS

Executive summary	3
Background	3
Main findings of the implementation study	4
Proposed next steps	6
Structure of the report	7
1. National regulatory and supervisory actions in general ..	7
1.1 Implementation of the CEBS Rem. HLP	7
1.2. Scope and proportionality	8
1.3 Possible supervisory measures and sanctions	9
1.4 Home/host dimension	9
2. Assessment of the substance of the Rem. HLP	10
2.1 Governance	10
2.1.1 The role of the management body in the institution	10
2.1.2 Central and independent review of the institution's remuneration policy.....	11
2.1.3 Practices regarding the setting up Remuneration Committees ...	11
2.1.4 Role of control functions	12
2.1.5 Remuneration of control functions.....	13
2.1.6 Supervisory review of governance arrangements	13
2.2 Transparency	14
2.2.1 Internal Transparency	14
2.2.2 External Transparency.....	14
2.3 Performance measurement	15
2.3.1 Criteria to determine individual compensation.....	15
2.3.2 Determination of bonus pools	16
2.3.3 Adjustments for risks	16
2.3.4 Remuneration of non-executive directors	17
2.4 Structure of remuneration	17
2.4.1 Proportion between fixed pay and variable pay	17
2.4.2 Review of the remuneration structure.....	18
2.4.3 Deferral of bonuses	18
2.4.4 Risk adjustment for future performance.....	20

Executive summary

Background

1. On 20 April 2009, CEBS published a set of High-level Principles for Remuneration Policies (hereafter: Rem. HLP). In drafting the Rem. HLP, CEBS cooperated closely with other bodies working on remuneration, in particular, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and Committee of European Securities Regulators (CESR). Financial institutions were expected to apply and implement the Rem. HLP by the end of Q3, 2009. However, jurisdictions were able to allow institutions a transitional period following implementation, e.g. in order to take the necessary steps to renegotiate existing contracts.

2. In its work program of 2010, CEBS envisaged several steps for the follow-up work on the Rem. HLP. As a first step, CEBS undertook an extensive implementation study regarding the national implementation of the Rem. HLP by supervisors on the one hand and institutions on the other. The implementation study was organised using questionnaires distributed among the CEBS members. The content of the questionnaires was aligned with the approach followed by BCBS. The first questionnaire (Q4, 2009) focused on the national regulatory and supervisory actions in the field of remuneration in the financial sector and on understanding key challenges regarding the implementation of the Rem. HLP. The second questionnaire (Q1 2010) focused on the implementation by the industry and on national supervisory actions and practices regarding the assessment of remuneration policies and practices in the institutions. For both questionnaires, almost all CEBS members provided answers.

3. The purpose of this report is to present the main findings of the implementation study that will be used as input for CEBS' further follow-up work on the Rem. HLP. As a second step, during the rest of 2010, CEBS will work on producing broader guidelines on remuneration policy and practices as required by CRD 3¹. These guidelines will allow institutions and supervisors to assess developments in remuneration policies and practices over time.

4. The conclusions in this report are based on the observations of supervisors about the current state of play. It is, however, proper to put in a caveat. The more detailed information and examples collected through the questionnaires were mostly about large, cross-border credit institutions and less about investment firms. Furthermore, information provided was often dependant on progress to be made by national supervisors with regard to the practical assessment of the institutions' remuneration policies and practices. Where practices of institutions are described, especially in areas that are still under regulatory or supervisory

¹ Directive of the European Parliament and of 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

development, this report does not seek to provide any judgment on their prudential suitability.

Main findings of the implementation study

5. Since the start of the financial crisis in 2007-2008, considerable progress has been made in the field of remuneration by both supervisors and institutions. Their efforts for change are continuous and genuine. Most countries have adopted a regulatory approach for remuneration, supported by supervisory guidance. The most concrete changes in institutions have occurred with the governance mechanisms that must support the remuneration policies and practices. Deferral schemes for variable remuneration are also becoming more frequent.

6. Several supervisors have not observed major problems to date with the way that small or local institutions have implemented remuneration policies in line with business and risk strategies. Several other supervisors considered that the implementation was less satisfactory, taking into account that the institutions were still in the process of adjusting compensation systems for all material risks. Discrepancies may still be observed between requirements set by supervisors to support adoption of the Rem. HLP and remuneration policies and practices that can be observed within institutions under supervision. When most pronounced, this discrepancy is caused either by underdeveloped practices in new fields such as risk-adjusted performance measurement, or by remaining uncertainty regarding dimensions such as scope, proportionality and home/host relationships and what implications these can have on the practices of institutions. There may also be a lack of convergence between national adoptions by supervisors. Ultimately, a greater degree of convergence is envisaged once the CRD 3 is in place followed by the CEBS guidelines.

7. The following paragraphs provide some additional detail in respect of the areas mentioned above.

8. **Scope** The scope of the Rem. HLP within the financial sector (i.e. credit institutions and investment firms) does not give rise to interpretation problems as such, although, the question of proportionality appear frequently here (see next paragraph). The scope of the Rem. HLP, within a given institution, raises more interpretation problems, especially as to how remuneration of certain categories of staff (senior management, risk takers and control functions) should be subject to specific measures. For future work, fine-tuning on the concept of "categories of staff whose professional activities have a material impact on the risk profile of the institution" (CRD 3) would be useful.

9. **Proportionality of supervisory practices** As to how to take size and complexity of the institutions into account, several supervisors indicated that proportionality was included in supervisory assessment methodologies for both on-site and off-site examinations and

in the SRP² methodology, and that this would be applied for remuneration risk. Focus, frequency and channelling of supervisory resources to remuneration risk would be based on the outcome of the national risk assessment systems. Even so, many national supervisors highlighted it as challenging with regard to how to answer proportionality claims from institutions in practice as well as how to obtain consistent treatment among institutions.

10. Governance Institutions have made considerable progress on the governance structures that must support remuneration policies and practices. The role of the management body in its supervisory function for remuneration purposes has often been expanded. Remuneration committees are now widespread in larger institutions and while not enough interaction is seen between the management body and the internal control functions, there are signs that this is improving. An independent review of remuneration policies is usually carried out. However, it is too early for a clear assessment of such reviews by supervisors.

11. Risk-adjusted performance measurement Qualitative, risk sensitive criteria have been taken on board in the remuneration scorecards at institutions. Bonus pools are usually determined at the level of the financial undertaking and/or the business lines, most frequently in a “top-down” approach. They are mostly determined by quantitative criteria such as return on equity, the net operating income for the institution or the economic profit. Some countries indicated that institutions have started to take into account *ex ante* risks when measuring the performances, e.g. on the basis of measures derived from expected losses, delinquency ratios/non-performing loans or risk-weighted assets. However, techniques are still premature, certainly for difficult to measure risks such as that of liquidity. When adjustments do occur, they tend to concentrate on credit and market risk. At the same time, some countries have indicated that they have seen no, only a few, or unsatisfactory attempts to adjust performance measurement for risks. Explicit mechanisms such as malus or clawback (*ex post* risk adjustment) have not yet been observed.

12. Remuneration structures Although some countries have detailed (numerical) policies regarding the proportion between fixed vs. variable pay, most countries follow, in one way or another, the open criterion, specified by the Rem. HLP, of a proportionate ratio between fixed pay and bonuses. In these cases, practices within institutions regarding this proportion are typically not formalized in detail or add little to the above-mentioned open criterion. Where proportions are stipulated, the proportion mainly differs depending on seniority and the type of business line, and relative limits are more common than absolute limits. As for the proportion of remuneration that must be deferred, the time horizon of deferral and the form of the deferred part, risk-sensitive practices are clearly emerging, but vary significantly among institutions.

² Supervisory review process according to Pillar II in the CRD

Still, deferral structures are becoming more frequent and deferral periods are becoming longer.

13. **Transparency** Internal transparency of remuneration policies towards employees does not seem to be problematic in institutions and accordingly is not the number one priority for supervisors. The present report does not contain a detailed assessment of external transparency because the questionnaires were closed off before remuneration information in the annual reports for 2009 could be examined³

14. **Home/host dimension** Supervisors all agree that remuneration issues should be part of the agenda of college work, but they may need further practical guidance for this kind of supervisory convergence. Furthermore, it would be useful to clarify how remuneration requirements for a given institution may be influenced by the fact that it is part of a group (either as parent or subsidiary).

Proposed next steps

15. The goal of the CEBS guidelines on remuneration policies and practices as required by the CRD 3 is to overcome the remaining discrepancy between the remuneration requirements set by supervisors and the remuneration policies and practices observed in institutions and to remedy the lack of convergence amongst supervisors.

16. For more technical areas such as performance measurement, risk adjustment and structures for remuneration packages (deferral, payment in equity-linked instruments, the proportion of fixed vs. variable pay), further cooperation and information sharing with FSB and BCBS will be sought in order to draw up a coherent set of guidelines, fully aligned with international standards. Dimensions such as scope, home/host relationships and proportionality are considered to be more EU specific and will be worked on by CEBS in close cooperation with CESR.

17. European supervisory authorities are to assess the compliance with remuneration principles as part of the broader assessment of the risk profile of an institution in the context of the supervisory review process of the Basel II capital framework, as implemented in the CRD. Therefore, in addition to the separate dimensions mentioned above, this SRP will deserve detailed attention in the envisaged CEBS guidelines on remuneration.

18. The time frame for the next steps is uncertain because of pending trilogue negotiations between the European Commission (EC), the European Council and the European Parliament for CRD 3. Once this amending directive has been approved, the CEBS guidelines on remuneration will be launched for consultation, so that the final guidelines can be published ahead of the scheduled implementation of CRD 3.

³ The CEBS report on Transparency assessment 2009 Annual Reports however provides a number of observations on remuneration related disclosures in banks 2009 annual reports. This paper will be published end of June 2010.

Structure of the report

19. Chapter 1 of this report gives a general overview of national regulatory actions and supervisory practices for remuneration, including aspects such as scope, proportionality and home/host relationships. This section also focuses on measures and sanctions and on practical constraints for supervisors with regard to reviewing remuneration policies and practices of institutions.

20. Chapter 2 deals in greater detail with the substance of the Rem. HLP. The first two subchapters deal with the governance in relation to remuneration policies and practices, and internal and external disclosure. The two other subchapters are concerned with risk alignment aspects of remuneration policies and practices: risk alignment incentives in performance measurement and risk alignment incentives in the structure of remuneration packages.

1. National regulatory and supervisory actions in general

1.1 Implementation of the CEBS Rem. HLP

21. Most CEBS members have adopted a regulatory approach to implementation of the Rem. HLP, with laws, regulations or recommendations that have come into force during 2009 or at the beginning of 2010. In a few countries, the regulatory framework for remuneration is still under consultation and will be implemented as soon as possible. In some cases, the CEBS Rem. HLP have only been incorporated through the national supervisory assessment methods for examinations. In those cases, the Rem. HLP serve as best practice guidelines for the institutions. Preparations for the implementation of the new CRD 3 are clearly ongoing in many countries, with a view to more detailed rules on remuneration policies and practices in line with the FSB principles and implementation standards. In a few countries, the banking industry has adopted codes of conduct related to remuneration policies.

22. In most countries, remuneration requirements fully cover the Rem. HLP. In some areas, requirements can be more prescriptive and detailed than the Rem. HLP, and several countries have included both the recommendations from the EC and the FSB Principles and Standards. Other areas further developed at the national level include: rules for transparency and disclosure of remuneration policies, more detailed governance requirements, as well as more specific requirements for measurement of performance and forms of remuneration. Chapter 2 will provide more detailed information about these respective topics.

23. Countries range from those that have just started supervision of remuneration policies and practices to those with a more developed form of supervision of these policies and practices. Whatever the level of supervision, it is clear that both institutions and supervisors are undergoing a learning process. Therefore, many countries (and their

supervisors) worked or are working in different phases, to gain more experience and to intensify their remuneration supervision gradually. 2010 seems to be a crucial year for setting up fully-fledged supervisory methodologies. Practical challenges that supervisors face when assessing institutions' remuneration policies and practices often boil down to:

- navigating through different rules and guidelines from FSB, BCBS, the EC, CEBS or other international bodies, and the corporate governance codes dealing with remuneration;
- safeguarding a level playing field between national financial markets;
- securing a consistent treatment among different institutions;
- allocating supervisory resources as efficiently as possible.

1.2. Scope and proportionality

24. In more than half of the countries, requirements on remuneration policies and practices apply to all financial institutions. "All financial institutions" is defined somewhat differently amongst supervisors, where it most commonly refers to credit institutions, investment firms, fund management companies and pension funds. Some countries also include insurance companies in the scope of their regulatory actions.

25. The majority of the countries have remuneration requirements that apply to all employees in these institutions⁴. In a few countries, the requirements apply only to senior executives, pending new requirements covering all employees that have a material impact on the risk profile of the institution, with reference to the CRD 3. The scope of the Rem. HLP, within a given institution, often gives rise to discussions between supervisors and institutions, especially as to how the remuneration of certain categories of staff within the whole organization (senior management, risk takers and control functions) should be subject to specific measures. In the remuneration policies of institutions, the delineation of these categories, in terms of their size and their relationship with the factual organisation of the institutions, is not always reflected clearly or in detail.

26. In almost all countries, the proportionality principle is deemed relevant for remuneration purposes. Drivers of proportionality are size, complexity of business model, ownership structure, listing on a regulated market, membership of a banking group, level of trading/investment activities (size of limits), level of capitalisation (risk-bearing capacity) and quality of risk management systems. Proportionality can be expressed explicitly, as part of laws, regulations or recommendations to implement the Rem. HLP, or can be more implicitly part of general supervisory assessment methodologies for both on-site and off-site examinations or SRP methodologies that are also applied to remuneration (risks).

⁴ This means all employees as a principle, with some aspects of the requirements focusing specifically on certain categories of staff.

27. Elaboration of the proportionality principle has not been commonly observed in EU countries. One example of the implementation of the proportionality principle that has been observed is a system of self-assessments in which institutions have to determine, based on certain criteria provided by the supervisor, whether "special" remuneration rules are applicable to them, or whether it is sufficient to comply with the "general" remuneration rules. Another observed proportionality method, still under discussion in some countries, is based on certain numerical thresholds (for variable remuneration or total remuneration) set by the supervisors to determine whether the more specific rules will be applied to certain categories of staff. As a final example, some supervisors define internally more detailed areas where proportionality can be applied, such as the presence/role of a remuneration committee, the presence/role of CFO and CRO, transparency and disclosure, methods of risk adjustment, the amount and period of deferral, the use of equity-linked instruments and the ratio between fixed and variable compensation.

28. A distinction can be found between proportionality within the financial sector (different kinds of institutions) and proportionality within a given firm (different categories of staff), but this is not a general observation. Some supervisors deem the latter form of proportionality redundant with the delineation of the different categories of staff for which specific measures must be worked out. Other supervisors believe this form of proportionality can still have added value compared to a correct delineation, especially when staff members are included, that only collectively, as part of a large group, are seen as risk-takers. In that case, it is deemed impracticable to apply all remuneration rules to such a large group.

1.3 Possible supervisory measures and sanctions

29. In line with the Rem. HLP, in most countries, both qualitative and quantitative measures are applicable. Qualitative measures refer to remedial measures aimed at improving remuneration policy and practices; quantitative measures refer to Pillar II capital add-on. Qualitative measures generally have priority over the more severe quantitative measures. Real life examples of quantitative sanctions have not yet been observed. Many countries point to the wide range of prudential measures that their supervisors can generally impose for breaches of prudential regulation (e.g. fines), but, at the same time, the need for proportionality in measures and sanctions was highlighted.

1.4 Home/host dimension

30. Generally, larger cross-border institutions operate with a firm wide remuneration policy, albeit with some adjustment, for example for local prudential regulations or fiscal and employment laws in the country where the subsidiary operates. Differences between parent company policies and solo unit policies can, however, be observed if the subsidiary is operating a different business model from that of the parent, for example, investment banking carried out in the subsidiary whilst the parent has a main strategic focus on retail banking.

31. From a supervisory perspective, it has been pointed out that all institutions within a consolidated group should be covered. Top down influence from the parent undertaking or holding company is accepted, but financial subsidiaries have local responsibilities in the field of remuneration.

32. In the majority of the countries, remuneration policies and practices have not yet been a topic of discussion in supervisory colleges for large cross border banks. Supervisors see colleges as a useful instrument for discussing remuneration policies and practices in larger cross border institutions and for achieving alignment in supervisory requirement and assessment practices. It was suggested that CEBS should design a framework for this discussion and recommend timelines.

33. Suggested topics for discussion in the colleges were:

- differences in regulation and how these can be resolved (not only remuneration issues in a strict sense, but also, for example, tax influence on remuneration);
- assessment of the influence by the parent / the responsibility of the local management;
- the interaction between a Group Remuneration Committee (hereafter: Rem. Co.) and a local Rem. Co.;
- remuneration systems of senior staff that are involved at both parent and subsidiary levels;
- exchange of supervisory practices.

2. Assessment of the substance of the Rem. HLP

2.1 Governance

2.1.1 The role of the management body in the institution

34. Some positive recent developments in market practices have been observed in terms of the reduction of CEO's powers over remuneration policies in favour of a more extensive role played by the management body in its supervisory function. However, other market practices include:

- too little involvement of the management body in its supervisory function in setting the overall remuneration policy and in the oversight of its implementation;
- inadequate information provided from the Rem. Co. to the management body about its decision-making process on the remuneration policy of the institution;
- little or no involvement of the management body (in its supervisory function) in the definition of the senior management compensation and more delegation to the business units.

35. Differences among countries exist, partly reflecting the different national legal traditions in company laws and corporate governance rules (e.g. board models). The majority of supervisors finds that – in line with the CEBS Rem. HLP – the compensation of the management body (in its management function) and the overall remuneration policy are approved by the management body (in its supervisory function).

36. In some countries, the shareholders' meeting plays a more pervasive role and is entrusted with specific tasks, such as the approval of the overall remuneration policy and/or the determination of the compensation of the management body.

2.1.2 Central and independent review of the institution's remuneration policy

37. Practices with regard to compensation show that a central and independent review is usually carried out, even though it may be part of a more general review of the overall activities of the institution. Differences emerge regarding the bodies/functions in charge of the review; it may be conducted by the Rem. Co/management body or the control functions (commonly, the internal audit in carrying out its ordinary control duties, sometimes jointly with other internal functions). Market practices also highlight that where external consultants intervene, it mostly occurs in large banks.

38. Supervisors still need more detailed information about in which ways such reviews are actually performed by financial institutions; having found that, in many cases, the involvement of the CRO/CFO in such reviews is not sufficiently developed.

2.1.3 Practices regarding the setting up Remuneration Committees

39. Setting up a Rem. Co. is a common practice especially among listed institutions (in accordance with corporate governance codes) and larger institutions (due to national provisions for the financial sector). The Rem. Co. is mainly composed of non-executive and/or independent members.

40. Market practices reveal some important differences among countries. This can be attributed to diverging corporate board models and company laws across Europe. From this perspective:

- in some countries the Rem. Co. is a component of the management body in its management function, rather than of the management body in its supervisory function;
- the Rem. Co. may include representatives of the risk management function, HR or other internal departments, but also executive managers (e.g. the CEO);
- the Rem. Co. is generally entrusted with one or more of the following tasks: a) proposal and advisory duties to the body responsible for the approval of the remuneration policy; b) assessment of the

compensation policies' consistency with the institution's situation and risk profile; c) oversight of the overall remuneration policy; d) carrying out of the annual review on compensation. In some cases, the Rem. Co. is also entrusted with the formal or de facto approval of the remuneration policy of the institution.

Further progress is still needed to ensure that the Rem. Co. always plays an active role in the design of the compensation policies and is not limited to providing an opinion, or being informed only ex-post.

41. Increasingly the Rem. Co. tends to work in close connection with other relevant functions of the institution such as the internal control, risk management, HR and other board committees, providing inputs and playing mostly an advisory role in the design of the remuneration policy of the institution. However, internal reporting lines in the institutions seem still to be incomplete. Where evidence is available, the Rem. Co. reports mainly to the management body in its supervisory function or, in some specific cases, to the shareholders' meeting. This topic deserves more attention by both institutions and supervisors in order to enhance the internal transparency and efficiency of the decision-making process and information flows.

2.1.4 Role of control functions

42. In some countries, supervisors expect that control units (e.g. risk control or compliance functions) should be represented in the Rem. Co. or advise the committee when designing the remuneration policy. For other supervisors, the control functions' engagement can be limited to consulting upon and controlling the remuneration policies already drafted or implemented. In general, control functions should at least be engaged in monitoring and evaluating on an annual basis the adequacy and effectiveness of the internal control system, including the remuneration policy of the institution.

43. So far, supervisors do not have much concrete information on how the control functions are involved in the development and review of remuneration policies and practices.

44. Still, it can be observed that, in some larger institutions, control functions give advice or provide input to the Rem. Co. or to other bodies responsible for remuneration policies. Some authorities have observed that internal audit has a central role in monitoring and evaluating the implementation of the remuneration policy and the observance of its rules. However, for many institutions these are new governance arrangements and more work will have to be done to further clarify and enhance the control functions' role in this process. Advising on the size of the bonus pool, as well as on performance criteria are possible areas of further involvement. Internal audit and compliance might be consulted when remuneration policies are developed.

2.1.5 Remuneration of control functions

45. Most countries have adopted the CEBS Rem. HLP which states that: "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."

46. In order to ensure the independence of internal control functions, it was recommended that the remuneration of persons responsible for these functions and other staff involved should be linked to specific objectives for these units. However, some supervisors allow the practice whereby remuneration is related to the performance of the institution as a whole, as a control function can barely influence those aggregated results.

47. In the majority of institutions, conflicts of interest are avoided because compensation for control functions is based on specific objectives achieved, independent of the profit level of the business unit they control. Some supervisors have observed institutions' transitional measure of minimising the percentage of remuneration that depends on the units they control.

48. The remuneration of control functions is mostly paid in the form of fixed compensation. Some policies observed within institutions targeted pay levels for control functions that are similar to comparable functions in other industries.

2.1.6 Supervisory review of governance arrangements

49. So far, the majority of supervisors have not used specific oversight methods and tools, beyond those currently used for carrying out the supervisory activity of the financial institution as a whole. Some countries declared that they have not yet developed a specific methodology, nor performed any evaluation, because, for example, the regulation is yet to come into force; the supervisory authority is currently reviewing its risk assessment system, or it is too early to provide further information. This topic will be included in the next ICAAP⁵/SRP cycle.

50. In general, the majority of supervisors' oversight activity primarily deals with:

- the review of the ways the management body, the Rem. Co. and other internal control functions actually perform their tasks and duties (through reports, minutes and so on);
- bilateral dialogues/interviews with institutions' responsible personnel;
- reviews of external audit reports.

⁵ The institution's internal capital adequacy assessment process according to Pillar II in the CRD.

2.2 Transparency

2.2.1 Internal Transparency

51. As far as can presently be observed, internal transparency regarding remuneration policies does not seem to be a problematic issue. Depending on its nature, information is provided either to all employees (e.g. common rules), or only accessible to relevant categories of staff (e.g. a specific department or business line). In general, there is no internal transparency with regard to specific remuneration of individual employees.

52. Institutions use different ways to communicate remuneration policies to their employees, such as internal information systems or internal instructions/rules. In general, the use of a specific instrument is up to the institutions and not country specific.

2.2.2 External Transparency

53. In most countries, institutions are expected to include information about their remuneration systems in their annual reports. In some countries, there are specific requirements for disclosure of information depending on the nature of the company (e.g. special requirements for listed companies).

54. Most supervisors had no representative observations as to whether remuneration policies and practices are disclosed externally in an adequate way at the time of the questionnaires. From the small number of cases observed, supervisors' assessments range from satisfactory to less than satisfactory. This difference may result from different supervisory requirements: the more specific supervisory requirements become, the more challenging it is for institutions to adequately follow them⁶.

55. With regard to the content of public disclosure on institutions' remuneration systems, a few countries have only general requirements in place, while a majority have set more detailed requirements by now. Detailed regulations typically include qualitative information with regard to the design of the remuneration systems and their governance as well as quantitative information regarding the remuneration paid to employees and management. Some of these provisions draw on the FSB principles/upcoming requirements on disclosure of CRD 3. Additionally, several countries have specific requirements in place for transparency for the remuneration of the management body. In some instances, the latter is only the case for listed companies. Furthermore, in some countries disclosure requirements include provisions beyond the (proposed) European requirements, such as information on remuneration levels broken down into bands or on individual remuneration packages.

⁶ The CEBS report on Transparency assessment 2009 Annual Reports however provides a number of observations on remuneration related disclosures in banks 2009 annual reports. This paper will be published end of June 2010.

56. With regard to transparency towards supervisors, most supervisors do not require any specific supervisory reporting in this respect at all. Information is expected to be given on supervisors' request only, for example, at regular meetings with institutions' representatives or when conducting an inspection of a bank's remuneration system as part of the SRP. A specific remuneration statement is only asked for by a few supervisors.

2.3 Performance measurement

2.3.1 Criteria to determine individual compensation

57. Individual variable compensation awards are usually determined on the basis of both quantitative and qualitative criteria, either voluntarily or due to supervisory requirements. In some cases, supervisors observe that the weight of the quantitative criteria prevails over that of the qualitative indicators.

58. In some countries, in order to determine individual compensation, institutions often use a performance scorecard approach which includes a series of quantitative and qualitative indicators that can be weighted in advance. These can include criteria such as financial results, "soft skills" (leadership qualities, cooperation efforts, personal development), market indicators (e.g. market conditions, performance of the business line as compared to competitors), risk indicators (complexity of activities, contribution to the risk and permanent control set up, compliance with rules and procedures), etc.

59. With regard to the measurement of financial performance, in most countries, institutions set predefined targets either at an individual or (more often) at the level of the division or the institution. The quantitative indicators most commonly referred to are market share, market conditions, return on equity (ROE), earnings per share (EPS), gross operating income, cost income ratio, risk-adjusted return on capital (RAROC), non-performing loans and core Tier 1 ratio (sometimes broken down to business units levels).

60. The observed qualitative criteria range from customer satisfaction, compliance with core standards, cooperation skills, quality of the management and relationship with counterparts including internal control functions, compliance with limits, performance regularity and successful development of strategic initiatives. Furthermore, in a majority of countries, qualitative criteria include, or are required to include (according to supervisory requirements), elements relating to the compliance with the institutions' rules and requirements and/or contribution to effective risk management. In this respect, a couple of countries required that poor performance in non-financial metrics such as poor risk management or other behaviours contrary to the firm values should override metrics of financial performance.

2.3.2 Determination of bonus pools

61. According to approximately half of the countries, bonus pools are usually determined at the level of the institution and/or its business lines, most frequently in a “top-down” approach, which means that the pool is determined at the highest level (consolidated parent company level) and then allocated to business lines, units, departments, etc. Some countries indicate that bonus pools can also be the result of a combination of a “top-down” and “bottom-up” approach, or result from a “bottom-up” approach. In such cases, benchmark studies are often conducted to determine function and level specific bands of fixed and variable remuneration for the employees. The bonus is then split into an individual/business unit performance and at an institution/group performance pool level.

62. Bonus pools are mostly determined by quantitative criteria, though judgemental factors can come on top of these. The quantitative criteria are related to the achievement of targets on key performance indicators of the institution. Several countries specify that these pool determinations are adjusted to risks before they are used in the remuneration process. Supervisors observed that only a few institutions calculate and risk-adjust their bonus pool much below the divisional level.

2.3.3 Adjustments for risks

63. In several countries, institutions have started to take into account the costs of risks when measuring the performances, e.g. on the basis of criteria derived from expected losses, delinquency ratios/non-performing loans, or risk-weighted assets. However, the quality of the adjustments has not been extensively assessed by supervisors yet.

64. At the same time, there are supervisors signalling that they have seen only a few attempts or indeed, none at all, to adjust performance measurement for risks. The attempts are often unsatisfactory, reflecting the fact that techniques are still premature. An adjustment for liquidity risk seems to be even less common due to, for example, difficulties in identifying specific indicators for liquidity risk.

65. Where observed, techniques to adjust profits and capital for risks include those based upon a calculation of economic profit or economic capital as well as, for example, the following indicators: return on capital required (ROC); risk-adjusted return on capital (RAROC); net operating profit (NOP)/risk weighted assets (RWA) vs. peers; satisfaction of client needs and expectations (KNIX and other ratios). Some institutions have started to develop projections for capital needs and techniques for calculating expected credit loss with a view to long term risk adjustments. Projections of compensation and cost income ratios have also been considered.

66. Overall, there is still considerable room for improvement in the area of risk adjustments and performance measurement.

2.3.4 Remuneration of non-executive directors

67. The remuneration of non-executive directors is usually based on a fixed amount, without any performance-related component. It is mostly based on time commitment (e.g. attendance to the meetings) or can be related to the duties and responsibilities of these directors, the scale and complexity of their business, or their commitment to achieving the objectives of the institutions.

68. Their remuneration usually takes the form of a cash payment. In some countries, non-executive directors may receive a payment in shares that are deferred until they leave the institution.

2.4 Structure of remuneration

2.4.1 Proportion between fixed pay and variable pay

69. In most countries, supervisory requirements regarding the proportion between fixed pay and variable pay make reference to an open criterion that demands a "reasonable", "appropriate", "adequate" ... balancing of the fixed vs. the variable pay. On top of the balancing requirement (or sometimes without the balancing criterion), there can be a requirement for a ceiling on the variable part of individual remuneration. This ceiling can be formulated as an absolute maximum amount on variable payment, or as relative limit compared to the fixed remuneration. Some authorities have clearly expressed their opinion that it is neither possible nor appropriate for a regulator/supervisor to fix ratios.

70. Furthermore, regulations often include prohibition that should prevent employees from being dependent on their variable payment, or - from the perspective of the institutions – to make it possibility for the institution to be able at all times to reduce variable payment to zero or the requirement that total variable remuneration should not limit the ability of institutions to strengthen their capital base.

71. Some requirements refer to the differentiation that institutions can and/or should make between different categories of personnel for the ratio between fixed and variable pay.

72. In practice, not all institutions have policies in place regarding the proportion between fixed pay and variable pay, especially when this specified proportion has not given rise to problems in the past. Where they occur, the policies often contain only general information on the proportion between fixed pay and variable pay. The business lines themselves and the human resources departments (in their coordinating role) seem to have a significant role in determining the details of the proportion.

73. If observed, the proportion mainly differs depending on seniority and the type of business line. Institutions may set in their policy a firm-wide maximum proportion, with different lower level maxima depending on a grading system. Relative limits are more common than absolute

limits. Sometimes a combination of absolute and relative limits is used, to allow for the fact that some staff already have a relatively high fixed salary and should not receive in addition an equally high bonus, while others start at a relatively low fixed income and receive on top of that a multiplicative bonus.

2.4.2 Review of the remuneration structure

74. Supervisors do not use specific techniques or a set of minimum requirements to review the remuneration structure. What seems to be decisive is that the overall remuneration structure is in line with the high-level principles that they apply in the field of remuneration. Such principles function as overarching, catch-all principles, allowing supervisors to insist that the overall remuneration structure is suitable.

75. From a conceptual point of view, supervisors stressed the Pillar II character of creating the right remuneration incentives: they consider the structure of remuneration as an internal policy of the bank (closely linked to the ICAAP of the institution), to be reviewed (instead of simply imposed) by supervisors. It is the primary responsibility of the institution to ensure that the remuneration links the incentives of the employee with the firm's risk appetite and the firm's risk management systems.

76. This implies that most supervisors are prepared to apply structural requirement flexibly, in the sense that they see room for differentiating among categories of staff. A guiding principle for this might be: the higher the seniority of the staff, the stricter the national and international principles regarding structure of remuneration applied. Level playing field considerations, for staff with similar kinds of responsibilities, are another guiding principle, especially among members of the management body in order to reinforce collectivism and solidarity. If institutions are not in favor of subscribing to a certain structural aspect, authorities might accept compensation in another aspect of remuneration (e.g. if an institution wants to reward a certain category of personnel with a relatively high proportion of variable vs. fixed, a relatively longer period of deferral and/or a stricter form of risk-adjustment might be required in exchange).

77. From a practical point of view, supervisors use different tools to review the structure of remuneration (as indicated in the BCBS Methodology of January 2010⁷). The choice of supervisory tool may well depend on the policies and practices of the institutions. As the institutions are still developing their practices, it is not, as yet, possible to furnish an exhaustive list of tools.

2.4.3 Deferral of bonuses

78. Regarding the proportion of remuneration that must be deferred, the supervisory requirements in most countries either refer to an open criterion (a "significant" part of variable pay must be deferred), or to specific numerical thresholds (40% to 60% of variable pay must be

⁷ <http://www.bis.org/publ/bcbs166.pdf>

deferred), both in line with the FSB Principles and Implementation Standards. The open criterion or the numerical thresholds may be further specified, often in relation to the weight of the variable vs. the fixed remuneration.

79. Regarding the time horizon of deferral, many national regulations/supervisory expectations refer to a three year period, as included in the FSB Implementation Standards. Some national requirements apply a pro rata spreading within the deferral period (also in line with FSB Implementation Standards), or in contrast, do not allow any intermediate payment within the deferral period.

80. Regarding the form of the deferred part, the requirements in most countries indicate that a part of the variable remuneration (sometimes specified as a part of the *deferred* variable remuneration) must be in equity-linked instruments. The size of this part is either up to the institution to decide, or is specified with reference to the 50% rule of the FSB Implementation Standards. The difference between listed and non-listed companies is generally not made clear in supervisory requirements. The draft CRD 3, as proposed by the European Commission, will require that equity-linked instruments should at least be 50 % of the deferred part.

81. In their practices, institutions often refer to a difference between “short term incentive plans” (being the upfront paid bonus) and “long term incentive plans” (being the deferred part of remuneration).

82. Regarding the proportion of remuneration that must be deferred, practices seem to vary significantly. Sometimes, no deferral at all is considered (e.g. because remuneration systems were not regarded as problematic during the crisis); sometimes institutions only defer part of the remuneration when deemed necessary/appropriate. Many practices however make reference to percentages that are (or will be deferred in the near future) more or less in line with the FSB Implementation percentages. Deferral of 50% of variable remuneration is common. For significant institutions deferrals of up to 60-75% have been noted. Sometimes, the proportion that is deferred is not expressed as a percentage of variable remuneration, but through a cascade of absolute amounts⁸.

83. Regarding the time horizon of deferrals, practices also vary significantly. A deferral period of at least one to two years is no longer uncommon. Significant institutions have deferral periods of three years, even four years, for their most senior personnel or their highest risk-takers. Institutions are sometimes explicit about the retention period for equity-linked instruments (that come on top of the deferral period) or are silent about this issue. A retention period of two years is most common for equity-linked instruments.

⁸ E.g. part between 0 and 50.000 euro is paid for 100% upfront; part between 50.000 and 100.000 euro is paid for 50% upfront and rest is deferred; above 100.000 euro, everything is deferred.

84. Regarding the form of the deferred part, practices are clearly mixed. Some institutions clearly prefer equity-linked instruments. This preference might be explained by the presumed linkage of risk adjustment to future performance. Other institutions are clearly against the use of equity-linked instruments because of a fear of dilution of ownership or fear of general stock market movements, unrelated to the performance of the institution. Intermediate forms are also seen: linking deferred cash parts to the evolution of the stock price or to the achievement of specific performance/sustainability indicators ("gates").

2.4.4 Risk adjustment for future performance

85. Not many supervisory specifications have been observed compared to the high-level principles on risk adjustment for future performance that have been drafted in the FSB Principles and Standards. However, a significant split can be observed between, on the one hand, some authorities that have accepted that equity-linked instruments are quasi-automatically linked to future performance, and on the other hand, authorities for whom equity-linked instruments are not sufficient as risk adjustment for future performance.

86. The form of risk adjustments for future performance mostly presented by institutions are that the deferred parts are in equity-linked instruments or that they include cash parts whose value is linked to the price of the stock. This value might be corrected in relation to the financial results of that year or, sometimes, even corrected (although not in a very transparent way) for economic cycle movements (with or without peer review), for the long term goals of the institution or in relation to other judgmental elements. One conclusion from these answers is that firm-wide risk adjustment is the most common type of performance adjustment, although some answers point to adjustments for future individual performance.

87. Overall, however, it should be stated that it is not yet clear how and indeed, whether institutions really perform an assessment at the end of the deferral period (or when a payment is made in between pro rata payment periods). This domain is clearly under full development. Examples of re-assessments of the risks that were taken into account for the initial risk adjustment of the upfront part of the variable remuneration (e.g. ex post risk adjustments of the style RAROC) have not yet been observed.