Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices

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1. CONTEXT FOR THE SURVEY

This report presents the results of an EBA survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices (hereafter: the Guidelines) amongst European banking supervisors, conducted in Q 4 2011. The Guidelines were published on 10 December 2010. The aim of the survey was twofold i.e. to get an overview of

- how legislators and supervisors have implemented the Guidelines in their legislative frameworks and/or their supervisory policies, focusing on possible differences between these implementations and the Guidelines;
- more importantly, how the requirements of the Guidelines have been supervised in practice, what progress has been made by institutions and which areas need further development.

This aim is set off against a level playing field concern that was raised when adopting the Guidelines, both by the sector and between supervisors. Although the Guidelines provide an extensive supporting framework to interpret the CRD III requirements on remuneration, they include numerous open aspects where judgment by institutions and by supervisors is required. The concern was that this judgment would lead to different implementations within the EU, further intensified by the fact that prudential supervision over remuneration policies has been since the crisis a completely new field of supervisory competence in most EU countries. Through this report the EBA wants to encourage greater regulatory consistency across the EU jurisdictions.

The survey benchmarks progress and further work to be done against the Guidelines, and consequently has a European context, with no direct link to level playing field concerns between Europe and other members of the FSB. In this respect, the FSB published in October 2011 a Thematic Review on Compensation that included this kind of level playing concerns, amongst other implementation survey work on the FSB Principles and Implementation Standards. As a follow-up, the FSB has launched a detailed ongoing monitoring program. In the European Union, this survey is not the only tool through which EBA monitors remuneration practices and levels in institutions across the Member States. A benchmark exercise based on remuneration data collected in accordance with the criteria for disclosure established in point 15(f) of part 2 Annex XII of CRD III, will be launched by EBA.

Twenty-one supervisors have participated in the survey; questions in the survey were mainly open and qualitative of nature, but for some aspects, numerical information was asked for a sample of institutions that represents 60 % of total assets in the banking sector or at least the 20 largest institutions in a particular Member State. Answers about practices in institutions relate mainly to the 2010 remuneration cycle (i.e. for performances in 2010), the first year of application of the CRD III requirements.

The intention of this implementation report is not to repeat the requirements of the Guidelines. Where necessary, references will be made to the numbers of the relevant paragraphs of the Guidelines in footnotes. Words or expressions used in this report which are also used in the Guidelines shall have the meaning in this report as in the Guidelines.

2. EXECUTIVE SUMMARY

The CRD III remuneration requirements sought to develop risk-based remuneration policies and practices, aligned with the long term interests of the institution and avoiding short-term incentives that could lead to excessive risk-taking. This was seen as a key contributory reform in restoring overall financial stability after the 2007-2008 financial crisis.

In most countries, the Guidelines came into force on 1 January 2011, with some countries suffering from delays in the legislative process. The CRD III combination of articles and annexes, with the Guidelines on top of these, is often mirrored in the countries as a combination of legislative acts, regulation, circulars and/or explanatory memoranda. The balance between legally prescriptive and supervisory regulatory approaches differs between the respondents.

Supervisors have actively assessed remuneration policies, imposing - where needed - amendments to the policy and consequently intervening in the remuneration structures and actual payouts of variable remuneration. In all countries, the Guidelines are part of the supervisory review over institutions.

- **The scope of the Guidelines is an area of significant concern.**

Regarding the scope of institutions, there are effectively no substantive exemptions at national level to the application of the remuneration requirements to institutions covered by CRD III. Considerable variations exist in the extent to which the remuneration requirements are applied beyond the scope of CRD III e.g. in some countries this extends to the financial sector as a whole. While these findings are reassuring or at least not problematic at first sight, they need further nuancing when put in the context of groups or when taken together with the proportionality CRD III allows. Groups with non-EEA entities or groups with non-regulated subsidiaries or regulated subsidiaries that are not subject to CRD III do not always obtain the standard of group-wide application of the remuneration policy. Differences in how the Guidelines apply beyond the EEA borders often have their origin in different implementation of the FSB Principles and Implementing Standards by third countries. Proportionality regimes, sometimes based on predetermined fixed criteria, other times based on an open case-by-case approach, can lead to significant variation in the net degree by which institutions are subject to the CRD III requirements.

Regarding staff under scope of the specific risk alignment requirements, CRD III requires that institutions identify the categories of staff that have a material impact on the risk profile of the institution (hereafter: the Identified Staff). Institutions use a large variety of criteria for this internal exercise but these are not always sufficient to grasp the risk impact aspect of this exercise or to take into account less quantifiable risks such as reputational risk. The numbers of Identified Staff differ considerably between Member States, but there is a clear tendency of institutions to select very low numbers. This affects the core of the CRD III requirements and undermines the effectiveness of EU supervisory reforms on remuneration. The process to determine the Identified Staff in a group can be applied differently between parent undertaking and subsidiaries. There is a genuine concern on supervisory differences regarding the identification process, within and outside the EEA. These differences can lead to regulatory arbitrage and competitive disadvantages. Many supervisors express the need for clear criteria and a process to identify risk takers in a single entity and within groups. More guidance is also needed on the application of the proportionality principle and the neutralization of requirements. Further harmonisation of the identification process is essential for a level playing field. In order to be able to align with the risk profile of institutions, a balance should be found between clarity and flexibility.

- **The governance of remuneration has shown considerable progress.**

This may be explained by the fact that remuneration governance is part of broader governance reforms after the financial crisis. There is a widespread good implementation of the Guidelines with regard to the general principles on corporate governance, the role of the management body in its supervisory and management function and the setting up of a Remuneration Committee (hereafter: Rem Co). If weaknesses occur, those mainly stem from the group governance context: differences in the implementation of the Guidelines across jurisdictions often have their origin in different corporate laws and practices; another source may be the difficult balance between the coherent application of the group policy and the local responsibilities, based on local risks profiles and regulatory environment, that subsidiaries may have in the field of remuneration.

- **The risk alignment of remuneration policies and practices remain underdeveloped.**

In the first cycle of application of CRD III, it appears that too many supervisory resources often have been spent to discussions with institutions regarding the numbers of Identified Staff rather than focusing more on risk alignment principles. Hardly any supervisory guidance, additional to the Guidelines, has been developed at national level.

Changes are perceptible in risk alignment during performance measurement of employees and in the parameters used ex ante for setting bonus pools. Net profits and to a certain extent also risk-adjusted performance parameters are now more in use for setting bonus pools, but much more experience needs to be gained here on the credibility of the parameters and on their simultaneous internal use for risk management purposes outside remuneration so that they can really become embedded in the organisation's risk management framework. The interaction of such risk-adjusted parameters and discretionary judgment needs more transparency and the level at which the ex ante adjustment is applied is still restricted too much to the highest levels of the organisation. Also it is particularly important to ensure that the level of variable remuneration is consistent with the need to maintain, strengthen and restore a sound capital base. . Regarding ex post risk alignment, more improvements seem to be desirable with a view to establishing sufficiently sensitive malus criteria which trigger forfeiture of deferred, i. e. unvested, variable remuneration. The malus criteria used do not always reflect the back testing character, which is inherent in the idea of a malus, with regard to the initially measured performance.

In light of the underdevelopment of risk adjustment techniques, the ratios of variable to fixed that institutions have set in their remuneration policies and that were used in this first CRD III cycle do not appear to signal a breach with practices from the past and tend to be high. The criteria by which institutions decide on the ratios in practice are not always clear.

Progress can however be observed in setting up multi-year frameworks, with deferral periods now being widespread. National requirements on the different elements of the multi-year framework (e.g. proportion being deferred, time horizon, vesting process, time span between end of accrual and vesting of deferred amount) show some minor variance or divergence from the Guidelines.

- **The use of instruments as part of variable remuneration suffers from a feasibility gap.**

CRD III introduced a requirement to pay at least 50% of the variable component of remuneration in instruments. Because the wording used for this requirement includes an "appropriate balance" of different types of instruments, there was some room for institutions to tailor this requirement to their own needs and possibilities.

In some countries, there is delay in complying with this CRD III requirement because banks have difficulties in finding suitable instruments. Listed institutions in several jurisdictions do not use common shares due to practical and dilution problems, even though based on the CRD III text there were expectations that such shares would be used by listed institutions. So-called "phantom shares plans" (equivalent non cash instruments) are more frequently used by both listed and non-listed institutions, although their development is still subject to many open issues. The main open issue concerns the valuation of these plans: by whom should the value be determined and what kind of method should be used to that end? Further practical experience is needed in this respect, especially to develop these instruments for non-listed companies. Still, some strong practices are emerging which may help to shape further policy.

Hybrid tier 1 instruments, part of the "appropriate balance" that CRD III envisaged, are so far in practice not used.

- **Disclosure of remuneration policies and practices deserves greater attention.**

Greater attention on disclosure of remuneration policies and practices could enhance the implementation. The tandem between public disclosure and supervisory reporting, once the EBA Guidelines 46 and Guidelines 47 on remuneration data collection exercises are implemented, should be helpful in this respect. Effective disclosure in fact allows the market's awareness on remuneration to increase. At the same time, it increases monitoring by the markets and regulators on the relation between pay, risk-taking and performance and can facilitate the emergence of best practices that address both financial stability concerns and the institutions' need for competitive pay schemes. It is therefore important to ensure an equal level of application of the disclosure requirements. Today, this is still hampered mainly by the fact that disclosure requirements relate to those categories of staff selected as Identified Staff, whose number can differ considerably between Member States, as already mentioned.

3. ANALYSIS OF THE IMPLEMENTATION

3.1. SCOPE

Scope issues are structured as follows: first the report discusses the institutions in scope, then the report examines how the concept of Identified Staff has been implemented. These two subsections have three parts: a general discussion and then an elaboration of how (1) the group context and (2) neutralization influence implementation. The Guidelines distinguish between proportionality between institutions and proportionality between staff, with neutralization being the most far-reaching form of these types of proportionality.

A. INSTITUTIONS WITHIN SCOPE

General

The CRD III remuneration requirements apply to credit institutions as defined under art. 4(1) of Directive 2006/48 and investment firms as defined under Directive 2006/49/EC, which in turn refers to Directive 2004/39/EC on markets in financial instruments (MiFID) (article 4 (1)(1)). It is clear that the implementation of the remuneration requirements has ensured comprehensive coverage of these institutions. Overall, jurisdictions have in place no substantive exemptions to the application of the requirements. However there were considerable divergences in two important areas:

- The extent to which the CRD III remuneration requirements were applied to sectors not within the scope of CRD III; and
- The approach which individual markets have taken to proportionality and the degree to which the remuneration requirements may be neutralized. (In this context neutralization means the decision not to apply certain of the remuneration requirements to certain covered institutions dependent upon nationally determined criteria).

Many jurisdictions apply the remuneration requirements solely to those institutions covered by CRD III. However, some others extend the application in relatively modest ways including, for example, the utilisation of broader definitions of credit institutions or extension to settlement and clearing institutions. Some authorities, though, have chosen to apply the requirements much more widely including in some cases to the whole of the financial services sector or to a significant number of additional sub-sectors, for example to insurance and reinsurance companies, investment management companies and private pension funds, asset management and finance leasing firms. The key positive outcome is that the remuneration requirements are comprehensively being applied to CRD III institutions and some jurisdictions have used national discretion to apply the requirements more widely. Future EU legislation for other financial services sectors e.g. Solvency II, will lead to more harmonisation.

Neutralization at the level of institutions

However, although all firms within scope are covered, there are very wide divergences across jurisdictions in the extent to which the remuneration provisions can be neutralized and the ways in which that neutralization is achieved. In a few cases there was little or no neutralization. Three jurisdictions operate tiered proportionality regimes. Whilst these have some differences in structure and detail, the proportionality regimes apply neutralization primarily in relation to the size, scope, complexity and nature of firms' businesses with the most significant firms unable to neutralize any of the provisions.

Germany

Germany has a very heterogeneous banking market with many smaller institutions that have a conservative business model, esp. with a focus on local retail and smaller to medium corporate client business.

For this reason the Remuneration Regulation for Institutions (Instituts-Vergütungsverordnung, in short InstitutsVergV) makes a distinction between general requirements applying to all institutions and all employees (sections 3, 4 and 7 InstitutsVergV), and additional more demanding requirements (sections 5, 6 and 8 InstitutsVergV) that are relevant for "major institutions" and the remuneration schemes of their management board and identified staff. Institutions that are not "major" may neutralize the following requirements listed in Annex 2 of the Guidelines ("major institutions" cannot neutralize the following requirements):

- (g) on performance criteria,
- (h) on the multi-year framework, except for the management body of every institution,
- (o) on instruments,
- (p) on deferral,
- (q) on risk adjustments,
- (r) on pension policy as "discretionary pension benefits" play no role in the German institutions
- the establishment of a Rem Co.

The general requirements of the InstitutsVergV (sections 3, 4 and 7) implement all other requirements listed in Annex 2 of the Guidelines (including Annex 2 (l) on the ratio variable/fix).

Qualification as a "major institution" depends on total assets and a risk analysis which the institution is required to perform itself. This risk analysis is relevant for all institutions whose total assets on the respective balance sheet dates for the last three completed financial years reached or exceeded an average of €10 billion. The risk analysis shall take particular account of the institution's size, its remuneration structure and the nature, scope, complexity, risk content and international scale of the business activities conducted. In this regard, particular significance will be attached to an institution's business activities. Institutions with total assets of at least €40 billion are generally considered to be "major". Institutions with total assets under €10 billion are not considered to be "major" unless these institutions deem themselves to be major.

Italy

Italy operates a proportionality regime based on three categories of institutions:

(a) 'major' banking groups with total consolidated assets of over €40 billion are required to adopt all the general and stricter requirements of the CRD III and the Guidelines;
(b) 'medium' banks and banking groups with total consolidated assets between €3.5 and €40 billion are required to apply all the general requirements and may consider not to apply the stricter requirements on a case by case basis;
(c) 'minor' banks with total consolidated assets lower than €3.5 billion are required to comply with the general requirements but not with the stricter provisions.

Stricter requirements are: (i) the payment of at least 50% of variable remuneration in shares/other financial instruments; (ii) the deferral of at least 40% to 60% of the variable remuneration for at least 3 to 5 years; (iii) the appointment of a Rem Co. All the other CRD III provisions have to be intended as "general requirements".
As a result of such proportionate approach, all Italian institutions must therefore comply with all the CRD III provisions and the Guidelines. Medium and minor institutions might neutralize only the stricter requirements. A Rem Co shall be however appointed in all listed institutions regardless of size.

The UK

The UK operates a four tiered proportionality regime:

(a) Tier One: banks and building societies with capital resources over £1 billion, investment firms with capital resources over £750 million and third country firms with total branch assets over £25 billion. These firms are subject to all the CRD III remuneration provisions although some third country firms may not need to establish a Rem Co. These firms are subject to annual review.
(b) Tier Two: banks and building societies with capital resources between £100 million and £1 billion, investment firms with capital resources between £100 million and £750 million and third country firms with total branch assets between £2 billion and £25 billion. These firms are subject to all the CRD III remuneration provisions although some third country firms may not need to establish a Rem Co.
(c) Tier Three: banks, building societies and investment firms that do not fall within tiers one or two and all third country firms not within tiers one, two or four. These firms do not have to apply the more stringent CRD III provisions.
(d) Tier Four: all limited licence and limited activity firms. These firms do not have to apply the more stringent CRD III provisions.

N.B. in the case of groups, each firm in the group falls into the same proportionality tier as the highest tiered entity. However individual firms in a group can apply to be retiered e.g. into the tier it would have been placed had it been operating as a solo firm.

Some other jurisdictions are prepared to consider applications for neutralization on a case by case basis. Others apply neutralization of some of the remuneration requirements to firms below a certain size, usually related to asset value. In a number of jurisdictions, if firms fall below certain criteria, in particular in relation to the size and complexity of the institution, the need to establish a Rem Co is neutralized.

This demonstrates clearly 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, including in some cases only minimal neutralization. This diversity may be related to the difference in size and complexity of national sectors. However some relatively large markets have chosen not to apply substantive neutralization. Although all jurisdictions appear to be fully compliant with the legislation 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.

Group context

In the case of groups, the remuneration requirements are generally implemented worldwide and in relation to all regulated and non-regulated subsidiaries. The responses received reveal that national regulations in all countries completely reflect the minimum requirements of the Guidelines with regard to the application of remuneration policies on a consolidated basis[1]. In many jurisdictions, the group Rem Co has a role in ensuring that remuneration provisions are applied at both group and subsidiary level.

In practice, the balance between the requirement of the parent company to have the group remuneration policy applied coherently and the requirement of subsidiaries to take into account local responsibilities, based on local risk profile and regulatory environment, proves to be difficult to obtain. Some supervisors faced practices where the parent company determined group wide policies which did not sufficiently respect the subsidiary's local responsibilities. Divergences occurred in the extent to which national regulations might take into account local non-EEA regulations (since within the EU there is a harmonised framework), practices or culture. In certain cases local regulations prevailed or were taken into account but in one case only if local regulation was tighter than national regulation. In those circumstances local requirements took precedence. In certain other jurisdictions home regulation automatically applied regardless of where the business was carried out. Sometimes institutions use (the absence of) local non-EEA regulations, practices or culture as an argument to implement less stringent remuneration policies in relation to activity in those third country markets. A supervisory response noted in that case was to bring activity in those markets at least within scope of the group policy, to ensure transparency towards and oversight by the management body.

There are similarly differences in the application of proportionality principles ranging from the full application of home country proportionality regimes to application on a case by case basis to no scope for proportionality. There is thus the potential here for Member States to operate different regimes for their institutions in the same third country markets. The possible impact of this would be greatest where local jurisdictions operated markedly less restrictive remuneration regimes than those applicable in the EEA.

B. STAFF WITHIN SCOPE

General

CRD III requires that institutions identify the categories of staff that have a material impact on the risk profile of the institution. The scope of the Identified Staff determines the scope of the specific risk alignment requirements.[2] Therefore the identification of staff is the essential starting point for

[1] The principles shall be applied by credit institutions at group, parent company and subsidiary levels,
[2] The Guidelines make a distinction between institution-wide application of most of the remuneration requirements and the application of some of the more specific risk alignment requirements to only the Identified Staff.

the effective management of risks. It is clear from the implementation report that the selection of Identified Staff has been the most important subject of discussion between institutions and supervisors. Because of the impact on the scope of the remuneration policies and on the competition between institutions, discussions between supervisors and institutions 'stuck' at this phase of the implementation of sound remuneration policies. The differentiation in the number of Identified Staff hinders the creation of a level playing field.

Institutional practices

CRD III and the CEBS Guidelines state the categories of staff which should be selected. The CEBS Guidelines provide some guidance on the selection of Identified Staff. However, it is clear from the implementation report that more guidance is needed. Varying practices lead to differences in the criteria used to identify staff and in the number of Identified Staff within jurisdictions and internationally. Those differences can lead to regulatory arbitrage and competitive disadvantages. The result is that institutions have tended to select low numbers of Identified Staff, which is contrary to the objective of managing effectively risks resulting from remuneration policies and practices.

Institutions use different processes to select Identified Staff. Some institutions first identify the relevant types of activity and then select the Identified Staff within these activities. Others base their selection on a risk analysis. Within the different categories of Identified Staff, mentioned in CRD III and the Guidelines, the category 'other risk takers' has proved to be the most challenging.

The implementation report also provides some information on the selection criteria. Institutions use a variety of criteria to select the 'other risk takers'; often more than one. The criteria are quantitative as well as qualitative. The good practices identified in the implementation report are mainly quantitative metrics which are based on responsibilities or are linked to the risk impact of the employee's activity. Examples which were mentioned are: credit competence; trading limits; bounded economic capital on business unit level; Value at Risk, Risk Weighted Assets-, revenue- or Profit&Loss impact; risk capital, total remuneration, ratio fixed to variable remuneration, and various thresholds (threshold above which staff are allowed to operate; amounts of revenue; assets under management). Qualitative criteria which are used by the institutions are the seniority of staff; hierarchy in the institution; type of responsibility of staff members; type of activity; and employee rating. Most of these criteria are applied at individual level. In one jurisdiction institutions are required to use also criteria at institutional level (see example below in box).

The implementation report also provides information per jurisdiction on the percentage of the total number of employees which institutions have selected as Identified Staff. These percentages should be treated with some care, because they are not always comparable. One reason for this is the different sizes of institutions. Although the absolute number of Identified Staff of a big institution will usually be higher than the number of a small institution, the percentage of the total number of staff can be lower. Also national regulation on proportionality or proportionality practices may impact the percentage of Identified Staff.

Nevertheless, the clear conclusion can been drawn that the numbers of Identified Staff which institutions have selected vary considerably per jurisdiction. This conclusion applies to all three categories of banks on which the Implementation report requested data: 'all institutions', 'investment banks', and 'retail banks'. For example, in the category 'all institutions' there are 6 jurisdictions with an average Identified Staff < 1% of total number of employees; in 5 jurisdictions the average Identified Staff is between 1-5 %; in 3 jurisdictions the average is between 5-10 %; and in 2 jurisdictions the average is more than 10%. Institutions tend to identify lower numbers of Identified Staff, especially the bigger institutions. In the view of supervisors this is inadequate for effective risk management.

Five supervisors have provided information on investment banks. Although one would expect investment banks consistently to have a higher percentage of Identified Staff than retail banks due to the higher risk profile, this is not the case in practice. In three jurisdictions investment banks have a higher percentage of Identified Staff than retail banks. However, in the other two jurisdictions the investment banks have a lower percentage.

In the majority of jurisdictions the management body is involved in the identification process. Often the board has the responsibility to set the criteria for the selection of Identified Staff. In a few jurisdictions the supervisory board has a role. More often the Rem Co is involved, but its responsibilities vary between jurisdictions.
Among the control functions, the human resources function is the most commonly involved in the identification process. The risk management function is clearly less often involved, although the aim of sound remuneration policies is the management of risks. The compliance function and the audit function appear to have only a minor role in the identification process.

Supervisory practices and guidance

Almost all supervisors have indicated that they apply the institution-wide rules of CRD III[3] and that the regulation covers all staff. In three jurisdictions, the regulations apply to a wider group of people, such as consultants, intermediaries[4], and persons to whom the institution has outsourced certain activities. The aim of covering this wider group is to avoid circumvention of the regulation. Almost all jurisdictions indicated that every institution covered by CRD has to select Identified staff.

The determination of Identified Staff (especially in the category ʽother risk takersʼ, at lower level of the hierarchy) proves to be difficult, because a process and clear criteria are lacking. One supervisor has developed further guidance on 'material impact'. Other supervisors have published guidance on the functions which should be appointed as Identified Staff and on the category 'remuneration bracket'.

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3 See annex 2 of the Guidelines.

4 CBFA Remuneration Circular of 14 February 2011: intermediaries are outside the scope of the remuneration provisions.

The Netherlands

The Dutch supervisor has published a Q&A concerning Identified staff. With regard to the category "other risk takers"' the Dutch Q&A gives criteria related to the most common financial risks. Depending on a bank's or investment firm's business, the relative importance of risk types may vary. It is up to the firm to demonstrate which are most important. For banks that engage in (mortgage) lending, credit risk may generally be expected to be among the principal risk types. Where a firm (also) does significant business in the wholesale or financial markets, market risk will be a prominent financial risk. For most banks, funding and liquidity risk will also be of importance. Where credit, market, capital and liquidity risk are concerned, the Dutch supervisor regards a (non-additive) combination of three criteria as a starting point for gauging the materiality of staff activities.

Risk type	Criteria
Credit risk	> 1% RWA
Market risk	> 1% RWA and > 1% P&L
Funding and liquidity risk	> 1% RWA and > 1% Balance sheet

Taken individually, every one of these tests have their limitations (e.g.: trading business is relatively immaterial in capital terms; taking capital as the sole criterion will provide inconclusive evidence). Thus a combination of all three tests provides the fullest overview of 'material activities'. Note that the test results are non-additive. Where a test score 'sticks out', the associated activity is assumed to materially affect the firm's risk profile. Next, relevant staff members may be identified within the scope of the selected activities. Functions which have a material influence on the risk profile are not limited to management functions (hierarchical positions), but also contain operational and controlling functions.
With regard to nonfinancial risks (e.g. reputation, legal, or IT risks) the Dutch Q&A states that it is difficult to lay down a single or a small number of quantitative measures. Therefore, institutions should primarily select staff responsible for decisions with strong impact on a firm's operational risk profile.

Denmark

The Danish order on remuneration includes the following criteria on which persons should be appointed as identified staff: 1) the management of the part of the institution that deals with or approves financial instruments, 2) the management of the part of the institution that invests the institution's own book, 3) employees in the part of the institution as mentioned in 1 and 2 who via financial instruments can take a material risk on behalf of the institution on the institutions own book (proprietary trading), 4) the management of the actuary function and the reassurance function who can take a material risk on behalf of the institution on the institution's own book, 5) managers of the part of the institution who control compliance of thresholds for risk taking, and 6) other employees that can cause the institution a material credit risk.

The UK

The UK FSA Handbook states that the first three categories of Identified Staff ("Code staff" in the Handbook) (senior management, risk takers and staff engaged in control functions) should include persons who perform a significant influence function for the firm, or is a senior manager; individuals holding key positions, including heads of significant business lines and support and control functions; and other risk takers, which firms may identify through setting their own metrics.

Many supervisors express the need for clear criteria and a process to select Identified Staff in a single entity and within groups. Further harmonisation of the identification process is essential for a level playing field to operate. In view of this it is also suggested to set appropriate quantitative and qualitative criteria for the number of Identified Staff. In order to be able to align with the risk profile of institutions, a balance should be found between clarity and flexibility.

Specific issues on which more guidance is needed are:
(i) the definition of the term 'material', with regard to activities/subsidiaries/business lines as well as to 'other risk takers'. Without a better definition, institutions interpret functions (such as CFO and control functions) differently.
(ii) the material impact of operating staff. This proves to be more difficult to determine than staff in hierarchical positions.
(iii) the relevant level in the organisation. Some supervisors mention that it is not clear how far down in the organisation institutions have to select Identified Staff. Although low in hierarchy, certain activities of staff in lower positions can have an impact on the risk profile.
(iv) the measurement of reputational risk and other not-easy-to-measure-risks when assessing the impact on the risk profile.
(v) determination of the category of 'risk takers who have collectively impact on the risk profile'. Clear criteria for the identification of this category are lacking.
(vi) the identification of Identified Staff within a group. Especially there are questions about the level within subsidiaries at which staff have to be identified (e.g. only the highest control function in a subsidiary or also the level below), and whether a further difference should be made between regulated and non-regulated subsidiaries.
(vii) the application of the proportionality principle and the neutralization of requirements. Diverging regulation or supervisory guidance on this point could have impact on the level playing field.

Neutralization at the level of Identified Staff

Annex 2 of the CEBS Guidelines provides a table which shows the applicability and the possibility of neutralization of requirements for Identified Staff. In three jurisdictions neutralization is not possible. In all other jurisdictions neutralization is allowed for the requirements (o), (p) and (q): pay out in financial instruments (combined with retention) and deferral (including ex post adjustment). In a few jurisdictions institutions have made use of this.

Reasons given for the neutralization of the requirements are: the business model in combination with the total (limited) number of employees; low ratio variable to fixed remuneration; the size of the group of persons which has collectively material impact; maximum threshold of total variable remuneration; the relative level of seniority of staff members; the size of the possible obligation entered into on behalf of the institution.

Group context

The process of identifying material risk takers can be done at group and subsidiary level in an integrated way (where the definition of Identified Staff or the group wide method to select Identified Staff is done at the parent company level and the subsidiaries comply with that group wide policy). In that case the result of this process to determine Identified Staff could be different for an institution that is part of a group compared to a stand alone institution. From the implementation report it appears that in the integrated approach the subsidiaries identify in some cases only their directors and not "other risk takers". Some regulators in host capacity apply criteria to identify material risk takers that take into account the significance of subsidiaries in terms of local market share.

The selection process in a group can also be done at an individual level, which paradoxically may lead to the identification of a higher number of employees than if done at group level in an integrated way.

As raised previously in the report, there is a big variety of criteria among institutions in different countries to identify material risk takers, especially at the lower level of the hierarchy. The Dutch

Q&A on Identified Staff (see box above) includes examples of functions within subsidiaries which should be included in the Identified Staff, e.g. the highest position of control functions and the level below .

3.2. GOVERNANCE

Much progress has been made in the field of governance of remuneration. Both institutions and supervisors have increased their awareness in this respect and have taken concrete actions to strengthen the governance arrangements. This may be explained by the fact that governance of remuneration is part of broader governance reforms undertaken after the financial crisis. The degree of compliance of national regulations with the Guidelines is therefore high. However, while many countries have proved themselves to be fully compliant from a regulatory point of view, many have pointed out that more time is still needed to complete an exhaustive assessment of good and bad practices. In a few circumstances, institutions claimed that the regulations were too recent to be fully and properly implemented.

The Guidelines on corporate governance have been generally well implemented, in particular in respect of: the role and compensation of the management body in its supervisory and management functions[5]; the setting up, role and composition of the Rem Co and the definition, role and composition of the control functions[6]. However, problems still persist in few limited areas; in these cases, supervisors have often expressly required institutions to rectify the practices and non-compliance (i.e. institutions have been asked to limit the role of the CEO, improve the formalisation and functioning of all the reporting lines, ensure adequate discussion among all corporate bodies etc.).

The effective involvement of the control functions in the design, oversight and review of the overall remuneration policy is of paramount importance in order to achieve the prudential goals of CRD III and the Guidelines[7]; nonetheless in many countries neither direct contact of the control functions with the bodies responsible for the design and approval of the compensation policy, nor access to the information needed to fully participate in the decision-making process seem to be guaranteed.

There is room for further regulatory convergence across EU jurisdictions on some detailed aspect of the governance Guidelines. However, some other differences can not be removed, as they stem from national corporate governance legislative frameworks (e.g. some specificities may derive from the different allocation of roles and responsibilities within the management and supervisory boards)[8].

Despite significant progress, many countries raised specific concerns with regard to group-wide remuneration policies and the structural relationship between the parent company and its subsidiaries (from a governance point of view). This increases diversity across Member States. The most frequent concerns mentioned are: the identification of the Identified Staff (see above in section 3.1.B - group context); clear documentation of the remuneration decision making process and the relationship between the subsidiaries and their parent company in that respect; the timely allocation of bonus pools at the subsidiary levels; too little or only an unbalanced interaction between the control functions (compliance, internal audit, HR) at parent and subsidiary level.

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[5] Some countries have also required non-executive staff members performing supervisory functions to be compensated only with fixed remuneration; according to the Guidelines para. 47, this is a best practice that helps in properly addressing potential conflicts of interests.

[6] In few countries human resources are not yet considered as control functions for the purposes of the CRD III and EBA Guidelines (see Guidelines para. 57, footnote no. 22).

[7] In some Member States also the shareholders meeting is involved and is required to set the remuneration of the board members and/or to approve the overall remuneration system (see Guidelines para. 48).

[8] E.g. the board where the Rem Co is appointed, the function in charge of the definition of the overall remuneration policies, etc.

There are good practices that may help in solving problems arising in the field of the group context. For example: 1) the human resources function at the subsidiary level receives a yearly local inspection of its remuneration policy performed by group control functions; 2) the internal audit function of the parent company reports to the home supervisory authority about the remuneration policy of the whole group; 3) a clear documentation on which local specificities (activities and risks of a subsidiary, local regulatory environment etc.) apply and how they are integrated in the group policy.
Besides encouraging these good practices, some supervisors have also required from parent institutions to provide them detailed data and information on the compensation schemes adopted at the subsidiary levels. Another good evolution is that cooperation and coordination initiatives amongst supervisory authorities have been activated, to ensure the effective compliance with regulation in cross-border groups.

France
French supervisors have required main banking institutions to report several months in advance their forecasting on the global pool of compensation that their business units and subsidiaries will submit to their control and supervisory functions. This practice has provided the French supervisor with both information and tools for 1. ensuring institutions' ability to comply in real time with the requirement that compensation pools are effectively aligned with institutions' risk profile and results; 2. testing the time needed for supervisory and control functions to perform in a group context an assessment of the amount and computation modalities of compensation pools which are submitted by management functions.

3.3. RISK ALIGNMENT: UNDERDEVELOPED TECHNIQUES

The need for risk aligned variable remuneration was a core issue raised in the wake of the financial crisis.[9] However, institutions and supervisors also had to focus on more supporting but important questions related to this risk alignment, such as the scope of remuneration requirements on institutions and staff. Therefore the issue of the actual risk alignment itself has to be given considerably more attention by institutions and supervisors. In this context, it is also important thatvariable remuneration is reduced where necessary to maintain, strengthen and restore a sound capital base[10].

A. OVERALL RISK ALIGNMENT

Risk alignment of variable remuneration has many different aspects that are reflected in CRD III and the Guidelines. The idea of risk alignment is embodied in several requirements like the alignment of remuneration systems with the institutions' strategies, the prohibition of guaranteed bonuses, personal hedging strategies and golden parachutes, the implementation of minimum ratios fixed to variable remuneration, the limits to the variable compensation when inconsistent with

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9 Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" of 07.04.2008, p. 20.
10 See also "EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence" of 08.12.2011, pp. 5 and 14.

a sound capital base as well as the use of risk adjusted performance parameters in the accrual period and of deferred variable remuneration with malus or clawback arrangements.

Most of the reporting Member States stated that the national provisions with regard to risk alignment of the variable remuneration show no identifiable differences to the Guidelines. Often Member States keep the national provisions on a more abstract and compacted level than the Guidelines. Nevertheless the Guidelines are at least used for interpretation and are sometimes even directly referred to. Some Member States seem to accentuate certain aspects with regard to risk alignment in their regulation and their supervisory practices. In some Member States the supervisory practice or regulation reached more prescriptive outcomes with regard to the scope or the maximum ratios of variable to fixed remuneration.

Alignment with strategies

Institutions' remuneration system and especially the variable part of the remuneration influence employees' behaviour with regard to (inappropriate) risk taking. Thus remuneration systems – intentionally or not – also serve as a management tool. As such remuneration systems could be aligned with institutions' business and risk strategies as well as in the risk management system. The link between strategies and especially between risk strategies and the remuneration system is not always well developed or documented. In some cases this may also have to do with underdeveloped business and risk strategies that make it difficult to derive operational objectives from these strategies. Also remuneration systems are not always sufficiently embedded in the strategy planning, transposition, assessment and modification process. Thus, performance parameters used for risk management purposes are still underrepresented in remuneration systems.

A good practice is to link the remuneration-related processes to the institutions' business and risk strategy process. This ensures that the remuneration system is aligned with the strategies and the operational objectives derived from these strategies. Furthermore those functions that are in charge of the strategy process including the risk management function should formally be involved in the process of development, implementation and modification of a remuneration system especially with a view to the objectives set out at the different levels of an institution's remuneration system.

Prohibitions

CRD III and the Guidelines disallow guaranteed bonuses (except when hiring new staff and limited to the first year of employment), personal hedging strategies to undermine the risk alignment effects as well as "golden parachutes" that would reward for failure, are not allowed. All responding Member States adopted these requirements in their national jurisdictions. Most institutions incorporated the aforementioned prohibitions in their remuneration policies.

Good progress has been made with a view to guaranteed bonuses. Except when hiring new staff and limited to the first year of employment guaranteed bonuses seem to play no relevant role in the remuneration practices of Member States' institutions. However, in practice also the classification of payments as guaranteed bonuses may not always be obvious. Supervisors notice cases where certain payments are presented as fixed payments, but where further examination of the characteristics of these payments leads to re-assessment of that qualification. A similar observation can be made with regard to golden parachutes. Their use is claimed to be nonexistent by institutions. Nevertheless, the classification of certain arrangements under "payments related to the early termination of a contract that do not reward for failure" may be questionable, e.g. in cases where persons have an entitlement to their fixed remuneration for the residual period of a fixed term contract in case the performance under that contract has been terminated before the originally anticipated term.

With a view to the prohibition of hedging strategies and liability-related insurance it is good practice if institutions require a commitment of their employees to adhere to this requirement.

B. RATIOS VARIABLE TO FIXED

Overall national regulations are in line with the Guidelines' requirements to have an appropriately balanced ratio of variable to fixed remuneration to ensure a fully flexible bonus that could be zero. In some Member States this provision has to be applied by all institutions and for all employees and is not limited to Identified Staff. Most Member States leave it to the institutions to set an internal maximum ratio. This ratio can differ internally between business lines of an institution. The criteria by which institutions decide on the ratios in practice are not yet well known. This may have to do with the fact that the use of ratios has a certain tradition and is therefore not always explainable. Another factor is market usages with a view to benchmarking among peer groups. However, it seems questionable whether institutions really use sophisticated approaches to determine such ratios. Only few Member States introduced maximum ratios.

With the implementation of more detailed requirements for the variable part of the remuneration, industry shifted parts of the variable pay into the fixed part of the remuneration. Some Member States found it opportune to prevent this unintended consequence of CRD III and introduced a requirement to keep the variable part of the remuneration sufficiently high so that risk adjustment requirement can have sufficient impact on that part when needed.

The ratios of variable to fixed remuneration for executive members of the management body (executives) and the other Identified Staff varied among Member States.

Through the implementation report, data have been collected on the average and maximum ratios of variable to fixed remuneration paid in the different Member States to executives and other Identified Staff. National competent authorities were asked to base their data collection on a representative sample of institutions in their jurisdiction, comprising either 60% of total domestic banking assets or the 20 largest institutions. Aggregate information on fixed to variable remuneration ratios was reported as minimum and maximum and average among all observations on an individual bank basis. For the purpose of this report, Member State figures have then been aggregated at Union level. The data show that the median of the average ratios among MS is 122% for executives and 139% for the other identified staff. The highest value of the average ratios that were reported by the MS was 220% for executives and 313% for the other identified staff. Furthermore, looking at the maximum ratios reported by the MS, the median of this is 225% for executives and 324% for the other identified staff. The highest reported values of these maximum ratios were 429% for executives and 940% for the other identified staff.

Because of the differences in the degree to which Identified Staff are determined by the institutions (see above in this report in section 3.1.B) and because the sample of institutions for which data have been collected may include very different types of institutions depending on the Member State concerned, the level of detail of these data did not allow numerical conclusions to be drawn from them. However, the general conclusion is that in all Member States, the variable part of the remuneration exceeds the fixed remuneration considerably for all Identified Staff. Moreover, in all Member States, this ratio is generally higher for the category "other risk takers" than for the category "executive members" (for the categories, see paragraph 16 of the Guidelines). Taking into account the nominal pay levels for the fixed component for executives and the other risk takers, the ratios observed can lead to very high variable remuneration components. If the potential variable remuneration is the dominating part of the total remuneration, this could incentivise staff to take too much risk in order to assure a certain minimum pay level.

Some supervisors informally communicate to their institutions a certain numerical maximum ratio of variable to fixed that they consider as appropriate; this allows them to obtain a clear level playing field in the whole sector under their supervision.

In this context, observed practices within institutions are:

- The remuneration policy determines in a detailed way the underlying reasons why for a particular business unit or person, it is considered appropriate to have a ratio variable to fixed remuneration above a certain level.
- High ratios above a certain threshold are approved by the management body in its supervisory function.
- Approval for ratios inside a division that exceed the average of the ratios inside this division considerably.
- Higher ratios result in a higher part of the variable payment deferred as well as in longer deferral and retention periods.

C. RISK ALIGNMENT TECHNIQUES EX ANTE AND EX POST

Risk alignment of variable remuneration has two main perspectives. Risks already have to play a prominent role in the performance measurement or accrual period and the award process when a certain pool of variable remuneration is determined and then allocated to divisional subpools, business units and individuals (ex ante perspective). As this forward-looking ex ante perspective may not identify all risks that later may emerge , risks also have to be considered retrospectively similar to a back testing of the initially measured performance (ex post perspective). The ex post perspective of risk alignment is subject to those requirements that cover the pay out process of variable remuneration, especially in the deferral and malus or clawback arrangements. Although these two perspectives cannot be mixed, they can not be seen separately either. A more conservative approach in one perspective may allow for a more flexible approach in the other perspective. For example institutions that apply longer accrual periods with risk adjusted performance parameters may only apply the minimum deferral period of three years or use shorter retention periods for instruments like shares.

The CRD III and the Guidelines require that the total variable remuneration does not limit the ability of institutions to maintain a sound capital base. In this respect, Member States shall have the power to impose corrective measures (e.g. limits to the variable remuneration, capital add-ons) and institutions shall have in place well-functioning ex ante (potential reduction of the bonus pool) and ex post risk alignment mechanisms[11]. The responses received reveal that national regulations in the majority of Member States completely reflect the CRD III and Guidelines requirements. As regard practices carried out by institutions, the level of capital seems to be taken into account among the risk-adjustment indicators, but there is no evidence as to if and how it operated to reduce, when necessary, the overall variable remuneration.

Risk alignment of variable remuneration is the most challenging aspect of a sound remuneration system. The practices in institutions and experiences of supervisors are still nascent.

Ex ante perspective

An important way to incorporate risks in the system of measuring remuneration-related performance is the use of risk adjusted performance parameters. Risk adjusted parameters are still underrepresented among the quantitative performance parameters used by institutions to determine and allocate the bonus pools. This may be partly due to the limitations of existing measures for different types of risk and assets. Rather, performance criteria used by banks tend to include measures (such as revenues, profit, RoE, business volume, earnings per share,...) [12] that may be subject to financial manipulation or do not provide employees with sufficient incentives to consider the quality of the business undertaken. Common techniques used to adjust profits and capital for risks are based on the calculation of economic profit or economic capital (VaR, RAROC,

[11] See in particular Guidelines para. 34 and 35. In this context, specific provisions also concerns institutions receiving exceptional government interventions (see Guidelines para. 38-41).

[12] European Central Bank, „Beyond RoE – How to Measure Bank Performance“, p. 20 et seqq.

RORAC). Accounting profits do not capture adequately future risks and may imply a certain degree of judgment in decisions on the performance-related part of remuneration is necessary. Adjusting remuneration for risk over a multi-year period, seems also to be quite difficult to achieve in practice for an institution. However, if compensation schemes rely on imperfect risk measures, they run the risk of becoming ineffective and, more importantly, of creating arbitrage-like opportunities for employees to take on risks that are not fully recognized by the measures. It is therefore important for institutions not to rely blindly on their risk models but to make qualitative judgments as well.

Institutions often also use discretion to adjust the bonus pools, e. g. to reflect external or unexpected events. However, discretion is also used for upward adjustments which makes the measurement and award process less transparent and susceptible to possible manipulations. In this context a very important factor that is considered when bonus pools - not only on institutional level but also on divisional and business unit level - are adjusted by discretion is the competitive environment in which institutions have to retain or attract their staff. Therefore even a bonus pool which is calculated predominantly on the basis of conservative performance parameters is often dominated by the need to grant competitive remuneration packages and especially variable remuneration. This has an overriding effect on the risk adjusted performance parameters used.

Many institutions determine and allocate their variable remuneration in more or less modified top-down approaches. A top-down approach starts by setting a bonus pool on the level of the institution, which is then allocated to business units and to individuals. Bigger institutions often have additional divisional sub pools under the bonus pool at the level of institution, which are then further distributed. On each of the aforementioned levels ex ante risk adjustment can be exercised.

Furthermore institutions seem to use risk adjusted parameters more at higher bonus pool levels, i. e. at the level of institution and at divisional level. At the level of the business unit, but especially at individual level, consideration of risk metrics by institutions seems to be rarely used. Real risk adjustments at these levels are more based on red flags raised e. g. in case of breaches of compliance. The other performance parameters used at business unit and individual level seem to be based more on operating results and some qualitative parameters like customer satisfaction etc. Some jurisdictions have more detailed expectations with a view to the ratio of institution wide, business unit and individual performance parameters (e. g. management board: 50% institution wide, 50% individual; others: in principle 1/3 on each level). The use of more risk adjusted performance parameters also at lower levels, i. e. business unit and individual level, should be a key future objective. This is because the behaviour of an employee in his specific job function will primarily be influenced by those parameters he can affect through his performance etc.

It is good practice to use a combination of appropriate quantitative and qualitative parameters on each level of performance measurement, i. e. on institutional, divisional and business unit level as well as on individual level. Quantitative parameters that refer to the annual performance of the institutions should refer to a multi-year period to avoid a high volatility of these metrics, which could lead to inappropriate risk taking. There should also be a formalized process and predefined criteria for a possible discretionary adjustment of these parameters, especially to reflect the adjustment of profits. The Rem Co and risk management function should formally be involved in this process. Possible adjustments and their rationale should be documented and be part of the reporting to the management body in its supervisory function. Supervisors should ask for the full calculations behind variable remuneration, checking the traceability of the different decisions.
Furthermore it is good practice to use the aforementioned performance parameters in combination with a secondary risk adjusted metric, which should coincide with the risk metrics used for risk management purposes at the respective level of performance measurement. For example, if the allocation of a divisional bonus pool to a business unit depends on operating results of a business unit, an existing VaR limit for this business unit could also serve as a performance cap. This performance cap would reduce the incentive to take higher risks in order to increase operative results.
For supervisors, it is important to monitor the strength of the incentives given by remuneration to executives and identified staff, by looking, for instance, at how much executives and other identified staff are insulated from downside risks.

Ex post perspective

More improvements seem to be desirable with a view to sufficient sensitive malus criteria which trigger forfeiture of deferred, i. e. unvested, variable remuneration. Malus criteria used do not always reflect the back testing character, which is inherent in the idea of a malus, with regard to the initially measured performance. Often, the ex post risk adjustment is only qualitative in nature, or where it is quantitative in nature, it is not sufficiently defined. For example, institutions often use a “significant downturn” as a parameter for ex post risk adjustment, without giving any details on what a “significant downturn” means.

Also the malus trigger should be applied at lower levels, i.e. business unit and individual level, as this has a more substantial effect on the employees’ behaviour (see above). Often malus triggers at lower levels do not take full account of negative operational performance and risk profiles of the business unit. At individual level a malus is often only triggered in the case of severe compliance breaches or when an employee leaves the firm voluntarily.

It is good practice if malus or clawback arrangements include a performance forfeiture on each level where the performance initially was assessed, i.e. on the institutional, divisional and business unit level as well as on individual level. This performance forfeiture should revert to those performance parameters that were already used in the ex ante accrual process to assess the initial performance on the respective level.

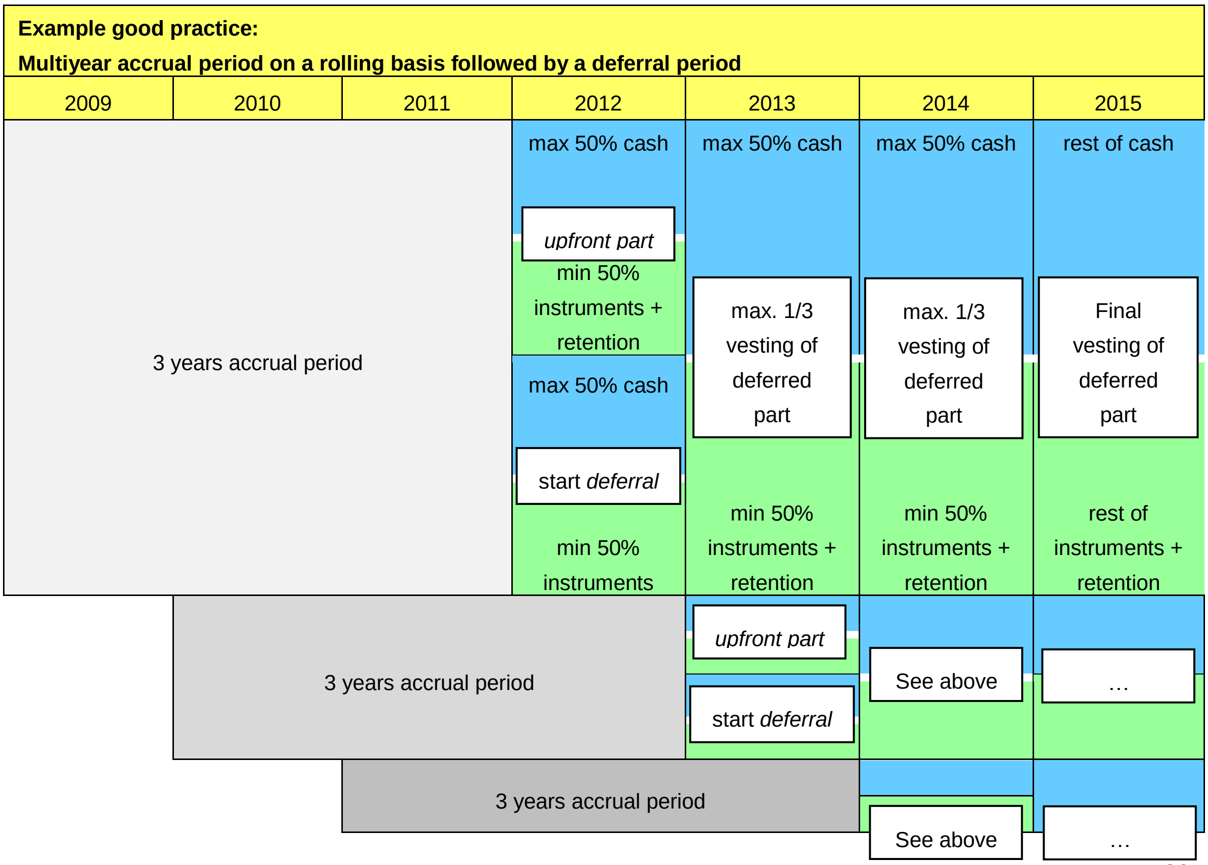
D. SETTING UP MULTI YEAR FRAMEWORKS

Performance measurement periods, deferral schedules with malus or clawback arrangements attached to them and retention periods in case instruments are used to pay out variable remuneration introduce a multi-year element, linking the employees' compensation schemes to the long term performance of the institutions. This is by now a widespread practice in institutions.

There are no major differences in the national regulation with respect to the requirements of the CRD and Guidelines for the different components of the multi year framework. In some countries longer accrual periods of at least two years are expected for members of the management body. The portion of variable remuneration to be deferred varies between minimum 40% and 60%, as prescribed in CRD, while the deferral period varies between minimum 3 and 5 years. Some countries fixed a threshold of variable remuneration below which there is no requirement for deferral to take place. Another country fixed a threshold of variable remuneration for which 60% needs to be deferred. The payment is in general on a pro-rata basis, with yearly vesting periods after the end of the accrual period, as prescribed in the Guidelines. . In general, no specific retention period has been fixed, an issue also left open in the Guidelines. Several countries, though, indicate a minimum retention period based on best practice and which can vary between 6 months and 2 years. Member States seem to comply as well with the application of the 50% minimum threshold for the instruments to be divided equally over the deferred and the non-deferred part, although some supervisors are of the opinion that rremuneration in shares is only likely to impact positively on behaviours if there is a requirement for the shares to be held for prolonged periods of time and that this is undermined by the requirement to pay 50% of the upfront portion in shares.

Institutions signal the administrative burden in designing and implementing new CRD III compliant incentive plans. Another difficulty is adjusting the multi year framework to the tasks and responsibilities of the different Identified Staff; up to now, there is little differentiation among the different levels of personnel in the multi year elements that are applied to them. With a view to the length of the accrual period one year periods seem to be widespread. Nevertheless longer periods are also used, especially for higher management levels. For deferral, institutions stick to the legal minima, with little variation in the 40 to 60 % or the 3 to 5 years ranges. The percentage deferred is however in general slightly higher for executive members of the management body. In almost all countries, most of the Identified Staff receives 50% of variable remuneration paid in instruments. The deferral period is 3 years in the practice of almost all countries. The retention period most commonly chosen is between 6 months and 18 months.

Occasionally, conceptually wrong deferral schemes are persistently presently by institutions.
The following examples show a good and an inappropriate practice to consider a multi-year performance measurement:



Example inappropriate practice: LTI with multi-year accrual period followed by retention period						
2009	2010	2011	2012	2013	2014	2015
3 years accrual period with annual performance measurement and a possible change of performance parameters during this period			Payout 50% cash Vesting 50% instruments and 12 months retention	End of retention period		
			3 years accrual period with annual performance measurement and a possible change of performance parameters during this period			Payout 50% cash Vesting 50% instruments and 12 months retention

While the first example shows an approach that combines a longer accrual period with the other requirements of the CEBS Guidelines, especially with a view to the pay out requirements (deferral etc.), the approach in the second example does not. The approach in the second example considers the accrual period simultaneously as a deferral period. Beside the very clear textual distinction between these periods in CRD III and in the CEBS Guidelines, the approach unduly blends the ex ante and ex post perspectives of risk alignment. Finally the performance parameters can be changed annually during the accrual period. Thus the multi-year accrual period in fact has the character of a short term accrual period.

3.4. INSTRUMENTS

A. COMMON SHARES VS. PHANTOM SHARE PLANS

At first sight, there are no major discrepancies between the CRD III requirements and the national requirements that implemented the obligation to pay 50% or more of the variable remuneration through different types of instruments. In practice, there is tension between the legal requirement and what the institutions and supervisors considered as feasible and practical in this first cycle of CRD III implementation. However, this tension may not be so problematic because CRD III itself leaves the issue of the different types of instruments open, using in Annex V, Section 11 Directive 2006/48/EC, point 23 (o) the wording “an appropriate balance” and furthermore, the Guidelines state in paragraph 122 that only “where appropriate and applicable”, there should be a combination of different types of instruments.

A different type of tension exists between practices demonstrated by listed and non-listed companies. Although the CRD III considers shares (or equivalent ownership interests) and share-linked instruments as the first option of possible instruments to be used by listed and non-listed institutions, and equivalent non-cash instruments as an option that is restricted to non-listed institutions, there is a tendency that equivalent non-cash instruments are also used by listed companies. Some supervisors have allowed this in the course of their review of remuneration policies because of the practical problems associated with ordinary shares (or equivalent ownership interests): the administrative burden that this may imply over the years and, most importantly, the dilution effect that such pure share plans have. The company's owners may want to share the economic value of equity, but not the equity itself (and the voting rights). Especially in Continental Europe, where ownership is not so dispersed, dilution is a problem. For these reasons, institutions prefer to use performance shares or stock appreciation rights or variations of these, commonly called “phantom shares”. The advantage of using this type of scheme is that there is no dilution of the issued share capital as no share has to be transferred to the employee at the time of the exercise of the phantom share. Moreover, this scheme is more flexible and the administration cost is minimal.

Again, the tension between the CRD III literal text and this tendency may not be so problematic, because most of the institutions that, for proportionality reasons, have to obey by the “50% in instruments” requirement are often also the institutions that are publicly listed (or where the parent is publicly listed). Because listed institutions have a value readily available for the type of instruments they use, whether real shares or equivalent non-cash instruments, the goal to put Identified Staff in a kind of ownership-like position is reached and part of the variable remuneration they enjoy thus fluctuates with the long term value of the company. However, the tension becomes more problematic when, depending on how national supervisors fill in proportionality, non-listed companies have to obey the “50% in instruments” requirement. They have no value readily available and consequently have to commit a lot of resources to developing a phantom share plan compared to their listed competitors. This may be especially burdensome for firms with specific characteristics, such as cooperatives or clearing & settlement types of institutions. Supervisors have insisted on them developing a kind of phantom share plan, allowing for the specific characteristics of the institution to be filled in.

The methods used by listed companies (and mentioned in the questionnaire) are: Total Shareholders Returns, Group Economic Profits, Net Asset Value adjusted for items that do not reflect the financial performance of the bank, Return on Risk Weighted Assets. For non-listed companies, methods mentioned in the questionnaire are: average earnings over a certain reference period, cash pools, using the value of bank's certificates which can be traded and for which a value is available; if the non-listed company is a subsidiary of a listed company, the subsidiary can use the group shares or the shares of the parent company, or relate the value of its company to the shares of the parent company.

The main difficulties that are associated with setting up phantom share plans are:

- The Guidelines require that a **value is determined by a third party**: it is not clear who that third party should be and what its role exactly is: is it sufficient that the institution uses externally audited accounts? Must the third party be different from the external auditor and be appointed for the sole purpose of determining a value for the phantom share plan? Are rating agencies a “third party”? This issue is especially important because this characteristic seems to be the factor that can truly make the difference between the cash and instruments part.
- What is the meaning of “comparable features in terms of **loss absorbency capacity**” (paragraph 125 of the Guidelines) if phantom share are paid out in cash (which is allowed by the Guidelines): some supervisors have explained this requirement in the sense that the resources that are needed to pay out the phantom share plan can, if needed, be redirected to building up the capital base of the institution. However, this is only an indirect way of loss absorbency capacity;
- What types of **valuation method** should be used? Institutions sometimes present a range of possible valuation methods, with very different results. Putting a value on the phantom shares may be a very sensitive issue for institutions because this fact may become known to external parties, through disclosure requirements or other means, and may be used for other, unintended purposes, such as a sale of an ownership interest in the institution. Such unintended purposes may even have prudentially dangerous consequences;

Strong practices regarding the development of phantom share plans are:

- Use the value of **publicly listed debt instruments** as a proxy for the value of the phantom shares: this is often a solution for cooperative banks. Another alternative for cooperative banks is that they use the value of the publicly listed "central bank" above the smaller cooperative institutions as a proxy;
- Use of a **valuation method that will remain constant** over longer periods: the fact that different valuation methods lead to different results is not the core concern. As long as the method remains constant over several years, so that results become comparable, the goal of the phantom share plan is reached. The valuation must however be capable of capturing more than day-to-day operations (financial performance), i.e. also non recurring, incidental factors such as one-off impairments or other losses.

Strong practices regarding instruments in general are:

- the upside evolution of the instruments is capped in one or another way: this is also safer in terms of the amounts of cash that institutions need to accumulate in order to be able to pay out the instruments;
- determine the amount of instruments that the employee receives on the basis of the average value over a longer reference period.

Practice shows that the elements of a (phantom) share plan that are of relevance for supervisory purposes are actually quite limited; the share plans that were reviewed so far often contain numerous clauses related to events such as pension and death or the early leaving of the institution. Most of the time, the issues can be considered as belonging to the contractual freedom of the parties, unless a prudential risk is obvious (e.g. clauses where deferred parts of the phantom share plan can be paid out directly, without the initially planned deferral, in case the control over the institution changes, may be considered as prudentially unsound in certain cases). Where the Guidelines have prohibited retention bonuses, a new kind of retention mechanisms seems to emerge in (phantom) share plans: often the deferred parts are forfeited in case the employee leaves the company.

The use of share-linked instruments, such as options, is not widespread. Some supervisors have even expressed concerns about options, because the incentives this type of instrument can give to employees may still lead to excessive risk taking. A possible solution to this problem is that the exercise of the options is conditional and proportional to performance achieved over a longer reference period, e.g. in terms of Relative Total Shareholder Return and Group Economic Profits (such metrics provide for an appropriate balance between internal risk adjusted and external relative performance indicators).

B. HYBRID TIER 1 INSTRUMENTS: NO USE

There is no evidence that hybrid instruments are in use at all. The reasons behind this requirement apparently are that share-based compensation schemes should be linked to the value of a basket of securities, including common shares, preferred shares and other types of outstanding bonds, in order to eliminate incentives to take risks that are inconsistent with the goals of prudential regulation. The basket of instruments should be based on broader metrics that reflect the interests of common shareholders, as well as preferred shareholders, bondholders, and the government as guarantor of deposits. Lastly, not yet finalized developments under Basel III and CRD IV may be a reason why this type of instrument is not yet in use.

<u>3.5. DISCLOSURE</u>

The role of disclosure is particularly crucial in the case of financial institutions, given that the remuneration of certain non-executive staff may exceed that of executives. These pay schemes can in fact have a significant impact on the level of risk-taking of the institution, particularly if the interests of managers who set them are not perfectly aligned with those of shareholders.

Greater disclosure and transparency regarding directors' and employees' remuneration and the procedure through which remuneration of executives and other employees is determined can help stakeholders to assess the incentive structure and the extent to which risk-taking is being controlled. Transparency is all the more important given that guidelines on compensation still allow some flexibility in their application. Financial institutions differ in their goals, culture and business models, as well as the regulatory framework and labour markets in which they function and will therefore tailor compensation schemes to their own needs, where some flexibility is permitted. Nevertheless, effective disclosure would allow shareholders to determine whether compensation schemes are in line with their interests. It can increase monitoring by regulators and the markets, by allowing them to assess the relation between pay, risk taking and performance as well as the incentive structure in general. Moreover, transparency should facilitate the emergence of best practices and it is an area where consistency among countries could exists.

The implementation report reveals that differences exist among countries in the application of the disclosure requirements. All countries have transposed into national regulation the requirements laid down in Annex XII of the Directive on the regular, annual updates that shall be disclosed to the public regarding the remuneration policy and practices of the credit institution. Disclosure requirements relate to those categories of staff selected as Identified Staff and whose professional activities have a material impact on the risk profile of the institution. Hence, in the implementation of transparency requirements, the identification of staff is an essential starting point, as it is for most risk alignment provisions. Because of the differences (and related issues) existing in the process of identifying staff, transparency may be applied by different countries with varying degrees of intensity. In most countries, the rules on protection of confidential data still apply and allow information not to be disclosed on the grounds of confidentiality. In addition, the level of disclosure will be affected by the varying ways in which the proportionality principle (e.g. based on number of employees or total assets) is taken into account regarding disclosure on remuneration practices.

Considering current practices, it is difficult to give a more precise evaluation on the current quality of transparency on remuneration at institutions. The level of disclosure for the years 2010 and 2011, in fact, varies depending on the disclosure practices adopted by countries before the implementation of the Guidelines and the Directive's provisions. Disclosure on compensation arrangements mainly applied to board level remuneration at listed companies and in general, is not as detailed as required by the Guidelines and the directive's provisions. The opaqueness with regard to directors’ remuneration, in varying degrees of intensity, was generally motivated by confidentiality arguments and may have also been due to the different ownership structures of listed companies and the ways in which the agency costs problem is perceived in each firm or country.

In terms of policy implications, sufficient transparency and disclosure of remuneration schemes and the governance structures are first needed to assess pay scales and incentive structure in a company. Detailed information on remuneration packages, policies and procedures allows the market to review the board’s action in this area and react to any abuse. At the same time, exposure to public scrutiny encourages the board of directors to take greater care in setting executive remuneration. An ongoing and open dialogue between financial institutions and regulators will facilitate the development of practices that address both financial stability concerns and the institutions' need for competitive pay schemes.