



10 December 2010

## Guidelines on Remuneration Policies and Practices

Introduction .....	6
1. Legislative basis and international context .....	6
2. Structure and goal of the guidelines .....	9
3. Implementation date .....	11
1. Outlines .....	12
1.1. Scope of the guidelines .....	12
1.1.1. Which remuneration? .....	13
1.1.2. Which institutions? .....	14
1.1.3. Which staff to be identified? .....	15
1.2. Proportionality .....	17
1.2.1. Proportionality in general .....	18
1.2.2. Proportionality among institutions .....	20
1.2.3. Proportionality among categories of staff .....	21
1.3. Group Context .....	22
Guidelines for institutions .....	22
Guidelines for Supervisors .....	23
1.4. Measures .....	24
1.4.1. Possible measures for breach of remuneration requirements .....	24
1.4.2. Capital base .....	25
1.4.3. State support and remuneration .....	27
2. Governance of remuneration .....	28
2.1. Management body .....	28
Guidelines for institutions .....	28
2.1.1. Design, approval and oversight of the remuneration policy .....	28
2.1.2. Remuneration of members of the management and supervisory function .....	29
2.1.3. Shareholders' involvement .....	30
2.1.4. Review of the remuneration policy .....	30
2.2. Remuneration Committee .....	31

Guidelines for institutions.....	31
2.2.1. Setting up a remuneration committee.....	31
2.2.2. Composition.....	32
2.2.3. Role .....	32
2.2.4. Process and reporting lines .....	33
2.3. Control functions .....	33
Guidelines for institutions.....	34
2.3.1. Definition and roles.....	34
2.3.2. Independence and appropriate authority.....	35
2.3.3. Remuneration of control functions.....	35
Guidelines to Supervisors.....	36
3. General requirements on risk alignment .....	37
3.1. The basic principle of risk alignment.....	37
Guidelines for institutions.....	38
3.1.1. The general remuneration policy, including the pension policy .....	38
3.1.2. Discretionary pension benefits.....	40
Guidelines for supervisors.....	40
3.2. General prohibitions.....	41
Guidelines for institutions.....	41
3.2.1. Guaranteed variable remuneration .....	41
3.2.2. Severance pay.....	41
3.2.3. Personal hedging .....	42
Guidelines for supervisors.....	43
4. Specific requirements on risk alignment .....	44
4.1. Fixed versus variable remuneration.....	44
Guidelines for institutions.....	44
4.1.1. Fully flexible policy on variable remuneration .....	44
4.1.2. Ratio between fixed and variable remuneration.....	45
Guidelines for supervisors.....	47
4.2. Risk alignment of variable remuneration .....	47

Guidelines for institutions.....	47
4.2.1. Risk alignment process .....	47
4.2.2. Common requirements for the risk alignment process .....	49
a. Time horizon.....	49
b. Levels of risk and performance measurement.....	50
c. Quantitative and qualitative measures .....	50
d. Judgmental measures.....	51
4.2.3. Risk measurement .....	51
4.2.4. Performance measurement .....	52
a. Qualitative/Quantitative measures.....	52
b. Relative/absolute and internal/external measures .....	53
Guidelines for supervisors .....	54
4.3. Award process .....	54
Guidelines for institutions.....	54
4.3.1. Setting and allocation of pools .....	54
4.3.2. The risk adjustment in the award process .....	56
a. Quantitative ex ante risk adjustment.....	57
b. Qualitative measures for ex-ante risk adjustment.....	58
Guidelines for supervisors .....	58
4.4. Payout process.....	59
Guidelines for institutions.....	59
4.4.1. Non-deferred and deferred remuneration.....	59
a. Time horizon and vesting.....	60
b. Vesting process .....	60
c. Proportion to be deferred .....	60
d. Time span between end of accrual and vesting of deferred amount....	60
4.4.2. Cash vs. instruments.....	61
a. Types of instruments .....	62

b. Retention policy .....	64
c. Minimum portion of instruments and their distribution over time .....	65
4.4.3. Ex post incorporation of risk for variable remuneration .....	66
a. Explicit ex-post risk adjustments .....	66
b. Implicit adjustments .....	68
c. Possibility of upward revisions.....	68
Guidelines for supervisors .....	69
5. Disclosure .....	70
Guidelines for institutions.....	70
5.1. Pillar 3 external disclosure .....	70
5.1.1. Specific and general requirements on disclosure .....	71
5.1.2. Policy and practices .....	72
5.1.3. Aggregate quantitative information .....	73
5.2. Internal disclosure .....	74
Guidelines for supervisors .....	74
Annex 1 - Concepts .....	76
Annex 2 - Mapping of the remuneration principles included in the CRD .....	77
Annex 3 - Schematic overview of some deferral mechanisms .....	85

## INTRODUCTION

### 1. Legislative basis and international context

*Recital (1) CRD III*<sup>1</sup> Excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally. While the causes of such risk-taking are many and complex, there is agreement by supervisors and regulatory bodies, including the G-20 and the Committee of European Banking Supervisors (CEBS), that the inappropriate remuneration structures of some financial institutions have been a contributory factor. Remuneration policies which give incentives to take risks that exceed the general level of risk tolerated by the institution can undermine sound and effective risk management and exacerbate excessive risk-taking behaviour. The internationally agreed and endorsed Financial Stability Board (FSB) Principles for Sound Compensation Practices (the FSB principles) are therefore of particular importance.

*Recital (2) CRD III* Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions requires credit institutions to have arrangements, strategies, processes and mechanisms to manage the risks to which they are exposed. By virtue of Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions, that requirement applies to investment firms within the meaning of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments. Directive 2006/48/EC requires competent authorities to review those arrangements, strategies, processes and mechanisms, and to determine whether the own funds held by the credit institution or investment firm concerned ensure a sound management and coverage of the risks to which the institution or firm is or might be exposed. That supervision is carried out on a consolidated basis in relation to banking groups, and includes financial holding companies and affiliated financial institutions in all jurisdictions.

*Recital (13) CRD III* The principles regarding sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector are consistent with and complement the principles set out in this Directive.

*Recital (14) CRD III* The provisions on remuneration should be without prejudice to the full exercise of fundamental rights guaranteed by the Treaties, in

---

<sup>1</sup> Directive 2010/.../EU of the European Parliament and of the Council of ... 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, not yet published in the Official Journal.) All text fragments in this and other grey boxes are based on PE-CONS 35/10 of 30 September 2010, as published on the website of the Council of the European Union, <http://register.consilium.europa.eu/pdf/en/10/pe00/pe00035.en10.pdf> .

particular Article 153(5) of the Treaty on the Functioning of the European Union (TFEU), general principles of national contract and labour law, legislation regarding shareholders' rights and involvement and the general responsibilities of the administrative and supervisory bodies of the institution concerned, as well as the rights, where applicable, of the social partners to conclude and enforce collective agreements, in accordance with national law and customs.

*Recital (19) CRD III* In order to promote supervisory convergences in the assessment of remuneration policies and practices, and to facilitate information collection and the consistent implementation of the remuneration principles in the banking sector, CEBS should elaborate guidelines on sound remuneration policies in the banking sector. The Committee of European Securities Regulators should assist in the elaboration of such guidelines to the extent that they also apply to remuneration policies for persons involved in the provision of investment services and carrying out of investment activities by credit institutions and investment firms within the meaning of Directive 2004/39/EC. CEBS should conduct open public consultations regarding the technical standards and analyse the potentially related costs and benefits. The Commission should be able to make legislative proposals entrusting the European supervisory authority dealing with banking matters and, to the extent it is appropriate, the European supervisory authority dealing with markets and securities matters, as established pursuant to the *de Larosière* process on financial supervision, with the elaboration of draft technical regulatory and implementing standards to facilitate information collection and the consistent implementation of the remuneration principles in the banking sector to be adopted by the Commission.

*Art. 22 Directive 2006/48/EC, paragraph 4* The Committee of European Banking Supervisors shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in points 23 and 24 of Annex V. The guidelines shall take into account the principles on sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector.

1. On 20 April 2009, CEBS published a set of 'High-level Principles for Remuneration Policies (Rem. HLP)'<sup>2</sup>; the principles were intended to assist in remedying unsound remuneration policies. Whilst institutions' remuneration policies were not the direct cause of this crisis, their drawbacks, nonetheless, contributed to its gravity and scale. It was generally recognized that excessive remuneration in the financial sector fuelled a risk appetite that was disproportionate to the loss-absorption capacity of institutions and of the financial sector as a whole. In drafting the Rem. HLP, CEBS cooperated closely with other bodies working on remuneration, in particular, the Financial Stability Board (FSB) - which released on 2 April 2009 its 'Nine principles for the

---

<sup>2</sup> Available at <http://www.c-eps.org/Publications/Standards-Guidelines.aspx>

achievement of sound compensation practices'<sup>3</sup> and the European Commission, which has set out principles on sound remuneration policies in the financial services sector in its Recommendation of 30 April 2009<sup>4</sup>.

2. Since April 2009, international supervisory work on remuneration has been unremitting. On 25 September 2009, the FSB released a set of standards designed to support the implementation of its earlier principles<sup>5</sup>. In January 2010, the Basel Committee on Banking Supervision (BCBS) published an 'Assessment Methodology' to guide supervisors in reviewing individual institutions' remuneration practices and assessing their compliance with the FSB principles and standards<sup>6</sup>. In October 2010, the BCBS also released a consultation report on the range of methodologies for risk and the performance alignment of compensation<sup>7</sup>, following a recommendation in the FSB 'Peer Review on Compensation'<sup>8</sup> that called for further progress in these technical areas. This report was taken into account while formulating these guidelines.

3. At the European level, the European Commission adopted in July 2009 a proposal (CRD III) to further amend the Capital Requirements Directive (CRD), addressing *inter alia* remuneration policies. On 7 July 2010, the European Parliament voted and approved CRD III. The Council approved CRD III at its meeting of 11 October 2010. Member States are to implement this Directive from 1 January 2011. The CRD III requires CEBS to issue guidelines on sound remuneration policies which comply with the principles included in the amended

---

<sup>3</sup> Financial Stability Forum, Principles for Sound Compensation Practices, 2 April 2009, available at [http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf)

<sup>4</sup> Available at [http://ec.europa.eu/internal\\_market/company/docs/directors-remun/financialsector\\_290409\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf)

<sup>5</sup> Financial Stability Board Principles for Sound Compensation Practices - Implementation Standards, 25 September 2009, available at [http://www.financialstabilityboard.org/publications/r\\_090925c.pdf](http://www.financialstabilityboard.org/publications/r_090925c.pdf)

<sup>6</sup> Basel Committee on Banking Supervision, Compensation Principles and Standards Assessment Methodology, January 2010, available at <http://www.bis.org/publ/bcbs166.htm>

<sup>7</sup> Basel Committee on Banking Supervision, Consultation Report on the Range of Methodologies for Risk and Performance Alignment of Remuneration, 14 October 2010, available at <http://www.bis.org/publ/bcbs178.pdf>.

<sup>8</sup> Financial Stability Board, *Thematic Review on Compensation - Peer Review Report* (30 March 2010).



Annex V of CRD<sup>9</sup> - to achieve this, CEBS has to work in close cooperation with CESR. To prepare for the guidelines, CEBS undertook in the course of Q 4 2009 and Q 1 2010 an extensive implementation study regarding the national implementation of the Rem. HLP by supervisors on the one hand and institutions on the other. The main findings of this study were published on 11 June 2010<sup>10</sup> and were used as input for the guidelines in this document.

The position used by CEBS in these guidelines is that remuneration policies and practices in the financial sector should be sound from a prudential perspective. CESR, from its part, intends to issue future guidance on the investor protection perspective for remuneration policies and practices.

## 2. Structure and goal of the guidelines

4. Article 22 of the CRD, as amended by CRD III, lays down the fundamental principle for institutions to ensure that their remuneration policies and practices are consistent with and promote sound and effective risk management. This particular article in the CRD indicates that remuneration policies and practices form part of institutions' overarching obligation to have robust governance arrangements in place; the basis for all other Pillar II requirements. The further remuneration requirements of CRD III are included in Annex V, Section 11 and Annex XII, Part 2, point 15 of the CRD. Considered together, the remuneration requirements in the annexes are divisible into three blocks: governance (Annex V), risk alignment (Annex V) and transparency (Annex XII). Proportionality, as explained further in these guidelines (from paragraph 19), is relevant for all three blocks.

5. To deliver effective and meaningful implementation of the above-mentioned requirement to have remuneration policies and practices that are consistent with and promote sound and effective risk management, institutions will, in many cases, have to apply requirements included in the Annexes of the CRD on an institution-wide basis. This is particularly true for those principles regarding governance and transparency, which are described as "essential for sound remuneration policies" in Recital (21) to CRD III.

- The governance requirements are by nature directed to the institution as a whole; they are, in essence, supporting measures to Article 22 of the CRD

---

<sup>9</sup> CEBS has decided to provide also level 3 guidance with regard to the transparency and disclosure requirements relating to remuneration, included in Annex XII of the CRD.

<sup>10</sup> Available at <http://www.c-eps.org/News--Communications/Latest-news/CEBS-today-publishes-its-report-on-national-implem.aspx>

obligations and complement the more general governance principles and standards developed at national and international levels<sup>11</sup>.

- In order to apply the disclosure requirements on an institution-wide basis, institutions will need to disclose general information on their overall remuneration policies and practices, compared to the detailed information they need to give on the basis of Annex XII for the Identified Staff (see next paragraph).

6. In addition to the governance and disclosure requirements, an institution-wide application is further required only for some of the principles that fall under the "risk alignment" block. For the other principles in this block, institutions must identify the staff members to whom the specific requirements will apply. Both Annex V and Annex XII of the CRD contain a reference to the categories of staff "whose professional activities have a material impact on the risk profile" of the institution (hereafter the "Identified Staff").

Therefore, the block on risk alignment is broken down into two types of requirements:

- the general requirements, that should apply to institutions and their staff as a whole (i.e. Principles (a), (b) and (r)<sup>12</sup> of Annex V, and (j), (m) and (s)<sup>13</sup> of Annex V that CEBS considers as essential correlates of (a), (b) and (r); these requirements are treated in these guidelines from paragraphs 65 to 75);

---

<sup>11</sup> See the upcoming CEBS's Internal Governance Guidebook, to be published in the spring of 2011.

<sup>12</sup> (a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution; (b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, [...]; (r) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution. [...]

<sup>13</sup> (j) guaranteed variable remuneration is exceptional and occurs only in the context of hiring new staff and is limited to the first year of employment; (m) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure; (s) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

- the specific requirements, that institutions have to apply only to the individual remuneration packages of the Identified Staff<sup>14</sup> (these requirements are treated in these guidelines from paragraphs 76 to 145).

7. In order to comply with the general requirements on risk alignment, institutions may always consider an institution-wide application (or, at least, a broader than strictly necessary application) of all or some of the specific requirements. Annex 2 to these guidelines indicates the specific requirements for which this voluntary institution-wide application is strongly recommended.

8. For every principle, guidance is given for both institutions and supervisors. This is meant to ensure that the new risk-related philosophy on remuneration in the financial sector is swiftly translated into action. The guidelines must also ensure that a level playing field is preserved amongst institutions, especially with a view to keeping claims on proportionality - both from supervisors and institutions - credible, effective and fair. Finally, these guidelines not only address high-level remuneration policies in institutions, but also the day-to-day practices of remuneration decisions and procedures through which the policy is implemented, otherwise, effective oversight (as part of the SRP or other supervisory methodologies) can not be achieved.

9. The assessment methodologies of supervisors may be constituted by both on-site and off-site controls, examination of information and data and meetings with institutions' representatives (i.e. dedicated meetings with the significant institutions' senior management in order to collect additional information and data on remuneration policies, pay-structure and governance; individual interviews to identify/address the potential implementation gaps and/or non-compliant practices). Supervisors should apply risk-based supervision; resources of supervisors should be directed primarily to those institutions that pose most risks.

### 3. Implementation date

*Recital (22) CRD III* In order to guarantee their full effectiveness and in order to avoid any discriminatory effect in their application, the provisions on remuneration laid down in this Directive should be applied to remuneration due on the basis of contracts concluded before the date of their effective implementation in each Member State and awarded or paid after that date. Moreover, in order to safeguard the objectives pursued by this Directive, especially effective risk management, in respect of periods still characterised by a high degree of financial instability, and in order to avoid any risk of circumvention of the provisions on remuneration laid down in this Directive during the

<sup>14</sup> In Annex 2, a list of *inter alia* the general and specific risk alignment principles is included.

period prior to their implementation, it is necessary to apply those provisions to remuneration awarded, but not yet paid, before the date of their effective implementation in each Member State, for services provided in 2010.

*Article 3 CRD III* 1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with: (a) points 3, 4, 16 and 17 of Article 1 and points 1, 2(c), 3 and 5(b)(iii) of Annex I, by 1 January 2011; and (b) [...] 2. The laws, regulations and administrative provisions necessary to comply with point 1 of Annex I shall require credit institutions to apply the principles laid down therein to: (i) remuneration due on basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date; and (ii) for services provided in 2010, remuneration awarded, but not yet paid, before the date of effective implementation in each Member State.

10. These guidelines should be implemented within the same timeline as the CRD III requirements. Institutions are called to undertake urgent actions to immediately start the process for the adoption of the Guidelines, acknowledging that some steps in this process may take time (e.g. shareholders' approval, where required; amendments to existing private and collective agreements). CEBS/EBA will monitor and review the implementation of these guidelines in order to facilitate a convergent application throughout the EU.

## 1. OUTLINES

### 1.1. Scope of the guidelines

*Recital (3) CRD III* In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, the requirements of Directive 2006/48/EC should be supplemented by an express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management. Those categories of staff should include at least senior management, risk takers, staff engaged in control functions and any employee whose total remuneration, including discretionary pension benefit provisions, takes them into the same remuneration bracket as senior management and risk takers.

*Recital (4) CRD III* Because excessive and imprudent risk-taking may undermine the financial soundness of credit institutions or investment firms and destabilise the banking system, it is important that the new obligation concerning remuneration policies and practices should be implemented in a consistent manner and should cover all aspects of remuneration including salaries, discretionary pension benefits and any similar benefits. In that context, discretionary pension benefits should mean discretionary payments granted by a credit institution or investment firm to an employee on an individual basis payable by reference to or expectation of retirement and which can be assimilated to variable remuneration. [...] The principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities

and, in particular, that it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC to comply with all of the principles. [...]

*Article 22 Directive 2006/48/EC* 1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management.

*Article 34 Directive 2006/49/EC* Competent authorities shall require that every investment firm, as well as meeting the requirements set out in Article 13 of Directive 2004/39/EC, shall meet the requirements set out in Articles 22 and 123 of Directive 2006/48/EC, subject to the provisions on level of application set out in Articles 68 to 73 of that Directive.

*Annex V, Section 11 Directive 2006/48/EC* Point 23. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles [...]: [...]

*Annex V, Section 11 Directive 2006/48/EC, point 23* (t) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive; [...]

### 1.1.1. Which remuneration?

11. For the purposes of the guidelines, remuneration consists of all forms of payments or benefits made directly by, or indirectly, but on behalf of<sup>15</sup>, institutions within scope, in exchange for professional services rendered by staff. All remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions, remuneration by third parties e.g. through carried interest models)

---

<sup>15</sup> Remuneration, for example, also includes consideration paid on behalf of a parent or other related companies of the institution in respect of the staff of the institutions within scope.

or non (directly) monetary benefits (such as health insurance, discounts, fringe benefits or special allowances for car, mobile phone, etc.). Ancillary payments or benefits that are part of a general, non-discretionary, institution-wide policy and pose no incentive effects in terms of risk assumption can be waived under this definition of remuneration for the purposes of the CRD specific risk alignment remuneration requirements.

12. A "retention bonus" is a form of variable remuneration and can only be allowed to the extent that risk alignment requirements are properly applied.

13. Institutions should ensure that variable remuneration is not paid through vehicles or that methods are employed which aim at artificially evading the requirements of the CRD III. The management body of each institution and of the parent company has the primary responsibility for ensuring that the ultimate goal of having sound and prudent remuneration policies and structures is not improperly circumvented both at individual and group-wide levels. Supervisors, in carrying out the Supervisory Review Process (SRP), should also devote adequate attention to this issue. Circumstances and situations that may pose a greater risk under this perspective may be: the conversion of parts of the variable remuneration into benefits that normally pose no incentive effect in respect of risk positions; the outsourcing of professional services to firms that fall outside the scope of the CRD III, or the use of off-shore centres (see also the Group Section); the use of tied agents or other figures not considered "employees" from a legal point of view; transactions between the institutions and third parties in which the risk takers have material interests; the setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay outs (e.g. improper use of carried interest models) and non-monetary material benefits awarded as incentive mechanisms linked to the performance.

#### 1.1.2. Which institutions?

14. The CRD III remuneration requirements apply to all institutions which are already currently covered by the CRD. These are:

- *Credit institutions* as defined under Article 4(1) of Directive 2006/48/EC;
- *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)).

Institutions which can benefit from the exemptions foreseen in Articles 2 or 3 of MiFID are not investment firms subject to that Directive and thus are not currently covered by the CRD.

Recital 4 of CRD III recognizes that "it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC to comply with all the principles" relating to remuneration policies and practices. Such institutions, for example those that are not authorised to provide the investment services listed in points 3 (dealing on own account) and 6 (underwriting and/or placing of financial instruments on a firm commitment basis) of Section A of Annex I of MiFID<sup>16</sup>, should be subject to a more proportionate regime, as they typically present a lower prudential risk profile (see further paragraph 20).

In the context of these guidelines, unless they are explicitly mentioned, credit institutions and investment firms are referred to as "institutions".

### 1.1.3. Which staff to be identified?

15. It is primarily the responsibility of institutions to identify the members of staff whose professional activities have a material impact on the institution's risk profile and to whom the specific requirements of these guidelines will apply, according to these guidelines and any other guidance or criteria provided by supervisors. Institutions must be able to demonstrate to supervisors how they have assessed and selected Identified Staff.

16. The following categories of staff, unless it is demonstrated that they have no material impact on the institution's risk profile, must be included as the Identified Staff:

- *Executive members of the credit institution or investment firms' corporate bodies, depending on the local legal structure of the institution, such as: directors, the chief executive officer, and also the chairman of the management body if he/she is an executive*<sup>17</sup>.
- *Senior Management responsible for day-to-day management, such as: the members of the management committee not included in the category above; all the individuals who directly report to an institution's corporate bodies; all the individuals responsible for heading significant business lines (including those responsible for heading regional areas) such as trading, equities, fixed interest, foreign exchange, commodities, derivatives, sales, capital markets, securitisation, investment banking, credit, asset management and corporate finance.*

---

<sup>16</sup> See Article 20(2) of Directive 2006/49/EC.

<sup>17</sup> Requirements for the remuneration of non-executives / independents members of the management body are included in paragraphs 46-47 (governance section).

- *Staff responsible for independent control functions*, such as: senior staff responsible for heading the compliance, risk management, human resources<sup>18</sup>, internal audit and similar functions (e.g. the CFO). These staff members will have remuneration requirements that are specific to their category of staff.
- *Other risk takers* such as: staff members, whose professional activities – either individually or collectively, as members of a group (e.g. a unit or part of a department) – can exert influence on the institution’s risk profile, including persons capable of entering into contracts/positions and taking decisions that affect the risk positions of the institution. Such staff can include, for instance, individual traders, specific trading desks and credit officers.

When assessing the materiality of influence on an institution’s risk profile, institutions must define what constitutes materiality within the context of their institution. Criteria that institutions may follow to check whether they are capturing the correct staff members include an assessment of:

- staff with the highest proportion of variable to fixed remuneration;
- staff earning above a certain absolute threshold of total remuneration,
- staff members or a group, whose activities could potentially have a significant impact on the institution’s results and/or balance sheet.

An analysis of job functions and responsibilities at the institution should be undertaken for a proper assessment of those roles that could materially affect the institution’s risk profile. There could be cases where a staff member does not earn a high amount of total remuneration but could have a material impact on the institution’s risk profile given the individual’s particular job function or responsibilities.

Additionally, if they have a material impact on the institution's risk profile, *other employees/persons, whose total remuneration takes them into the same remuneration bracket as senior managers and risk takers* must be included as the Identified Staff, such as: high-earning staff members who are not

---

<sup>18</sup> See footnote no. 22.



already in the above categories and who have a material impact on the risk profile of the institution. 'Remuneration bracket' refers to the range of the total remuneration of each of the staff members in the senior manager and risk taker categories – from the highest paid to the lowest paid in these categories. Any staff member, whose total remuneration would fall within that range, should be assessed. It is likely that in some cases, those staff members whose remuneration is as high as or higher than senior executives and risk takers will be exerting material influence on the institution's risk profile in some way. In other situations, this may not be the case.

17. Consideration must also be given to the position of individual sole traders and partnerships and, in certain cases, depending on the legal structure of the institution or entity, some of the remuneration requirements may not be applicable to staff at such ownerships or partnerships. Dividends that partners receive as owners of an institution are not covered by these guidelines (unless they represent a vehicle or method for circumvention); however, any imprudent extraction of capital out of the institution through pay outs of dividends would be covered by normal capital adequacy rules under Pillars 1 and 2.

18. The examples mentioned in paragraph 16 are not conclusive. The greater the assumption that there may be risk-takers in certain business units, the more in-depth must be the risk analysis to assess whether a person is to be considered a material risk-taker or not.

## 1.2. Proportionality

*Recital (4) CRD III* [...] The principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities [...]

*Article 22 Directive 2006/48/EC* 1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management.

*Article 22 Directive 2006/48/EC* 2. [...] the arrangements, processes and mechanisms referred to in paragraph 1 shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities.

*Annex V, Section 11, Directive 2006/48/EC* 23. When establishing and applying the total remuneration policies, [...] credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and complexity of their activities: [...]

*Annex XII, Part 2, Directive 2006/48/EC* 15. The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices [...]: [...].Credit institutions shall comply with the requirements set out in this point in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities [...]

### 1.2.1. Proportionality in general

19. The proportionality principle aims to consistently match the remuneration policies and practices with the individual risk profile, risk appetite and the strategy of the institution, so that the objectives of the principles are more effectively achieved.<sup>19</sup> The proportionality principle applies to the general as well as to the specific requirements of the CRD III. The effect of the proportionality principle is that not all institutions have to give substance to the remuneration requirements in the same way and to the same extent. Proportionality operates both ways: some institutions will need to apply more sophisticated policies or practices in fulfilling the requirements; other institutions can meet the requirements of the CRD in a simpler or less burdensome way.

CRD III sets some specific numerical criteria. These are:

- the minimum deferral period of three to five years, as further explained in paragraph 116;
- the minimum portion of 40 to 60 % of variable remuneration that should be deferred, as further explained in paragraph 119;
- the minimum portion of 50 % of variable remuneration that should be paid in instruments, as further explained in paragraph 133.

Because these criteria refer to minima, it is not possible to apply, within an institution, lower criteria based on proportionality.

20. The application of the proportionality principle may lead however to the neutralization of some requirements<sup>20</sup> if this is reconcilable with the risk profile, risk appetite and the strategy of the institution. These guidelines set the limits on which requirements can potentially become neutralised. If institutions deem neutralization for these requirements appropriate for their type of institution or Identified Staff, they should be able to explain the rationale for every single

---

<sup>19</sup> Recitals 4, 5 and 9 of the CRD III and point 24 of Annex V, Section 11 of CRD are examples of requirements in which the proportionality principle is explicitly referred to.

<sup>20</sup> For those requirements that possibly can become neutralized because of proportionality, this is indicated so in Annex 2 to these guidelines.

requirement that can potentially become neutralised. Neutralization is never automatically triggered on the basis of these guidelines alone.

Neutralization can be applied to:

- the requirements on the pay-out process, discussed under section 4.4., starting from paragraph 114. This kind of neutralization can be based on either "proportionality between institutions" (as explained in 1.2.2. below) or "proportionality between categories of staff" (as explained in 1.2.3. below). This means that some institutions, either for the total of their Identified Staff or for some categories within their Identified Staff, can put aside the requirements on
  - variable remuneration in instruments;
  - retention;
  - deferral;
  - ex post incorporation of risk for variable remuneration.
- the requirement to establish a remuneration committee (hereafter 'Rem Co'), as discussed from paragraph 52 of these guidelines.

In addition, for the types of investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC, as described in paragraph 14 of these guidelines, neutralization can also be applied to the requirement on the ratio between fixed and variable remuneration, discussed under section 4.1.2 of the guidelines. For the requirement on a multi-year framework (see section 4.2.2.a), in particular the accrual and ex-ante risk adjustment aspects of it, these investment firms can take into account the specific features of their types of activities.

Neutralization can also be applied if the activities are organised as a business line within an institution rather than as a separate legal entity.

21. As it is laid down both in the recitals and in the provisions of the CRD III, the notion of proportionality must be taken into account by both institutions, when implementing the remuneration requirements, and by supervisors, when carrying out supervision over remuneration policies and practices. It is primarily the responsibility of the institution to assess its own characteristics and to develop and implement remuneration policies and practices which appropriately align the risks faced and provide adequate and effective incentives to its staff.

22. Whilst each institution has the duty to properly assess its own risk profile, risk appetite and other characteristics in the design and implementation of the remuneration policy, supervisors should ensure that the application of the proportionality approach by institution does not prejudice the achievement of the objectives of the remuneration principles and the need to preserve a level

playing field among different institutions and jurisdictions. From this perspective, supervisors should review the ways institutions actually implement the proportionality principle, thereby taking into account the overall financial market characteristics and the achievement of regulatory objectives.

23. With specific regard to the remuneration requirements, the CRD III distinguishes between two dimensions of proportionality: proportionality among different types of institutions and proportionality among an institution's different categories of staff whose professional activities have a material impact on its risk profile (Identified Staff). The first form of proportionality is relevant for both the general and specific requirements on remuneration. The latter form of proportionality is only relevant for the specific requirements on risk alignment.

#### 1.2.2. Proportionality among institutions

24. The different risk profiles and characteristics among institutions (e.g. complex and/or international institutions on the one hand and less complex and/or local on the other hand) justify a proportionate implementation of the remuneration principles. According to the CRD III, criteria addressing the application of the proportionality principle among institutions are the size, internal organization and the nature, scope and complexity of their activities.

- The size criterion can relate to the value of assets; liabilities or risks exposure; level of capital; as well as the number of staff or branches of an institution. The size of an institution alone is not a relevant criterion for the application of the proportionality principle. An institution might be considered "small" in terms of number of staff or branches, but be engaged in a high level of risk taking. Strict adherence to the specific requirements shall also be required where:
  - an entity within a large international financial conglomerate is small but significant in the country where it is located; or
  - the aggregate set of group entities - each of them considered "small"
  - accounts for a large portion of the whole financial system (e.g. in terms of total assets).

As already mentioned, the general obligation to have sound remuneration policies and practices applies to *all* credit institutions and investment firms, regardless of their size or systemically importance.

- The internal organization can relate to the legal structure; the listing on regulated markets; the authorization to use internal/advanced methods for the measurement of capital requirements (e.g. IRB, AMA methods); or the corporate goals (e.g. non-profit oriented co-operatives vs. profit oriented institutions).

- In considering the nature, scope and complexity of the business activities, the underlying risk profiles of the business activities that are carried out, must be taken into account. Relevant elements can be: the type of authorized activity (saving banks, investment banking); the type of clients (retail, corporate, small businesses); the portion of the riskier activities or clients on the total of activities or clients; the national or international nature of the business activities (active in only one or more jurisdictions); the nature, stability, measurability and predictability of the risks of the business activities; the frequency, time horizon and significance of the risks; the complexity of the products or contracts (e.g. options, guarantees or structured products).

25. In assessing what is proportionate, the focus should be on the combination of all the mentioned criteria (size, internal organization and the nature, scope and complexity of the activities) and, as this is not an exhaustive list, of possible other criteria. For instance, a business may well be small-scale but could still include complex risk-profiles because of the nature of its activities or the complexity of its products. Or an institution may have a cooperative legal structure, but still be 'large' in terms of assets, scope or activity.

#### 1.2.3. Proportionality among categories of staff

26. The proportionality principle also operates within an institution for some of the specific requirements. The categories of staff whose professional activities have a material impact on their risk profile should comply with specific requirements which aim to manage the risks their activities entail. The same criteria of size, internal organisation and the nature, scope and complexity of the activities apply. In addition to the elements mentioned above, the following elements could be taken into account:

- The degree of seniority;
- The size of the obligations into which a risk taker may enter on behalf of the institution;
- The size of the group of persons, who have only collectively (see *supra*) a material impact on the risk profile of the institution;
- The business model of the line of business of the staff members (e.g. fixed salary with a variable remuneration vs. profit sharing arrangements);
- The ratio variable/fixed payment and/or in combination with the total amount of remuneration.

### 1.3. Group Context

*Annex V, Section 11 Directive 2006/48/EC, point 23* (t) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive.

The principles set out in this point shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

#### Guidelines for institutions

27. Remuneration policies should apply to all firms within an EEA consolidation group (the scope of consolidated supervision is set out in the CRD) in addition to being applied on a solo basis (which includes branches). To this end, the parent institution should ensure that the requirements, including the process for determining the Identified Staff, of a group-wide remuneration policy are coherently observed at group and subsidiary level (including non-EEA subsidiaries). The EU parent institution has a top-down influence, but subsidiaries might have local responsibilities in the implementation of remuneration policies. Any group-wide remuneration policy should take into account local regulations (e.g. fiscal or employment legislation) in the jurisdiction in which the institution's subsidiaries operate. It is the subsidiary's primary responsibility to ensure compliance with specific local requirements. Differences in remuneration policies and practices, including with regard to neutralization, may also be observed where the subsidiary is operating a different business model from that of the parent institution. The effects of differences in management structures, such as cross-border matrix reporting lines, should also be considered within group-wide policies to ensure that there is a consistent application of remuneration principles.

28. As mentioned above, the remuneration policies and practices should apply to any subsidiary of an EEA parent institution that is located offshore, including in a non-EEA jurisdiction, but proportionality remains valid also in this context. Institutions should however not be able to create special group structures or offshore entities in order to circumvent the application of the remuneration policies to staff to which the remuneration principles should otherwise apply. In other words, staff will not be able to bypass the remuneration requirements by becoming employees of an offshore or non-regulated entity of the group while still performing services/duties for EU-based institutions. Likewise, the remuneration policies of any subsidiary should take into account the nature, scale and complexity of the activities of the subsidiary along with the level and types of staff members working at that subsidiary. If the subsidiary poses a higher risk to the EEA parent institution, then more robust remuneration policies and practices should be required for either or both of the entities.

29. Where the EEA subsidiary is part of a wider non-EEA group, the remuneration policies would apply at the solo or EEA-based level. The solo entity might need to ensure that the group-wide remuneration policies were taken into consideration within its own remuneration policies as far as in line with CRD III and these guidelines.

For the purposes of a level playing field, the guidelines should be applied to the remuneration of the staff of non-EEA branches of third country parent companies, operating within EEA Member States.

Additionally, where staff members are formally employed by a parent company based in a non-EEA jurisdiction, but perform duties/services for an EEA-based institution, then the remuneration requirements of the EEA jurisdiction where the staff member is actually working should be followed for the remuneration paid to these staff members.

30. Where groups carry on activities that fall outside the scope of the CRD, consideration should be given to any applicable sectoral remuneration requirements that might apply to determine how these are to be reconciled with the group-wide remuneration policy. For example, where a group contains sectors regulated under different directives (e.g. insurance and banking), appropriate requirements should be taken into account when applying remuneration policies and practices for each type of sector. The group parent institution should oversee the remuneration policies, practices and procedures for each type of sector within its group and should ensure that each sectoral institution complies with its particular set of regulation.

#### Guidelines for Supervisors

31. Supervisory colleges should discuss remuneration issues and assess alignment between home/host supervisory requirements of remuneration policies and practices. Concrete topics for discussion might include an assessment of:

- the remuneration policy at group level;
- differences of remuneration regulations in different jurisdictions;
- the influence of the parent on the subsidiary with regard to the development and application of remuneration policies;
- subsidiary responsibilities with regard to remuneration policies and practices;
- the interaction between the group Rem Co and (if established) subsidiary 's Rem Co;
- compliance with the remuneration principles by all entities within the group;

- application of remuneration policies within matrix management structures; and
- consistency within the group for the purposes of the determination of Identified Staff and the application of neutralization.

32. Supervisors should assess whether the groups ensure that each subsidiary complies with all national remuneration laws and requirements of the jurisdiction where the subsidiary operates.

Supervisors should ensure that groups do not circumvent the remuneration principles irrespective of their group structures (see also paragraph 13).

Unless there are relevant differences in the risk profiles that justify a difference in treatment in individual cases, supervisors should expect group-wide policies to be applied by each subsidiary.

## 1.4. Measures

### 1.4.1. Possible measures for breach of remuneration requirements

*Recital (15) CRD III* In order to ensure fast and effective enforcement, the competent authorities should also have the power to impose or apply financial or non-financial penalties or other measures for breach of a requirement under Directive 2006/48/EC, including the requirement to have remuneration policies that are consistent with sound and effective risk management. Those measures and penalties should be effective, proportionate and dissuasive. [...]

*Recital (16) CRD III* In order to ensure effective supervisory oversight of the risks posed by inappropriate remuneration structures, the remuneration policies and practices adopted by credit institutions and investment firms should be included in the scope of supervisory review under Directive 2006/48/EC. In the course of that review, supervisors should assess whether those policies and practices are likely to encourage excessive risk-taking by the staff in question. [...]

*Recital (20) CRD III* Since poorly designed remuneration policies and incentive schemes are capable of increasing to an unacceptable extent the risks to which credit institutions and investment firms are exposed, prompt remedial action and, if necessary, appropriate corrective measures should be taken. Consequently, it is appropriate to ensure that competent authorities have the power to impose qualitative or quantitative measures on the relevant entities that are designed to address problems that have been identified in relation to remuneration policies in the Pillar 2 supervisory review. Qualitative measures available to the competent authorities include requiring the credit institutions and investment firms to reduce the risk inherent in their activities, products or systems, including by introducing changes to their structures of remuneration or freezing the variable parts of remuneration to the extent that they are inconsistent with effective risk management. Quantitative measures include a requirement to hold additional own funds.



*Article 54 Directive 2006/48/EC, new paragraph:* Member States shall ensure that, for the purposes of the first paragraph, their respective competent authorities have the power to impose or apply financial and non-financial penalties or other measures. Those penalties or measures shall be effective, proportionate and dissuasive.

*Article 136(2) Directive 2006/48/EC, new subparagraph:* For the purposes of determining the appropriate level of own funds on the basis of the review and evaluation carried out in accordance with Article 124, the competent authorities shall assess whether any imposition of a specific own funds requirement in excess of the minimum level is required to capture risks to which a credit institution is or might be exposed, taking into account the following:

- (a) the quantitative and qualitative aspects of the credit institutions' assessment process referred to in Article 123;
- (b) the credit institutions' arrangements, processes and mechanisms referred to in Article 22;
- (c) the outcome of the review and evaluation carried out in accordance with Article 124.

33. Supervisory authorities shall ensure that they have the ability to impose corrective quantitative and/or qualitative measures where institutions are in breach of the requirement to have remuneration policies and practices that are consistent with sound and effective risk management. In particular, quantitative measures shall consist of Pillar II capital add-ons, without prejudice to other supervisory measures possible under the CRD (e.g. Article 136 Directive 2006/48/EC); qualitative measures shall consist of actions by institutions to remedy deficiencies in their remuneration policy and to address potential gaps in their implementation (e.g. organizational adjustments and risk mitigation programs or measures). Qualitative measures generally have priority over the quantitative ones, but quantitative measures shall not be ruled out.

#### 1.4.2. Capital base

*Recital (10) CRD III* [...] In that context, Member States' competent authorities should have the power to limit variable remuneration, inter alia, as a percentage of total net revenue when it is inconsistent with the maintenance of a sound capital base.

*Article 136(1) Directive 2006/48/EC, new points:*

- (f) requiring credit institutions to limit variable remuneration as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base;
- (g) requiring credit institutions to use net profits to strengthen the capital base.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (q) the variable remuneration, [...], is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration

shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account [...] current compensation [...]

34. The CRD contains requirements with regard to the capital base of institutions addressed to national competent authorities and institutions themselves. Both should ensure that a careful balance between a sound capital base and the award, pay out or vesting of variable remuneration is maintained.

35. Both the awarding of variable remuneration as paying out or the vesting of variable remuneration can be detrimental for the institution when the effect would be that its capital base would no longer be sound. Therefore, the institution should ensure that capital adequacy will not be adversely affected by:

- 1) the overall pool of variable remuneration that will be awarded for that year; and
- 2) the amount of variable remuneration that will be paid or vested in that year.

36. The fact that an institution is or risks becoming unable to maintain a sound capital base, should be a trigger for: 1) reducing the variable remuneration pool for that year and 2) the application of performance adjustment measures (i.e. malus or clawback) (Annex V, section 11, point 23 (q)) in that financial year. Instead of awarding, paying out or vesting the variable remuneration, the net profit of the institution for that year and potentially for subsequent years should be used to strengthen the capital base. The institution should not compensate for this by awarding, paying out or vesting (more) variable remuneration in later years.

National competent authorities should be able to intervene where the awarding of variable remuneration is detrimental to the maintenance of a sound capital base. Supervisors should have the power to limit variable remuneration in order to keep the capital base at an adequate level.

In the situation where the capital base of an institution is or risks not being sound, the supervisor can:

- 1) require the institution to reduce (or apply a cap to) the overall pool of variable remuneration determined in the year where capital adequacy is affected and potentially for subsequent years until the capital adequacy situation improves; and
- 2) require the institution not to pay out in the year where capital adequacy is affected and potentially for subsequent years until the capital adequacy situation improves.

37. Institutions should ensure that they adapt their contractual agreements with staff members in order to ensure that they do not limit their ability to comply with these requirements.

#### 1.4.3. State support and remuneration

*Recital (12) CRD III* Regarding entities that benefit from exceptional government intervention, priority should be given to building up their capital base and providing for recovery of taxpayer assistance. Any variable remuneration payments should reflect those priorities.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (k) in the case of credit institutions that benefit from exceptional government intervention:

- (i) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;
- (ii) the relevant competent authorities require credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the credit institution within the meaning of Article 11(1);
- (iii) no variable remuneration is paid to the persons who effectively direct the business of the credit institution within the meaning of Article 11(1) unless justified;

38. The variable remuneration of an institution should not prevent an orderly and adequate payback of the government support. Therefore, the institution should ensure that a variable remuneration pool or the vesting and paying out of variable remuneration does not pose a detriment to the timely building up of its capital base and a decrease in its dependence on exceptional government support. The importance of the timely building up of capital must clearly be reflected in the payment of the variable remuneration. The national competent authority can require restrictions on overall variable remuneration pool levels or on paying awards by the institution.

39. It is up to the national competent authorities to decide which relevant authority should assess and decide on the level of variable remuneration in institutions that have been given exceptional government support.

40. Limits to the remuneration of directors (within the meaning of Article 11 of the CRD) are important for restructuring remuneration within the institution. The competent authority may require the institution not to pay out variable remuneration for the year in which government support was asked for or to lower variable remuneration which was deferred and not yet vested. The competent authority could also require the institution not to award any variable remuneration as long as the government support is not yet paid back, or until a recovery plan for the institution is implemented/accomplished. Such measures should be limited in time. The period during which the limits apply or the criteria for the limits should be clearly recorded when government support is given.

41. It may be necessary to pay variable remuneration to new directors, who are hired to rescue the institution. As it will be difficult to hire new adequate management capacity for an institution in difficulties, it may be justified to award or pay variable remuneration to new directors. In that case, all remuneration requirements of the CRD apply.

## 2. Governance of remuneration

### 2.1. Management body

*Recital (4) CRD III* [...] In order to ensure that the design of remuneration policies is integrated in the risk management of the credit institution or investment firm, the management body, in its supervisory function, of each credit institution or investment firm should adopt and periodically review the principles to be applied. In that context, it should be possible, where applicable and in accordance with national company law, for the management body in its supervisory function to be understood as the supervisory board.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (b) the remuneration policy [...] incorporates measures to avoid conflicts of interest;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (c) the management body, in its supervisory function, of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

### Guidelines for institutions

#### 2.1.1. Design, approval and oversight of the remuneration policy

42. To properly perform its tasks on remuneration stated below, the management body in its supervisory function<sup>21</sup> (hereafter 'supervisory function') should include non-executive members that collectively have sufficient knowledge of remuneration policies and structures. An institution's remuneration

---

<sup>21</sup> The identification of the body that performs the responsibilities of the management body in its supervisory function may differ among countries due to national corporate law. CEBS is aware that within Member States usually one of two governance structures is used – a unitary or a dual board structure. No particular structure is advocated by these guidelines.

policy should be driven primarily by a culture that encourages strong risk alignment practices.

43. The supervisory function is responsible for approving and maintaining the remuneration policy of the institution, and overseeing its implementation. The remuneration policy should not primarily be controlled by the CEO or other executive directors. The supervisory function should also approve any subsequent material exemptions or changes to the remuneration policy and carefully consider and monitor their effects. Procedures to determine remuneration should be clear, well-documented and internally transparent. For example, proper documentation should be provided on the decision-making process, the determination of the Identified Staff, the measures used to avoid conflicts of interest, the criteria used to determine the ratio between the fixed and variable remuneration components, the risk-adjustment mechanisms used etc.

44. In the design and oversight of the institution's remuneration policies, the supervisory function should take into account the inputs provided by all competent corporate functions (i.e. risk management, compliance, human resources, strategic planning, etc.). As a result, those functions should be properly involved in the design of the remuneration policy of the institution.

45. Ultimately, the supervisory function should ensure that an institution's remuneration policy is consistent with and promotes sound and effective risk management. The remuneration policy should not encourage excessive risk taking and should enable the institution to achieve and maintain a sound capital base.

The supervisory function should ensure that the institution's overall corporate governance principles and structures, as well as their interactions with the remuneration system are considered within the design and implementation of an institution's remuneration policies and practices (i.e. the clear distinction between operating and control functions; the skills and independence requirements of members of the management body; the role performed by internal committees, including the Rem Co; the safeguards for preventing conflicts of interests; the internal reporting system and the related parties' transactions rules).

#### 2.1.2. Remuneration of members of the management and supervisory function

46. The remuneration of the members of the management body in its management function (hereafter 'management function') should be consistent with their powers, tasks, expertise and responsibilities.

The management function should not determine its own remuneration. The supervisory function should determine and oversee the remuneration of the

members of the management function. Without prejudice to national law, the supervisory function should also specifically approve and oversee the remuneration of senior executives and staff members who receive the highest amounts of total remuneration within the institution.

47. In order to properly address conflicts of interests, it is good practice for members of the supervisory function to be compensated only with fixed remuneration. Incentive-based mechanisms should generally be excluded. If such mechanisms do occur, they must be strictly tailored to the assigned monitoring and control tasks, reflecting the individual's capabilities and the achieved results. If instruments are granted, appropriate measures should be taken, such as retention periods until the end of the mandate, in order to preserve the independence of judgment of those members of the management body.

#### 2.1.3. Shareholders' involvement

48. The approval of an institution's remuneration policy and, where appropriate, decisions relating to the remuneration of members of the management body, may be assigned to the shareholders' meeting, depending on the institution's characteristics or on the national rules in the jurisdiction in which the institution operates. The shareholders' vote may be either consultative or binding. To this end, shareholders should be provided with adequate information in order that they might be able to make informed decisions. The supervisory function remains responsible for the proposals submitted to the shareholders' meeting, as well as for the actual implementation and oversight of any changes to the remuneration policies and practices.

#### 2.1.4. Review of the remuneration policy

49. The supervisory function should ensure that the remuneration policy of the institution will be reviewed on an annual basis at a minimum. Such central and independent reviews should assess whether the overall remuneration system:

- operates as intended (in particular, that all agreed plans/programs are being covered; that the remuneration payouts are appropriate, and that the risk profile, long-term objectives and goals of the institution are adequately reflected); and
- is compliant with national and international regulations, principles and standards.

The relevant internal control functions (i.e. internal audit, risk management, compliance functions, etc.) as well as other key supervisory function committees (i.e. audit, risk, and nominations committees) should be closely involved in reviewing the remuneration system of the institution.

Where periodic reviews reveal that the remuneration system does not operate as intended or prescribed, the supervisory function should ensure that a timely remedial plan is put in place.

50. The periodic review of remuneration policies and practices may be, partially or totally, externally commissioned when appropriate according to the proportionality principle. Larger and more complex institutions are expected to have sufficient resources to conduct the review internally, though external consultants may complement and support the institution in carrying out such tasks. In line with the proportionality principle, small and less complex financial institutions may decide to outsource the entire review. In all cases, the supervisory function remains responsible for ensuring that the results of the review on remuneration policies and practices are dealt with. Where review processes are outsourced, institutions should also comply with CEBS guidelines on outsourcing.

51. The results of the internal and/or external reviews should be made available to the competent bodies, committees and functions.

## 2.2. Remuneration Committee

*Recital (5) CRD III* Credit institutions and investment firms that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities should be required to establish a remuneration committee as an integral part of their governance structure and organisation.

*Annex V, Section 11 Directive 2006/48/EC, point 24* Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The Chair and the members of the remuneration committee shall be members of the management body who do not perform any executive functions in the credit institution concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.

### Guidelines for institutions

#### 2.2.1. Setting up a remuneration committee

52. Institutions that are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities should establish a Rem

Co. However, setting up a Rem Co is one of the requirements that can be neutralized via the application of the proportionality principle. Nevertheless, for others it can be considered as a best practice.

In order to identify whether a Rem Co is expected to be set up, the factors mentioned in section 1.2 (proportionality) should be considered. As a possible example, a subsidiary of an EEA-based parent institution may not establish a Rem Co where: i) the parent institution is obliged to set up a Rem Co performing its tasks and duties for the whole group; and ii) the subsidiary adopts the remuneration policy and structure defined by the parent institution.

### 2.2.2. Composition

53. In order to operate independently from senior executives, the Rem Co should be comprised of members of the supervisory function who do not perform executive functions, and, at least the majority of whom qualify as independent. The chairperson of the Rem Co should be an independent, non-executive member.

At least one member of the Rem Co should have sufficient expertise and professional experience concerning risk management and control activities, namely with regard to the mechanism for aligning the remuneration structure to institutions' risk and capital profiles.

The Rem Co should be encouraged to seek expert advice internally (i.e. from risk management) and externally.

The chief executive officer should not take part in the Rem Co meetings which discuss and decide on his/her remuneration.

### 2.2.3. Role

54. The Rem Co should:

- be responsible for the preparation of recommendations to the supervisory function, regarding the remuneration of the members of the management body as well as of the highest paid staff members in the institution;
- provide its support and advice to the supervisory function on the design of the institution's overall remuneration policy;
- have access to advice, internal and external, that is independent of advice provided by or to senior management;
- review the appointment of external remuneration consultants that the supervisory function , may decide to engage for advice or support;
- support the supervisory function in overseeing the remuneration system's design and operation on behalf of the supervisory function;



- devote specific attention to the assessment of the mechanisms adopted to ensure that the remuneration system properly takes into account all types of risks, liquidity and capital levels as well as ensuring that the overall remuneration policy is consistent with the long-term sound and prudent management of the institution; and
- formally review a number of possible scenarios to test how the remuneration system will react to future external and internal events, and back test it as well.

55. The Rem Co itself may be in charge of overseeing the central and independent review of the remuneration policies and practices.

#### 2.2.4. Process and reporting lines

56. The Rem Co should:

- have access to all data and information concerning the decision-making process of the supervisory function, on the remuneration system's design and implementation;
- have unfettered access to all information and data from risk management and control functions. Such access should not hinder the institution's ordinary activities;
- ensure the proper involvement of the internal control and other competent functions (e.g. human resources and strategic planning). The Rem Co should collaborate with other board committees whose activities may have an impact on the design and proper functioning of remuneration policy and practices (e.g. risk audit, and nomination committees); and
- provide adequate information to the supervisory function, and, where appropriate, to the shareholders' meeting about the activities performed.

#### 2.3. Control functions

*Annex V, Section 11 Directive 2006/48/EC, point 23* (e) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (f) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in point (24) or, if such a committee has not been established, by the management body in its supervisory function;

## Guidelines for institutions

### 2.3.1. Definition and roles

57. Institutions must provide for an active participation of control functions in the design, ongoing oversight and review of the remuneration policies for other business areas. Control functions include risk management, compliance, internal audit, human resources<sup>22</sup> and similar functions (e.g. the CFO to the extent that he/she is responsible for the preparation of the financial statements) within an institution.

58. Working closely with the Rem Co and the supervisory and management functions, the control functions should assist in determining the overall remuneration strategy applicable to the institution, having regard to the promotion of effective risk management. This will include establishing an effective framework to determine role descriptions, performance management, risk adjustment and the linkages to reward. In particular, the procedures for setting remuneration should allow risk and compliance functions to have significant input into the setting of remuneration awards where those functions have concerns regarding: 1) the impact on staff behaviour, and 2) the riskiness of the business undertaken.

The human resources function can draw up, on behalf of management, a remuneration policy for all job groups within the institution to which the remuneration principles apply. The human resources function also coordinates the monitoring of the consistent application of the policy and evaluates its operation. The human resources function will most likely be the custodian of contractual terms (including the creation and maintenance of reward tools and mechanisms such as long-term incentive plans).

The risk management function should assess how the variable remuneration structure affects the risk profile of the enterprise. It is good practice for the risk management function to validate and assess risk adjustment data, and to attend a meeting of the Rem Co for this purpose.

The compliance function should analyse how the remuneration structure affects the enterprise's compliance with legislation, regulations and internal policies.

The internal audit function should periodically carry out an independent audit of the design, implementation and effects of the enterprise's remuneration policies.

---

<sup>22</sup> Human resources, while traditionally not seen as a control function, play an essential role in the design and implementation of the remuneration policies developed by the supervisory function.

### 2.3.2. Independence and appropriate authority

59. Effective independence and appropriate authority of control functions are necessary to preserve the integrity of financial and risk management's influence on incentive remuneration. The method of determining the remuneration of the relevant persons involved in the control functions must not compromise their objectivity or be likely to do so.

### 2.3.3. Remuneration of control functions

60. The remuneration level of staff in the control functions should allow the institution to employ qualified and experienced personnel in these functions.

The mix of fixed and variable remuneration for control function personnel should be weighted in favour of fixed remuneration. If they receive variable remuneration, this part should be based on function-specific objectives and should not be determined by the individual financial performance of the business area they monitor.

The remuneration structure of control function personnel should not compromise their independence or create conflicts of interest in their advisory role to the Rem Co, supervisory and/or management functions. If remuneration of the control functions includes a component based on institution-wide performance criteria, the risk of conflicts of interest could be increased and, therefore, should be properly addressed.

61. For institutions which are required to have a Rem Co, the remuneration of the senior staff responsible for heading the control functions should not be solely left to the supervisory function, but should be directly overseen by the Rem Co. The remuneration of those staff members in compliance and risk management functions must be designed in a way that avoids conflict of interests related to the business unit they are overseeing and, therefore, should be appraised and determined independently. The Rem Co should make recommendations to the management body on the remuneration to be paid to the senior officers in the risk management and compliance functions.

62. Conflicts of interest which might arise if other business areas had undue influence over the remuneration of staff within control functions should be adequately managed. The need to avoid undue influence is particularly important where staff members from the control functions are embedded in other business areas. However, the views of other business areas should be sought as an appropriate part of the assessment process.

Control function personnel should not be placed in a position where, for example, approving a transaction, making decisions or giving advice on risk and financial control matters could be directly linked to an increase in their performance-based remuneration.

## Guidelines to Supervisors

63. When assessing the whole of the governance arrangements for remuneration, supervisors should:

- review the assessment of the institution as to whether to have a Rem Co or not, especially for a subsidiary institution in cases where the EEA parent institution has established a Rem Co for the group;
- ensure that the independence and expertise requirements for the members of the supervisory function are met and, to this end, periodically review the composition of the supervisory function, in particular to ensure it has the appropriate professional skills with respect to the risk management issues related to remuneration;
- ensure that a proper exchange of information among all internal bodies and functions involved in defining and monitoring the remuneration structure is carried out;
- examine the process developed for conducting the annual remuneration review and assess its main results;
- review the charter/ terms of reference of the Rem.Co to ensure that it has sufficient powers to perform its functions;
- review the arrangements under which the Rem.Co receives advice from the risk management function;
- review the engagement process for commissioning external advisers and ensure that these advisers directly report to the supervisory function, or to the Rem. Co;
- review the operating structure of the control function team;
- ensure that the objectives for control function personnel are function-specific and include qualitative criteria;
- review the performance metrics or performance indicators developed for control function personnel to determine that these metrics or indicators are not linked to the performance of the portfolios they monitor;
- review, subject to relevant employment legislation, the performance appraisal documents for control function personnel to determine that they are signed off as appropriate; and
- review the remuneration policies to ensure that the remuneration of control function personnel is not determined by either the personnel or the financial performance of the business area they oversee.

64. Supervisors can also review: (i) the minutes of the deliberation of the supervisory function on remuneration policies, in particular with respect to the results of the oversight of the remuneration system's design and operation conducted by the Rem Co; and (ii) the minutes of the Rem Co and other committees, including the risk committee, involved in the oversight of the remuneration system's design and operation. Supervisors may also hold interviews with institution's directors and heads of relevant internal functions.

### 3. GENERAL REQUIREMENTS ON RISK ALIGNMENT

#### 3.1. The basic principle of risk alignment

*Recital (4) CRD III* Because excessive and imprudent risk-taking may undermine the financial soundness of credit institutions or investment firms and destabilise the banking system, it is important that the new obligation concerning remuneration policies and practices should be implemented in a consistent manner and should cover all aspects of remuneration including salaries, discretionary pension benefits and any similar benefits. In that context, discretionary pension benefits should mean discretionary payments granted by a credit institution or investment firm to an employee on an individual basis payable by reference to or expectation of retirement and which can be assimilated to variable remuneration. It is therefore appropriate to specify clear principles on sound remuneration to ensure that the structure of remuneration does not encourage excessive risk-taking by individuals or moral hazard and is aligned with the risk appetite, values and long-term interests of the credit institution or investment firm. Remuneration should be aligned with the role of the financial sector as the mechanism through which financial resources are efficiently allocated in the economy. In particular, the principles should provide that the design of variable remuneration policies ensures that incentives are aligned with the long-term interests of the credit institution or investment firm and that payment methods strengthen its capital base. Performance-based components of remuneration should also help enhance fairness within the remuneration structures of the credit institution or investment firm. [...]

*Recital (7) CRD III* Remuneration policy should aim at aligning the personal objectives of staff members with the long-term interests of the credit institution or investment firm concerned. [...]

*Recital (10) CRD III* Credit institutions and investment firms should ensure that the total variable remuneration does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of the current capital position of the credit institution or investment firm. [...]

*Art 1, Directive 2006/48/EC, point (49)* 'discretionary pension benefits' means enhanced pension benefits granted on a discretionary basis by a credit institution to an employee as part of that employee's variable remuneration package, which do not include accrued benefits granted to an employee under the terms of the company pension scheme.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, [...]

*Annex V, Section 11 Directive 2006/48/EC, point 23* (i) the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (r) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution.

If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of five years in the form of instruments referred to in point (o). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (o) subject to a five-year retention period;

## Guidelines for institutions

### 3.1.1. The general remuneration policy, including the pension policy

65. This principle is aimed at the alignment of remuneration with prudent risk taking. The long-term strategy must include the overall business strategy and quantified risk tolerance levels (in accordance with requirements in Pillar 2) with a multi-year horizon, as well as other company values such as compliance culture, ethics, behaviour towards customers, measures to mitigate conflicts of interest etc. The design of the remuneration systems must be consistent with the objectives set out in the strategies and changes that could appear in the strategies must be taken into account. Institutions must, therefore, ensure that their remuneration systems are well designed and implemented. This includes, in particular, a proper balance of variable to fixed remuneration, the measurement of performance as well as the structure and, where appropriate, the risk-adjustment of the variable remuneration. Even a smaller or less sophisticated institution should ensure it makes the best possible attempt to align its remuneration policy with its long-term interests.

66. When developing its remuneration policy, institutions should give due consideration to the following two aspects:

1. How remuneration contributes to the prevention of excessive risk-taking and the consistency of the remuneration policy with effective risk management

Remuneration has a direct or indirect influence on people's behaviour. Variable remuneration may encourage staff to take undesirable or irresponsible risks in the hope of generating more turnover or making more profit and thus increasing his/her variable remuneration. Furthermore, staff members may be tempted to 'play' with or manipulate information with a view to making their (measured) performance look better. E.g. if the variable part of the remuneration consists predominantly of remuneration instruments that are paid out immediately, without any deferral or ex post risk adjustment mechanisms (malus or claw back), and/or are based on a formula that links variable remuneration to current year revenues rather than risk-adjusted profit, there are strong incentives for managers to shy away from conservative valuation policies, strong incentives to ignore concentration risks, strong incentives to rig the internal transfer pricing system in their favour and strong incentives to ignore risk factors, such as liquidity risk and concentration risk, that could place the institution under stress at some point in the future.

By connecting risk management<sup>23</sup> elements to the remuneration policy, the aforementioned dangers can be counterbalanced. Indeed, when properly structured and implemented, variable remuneration can be an efficient tool to align the staff's interests with the long-term interests of the institution. Having regard to the nature, scale and complexity of an institution, alternative approaches exist for connecting risk management elements to a remuneration policy.

## 2. How remuneration is included in capital and liquidity planning and contributes to safeguarding a sound capital base

Institutions need to consider the risk associated with its remuneration system with regard to its possible impact on its capital base. Therefore, institutions should include the impact of remuneration pay out levels - both upfront and deferred amounts - in their capital planning and in their overall capital assessment process, taking into account their current capital position. The total variable remuneration awarded by an institution shall not limit the ability of the institution to maintain or restore a sound capital base in the long term and has proper regard to the interests of depositors, investors and other stakeholders. Remuneration represents an important cost factor for financial institutions as remuneration payments influence the institution's capital base. If an institution falls short of its capital targets, priority is to be given to building up the necessary capital or solvency buffer, and a conservative remuneration policy

---

<sup>23</sup> See also the Risk Management section of the CEBS Guidebook on Internal Governance, to be published in the spring of 2011.

must be pursued, particularly regarding variable remuneration. In addition to capital planning, remuneration must also be taken into account for liquidity planning purposes. In this way, remuneration payments will be prevented from further weakening an institution and its stability.

### 3.1.2. Discretionary pension benefits

67. As required by the directive, remuneration policy should cover all aspects of remuneration including fixed components, variable components, pension terms and other similar specific benefits. The pension policy (the fixed as well as the variable pension payments) should be aligned with the long term interests of the institution.

In case of discretionary pension benefits, as part of the variable remuneration, a staff member should not retire or leave the credit institution with such benefits vested, with no consideration of the economic situation of the institution or risks that have been taken by the staff member in the long term.

In order to align this specific kind of pension benefits with the economic situation of the institution, discretionary pension benefits should always be paid in the form of shares or equity-linked instruments or, where appropriate, other instruments that adequately reflect the credit quality of the institution (see further the description of 'instruments' starting from paragraph 121).

In the context of a retirement, the discretionary pension benefits vested to the staff member should be subject to a five years retention period (see the definition of 'retention' in Annex 1).

In the context of the termination of a job, when the staff member leaves the institution before retirement, the discretionary pension benefits should not be vested before a period of five years and should be subject to performance assessment and ex post risk adjustment before pay out.

### Guidelines for supervisors

68. Supervisors should:

- check how institutions connect their remuneration policy to:
  - the setting of their risk appetite/risk tolerance levels, the business strategy and the long term interest of the institution;
  - the broader performance management framework of the institution;
  - the control and compliance culture that is implemented in the institution; and
  - the institution's code of conduct;



- examine how institutions assess the impact of remuneration policy and practices on conducting business and advising/selling products to different customer groups;
- examine the process of the linkage between the remuneration policy and practices and risk management;
  - check how priorities are set within this process (check, for example, whether business segments which pose the highest danger of excessive risk-taking have been duly considered); and
  - check whether the output of this process leads to changes in the remuneration policies and practices when needed;
- check whether remuneration is taken into account for the ICAAP/liquidity planning.

## 3.2. General prohibitions

### Guidelines for institutions

#### 3.2.1. Guaranteed variable remuneration

*Recital (8) CRD III* [...] In order to ensure coherent remuneration practices throughout the sector, it is appropriate to specify certain clear requirements. Guaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and should, as a general rule, be prohibited.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (j) guaranteed variable remuneration is exceptional and occurs only -when hiring new staff and is limited to the first year of employment;

69. Guaranteed variable remuneration can take several forms such as a "guaranteed bonus", "welcome bonus", "sign-on bonus", "minimum bonus", etc. and can be granted either in cash or in instruments.

These practices can only be allowed in so far as they remain within the remit of the provisions of the directive: they should be applicable only for the first year of employment and in the context of hiring new staff. Institutions will no longer be able to guarantee multi-year variable remuneration over, for example, two or three years.

#### 3.2.2. Severance pay

*Annex V, Section 11 Directive 2006/48/EC, point 23* (m) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;

70. “Golden parachute” arrangements for staff members who are leaving the institution and which generate large payouts without any performance and risk adjustment are prudentially unsound. Such arrangements create a “heads I win, tails I still win” approach to risk, which encourages more risk-taking than would likely be preferred by the institution’s shareholders or creditors. Any such payments should be related to performance achieved over time and designed in a way that does not reward failure. This does not preclude termination payments in situations such as early termination of the contract due to changes in the strategy of the company, or in merger and/or takeover situations.

71. Without prejudice to employment law or contract law, severance payments are meant to provide a safety net for a staff member in cases of early termination of the contract. Severance payments may include payments related to the duration of a notice period, redundancy remuneration for loss of office, and may also include a non-competition clause in the contract.

Institutions should set up a framework in which severance pay is determined and approved, in line with the institution’s general governance structures for employment. The framework should ensure that there is no reward for failure. Institutions should be able to explain to supervisors the criteria they use to determine the amount of severance pay. It is good practice to defer any outstanding variable payments or long-term incentive plans and for these to mirror the original deferral schemes.

### 3.2.3. Personal hedging

*Recital (11) CRD III* Credit institutions and investment firms should require their staff to undertake not to use personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (s) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

72. An appropriate remuneration policy which is aligned with risks will, if sufficiently effective, occasionally result in a downward adjustment to the amount of variable remuneration awarded to staff. This will be the case explicitly, for example, if performance adjustment measures such as malus are implemented, or implicitly, if the value of deferred instruments is reduced.

The effectiveness of risk alignment will be significantly weakened if staff members are able to transfer the downside risks to another party through hedging or certain types of insurance.

73. Staff could be considered to have hedged away the risk of a downward adjustment in remuneration if:

- the staff member enters into a contract with a third party; and
- the contract requires the third party to make payments directly or indirectly to the staff member that are linked to or commensurate with the amounts by which the staff member's variable remuneration has been reduced.

The effectiveness of risk alignment would also be undermined if staff members were to buy an insurance contract with a stipulation to compensate them in the event of a downward adjustment in remuneration. As a general rule however, this would not prohibit insurance designed to cover personal payments such as healthcare and mortgage instalments, although each case would be judged on its merits.

74. The requirement not to use personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements would apply to deferred and retained variable remuneration. Institutions should maintain effective arrangements to ensure that the staff member complies with this requirement.

#### Guidelines for supervisors

75. Supervisors should:

- review any guaranteed variable remuneration arrangements (amount, duration, conditions, etc);
- review the number of circumstances in which guaranteed arrangements were made to new hires compared to the total number of new hires at the institution;
- review new sign-on payments made during the financial year and the number of beneficiaries of such payments;
- request the names of individuals who have been offered a guaranteed variable remuneration each year to check that the same people are not being offered repeated guaranteed variable remuneration (even in cases of an 'internal promotion');
- check the amounts of severance payments made in relation to the staff member's total remuneration;
- check whether an institution has a framework in place to determine and approve severance payments;

- check whether an institution's "code of conduct" or 'personal account (PA) dealing procedures include this prohibition on personal hedging and can allow for an inspection of compliance with such manuals; and
- check whether there have been any breaches to the institution's code of conduct or PA dealing procedures relating to personal hedging or insurance and whether remedial action has been taken.

#### 4. SPECIFIC REQUIREMENTS ON RISK ALIGNMENT

##### 4.1. Fixed versus variable remuneration

###### Guidelines for institutions

##### 4.1.1. Fully flexible policy on variable remuneration

*Recital (8) CRD III* To minimise incentives for excessive risk-taking, variable remuneration should constitute a balanced proportion of total remuneration. It is essential that an employee's fixed salary represents a sufficiently high proportion of his total remuneration to allow the operation of a fully flexible variable remuneration policy, including the possibility to pay no variable remuneration.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (l) [...] the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component. [...]

76. Having a fully-flexible policy on variable remuneration implies not only that variable remuneration should decrease as a result of negative performance but also, that it can go down to zero in some cases. For its practical implementation, it also implies that the fixed remuneration should be sufficiently high to remunerate the professional services rendered, in line with the level of education, the degree of seniority, the level of expertise and skills required, the constraints and job experience, the relevant business sector and region. These guidelines are not directly concerned with setting certain numerical levels of fixed remuneration for individual staff members, recognizing that the fixed remuneration is primarily the result of negotiations between a staff member and the institution and that it is up to the institutions to decide how to best align remuneration structures to meet the remuneration requirements laid down in the CRD. Individual levels of fixed remuneration are, however, indirectly impacted by the basic principle on risk alignment, and more specifically by the requirement that remuneration should be included in the capital and liquidity planning of the institution and should contribute to safeguarding a sound capital base.

77. Meeting the requirement of a fully flexible variable remuneration policy implies as a prerequisite the accomplishment of several mechanisms that are dealt with in subsequent sections of these guidelines, including:

- the maximum ratio on the variable remuneration compared to the fixed remuneration: the higher the ratio, the stronger the presumption that the staff member significantly depends on his or her variable remuneration; and
- proper performance measurement and associated risk adjustments, i.e. adjustments that ensure that variable remuneration can be reduced in a flexible manner, not imposing a floor on the adjustment, applied to both non-deferred and deferred variable remuneration.

#### 4.1.2. Ratio between fixed and variable remuneration

*Annex V, Section 11 Directive 2006/48/EC, point 23* (l) fixed and variable components of total remuneration are appropriately balanced [...] Credit institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration.

*Article 22 Directive 2006/48/EC* 4. The Committee of European Banking Supervisors shall, inter alia, ensure the existence of guidelines to: (a) set specific criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration within the meaning of point 23(l) of Annex V; [...]

78. Variable remuneration provides an incentive for staff members to pursue the goals and interests of the company and enables them to share in its success. It is also an important element of cost flexibility for institutions. Provided the interests of the company owners are taken into account and there is no inducement to assume inappropriate risks, variable remuneration can benefit all stakeholders of an institution. Indeed, in principle, a variable component linked to performance can have a positive effect on “risk-sharing” and incentivizing safe and sound performance. However, a variable component that is inappropriately balanced could, under certain circumstances, have negative effects. The higher the possible variable remuneration compared to the fixed remuneration, the stronger the incentive will be to deliver the needed performance, and the bigger the associated risks may become. This will be all the more valid if staff becomes accustomed to and expects to receive a considerable variable remuneration. If the fixed component is too low compared to the variable remuneration, an institution may find it difficult to reduce or eliminate variable remuneration in a poor financial year. Therefore, fixed and variable components of total remuneration should be appropriately balanced.

79. Consequently, an institution should set in its remuneration policy explicit maximum ratio(s) on the variable component in relation to the fixed component of remuneration. This maximum ratio must be set for the different relevant

categories of staff whose professional activities have a material impact on the risk profile of the institution. The maximum balance between fixed and variable remuneration should be set in a sufficiently granular way, so that exceptions are avoided or are kept at a minimum. If an exception is, however, needed, and can be justified on grounds that do not harm the risk alignment of the remuneration structure in question, such an exception should be flagged to the management body in its supervisory function.

80. An appropriate maximum ratio of the variable to fixed component is a strong and relatively uncomplicated technique for obtaining risk alignment (compared to risk adjustment) in the remuneration structure. The appropriate balance of the fixed and variable remuneration components may, however, vary across the staff, according to market conditions and the specific context in which the financial undertaking operates.

In all cases, the separation between the fixed and variable components must be absolute. There must be no leakage between these two components.

81. Because situations vary enormously, it is not possible to decree one optimal relationship between the fixed and variable components of remuneration. To determine the actual institution specific ratio(s), the starting point is that a high ratio of variable to fixed components implies less discretion for the institution to make choices about how to comply with the other specific requirements on risk alignment. The reason is that a staff member with a high ratio of variable to fixed components tends to be incentivized to keep taking risks in order to maintain his level of income, whereas a staff member with a more balanced ratio is less incentivized to do this. Institutions should be able to explain retained ratios of variable to fixed components through their remuneration policy. Institutions should also be able to explain how the ratio will evolve when the institution is faced with a serious loss.

82. The appropriate balance will depend on:

- the quality of performance measurement and associated risk adjustments;
- the length of the deferral and retention periods;
- the legal structure of the institution, kinds and scope of the activities;
- business types and which risks are involved (long term risks vs. short term risks);
- category of staff (e.g. control functions should have a lower ratio of variable to fixed); and
- level of the staff member in the organization and responsibilities attached to the job position.

83. The ratio between fixed and variable remuneration must be determined at the moment of initial performance measurement, independent of any future ex post risk adjustments or fluctuation in the price of instruments. Maximum ratios allowable should include levels of payouts that would cover 'above target' or exceptional performance and should not only reflect 'on target' or expected performance.

#### Guidelines for supervisors

84. Supervisors should:

- check whether the remuneration practices are in keeping with policies regarding downsizing of payout in years where income and profitability of the institution/business unit are decreasing, or in the case of negative individual performance contributions;
- when examining the maximum ratio of variable to fixed remuneration: take into account the quality of ex-ante and ex-post risk adjustment. Examples will include:
  - *Ex-ante* – measures used to calculate pools and take account of risks; and
  - *Ex-post* - percentage and length of deferral, retention policy and effectiveness of malus/clawback arrangements; and
- assess and challenge the ratio(s) of variable to fixed remuneration, and how they interrelate with other risk alignment elements of the remuneration policy.

### 4.2. Risk alignment of variable remuneration

#### Guidelines for institutions

85. Risk alignment processes are still under development in the financial sector and may evolve over time. These guidelines reflect the expectations of supervisors as at the time of publication of these guidelines.

##### 4.2.1. Risk alignment process

*Recital (7) CRD III* Remuneration policy should aim at aligning the personal objectives of staff members with the long-term interests of the credit institution or investment firm concerned. The assessment of the performance-based components of remuneration should be based on longer-term performance and take into account the outstanding risks associated with the performance. The assessment of performance should be set in a multi-year framework of at least three to five years, in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over the business cycle of the credit institution or investment firm.

*Annex V, Section 11 Directive 2006/48/EC, point 23* (g) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution [...]

*Annex V, Section 11 Directive 2006/48/EC, point 23* (h) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (n) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required. The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;

86. To limit excessive risk taking, variable remuneration should be performance-based and risk adjusted. To achieve this aim, an institution should ensure that incentives to take risks are constrained by incentives to manage risk. A remuneration system should be consistent with effective risk management and governance processes within the institution.

Risk alignment includes the performance and risk measurement process, the award process and the payout process.

#### 1. Performance and risk measurement process

Setting up a remuneration system starts by defining the objectives of the institution, the unit, as well the staff. These objectives must be derived from the business strategy and must be in line with the risk appetite of the institution. The performance criteria, which must be used to assess the staff member's achievement of his objectives during the accrual period, can be directly derived from these objectives. If properly designed, the performance assessment links the remuneration with the achievement of the business strategy. On the contrary, performance criteria which are badly designed, can be an incentive for taking too much risk. When assessing performance, only the effective results should be taken into account. Risk alignment during performance measurement can be achieved by using risk adjusted performance criteria or by adjusting performance measures for risk afterwards. The risk adjustment may differ according to the activity of the staff member and the business line.

#### 2. Award process

After the accrual period, the institution will use a given award process in order to translate performance assessment into the variable remuneration



component for each staff member. This is usually carried out through so-called "pools" of variable remuneration that are first determined and later on allocated. As not all performance and risk measures are suitable to be applied at the level of the institution, the business unit and the staff member, the institution should identify the risks at each level and ensure that a risk correction adequately captures the severity and the duration of the risk at each level. This so-called "ex-ante risk adjustment" adjusts remuneration for potential adverse developments in the future. Because of their upfront application, ex-ante risk adjustments have an immediate effect on risk taking behaviour. But the consequence of this is also that not all risk and performance outcomes can be fully taken into account.

### 3. Payout process

In order to align the actual payment of remuneration to the business cycle of the institution and the business risks, the variable remuneration is partly paid upfront (short-term) and partly deferred (long-term). The short-term component is paid directly after the award and rewards staff for performance delivered in the accrual period. The long-term component is awarded to staff during and after the deferral period. It rewards staff for the sustainability of the performance in the long term, which is the result of decisions taken in the past.

Before paying out the deferred part, a reassessment of the performance and, if necessary, a risk adjustment is required in order to align variable remuneration to risks and errors in the performance and risk assessments that have appeared since the staff members were awarded their variable remuneration component. This so-called ex post risk adjustment is always necessary, because at the time remuneration is awarded, the ultimate performance cannot be assessed without uncertainty.

The performance and risk measurement process underpins both the award process and the payout process. Guidelines on performance and risk measurement will be given in sections 4.2.3. and 4.2.4. The award process and pay out process are discussed in sections 4.3. and 4.4. For the whole risk alignment process, there are some common requirements. These will be discussed in the section below.

#### 4.2.2. Common requirements for the risk alignment process

##### a. Time horizon

87. Institutions, when assessing risk and performance, should take into account both current and future risks that are taken by the staff member, the business unit or the institution as a whole. For this exercise, institutions must examine what the impact of the staff member's activities could be on the institution's short and long term success. To be able to do so, the institution

should align the horizon of risk and performance measurement with the business cycle of the institution. The requirement of an institution to assess the performance of its staff in a multi-year framework implies having the appropriate cumulative length of the accrual period and the payout period for short-term and long-term remuneration. There is a link between these periods.

88. The right balance between accrual and payout periods will depend on the type of business and activity developed by the staff member. However, the use of multi-year accrual periods is more prudent since the assessment of the performance can take into account with certainty more risks that have materialized since the beginning of the accrual period.

#### b. Levels of risk and performance measurement

89. To avoid excesses due to over-individualistic behaviour, performance-related remuneration should include parameters linked to the risks and performance of the business unit and the institution in addition to the risks and performance of the individual activities. Thus, the amount of variable remuneration a staff member is eligible for shall be determined by his/her individual performance, the performance of his/her business line and the performance of the institution. The relative importance of each level of the performance criteria should be determined beforehand and adequately balanced to take into account the position or responsibilities held by the staff member.

90. To have the greatest impact on staff behaviour, the variables used to measure risk and performance should be linked as closely as possible to the level of the decisions made by the staff member that is subject to the risk adjustment. Performance criteria should include achievable objectives and measures on which the staff member has some direct influence. For example, for senior executives, institutions may design the remuneration policies to include financial measures based on the performance of the entire institution, or for performance and risks of units, or decisions that were determined by senior executive strategy. In contrast, variables for a lending officer could be the performance of loans originated or monitored by that person. Variables for the manager of a business unit ideally would be for performance and risk of that unit.

#### c. Quantitative and qualitative measures

91. The risk alignment process should use a mix of quantitative and qualitative approaches (e.g. measurement of performance or risk; setting of the pool and adjustment to risks).

Quantitative measures may have some advantages in terms of transparency if they are pre-defined. They can, therefore, influence the behaviour of staff more directly. However, quantitative measures or criteria are not sufficient to measure all risk or performance or to risk adjust remuneration. To complete the

measurement and adjustment of risk or performance, institutions also need to rely on qualitative approaches.

#### d. Judgmental measures

92. Quantitative measures (e.g. the formulae used for setting the pool) may themselves (partly) rely on judgmental inputs, the derivation of which may lack transparency. Qualitative measures generally require a higher use of judgement than quantitative measures. There are inherent risks in relying on judgement, including lack of transparency in decision-making from staff and other stakeholder's perspectives, and poor judgement being made. To offset these risks it is important that whenever judgement is used for a risk and performance measurement or risk adjustment, there should be:

- a clearly written policy outlining parameters and key considerations on which the judgment will be based;
- clear and complete documentation of the final decision regarding risk and performance measurement or risk adjustment;
- involvement of relevant control functions experts; and
- appropriate levels of approval obtained, e.g. of the management or supervisory body, or of the Rem Co and consideration of the personal incentives of the manager making the judgement, e.g. by using scorecards.

For both kind of measures, institutions should be prepared to disclose and reproduce any judgmental elements incorporated into their risk alignment process. Institutions should also provide detailed information to the supervisor if the final outcome after applying judgmental measures is significantly different from the initial outcome using pre-defined measures.

#### 4.2.3. Risk measurement

93. Institutions should take into account all risks, whether on or off balance sheet, differentiating amongst risks affecting the institution, business units and individuals. Though institutions usually bear all types of risk at institution-wide level, at the level of (the measurement of the performance of) the individual staff members or business units, only some types of risk may be relevant. Risk identification and quantification at the institution and business unit level can generally be found in the institution's Internal Capital Adequacy Assessment Process (ICAAP) and in the institution's individual liquidity adequacy assessment. Institutions should also determine whether measures they are utilizing for risk adjustment include 'difficult-to-measure' risks, such as reputational and operational risk.

94. In order to take into account all material risks, institutions should use the same risk measurement methods as used in the Internal Capital Adequacy Assessment Process. Taking the proportionality principle into account, the ICAAP calculations should be transparent and the institutions should be able to demonstrate how the risk calculations can be broken down by business units and different types of risk positions throughout the organisation. The quality of methods and models used should influence the extent to which an institution should implement a more sophisticated variable remuneration policy based on performance measurements.

#### 4.2.4. Performance measurement

##### a. Qualitative/Quantitative measures

*Annex V, Section 11 Directive 2006/48/EC, point 23 (g) [...] when assessing individual performance, financial and non-financial criteria are taken into account.*

95. Institutions should use both quantitative (financial) as well as qualitative (non-financial) criteria for assessing individual performance. Usually, quantitative criteria are more frequently available at a institution-wide level while qualitative factors are usually assessed at the individual level, where they are more relevant. However, qualitative criteria can also be relevant at a institution-wide level or business level (such as the achievement of results, compliance with strategy within the risk appetite and compliance track record).

The appropriate mix of quantitative and qualitative criteria will also depend on the tasks and responsibilities of the staff member. In all cases, the quantitative and qualitative criteria and the balance between them should be specified and clearly documented for each level and category of staff.

96. Quantitative measures should cover a period which is long enough to properly capture the risk of the staff member's actions and should incorporate risk adjustment and economic efficiency measures. Such measures relate to capital needed to generate revenues. This is necessary, because performance measurement should always be in line with the target capital ratio. By assessing the revenues against the capital needed for the activities, these measures incorporate (at least partially) the risks.

Examples of performance measures which fulfil abovementioned requirements are risk-adjusted return on capital (RAROC), return on risk-adjusted capital (RORAC), economic profit, internal economic risk capital, net economic contribution, risk-adjusted cost of funding or pure accounting adjustments. On the contrary, operating efficiency indicators (profits, revenues, productivity, costs, and volume metrics) or some market measures (share price and total shareholder's return) do not incorporate explicit risk adjustment and are very short term. Therefore, they are not sufficient to capture all risks of the staff member's activities.

97. In addition to quantitative performance measures, variable remuneration awards should also be sensitive to the staff's performance with respect to qualitative (non financial) measures. Examples are the achievement of strategic targets, customer satisfaction, adherence to risk management policy, compliance with internal and external rules, leadership, management, team work, creativity, motivation and cooperation with others business units and with control functions. Such determined qualitative criteria could rely on compliance with risk control measures such as limits and audit results. Negative non-financial performance, in particular unethical or non-compliant behaviour, should override any good financial performance generated by a staff member and should diminish the staff member's variable remuneration.

b. Relative/absolute and internal/external measures

98. Absolute performance measures are measures set by the institution on the basis of its own strategy, which includes its risk profile and risk appetite, as further developed down through the chain of business levels. Such measures help to minimize the risk that remuneration is awarded that is not justifiable by the institution's performance. They are also apt to create long term incentives. However, it may be difficult to calibrate absolute performance measures, especially for new entrants or for new kinds of financial activities (with difficult-to-measure risks).

99. Relative performance measures are measures that compare performance with peers, either 'internal' peers (i.e. within the organization) or 'external' (similar institutions). Relative performance measures are easier to set because the benchmark is readily available. However, such measures pose the risk that variable remuneration that is not supported by long-term success of the business unit or the institution will be paid out anyway. In a period of sector wide positive financial performances, it could lead to 'raising the bid' and/or 'herd' mentality, providing incentives to take on excessive risk. In a downturn economic cycle where most institutions perform poorly, relative measures may nonetheless lead to positive outcomes (and thus to an insufficient contraction of the institution's total variable remuneration) even if absolute performance has deteriorated compared to previous periods.

From a prudential point of view, relative measures pose more risks than absolute measures since they can encourage excessive risk taking. Thus, they should be used with caution and always supplemented with other metrics and controls, including the use of prudent judgmental analysis during the awarding process.

100. Similarly, internal (e.g. profits) and external (e.g. share price) variables come with both advantages and disadvantages that should be balanced carefully. Internal performance measures are able to generate more involvement of the staff members if they can influence the outcome by their own behaviour. This is especially true if the performance measures are fixed at the level of the business

unit (rather than on the institution-wide level). Furthermore, it is easier to introduce risk adjustment features for internal measures, because the link with in-house risk management techniques is more readily available. On the other hand, such measures can be manipulated and can create distorted outcomes on a short-term basis. External performance measures are less subject to this danger of manipulation, although attempts to artificially increase the stock price (probably only relevant for top executives) may still occur.

#### Guidelines for supervisors

101. Supervisors should review:

- the indicators used to measure financial performance and determine whether
  - the indicators are aligned with the institution's objectives;
  - they are realistic compared to individual objectives; and
  - staff can influence them by their actions;
- the quality of the revenues used in producing performance measures, such as, prudent use of accounting principles and valuation methods and prices and proper distribution of all direct and indirect costs;
- the quantitative and qualitative criteria used to assess the performance of the staff and their adequate balance;
- the levels of performance assessment (at the individual, business unit or institution level);
- the documentation of criteria, for example
  - the time horizon for performance assessment;
  - whether qualitative criteria over-ride quantitative criteria;
  - whether the institution sets caps on its overall bonus pools (in a top down approach) on which the overall pool will be based.

### 4.3. Award process

#### Guidelines for institutions

##### *4.3.1. Setting and allocation of pools*

102. During the award process, the individual variable remuneration is determined. A key challenge of the award process is translating performance measures into actual remuneration awards and defining at what level performance can be accurately assessed and risk adjustment can be applied.

In most institutions, the award process is centered on the notion of “bonus pools”. In both the top-down and bottom-up approaches, the size of the bonus pool must first be set and then allocated to individuals and organizational units.

103. The top-down process starts by setting the amount of the pool at the level of the institution, which is then distributed among the business lines and the staff within business lines. In practice this means the setting of the overall institution's pool is realised using performance criteria defined for the overall institution (quantitative criteria). This institution-wide pool is then distributed to the first level units after evaluating their own performance and the process is continued down the line to individual awards, after a process of individual performance assessment based on both quantitative and qualitative criteria. At each level, specific performance criteria are applied, considering responsibilities and objectives of the institution assessed and current and future risks. The performance indicators used to calculate the variable remuneration pool should rely on lasting and effective results. A prudent use of accounting and valuation methods shall be in place (e.g. revenues reflecting highly uncertain valuation practices should be excluded).

104. The setting of the pool could also follow the bottom-up approach, starting the process at single staff level. Depending on the performance criteria by which the staff are assessed, a variable remuneration allocation is made. Thus, the pool of the business unit equals the sum of remuneration awards to subordinated levels. The bottom-up approach has two weaknesses. Firstly, the overall corporate performance is neglected. Secondly, the value of the performance at an individual level may be difficult to assess over time as the organization of business units could change and the data for risk-adjusted metrics could be incomplete or not relevant.

105. In the determination of the overall variable remuneration pool, whether an institution utilizes a top-down, bottom-up or a combined approach, it is important that the institution has a challenge framework in place to provide the necessary checks and balances between the two approaches. Institutions should maintain records to show that such challenges take place.

106. When distributing the pool, to business unit or individual staff member level, the allocation can be based on pre-defined formulae or by using a judgmental approach, or a combination of approaches. Both methods have advantages and disadvantages. Formulae are more transparent and, therefore, lead to clear incentives, as the staff member knows all factors determining his/her variable remuneration. However, formulae may not capture all objectives, especially the qualitative ones. The discretionary approach gives more flexibility to management and can, therefore, weaken the risk-based incentive effect of the performance-based variable remuneration. It should, therefore, be conservatively applied and be made transparent to supervisors. Factors such as budgets constraints, retention and recruiting considerations, subsidization among

business units etc. should not dominate as they can weaken the relationship between performance and risk measurement and remuneration value.

#### 4.3.2. The risk adjustment in the award process

*Recital (7) CRD III* [...] The assessment of the performance-based components of remuneration should [...] take into account the outstanding risks associated with the performance. [...]

*Annex V, Section 11 Directive 2006/48/EC, point 23* (n) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required. The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;

*Annex V, Section 11 Directive 2006/48/EC, point 23* (q) the variable remuneration, [...], is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account [...] current remuneration [...]

107. This section deals with the implementation of ex-ante risk adjustment in the award process and the types of and techniques for ex-ante risk adjustment.

In determining remuneration pools or individual awards, institutions should consider the full range of current and potential (unexpected) risks associated with the activities undertaken. Performance measures used in setting the remuneration pool may not fully or adequately capture risks undertaken, thus, ex-ante adjustments should be applied to ensure that the variable remuneration is fully aligned with the risks undertaken. Institutions should establish whether the risk adjustment criteria they are using take into consideration severe risks or stressed conditions. Institutions' economic capital and regulatory capital models should incorporate scenario analysis. For example, if an institution uses an Advanced Measurement Approach (AMA) to calculate its operational capital requirements, this methodology will already include severe risks. Similarly, institutions' credit risk and market risk models may also be incorporating certain severe or stressed risks. Alternatively, institutions' economic capital models or other cost of capital metrics may be capturing these types of risks.

108. Institutions should determine to what level they are able to risk adjust their variable remuneration calculations quantitatively – whether to the business unit level or further down the line such as to a trading desk level or even to an



individual level. Institutions should determine the level of granularity that is suitable for each level.

a. Quantitative ex ante risk adjustment

109. In order to have a sound and effective remuneration scheme, institutions will use a number of different quantitative measures for their risk adjustment process. Normally, these measures will be based on an overarching risk adjustment framework.

When measuring the profitability of the institution and its business units, the measurement should be based on a net revenue where all direct and indirect costs related to the activity are included. Institutions should not exclude IT costs, group overheads, the cost of run off inventories or discontinued businesses. Institutions should make sure that remuneration pools are not being “back-fitted” to meet remuneration demands.

110. Amongst the financial factors that should be used as the basis for adjusting variable remuneration to risk, an institution should take into account:

- the cost and quantity of the capital required for the risks of its activities. The capital costs should reflect the risk profile of the institution. The entirety of any capital costs should be considered in a comprehensive manner. This means that the whole of the institution’s equity should be fully allocated and charged;
- the cost and quantity of liquidity risk assumed in the course of business. A functioning liquidity allocation mechanism requires first of all a clear definition of risk tolerance and an institution’s fund transfer pricing system. The latter has two components : the cost of raising funds from an asset and liability management perspective, and the interest rate curve cost component; and
- indirect liquidity costs should also be considered (i.e. mismatch liquidity costs, cost of contingent liquidity risk and other liquidity risk exposure that an institution may have).

111. Pools and individual awards can be adjusted to risk by using specific quantitative risk adjustments examples include Economic Capital, Economic Profit, Return on Risk Weighted Assets and Return on Allocated Equity. Ex-ante adjustments are then determined by considering the institution’s performance against these measures. These measures can provide a more transparent picture of the institution’s performance, compared to pure accounting-based measures.

The quantitative ex-ante risk adjustments made by institutions largely rely on existing measures within the institutions, generally used for other risk management purposes. As a result, the limitations and potential issues related to

these measures are also relevant for the remuneration process. The risk adjustments used should benefit from the experience gained when dealing with these risks in other contexts and should be challenged like any other component of the risk management process.

#### b. Qualitative measures for ex-ante risk adjustment

112. It is important that qualitative risk elements are considered. These ex-ante adjustment could take place while setting institution-wide and business unit remuneration pools or when determining or allocating individuals' remuneration. Qualitative ex-ante risk adjustments are common at pool and individual levels, contrary to quantitative adjustments which tend to be mostly observed only at the pool level.

Institutions make qualitative risk adjustments when allocating/determining individuals' remuneration through the use of balanced scorecards that explicitly include risk and control considerations such as compliance breaches, risk limit breaches and internal control breakdowns (e.g. based on internal audit results).

#### Guidelines for supervisors

113. Supervisors should:

- determine whether control function and risk management function are involved in the determination of ex ante risk adjustment mechanisms;
- determine whether the institution is capping their overall variable remuneration pools, what metric is used to calculate the cap and how much the cap is;
- determine how granular the risk adjustment metrics are;
- review the challenge framework in place at the institutions to provide the necessary checks and balances between top down and bottom up approaches in variable remuneration calculation;
- ensure that institutions are maintaining records on ways used to implement ex ante risk adjustment in their remuneration process;
- review internal procedures and the minutes of the Rem Co meetings to understand how judgmental factors are applied in the ex ante risk adjustment of variable component of remuneration at individual level or in the calculation of a pool at business unit level;
- review (if relevant) cases of contestation by staff of the use of formulaic or judgmental factors in the determination of the variable component of its remuneration; and

- review the institution's policy and procedures to ensure that the institution actually applies an adjustment that is big enough to materially reduce the size of the pool in bad times.

#### 4.4. Payout process

##### Guidelines for institutions

##### 4.4.1. Non-deferred and deferred remuneration

*Recital (9) CRD III* A substantial portion of the variable remuneration component, such as 40 to 60 %, should be deferred over an appropriate period of time. That portion should increase significantly with the level of seniority or responsibility of the person remunerated. [...]

*Annex V, Section 11 Directive 2006/48/EC, point 23 (h)* [...] the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

*Annex V, Section 11 Directive 2006/48/EC, point 23 (p)* a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question. Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

114. A deferral schedule is key to improving risk alignment effects in a remuneration package, since it allows for part of the remuneration to be adjusted for risk outcomes over time through ex-post risk adjustments. Although remuneration is aligned through ex-ante risk adjustments, due to uncertainty, ex-post risk adjustments are needed to keep incentives fully aligned. This can only be done if part of the remuneration has been deferred.

115. A deferral schedule is defined by different components: (a) the time horizon of the deferral, (b) the proportion of the variable remuneration that is being deferred, (c) the speed at which the deferred remuneration vests (*vesting process*) and (d) the time span from accrual until the payment of the first deferred amount; another related issue is the form of the deferred variable remuneration (although it is not specific to deferral - see section 4.4.2.). Institutions can differentiate their deferral schedules by varying these five components. A stricter than necessary application for one component may influence the supervisory scrutiny for another component. In any case, the way

in which an institution combines these components must lead to a meaningful deferral schedule, in which the long-term risk alignment incentives are clear.

a. Time horizon and vesting

116. The deferral period always starts at the moment the upfront part of the variable remuneration is paid out and can be coupled either to cash variable remuneration or variable remuneration in instruments. It ends when the last variable remuneration has vested. The minimum deferral period is three to five years, depending on the potential impact of the staff on the risk profile of the institution. The actual deferral period should be further accommodated to the responsibilities and tasks performed by the staff and expected fluctuations in the economic activity of the institution, which in many cases will imply longer time horizons. At least for members of the management body in its management function, the institution should consider longer deferral periods.

b. Vesting process

117. *Pro rata* vesting (or payment) means for e.g. a deferral period of three years that at the end of years  $n+1$ ,  $n+2$  and  $n+3$ ,  $1/3$  of the deferred remuneration vests, if the end of  $n$  is the moment at which the performance is measured to determine the variable remuneration. Annex 3 to these guidelines includes a diagram showing an example of a pro rata spreading for a deferral scheme in which 60% of the variable remuneration is deferred (first diagram).

118. In any case, vesting should not take place more frequently than on a yearly basis (e.g. not every six months) since higher frequencies do not allow for a proper assessment of risks and thus, an ex-post adjustment of remuneration.

c. Proportion to be deferred

119. The proportion of the variable remuneration that must be deferred ranges from 40 to 60 %, depending on the impact the staff member (or category of staff) can have on the risk profile of the institution and the responsibilities and tasks performed, and depending on the amount of variable remuneration. If institutions decide to determine the proportion that is being deferred by a cascade of absolute amounts (rather than percentages of the total variable remuneration - e.g. part between 0 and 100: 100% upfront, part between 100 and 200: 50% upfront and rest is deferred, part above 200: 25% upfront and rest is deferred ...), supervisors will review that on an average weighted basis, such institutions respect the 40 to 60 % threshold.

d. Time span between end of accrual and vesting of deferred amount

120. In order to ensure a proper assessment of the performance outcome and, thus, to undertake a proper ex-post risk adjustment, the first deferred portion cannot be paid out too soon after the accrual period. For the deferral to be really

effective with regard to the staff's incentives, the first vested amount should not be sooner than 12 months after the accrual. See also the first diagram in Annex 3 on pro rata spreading.

#### 4.4.2. Cash vs. instruments

*Recital (7) CRD III* [...] To align incentives further, a substantial portion of variable remuneration of all staff members covered by those requirements should consist of shares, share-linked instruments of the credit institution or investment firm, subject to the legal structure of the credit institution or investment firm concerned or, in the case of a non-listed credit institution or investment firm, other equivalent non-cash instruments and, where appropriate, other long-dated financial instruments that adequately reflect the credit quality of the credit institution or investment firm. It should be possible for such instruments to include a capital instrument which, where the institution is subject to severe financial problems, is converted into equity or otherwise written down. In cases where the credit institution concerned does not issue long-dated financial instruments, it should be permitted to issue the substantial portion of variable remuneration in shares and share-linked instruments and other equivalent non-cash instruments. The Member States or their competent authorities should be able to place restrictions on the types and designs of those instruments or prohibit certain instruments, as appropriate.

*Recital (9) CRD III* [...] Moreover, a substantial portion of the variable remuneration component should consist of shares, share-linked instruments of the credit institution or investment firm, subject to the legal structure of the credit institution or investment firm concerned or, in the case of a non-listed credit institution or investment firm, other equivalent non-cash instruments and, where appropriate, other long-dated financial instruments that adequately reflect the credit quality of the credit institution or investment firm. In that context, the principle of proportionality is of great importance since it may not always be appropriate to apply those requirements in the context of small credit institutions and investment firms. Taking into account the restrictions that limit the amount of variable remuneration payable in cash and payable upfront, the amount of variable remuneration which can be paid in cash or cash equivalent not subject to deferral should be limited in order to further align the personal objectives of staff with the long-term interest of the credit institution or investment firm.

*Annex V, Section 11 Directive 2006/48/EC, point 23*

(o) a substantial portion, and in any event at least 50 %, of any variable remuneration shall consist of an appropriate balance of:

- (i) shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non-listed credit institution, and
- (ii) where appropriate, other instruments within the meaning of Article 66(1a)(a), that adequately reflect the credit quality of the credit institution as a going concern.

The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate.

This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (p) and the portion of the variable remuneration component not deferred;

*Article 22 Directive 2006/48/EC, paragraph 4* The Committee of European Banking Supervisors shall, *inter alia*, ensure the existence of guidelines to: [...] (b) specify instruments that can be eligible as instruments within the meaning of point 23(o)(ii) of Annex V that adequately reflect the credit quality of credit institutions within the meaning of point 23(o) of that Annex.

#### a. Types of instruments

121. For the purposes of these guidelines (and as set out in Annex V to the CRD), instruments can be understood as instruments that fall within one of the following two categories:

- shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned, or share-linked instruments, or in the case of a non-listed institution equivalent non-cash instruments<sup>24 25</sup>; and
- other instruments within the meaning of Article 66, paragraph 1a, letter a) CRD, where applicable, that adequately reflect the credit quality of the credit institution as a going concern.

This requirement is without prejudice to national corporate law and the legal or regulatory framework that, *inter alia*, may put limits to the total amount of instruments that a shareholder can hold (e.g. this may be the case for co-operative institutions). In deciding the amount and the type of instruments to be used, institutions may take into account the impact on the governance structure of the institution.

122. Where appropriate and applicable, the proportion of the variable remuneration that is paid out in instruments (either upfront or deferred) must be a combination, appropriately balanced, of both categories.

123. One of the basic purposes for remunerating staff in instruments is to put the staff into an owner-like position in order to align the staff's interests with those of the stakeholders, esp. of the owners. The owner-like position incentivises the staff to increase the institution's value. This added value will then be reflected in the instruments' value.

---

<sup>24</sup> In a group context, non-listed subsidiary institutions could have the option to use instruments issued by the parent company.

<sup>25</sup> Indices can not be used as a reference for the value of an institution.

124. The availability of instruments under the first category is dependent on the legal form of an institution. For institutions in the legal form of a stock corporation, shares or share-linked instruments are able to align the interests of the owners and staff. Share-linked instruments are those whose value is based on a market value appreciation of the stock and that have the share price as a reference point, e.g. stock appreciation rights, types of synthetic shares.

125. For many institutions which are not stock corporations, share-linked instruments are not an option due to their legal form. Even for unlisted stock corporations it may be difficult to determine a share price that represents the institution's value when no market price is available. In these cases alternative instruments, also those based on cash pools, may be used that reflect the institution's value and have the same intended effect as share-linked instruments. Differently from shares and share-linked instruments, the value of these equivalent non-cash instruments is determined by a third party, not by a stock market. Instruments, other than shares or share-linked instruments, should have comparable features to shares in terms of their loss absorbency capacity. For the acceptance of alternative instruments like phantom plans based on a third party valuation, it is crucial that the institution's value is determined correctly and comprehensibly. To reflect the institution's current value in these alternative instruments the institution's value must be determined directly on the moment of awarding, before the vesting and before the retention period ends respectively. A negative development of the institution's value will so be reflected in the value of these alternative instruments.

Neither dividends nor interests are paid on these types of instruments before vesting.

CEBS will monitor the regulatory and market developments regarding these alternative instruments and if needed, will provide further guidance on the use of these instruments in the remuneration context.

126. The second category refers to a specific subset of so-called Tier 1 hybrid instruments that are further described in Article 66, paragraph 1a, letter a) of the CRD: instruments that must be converted during emergency situations and may be converted at the initiative of the competent authority, at any time, based on the financial and solvency situation of the issuer into original own funds referred to in Art. 57(a) CRD<sup>26</sup>, within a pre-determined range.

---

<sup>26</sup> For these original own funds that can be included in the capital base within any limit, CEBS has published on 14 June 2010 Implementation Guidelines regarding Instruments referred to in Article 57(a) of Directive 2006/48/EC recast, available at <http://www.c-ebs.org/Publications.aspx>.

127. CEBS has already published guidelines regarding hybrid capital instruments on 10 December 2009<sup>27</sup>. These guidelines complement the CRD, describing the criteria for eligibility of hybrid capital instruments as original own funds. For the instruments within the meaning of Article 66, paragraph 1a, letter a), the guidelines define describe the features e.g. in terms of conversion into instruments referred to in article 57 (a) of the CRD. As a consequence, these instruments will, for the downside risk, share losses pari passu with the shareholders from the date of issue of these instruments.

#### b. Retention policy

128. To obtain the necessary risk alignment for instruments, a retention policy should be determined by the institution in the remuneration policy. The institution should be able to explain how the retention policy relates to other risk alignment measures in the total remuneration policy and should explain whether and how they differentiate between instruments paid upfront and deferred instruments.

Retention periods, as the most important element of the retention policy, are coupled with the vesting of instruments.

In the case of upfront instruments, retention periods are the only mechanism available to emphasize the difference between cash paid upfront and instruments awarded upfront in order to align incentives with the longer-term interests of the institution.

In the case of deferred instruments, the retention periods come after every vested portion (see also the concepts in Annex 1 and the second diagram in Annex 3 that illustrate these concepts). Supervisors will determine whether the retention periods proposed by the institution are deemed to be sufficient and appropriate.

129. The minimum retention period should be sufficient to align incentives with the longer term interests of the institution. Different factors may tend to suggest that this period could be longer or shorter. For example, when there is a deferral period above the minimum, being three years for Identified Staff with less material impact, and five years for Identified Staff with the highest material impact, or where institutions measure the performance of their staff over multi-year accrual periods and the ex ante risk adjustments have a high level of accuracy, institutions can shorten the retention period for deferred instruments accordingly. On the other hand, a longer period may be considered in cases

---

<sup>27</sup> Available at <http://www.c-eps.org/Publications.aspx>



where the risks underlying the performance can materialize beyond the end of the minimum retention period. Furthermore, it would be appropriate to apply longer retention periods for staff with the most material impact on the risk profile of the institution.

130. It is possible that a retention period lasts for a shorter period than the deferral period of a minimum three to five years applied to the instruments that are not paid up front. However, as an example of proportionality, for their most senior staff, large and complex institutions should consider the use of a retention period for upfront paid instruments that goes beyond the deferral period for the deferred instruments.

131. Instruments should be valued on the date of the award (at the end of the accrual period) of these instruments as the contrary would run against the long term interests of the institution. This value is the basis for the determination of the initial number of instruments and for later ex-post adjustments to the number of instruments.

132. It is important to highlight that the upfront payment of instruments, even with a minimum retention period of, for example, 3 years, is not equivalent to deferred instruments. Instruments paid upfront belong to the staff member (they are vested rights) which imply that no malus clauses can be applied to them. Although the staff member cannot sell the instruments for a 3-year period, the institution cannot change the number of instruments it has awarded. On the contrary, deferred instruments are subject to an ex-post risk adjustment due to the back-testing of the underlying performance, possibly leading to a reduction in the number of instruments that will eventually be paid out (see below from paragraph 134).

This difference is illustrated in the second diagram in Annex 3.

#### c. Minimum portion of instruments and their distribution over time

133. The end of point (o) of Annex V, Point 23, states that at least 50% of any variable remuneration shall consist of equity-linked instruments. A requirement is also included to apply this point to both the portion of the variable remuneration component that is deferred and the portion of the variable remuneration component not deferred. This means that the 50% minimum threshold for instruments must be applied equally to the non-deferred and the deferred part; in other words, institutions must apply the same chosen ratio between instruments and cash for their total variable remuneration to both the upfront and deferred part.

Examples:

- Correct practice: For a certain category within its Identified Staff, an institution establishes a 50 instruments / 50 cash ratio for the variable

remuneration, combined with a 60% deferral schedule (that is, 40% of non-deferred variable remuneration). This comes down to an upfront payment in instruments of 20 (i.e. 50% of 40) and 20 in cash. The deferred part consists of 30 in instruments and 30 in cash.

- Correct practice: For a certain category within its Identified Staff, an institution establishes a 70 instruments / 30 cash ratio for the variable remuneration, combined with a 40% deferral schedule (that is, 60% of non-deferred variable remuneration). This comes down to an upfront payment in instruments of 42 (i.e. 70% of 60) and 18 in cash. The deferred part consists of 28 in instruments and 12 in cash.
- Incorrect practice: If for a certain category within its Identified Staff, an institution were to establish a 50 instruments / 50 cash ratio for the variable remuneration, combined with a 40 % deferral scheme, the institution cannot decide to pay 50 in cash upfront and 10 in instruments, leading to a deferred pay out of 40 in instruments.
- Incorrect practice: If for a certain category within its Identified Staff, an institution were to establish a 70 instruments / 30 cash ratio for the variable remuneration, combined with a 50% deferral scheme, the institution cannot decide to pay 50 upfront in instruments and 0 in cash, leading to a deferred pay out of 20 in instruments and 30 in cash.

In Annex 3, an example of this equal distribution of instruments over the non-deferred and deferred is provided (second diagram).

#### 4.4.3. Ex post incorporation of risk for variable remuneration

*Annex V, Section 11 Directive 2006/48/EC, point 23 (g) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.*

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account [...] reductions in payouts of amounts previously earned, including through malus or clawback arrangements;

##### a. Explicit ex-post risk adjustments

134. Once an initial variable remuneration component has been awarded to the staff member, and an upfront part has already been paid, the institution still will be able to adjust, by way of a reduction, the variable remuneration as time goes by and the outcomes of the staff's actions materialize. This is the "ex-post risk

adjustment”, an element absolutely necessary to improve full alignment of the remuneration policy with risk taking.

135. An ex-post risk adjustment is an explicit risk alignment mechanism through which the institution itself adjusts remuneration of the staff member by means of malus arrangement or clawback clauses (e.g. by lowering cash remuneration or by awarding a lower number of instruments). Ex-post risk adjustment should always be performance-related: techniques that are, for example, based on the amount of dividends or the evolution of the share price are not sufficient. Therefore, ex-post risk adjustments are frequently also called “performance adjustments” because they are a response to the actual risk outcomes of the staff’s actions. Performance measures taken at this stage will allow the institution to perform an analysis (similar to back testing) as to whether its initial ex-ante risk adjustment was correct. Institutions should ensure there is a link between the initial performance measurement and the back-testing. Thus, the extent to which an ex-post risk adjustment is needed depends on the quality (accuracy) of the ex-ante risk adjustment.

136. Malus is a method for the implementation of risk adjustment and reducing the value of a part of the deferred remuneration, taking into account risk outcomes of the underlying performances of the institution as a whole, the business unit and, where possible, the staff member. The effect of this kind of ex-post risk adjustment cannot be inflated by paying out artificially high interest (above market rates) on the cash deferred parts to the staff member. Maluses operate by affecting the vesting process and cannot operate after the end of the deferral period. Furthermore, clawback can be a method for achieving an ex-post risk adjustment on variable remuneration (see also the concepts in Annex 1).

137. Institutions may utilize specific criteria whereby malus (to both the cash portion and the instruments portion of deferred remuneration) and clawbacks would apply. Such criteria should, for example, include:

- a. evidence of misbehavior or serious error by the staff member (e.g. breach of code of conduct and other internal rules, especially concerning risks);
- b. whether the institution and/or the business unit subsequently suffers a significant downturn in its financial performance (specific indicators are to be used);
- c. whether the institution and/or the business unit in which the staff member works suffers a significant failure of risk management;
- d. significant changes in the institution's economic or regulatory capital base.

A clawback typically operates in the case of established fraud or misleading information. Where applicable institutions should include clawback clauses in addition to the two cases mentioned before e.g. for remuneration received in breach of the CRD and these guidelines.

138. Similar to ex-ante risk adjustment and ex-post risk adjustment could be based on both quantitative measures and informed judgment. The benefit of judgmental approaches is that they can take into account circumstances that are difficult to capture in a formulaic approach.

139. To have the greatest impact on staff's incentives, the variables should measure outcomes as close as possible to the level of the decisions made by the staff member that is subject to the ex-post explicit adjustment. For example, variables for senior executives probably should be for outcomes for the institution as a whole, or for outcomes of units or decisions that were determined by senior executive strategy. In contrast, variables for a lending officer ideally would be based on the loans originated or monitored. Variables for the head responsible for a business unit ideally would be for outcomes of that unit.

#### b. Implicit adjustments

140. When the variable remuneration takes the form of instruments, the final payout to the staff member will depend partly on market prices due to fluctuations during the deferral or retention period. This implicit adjustment on remuneration is not related to any explicit decision of the institution, but inherent to the form that is used for paying out. Under no circumstances should the evolution of the stock price be considered sufficient as a form of ex-post risk adjustment. There should always be a form of explicit risk adjustment on the initiative of the institution. This is because price movements may respond to many factors other than the risk outcomes of performance of staff members. For non-senior staff in particular, there may be no direct relation between their decisions and the value of the institution.

141. Retention periods affect the risk-taking incentives of staff members only by extending the period during which implicit adjustments can take place. Therefore, a retention period on its own can never be sufficient to design an ex-post risk adjustment for instruments. A retention period is not a substitute for a longer deferral period.

#### c. Possibility of upward revisions

142. Symmetry between remuneration and risk outcomes has two important dimensions. First, variable remuneration must be flexible enough to be able to go to zero if results turn out to be unexpectedly negative (see above). On the other hand, there is the question as to whether they should be allowed to increase, above the amount that was initially awarded, if the results are unexpectedly good.

143. The answer is straightforward for instruments, since their market price can go up, so implicitly they will be subject to movements in their value in both directions.

144. The question turns more complicated with regard to explicit ex-post risk adjustments (both for cash and instruments). As a general rule, malus arrangements/clawback clauses will normally result in a reduction of the variable remuneration. Under no circumstances should the ex- post risk adjustment lead to an increase of the deferred part. When the staff member is exposed to both the positive and the negative part of the outcomes distribution, he will be given incentives to take more risk than that which can be considered prudent from a supervisory point of view.

#### Guidelines for supervisors

145. Supervisors should:

- check the time horizon of the applicable deferral schedules and see how it relates to the total time horizon for a given variable component of remuneration, i.e. the total horizon of the accrual period(s), the deferral period and retention periods, if not overlapping with the deferral period. This total time horizon should reflect the business cycle of an institution;
- examine historical remuneration information, to be provided by the institutions, about deferral and equity-linked remuneration schemes to check how the different numerical thresholds have been respected;
- review the combination of equity-linked instruments that the institution uses to meet the 50% threshold to ensure that it adequately reflects the long term interests of the institution in question;
- check whether explicit ex-post risk adjustments are defined and detailed;
- review whether explicit ex-post risk adjustments are based on performance assessment of the staff member, check the criteria used to measure the performance of the staff member (quantitative measures, informed judgment and balance between the two) and check whether deferred variable remuneration has been contracted or not vested where relevant;
- check whether malus has been applied to both the cash and equity part of the deferred variable remuneration and to the criteria on which malus relies;
- check whether ex-post risk adjustments do not result in an increase of the variable remuneration; and

- review (if relevant) the cases of contestation of malus applications by staff.

## 5. DISCLOSURE

### Guidelines for institutions

#### 5.1. Pillar 3 external disclosure

*Recital (21) CRD III* Good governance structures, transparency and disclosure are essential for sound remuneration policies. In order to ensure adequate transparency to the market of their remuneration structures and the associated risk, credit institutions and investments firms should disclose detailed information on their remuneration policies, practices and, for reasons of confidentiality, aggregated amounts for those members of staff whose professional activities have a material impact on the risk profile of the credit institution or investment firm. That information should be made available to all stakeholders (shareholders, employees and the general public). However, that obligation should be without prejudice to Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with the regard to the processing of personal data and on the free movement of such data.

*Annex XII, Part 2 Directive 2006/48/EC, new point 15*

The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices of the credit institution for those categories of staff whose professional activities have a material impact on its risk profile:

- (a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;
- (b) information on link between pay and performance;
- (c) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;
- (d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;
- (e) the main parameters and rationale for any variable component scheme and any other non-cash benefits;
- (f) aggregate quantitative information on remuneration, broken down by business area;
- (g) aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk

profile of the credit institution, indicating the following:

- (i) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;
- (ii) the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;
- (iii) the amounts of outstanding deferred remuneration, split into vested and unvested portions;
- (iv) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;
- (v) new sign-on and severance payments made during the financial year, and the number of beneficiaries of such payments; and
- (vi) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

For credit institutions that are significant in terms of their size, internal organisation and the nature, scope and the complexity of their activities, the quantitative information referred to in this point shall also be made available to the public at the level of persons who effectively direct the business of the credit institution within the meaning of Article 11.

Credit institutions shall comply with the requirements set out in this point in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to Directive 95/46/EC.

#### 5.1.1. Specific and general requirements on disclosure

146. Institutions should disclose, to the public, detailed information regarding their remuneration policies and practices for members of staff whose professional activities have a material impact on the institution's risk profile. Institutions should also provide general information about the basic characteristics of their institution-wide remuneration policies and practices.

147. The overall Pillar 3 requirements do not specify where an institution should disclose information. In all cases, however, the institution should ensure that the disclosure is easily accessible. The institution should ensure that the disclosures on remuneration provide appropriate cross-references to other information and disclosures in the Pillar 3 context which may be of relevance to users.

148. Pillar 3 remuneration disclosures may be made on a proportionate basis and the overall remuneration proportionality principle will apply to the type and amount of information disclosed. Small or non-complex institutions will only be expected to provide some qualitative information and very basic quantitative information where appropriate. In practice, this could mean that such institutions

are not expected to provide (all) the information under point 15 (g) of Annex XII. Institutions should disclose how they have applied the proportionality principle, including possible neutralizations of some of the provisions at their institution.

149. Existing Pillar 3 provisions exempt certain types of information from being disclosed on the basis of materiality, proprietary nature, or confidentiality<sup>28</sup>. Given the aggregate nature of the quantitative disclosures on remuneration, it is unlikely that these exemptions will be applicable. The disclosure requirements are without prejudice to Directive 95/46/EC.

According to article 72 (1) and (2) CRD, Pillar 3 remuneration disclosures are to be made at consolidated level. Certain institutions may also be subject to a waiver so that they do not have to comply with the disclosure requirements; this waiver is, however, only available where an institution is a subsidiary of a non-EU institution and the latter prepares equivalent disclosures at parent level (article 72 (3) CRD). Thus, the disclosures still cover the entity with a waiver, albeit indirectly at the consolidated level.

150. The disclosure should be published on, at least, an annual basis and as soon as practicable. Supervisors expect institutions to provide the first disclosure reports in compliance with the requirements in the course of 2011; it is also expected that institutions' disclosures will evolve over time to reflect developments within peer groups and in markets.

#### 5.1.2. Policy and practices

151. The disclosure report should set out the decision-making process used to determine the remuneration policy for the individuals to which it applies. This may include the governance procedure relating to the development of the remuneration policy and should include information about the bodies (including their composition and mandate), such as the Rem Co or external consultants, which played a significant role in the development of the remuneration policy. Institutions should outline the role of all relevant stakeholders involved in the determination of the remuneration policy. Additionally, the disclosure should include a description of the regional scope of the institution's remuneration policy, the types of staff considered as material risk takers and the criteria used to determine such staff.

---

<sup>28</sup> Information is material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. Information is proprietary if sharing that information with the public would undermine the firm's competitive position. Information is confidential if there are obligations to customers or other counterparty relationships binding the firm to confidentiality.



152. The report should include information on how pay and performance are linked. Such information should include a description of the main performance metrics utilized for: the institution, top-level business lines, and for individuals (i.e. scorecards). Institutions should disclose information relating to the design and structure of remuneration processes, such as the key features and objectives of the remuneration policy and how the institution ensures that staff members in control functions are remunerated independently of the businesses they oversee. The report should also include a description of the different forms of variable remuneration utilized (i.e. cash, equity, options, other capital instruments, and long-term incentive plans) and should include the rationale for using these different forms and for allocating them to different categories of staff. Additionally, the report should include a discussion of the parameters used to allocate deferred and non-deferred remuneration for different staff categories.

153. Disclosure reports should describe how the institution takes into account current and future risks to which they are exposed when implementing remuneration methodologies and what these risks are. Also, institutions should describe the measures used to take account of these risks and the ways in which these measures affect remuneration. In addition, institutions should disclose the ways in which they seek to adjust remuneration to take account of longer-term performance - as in the institution's policy on deferral, vesting and performance adjustment.

154. It would be useful to ensure that the disclosure is produced and owned by the management body that has the ultimate sign-off on remuneration decisions.

### 5.1.3. Aggregate quantitative information

155. Institutions should provide aggregate quantitative information by business area and on remuneration for members of staff whose actions have a material impact on the risk profile of the institution. The information for each of the major business areas at an institution, i.e. investment banking business area, retail banking business area, etc. should include: number of staff, total remuneration and total variable remuneration. Some institutions may only have one or two business areas.

156. More detailed qualitative information on remuneration should be disclosed for senior managers and other members of staff whose actions have a material impact on the risk profile of the institution including aggregate information on amounts of remuneration, amounts and forms of variable remuneration, and amounts of outstanding deferred remuneration. Other more detailed quantitative information is also required as per the Directive.

157. Quantitative information on remuneration should also be disclosed separately on an aggregate basis at the level of directors (within the meaning of Article 11 of the Directive<sup>29</sup>) for institutions that are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities. This will be a separate category of disclosure information to the categories of senior management and other staff members who have a material impact on the risk profile of the institution.

## 5.2. Internal disclosure

158. The remuneration policy of a credit institution or investment firm should be accessible to all staff members of that institution. Institutions should ensure that the information regarding the remuneration policy disclosed internally reveals at least the details which are disclosed externally. Therefore, according to the size, internal organisation and the nature, scope and complexity of the activities of the institution, the information provided to staff members might contain some of the elements listed in Annex XII, Part 2, Point 15. The staff members should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and should be transparent to the member of staff concerned. Confidential quantitative aspects of the remuneration of staff members shall not be subject to internal disclosure.

### Guidelines for supervisors

159. Supervisors should<sup>30</sup>:

- Assess whether there is a need to review public disclosures on remuneration made by institutions;
- Require periodic (or ad hoc) supervisory reporting on remuneration disclosure in order to monitor the development of remuneration practices within institutions;
- Ask for staff member assessment documents including balanced scorecards that are used to assess member of staff's performance;
- Interview staff members at an institution to see if they have access to the institution's remuneration policies and to check that they understand how their remuneration is determined.

---

<sup>29</sup> Article 11 of the Directive refers to those persons who effectively direct the business of the credit institution.

<sup>30</sup> Also with a view to the benchmarking requirements that are included in the new paragraphs 3 and 4 of Article 22 CRD.



## ANNEX 1 - CONCEPTS

The meaning of the specific terminology related to the time horizon of deferral schedules, as used for the purposes of these guidelines, is outlined here.

**Accrual period:** Period during which the performance of the staff member is assessed and measured for the purposes of determining its remuneration. The right to receive the variable remuneration is earned ("awarded") at the end of the period or during the period. The accrual period is at least one year, but it may be longer. In some cases different accrual periods may overlap.

**Vesting process:** An amount of remuneration vests when the staff member receives payment and becomes the legal owner of the remuneration. Once the remuneration vests, no explicit ex-post adjustments can occur apart from clawback clauses.

**Deferral period:** Variable remuneration payment can be made immediately after the accrual period ("upfront payments") or later on. The deferral period is the period during which variable remuneration is withheld following the end of the accrual period. A deferral period should not be less than three to five years. Deferred remuneration meets two essential conditions: it is unvested and it is subject to ex-post malus risk adjustments. Deferred remuneration pay-out can be a once-only event at the end of the deferral period or may be spread out over several payments in the course of the deferral period, according to a pro-rata vesting scheme.

**Instruments:** see paragraphs 121-127 of the guidelines.

**Retention period:** period of time during which variable remuneration that has been already vested and paid out in the form of instruments cannot be sold. The retention period is independent from the deferral period. This means that, in order to meet the requirement of a minimum deferral period of three to five years, the retention period counts for nothing. The retention period can last for a shorter or longer period than the deferral period applied to the instruments that are not paid upfront.

**Malus:** arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes of performs. Malus is a form of ex-post risk adjustment.

**Clawback:** contractual agreement in which the staff member agrees to return ownership of an amount of remuneration to the institution under certain circumstances. This can be applied to both upfront and deferred variable remuneration. When related to risk outcomes, clawback is a form of ex-post risk adjustment.

## ANNEX 2 – MAPPING OF THE REMUNERATION PRINCIPLES INCLUDED IN THE CRD

CRD Requirement – Annex V point 23 & 24		Coverage in these guidelines (the numbers refer to the relevant paragraphs)	Applicability: either	Neutralization
(a)	the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;	65-66	<ul style="list-style-type: none"> <li>• Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>• Only to the Identified Staff but institution-wide strongly recommended</li> <li>• Institution-wide obligatory</li> </ul>	No
(b)	the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest;	65-66 42-51	<b>Institution-wide obligatory</b>	No
(c)	the management body, in its supervisory function, of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;	42-51	<b>Institution-wide obligatory</b>	No
(d)	the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;	49-51	<b>Institution-wide obligatory</b>	No
(e)	staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in	57-62	<b>Institution-wide obligatory</b>	No

<b>CRD Requirement - Annex V point 23 &amp; 24</b>		<b>Coverage in these guidelines (the numbers refer to the relevant paragraphs)</b>	<b>Applicability: either</b>	<b>Neutralization</b>
	accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;		<ul style="list-style-type: none"> <li>Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>Only to the Identified Staff but institution-wide strongly recommended</li> <li>Institution-wide obligatory</li> </ul>	
(f)	the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in point (24) or, if such a committee has not been established, by the management body in its supervisory function;	57-62	<b>Institution-wide obligatory</b>	No
(g)	where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial and non-financial criteria are taken into account;	89-92 95-97	<b>Only to the Identified Staff but Institution-wide strongly recommended</b>	No
(h)	the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;	87-88 116-120	<b>Identified Staff (Institution-wide voluntary)</b>	No
(i)	the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;	34-37 66	<b>Institution-wide obligatory</b>	No

CRD Requirement - Annex V point 23 & 24		Coverage in these guidelines (the numbers refer to the relevant paragraphs)	Applicability: either	Neutralization
(j)	guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment;	69	<ul style="list-style-type: none"> <li>Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>Only to the Identified Staff but institution-wide strongly recommended</li> <li>Institution-wide obligatory</li> </ul>	No
(k)	<p>in the case of credit institutions that benefit from exceptional government intervention:</p> <p>(i) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;</p> <p>(ii) the relevant competent authorities require credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the credit institution within the meaning of Article 11(1);</p> <p>(iii) no variable remuneration is paid to the persons who effectively direct the business of the credit institution within the meaning of Article 11(1) unless justified;</p>	38-41	Institution-wide obligatory	No
(l)	fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component.	76-77 78-83	<b>Only to the Identified Staff but institution-wide strongly recommended</b>	No, except that for investment firms as referred to in paragraph 14 and 20 of the guidelines, the requirement to

<b>CRD Requirement - Annex V point 23 &amp; 24</b>		<b>Coverage in these guidelines (the numbers refer to the relevant paragraphs)</b>	<b>Applicability: either</b>	<b>Neutralization</b>
	Credit institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration;		<ul style="list-style-type: none"> <li>• Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>• Only to the Identified Staff but institution-wide strongly recommended</li> <li>• Institution-wide obligatory</li> </ul>	have appropriate ratios between the fixed and variable remuneration can become neutralized.
(m)	payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;	70-71	<b>Institution-wide obligatory</b>	No
(n)	the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required. The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;	93-94 107-112	<b>Only to the Identified Staff but institution-wide strongly recommended for profit-based measurement</b>	No
(o)	a substantial portion, and in any event at least 50 %, of any variable remuneration shall consist of an appropriate balance of: (i) shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non-listed credit institution, and (ii) where appropriate, other instruments within the meaning of Article 66(1a)(a), that adequately reflect the credit quality of the credit	121-133	<b>Identified Staff (institution-wide voluntary)</b>	Yes  At institutional level: for those non-complex institutions who are not publicly traded and have no alternatives instruments for shares or share-



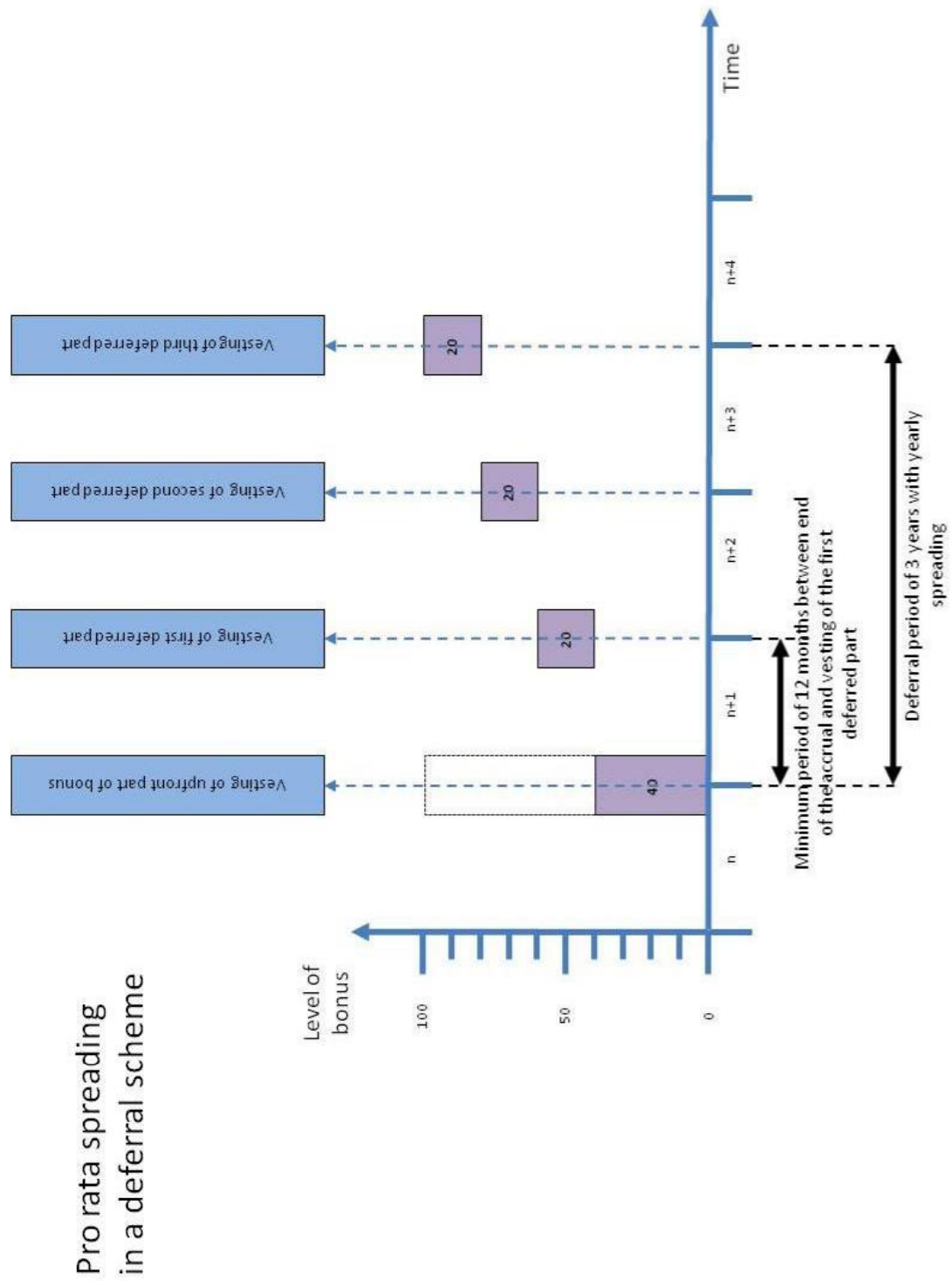
CRD Requirement - Annex V point 23 & 24	Coverage in these guidelines (the numbers refer to the relevant paragraphs)	Applicability: either	Neutralization
	institution as a going concern. The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (p) and the portion of the variable remuneration component not deferred;	<ul style="list-style-type: none"> <li>• Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>• Only to the Identified Staff but institution-wide strongly recommended</li> <li>• Institution-wide obligatory</li> </ul>	linked variable remuneration available  At the level of Identified Staff: for those with less material impact on risk profile
(p)	a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.  Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;	<b>Identified Staff (institution-wide voluntary)</b>	Yes  At institutional level: for non-complex institutions  At the level of Identified Staff: for those with less material impact on risk profile

<b>CRD Requirement - Annex V point 23 &amp; 24</b>		<b>Coverage in these guidelines (the numbers refer to the relevant paragraphs)</b>	<b>Applicability: either</b>	<b>Neutralization</b>
(q)	the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;	37-40 107-112 134-144	<ul style="list-style-type: none"> <li>Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>Only to the Identified Staff but institution-wide strongly recommended</li> <li>Institution-wide obligatory</li> </ul> <b>Identified Staff (institution-wide voluntary)</b>	<p>Yes with regard to ex post risk adjustment</p> <p>At institutional level: for non-complex institutions</p> <p>At the level of Identified Staff: for those with less material impact on risk profile</p>
(r)	the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution.  If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of five years in the form of instruments referred to in point (o). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (o) subject to a five-year retention period;	65-66 67-74	<b>Institution-wide obligatory</b>	No

<b>CRD Requirement - Annex V point 23 &amp; 24</b>		<b>Coverage in these guidelines (the numbers refer to the relevant paragraphs)</b>	<b>Applicability: either</b>	<b>Neutralization</b>
(s)	staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;	72	<ul style="list-style-type: none"> <li>Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>Only to the Identified Staff but institution-wide strongly recommended</li> <li>Institution-wide obligatory</li> </ul>	No
(t)	variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive.	13	<b>Institution-wide obligatory</b>	No
The principles set out in this point shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.		27-30	<b>Institution-wide obligatory</b>	No
Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.		52-56	<b>Institution-wide obligatory</b>	Yes
The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The Chair and the members of the remuneration committee shall be members of the management body who do				

CRD Requirement - Annex V point 23 & 24	Coverage in these guidelines (the numbers refer to the relevant paragraphs)	Applicability: either	Neutralization
<p>not perform any executive functions in the credit institution concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.</p>		<ul style="list-style-type: none"> <li>• Only to the Identified Staff (but voluntary institution-wide application is always possible)</li> <li>• Only to the Identified Staff but institution-wide strongly recommended</li> <li>• Institution-wide obligatory</li> </ul>	

ANNEX 3 - SCHEMATIC OVERVIEW OF SOME DEFERRAL MECHANISMS



# Accrual vs. deferral vs. retention

