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Update on Capital Requirements Directive III (CRDIII) Remuneration Guidelines

By Lex Verweij
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The long awaited guidance from the Committee for European Banking Supervisors (CEBS) was published 8 October 2010. The guidelines are designed to help institutions and regulators interpret and implement the remuneration aspects of the EU CRD III legislative resolution on the implementation of the Basel III agreement on solvency. In short, these guidelines will direct institutions on how they can compensate a significant number of their most crucial employees. As was anticipated, the guidelines are strict on the conditions and structure of variable pay from a risk management and solvency perspective.

This McLagan Alert reviews these guidelines and their implications based on our discussions with institutions and regulators. Shortly, we will also publish our response to the proposed guidelines as part of the ongoing consultation process.

Role of the CEBS

The CEBS will oversee the implementation of the CRD until the European Banking Authority is established in 2011. The CEBS consists of the national supervisors of the individual member states and is mandated to provide guidelines to national regulators on the remuneration aspects of the CRD. Whilst national regulators have some flexibility on the extent to which they follow the guidelines issued by the CEBS, it is our view that most regulators will follow the guidelines closely because of the intense political pressure for consistency and because most regulators were involved in the development of the guidelines.

When implementing the regulations, the financial institutions must deal directly with their national regulator. The institution will have recourse to the CEBS if they find that the rules are being inconsistently administered.

Summary of Guidelines

- **CRD III applies to:**
  - All staff globally of institutions based in the EU.
  - EU based staff employed by non- EU institutions. In case of state support, competent national authorities decide on the level of and limitations on variable pay.
- All remuneration paid after **1 January 2011**, including variable pay resulting from 2010 performance, must comply with the CRD III requirements.
- As part of the implementation of the Basel III agreement the **relationship between variable pay-outs and capital base** is an important driver for the regulations and guidelines. Regulators have the power to limit variable remuneration as a percentage of net revenues when it is inconsistent with the maintenance of a sound capital base.

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- **Specific pay-out rules apply to “identified staff” consisting of:**
  - Members of the Board
  - Senior executives and senior management
  - Members of control functions (e.g., as risk, HR, audit)
  - Individuals and groups with a “material impact on balance sheet and/or results”
  - Highly compensated individuals with high variable compensation (*Note:* specific thresholds for benchmarks to determine eligibility on this basis were not included in the published guidelines).

- **General guidelines** apply to the institution on governance, role and compensation of the remuneration committee, control functions, risk alignment and prohibitions on guaranteed variable pay, specific severance agreements and hedging of deferrals.
  - Governance includes the role, composition and compensation of the Remuneration Committee and how control functions assist and manage the process of policy making and performance management and how they are compensated.
  - Risk alignment requires that the remuneration policy identifies how excessive risk taking will be prevented and how it will contribute to safeguarding a sound capital base.
  - Performance must be measured on quantitative and qualitative measures whereby negative qualitative performance such as failing to comply with risk policies can overrule any quantifiable positive performance in determining variable pay.
  - Guarantees as they relate to variable pay are allowed only for the first year for new staff.
  - Severance should be limited to provide a safety net and managed by the internal governance structure. For Directors of listed companies, the maximum of two-year fixed remuneration should be applied in line with corporate governance recommendations in the EU.
  - Hedging of downward risks on deferred compensation is not permitted.

- **Specific guidelines for identified staff:**
  - All incentive payouts must be 50% in equity or equity like instruments.
  - In addition, 40-60% of incentive payments must have a minimum three year deferral with the potential for malus (i.e., negative discretion) approach to vesting in addition to the legal claw-back.
  - Upside potential on the deferral (other than the underlying share price increase) is prohibited.
  - After vesting, an additional retention period is required bringing the deferral period up to five years. In other words, there is a further two-year no sale requirement.

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- **Partial Relief:** A **proportionality** clause exists in the application of the CRD III rules and the CEBS guidelines:
  - Some of the more general requirements (such as RemCo responsibilities) as well as specific requirements (such as deferral into equity) can be neutralised for **organisations** that do not pose systemic threat and also for some **staff** within an organisation.
- The **"appropriate ratio" between fixed and variable** remuneration has to be defined based on role and business line.

Implications for Institutions

There are a few concepts and definitions which have to be addressed by institutions in response to the guidelines.

1. Proportionality

It is important to first establish to whom the guidelines will actually apply, and to what extent the proportionality clause exempts certain staff from some of the requirements.

Proportionality can apply to the size, legal structure, nature, scope and complexity of an institution. In some cases full "neutralisation" could apply to the requirement of a RemCo and to the specific requirements for the pay-out structure (e.g., equity, deferral and retention).

When equity is not an option, equity like vehicles such as SARS or Phantom Shares can be used.

In addition, there could be a partial or full exemption if institutions have established client aligned business models, sound compensation framework and robust ex ante pool adjustments on risk. The reasoning behind this is that ex ante adjustments on the pool and ex post adjustments through malus can actually be interchangeable to some extent. This is particularly helpful for investment firms with partnership structures and carried interest type incentives tied to the performance and time horizon of the assets.

For banking organisations there is an important opportunity here to improve the remuneration structure in line with the requirements, whilst limiting the need for a deferral. Any institution that can prove that they take prudent behaviour towards risk can apply for this exemption. In cases where sophisticated risk and time horizon adjustments to the bonus pool calculation are applied (e.g., Return on Risk Weighted Assets) in combination with strong governance and multi-year performance management, some of the ex post deferral requirements could be neutralised.

2. Incentive and Pay-out Design

The proposed guidelines will challenge all covered organisations to rethink the design of their incentive plans. The flexibility granted under the concept of proportionality will have the greatest opportunities for design in the decision to use equity, cash based equity-like vehicles or carried interest and co-investments programs.

- Adjustment of the pool (ex ante adjustment) for risk, time horizon and solvency.

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- Creation of separate incentive pools of “Identified Staff” as opposed to combined bonus pools for all staff.
- Methodologies for adjustment of deferral with malus conditions (ex post).
- Creation of reasonable "retention requirements” in addition to required “vesting periods” (total period being at least 3 to 5 years).

An important driver for the level of deferral and retention is the extent to which bonus pools can be adjusted for risk, returns and solvency and time horizon. If a bonus is not paid out until all criteria are met including time horizon (i.e., there is no unaccounted tail end risk left) the deferral requirement can be lowered accordingly. Though this seems like a reasonable way to lower deferrals, it is important that the implications are fully understood. This “trade off” between ex post and ex ante adjustments is only allowable if it can be demonstrated to lower “risk seeking behaviour” and/or can be proven to better align the risk profile of the institution and the solvency requirements.

For some investment managers who have incentives tied to the performance on behalf of the investor (closed funds with profit sharing), this is relatively easy to implement. For other investment managers and most banks this would involve a more substantial overhaul of the current incentive structure, governance and performance management systems.

3. Identified Staff

One of the most complex processes facing financial institutions is the determination of the group of employees subject to these provisions. This group is comparable to the “material risk takers” that the Federal Reserve in the U.S. is seeking to identify and to the Code Staff definition of the FSA. While many of the categories of employees (e.g., Board, executives and specific roles such as traders) are explicitly mentioned in the regulations there are sufficient grey areas where organisations will seek consistency across institutions to ensure that they will not be competitively disadvantaged. In this latest release there are some additional guidelines such as percentage of the overall population and a direction to look at job descriptions. Job descriptions mentioning risk, returns and use of capital could be considered an identifier. Also, if in internal ranking the compensation ranks towards the highest end in variable versus fixed remuneration, the role would likely fall in the definition of identified staff.

4. Appropriate Ratio Between Fixed and Variable Remuneration (Pay Mix)

Following the definition of “Identified Staff” the institution must identify appropriate pay mixes for different categories of staff. It is left to the institution on how this is achieved. Based on our discussions with regulators that broad categorisation of employees in respect to:

1) Balance sheet/results and sensitivity to risk
2) Franchise value versus individual prominence

would allow for different pay mixes for each category and would create sufficient granularity to comply with this requirement.

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5. **Disclosure**
   Institutions are required to disclose the policies, decision making process and involved stakeholders as well as the link between performance and pay in general. These requirements are similar to the existing practices for remuneration reports from the Remuneration Committee. Aggregate information should be disclosed on remuneration for Identified Staff and Directors. These rules do not apply (in full) to proportionally exempted organisations.

In Conclusion

The challenges have just begun, and there will be a race to the end of the year addressing the topics and defining a response to the regulator. More importantly, defining the appropriate pay-mix and incentive structure will be crucial to a firm's success. We will continue to update you on further developments as we interact with the industry and regulators. ■

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Lex is also involved in advisory work for the FSB, CEBS and national regulators in Europe to help improve alignment between the regulators. He can be reached at +44 (0)20 7680 3809 or lverweij@mclagan.com.

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