Ever since the financial crisis, credit institutions within Europe have faced increasing regulatory pressures at almost every level of their operations. More than mere restrictions on operations, regulations affect the way remuneration is to be delivered to the workforce of financial institutions. With the introduction of CRD III (Directive 2010/76/EU) and now CRD IV (Directive 2013/36/EU), the European Union is attempting to reduce excessive and imprudent risk taking within financial institutions fueled by inappropriate remuneration practices. Regulators believe that poorly designed remuneration structures may have negative effects on the sound management of risk, the control of risk and above all the risk-taking behavior of given individuals. Today’s evolving remuneration requirements have major implications for the cost structures of financial institutions as they work to ensure full compliance. Indeed, remuneration requirements under CRD IV not only affect individuals themselves, but also have major consequences for the entire remuneration and benefits processes. This will also have an impact on talent and HR as a whole.

Understanding the major regulatory implications of CRD IV: “the eight commandments”

CRD IV, like all other directives affecting the financial industry, applies the same core principles regarding remuneration practices and procedures. However, the implementation and specific rules related to such practices differ in each directive. In light of this, we have identified the eight core principles that underpin the regulatory framework for remuneration practices, and these are illustrated below.
The 8 core principles for remuneration practices

1. Remuneration policy
   - Written remuneration policy
   - Effective implementation & annual review

2. Identified Staff
   - Material impact on an institution’s risk profile
   - Specific provisions in regards to the remuneration

3. Performance assessment criteria
   - Qualitative & Quantitative
   - Multi-Year framework

4. Governance
   - Governance mechanisms
   - Remuneration Committee where applicable

5. Balance
   - Balance between Fixed and variable pay
   - Allow flexibility on variable remuneration due to balance

6. Instruments & deferrals
   - Payment through financial instruments
   - Deferral over a multi-year framework

7. Malus/clawback
   - Failure is not rewarded
   - Retaining a variable remuneration

8. Proportionality Principle
   (see below)

Proportionality Principle
The principle of proportionality allows institutions and national regulators to provide exemptions to certain requirements if their impact in particular cases would be disproportionate, both at institutional, as well as, individual level. The following factors should be considered together to assess the applicability of the proportionality principle:

1. Size
2. Nature, scope and complexity of activities
3. Internal organization

Institutional level

Individual level

Disapplication of Requirements
- Payment in instruments & Deferral requirements
- Retention periods
- Malus / clawback provisions
- Appointment of a remuneration committee
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Setting up a remuneration policy
The first key point to note from the above is that each institution must have a remuneration policy that is independently reviewed at least once per year. A major observation in market practices is that financial institutions often seem to think that having a standard drafted policy will be sufficient.

However, reality diverges from this point of view. Any remuneration policy should accurately reflect how remuneration is structured within the relevant institution and, most importantly, must provide sufficient evidence to prove that the given practices promote healthy risk management. It is important for institutions to realize that their remuneration practices are subject to independent annual review and will eventually be tested. Should the policy not reflect the reality on the ground, the report of the independent review will be submitted to the national regulator.

Understanding who affects the institution’s risk profile
Another principle is the identification of staff. When referring to the so-called “identified staff” or “material risk takers,” the regulator is targeting the people within the credit institution who might have a material impact on the company’s risk profile as a result of their role and/or the nature of their activities.

But how can institutions identify material risk takers?
Under regulation (EU) 604/2014, credit institutions are given instructions regarding how to identify material risk takers. The regulations state that institutions shall identify their material risk takers through the use of qualitative and quantitative criteria, where the former might be linked to a persons’ influence on the decision-making process or their power to use “veto” votes, and the latter is linked to the actual remuneration of that person. For example, if any employee is in the same remuneration bracket as senior management, such a person shall be considered as having a material impact on the institution’s risk profile, regardless of his/her role and responsibilities.

Certain roles, such as the board of directors, senior management, and the control and risk functions, are officially listed as being in scope. However, the question then remains: who exactly in such roles is defined as “identified”? What common market practice currently tells us is that if people within the given functions/teams have the authority and power to act upon their decisions without any need for specific approvals, they are to be included in the list of material risk takers.

Institutions are obliged to set up a remuneration structure and practices that apply to all employees, with some specific requirements applicble only to identified staff.

If the remuneration policy only applies to material risk takers, what’s the big deal? This question reflects a common misconception. Experience has shown that many actors within the financial industry believe that the requirements (of CRR or other regulations) only apply to material risk takers. The reality, however, is that institutions are obliged to set up a remuneration structure and practices that apply to all employees, with some specific requirements applicable only to identified...
staff. Yet, it is very important to understand that the general mindset of promoting a sound and effective remuneration policy needs to be reflected throughout the remuneration process with regard to every employee. All remuneration structures must be based upon specific evaluation criteria, and even aligned with the long-term strategy of the firm, as well as promoting its values and what it stands for.

**Performance assessment**

Regulators are of the opinion that, in the past, variable remuneration was too dependent on individual performance and did not reward respect for internal procedures and/or proper risk management in the decision-making process. In light of this, organizations in the financial industry need to ensure that the performance assessments used to determine variable remuneration reflect both quantitative and qualitative criteria. Moreover, one of the differences between the way that material risk takers and the wider workforce are evaluated is the length of the evaluation cycle used to set variable remuneration. Whereas the institution needs to link the variable remuneration for the overall workforce to performance over the given evaluation cycle, credit institutions assessing material risk takers must also account for performance across a multi-year framework.

The multi-year framework plays an important role within the entire concept behind the remuneration-related restrictions. It is important to understand that a good decision today might have negative future consequences. As such, risk takers with very bad evaluations two years ago and very good evaluations this year should not benefit from the maximum bonus amount, as their past decisions might still have a negative influence on future events.

Additionally, organizations must bear in mind that control functions are subject to other specifications, because the variable remuneration for such employees must be linked to the objectives of their function and their function only, independent of the performance of business activities they may oversee.

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**Ensuring a balance between fixed and variable remuneration**

The notion of the balance between fixed and variable remuneration is quite vague. Fortunately, the CRD IV provides quite clear instructions as to what it means. The variable remuneration of any risk taker in a financial institution should not exceed 100 percent of his/her fixed remuneration, yet under specific circumstances this ceiling may be extended up to 200 percent. Such a ceiling can only be exceeded if the majority of shareholders agree. Should one of the shareholders fall within the scope of the exceeded 1:1 ratio, however, his/her vote shall not be taken into account.

If a company believes that they may exceed the ceiling, there is a specific procedure it must follow. First, the institution must notify the regulator about its intention to exceed the 1:1 ratio. Then the organization needs to enter into a shareholder voting process and secure a majority of at least 66 percent (provided that at least 50 percent of the shares or equivalent ownership rights are represented or, failing that, a majority of 75 percent of the ownership rights are represented). Once the vote has been validated, the institution should notify the regulator about the decision and provide a reasonable justification.

**Pay-out process rules: deferral, payment in instruments and malus/clawback for identified staff**

In order to ensure that variable remuneration links to the long-term strategy of the institution and reflects overall performance, regulators have imposed rules on how variable remuneration is to be paid out:

- At least 40 percent of the amount of variable remuneration in any event should be deferred
- The deferral period cannot be shorter than between three and five years
- For the remaining 60 percent of the variable remuneration, only 50 percent of the given amount is to be paid in cash, whereas the remaining 50 percent must be paid in shares, which are subject to a six-month retention period
The illustration below gives a basic overview of some of the CRD IV requirements in terms of deferral and retention.

Given the above, the link between variable pay and payout in instruments enables institutions to align remuneration with risk-related exposure so that variable remuneration can also amount to zero. Indeed, financial institutions must ensure that variable remuneration under no circumstances rewards failure.

**Governance**

In order to avoid any type of conflict of interest, companies must devise an internal governance structure that proves that its remuneration processes are reasonable and independent. Organizations must understand the fact that the board members who define the remuneration principles and general guidelines within the firm are also considered to be “identified staff.” As such, it would be easy to bias such practices and principles based on personal interests. Therefore, the regulators want credit institutions to set up remuneration committees to ensure that an independent body reviews remuneration practices and principles and their proper implementation. Rather than simply setting up a remuneration committee, institutions should involve control and HR departments in the process and ask compliance to ensure that the legal requirements are met.

**Proportionality**

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The proportionality principle is most probably the holy grail of every financial institution, whereby it may choose to disapply one or more of the specific provisions imposed by regulators.
Applying proportionality allows an institution to disapply the following elements:

- Pay-out of part of the variable remuneration in instruments
- Retention period
- Deferral of part of the variable remuneration
- Ex post incorporation of risk
- Establishment of a remuneration committee

Indeed, this is pretty convenient for institutions and many seek to apply this principle. What many local institutions forget, however, is that when applying proportionality organizations need to provide a justification showing why they are eligible for it. Most entities just use the quantitative data as provided by CSSF 10/505, hence neglecting the fact that the regulator strongly recommends using the quantitative measure as a reference and also referring to an overall framework as stipulated by the Committee of European Banking Supervisors (CEBS) guidelines.

On the topic of CEBS, it is important to note that these guidelines still refer to CRD III requirements, whereas under CRD IV the European Banking Authority (EBA) is mandated to guide institutions as they interpret and implement CRD IV in terms of remuneration. As such, all eyes are currently on the new guidelines issued by EBA surrounding CRD IV, which will replace, from 1 January 2017, the existing guidelines on remuneration policies and practices published by the CEBS in December 2010. These will apply to companies that are subject to CRD IV on a solo and consolidated basis.

The most significant development to note is that the guidelines uphold, as expected, the EBA’s position in relation to proportionality as the EBA outlined in the draft guidelines published in March 2015. It remains the EBA’s position that, based on the current text of CRD IV, firms should not be permitted to “neutralize” or disapply entire provisions under CRD IV, either on account of their size and complexity or in relation to individuals who receive a lower level of variable pay.

It should be noted that the EBA has published a separate opinion alongside the guidelines pertaining to the application of the principle of proportionality, in which it states that small and non-complex institutions (other than subsidiaries of large firms) should be permitted to disapply the requirements relating to deferral, pay-out in instruments and discretionary pension benefits. It also states its view that it should be possible for these requirements to be disapplied by all firms, regardless of their size, in relation to staff who receive “low levels” of remuneration, though no indication has been given as to what would constitute a low level of remuneration for these purposes (and whether such levels would be determined on a relative or on an absolute basis).

However, the EBA believes that, in order for there to be a legal basis for these exemptions, legislative changes will need to be made to CRD IV. It is therefore likely to take some time before any such exemptions will take effect and it is unclear whether it will be possible for such amendments to be made prior to the coming into force of the guidelines on 1 January 2017.
Complex performance management process
The challenge is the fact that HR must now integrate the notion of a multi-year evaluation framework, where employees will receive variable pay not only relating to their performance for the given evaluation year, but in relation to prior evaluation cycles as well. HR needs to understand the different structure variable remuneration will adopt and even needs to monitor the deferral of such pay and the possible shifts in its value, knowing that each year a new level of variable pay will be entered into the system for the employee in question. Moreover, when monitoring the remuneration of the workforce, HR needs to clearly understand the parameters applied to identified staff. Moreover, HR must constantly be aware of shifts in the status of the different people within different departments so that the relevant criteria can be applied.

As of today, major HR trends show the desire to shift towards simpler performance management processes, with an emphasis on development rather than evaluation. Yet the increasing requirements regarding remuneration and the respective link to performance intensifies the need to maintain complex evaluation systems.

Remaining an employer of choice
Restrictions imposed on remuneration in the European Union have a wider effect than initially intended by the regulators. The many regulations imposed on financial institutions, especially in terms of remuneration, will mean that new talent increasingly turns to new markets, far away from Europe.

The question we must ask ourselves is: “what is the incentive for bankers, financial analysts and others to choose a European employer over any other?” Under such circumstances, it is becoming difficult for HR to recruit the necessary talent to respond to the organizational talent demand. In addition to attracting talent, retaining talent is also becoming challenging, as many choose to find refuge either in emerging economies or well-established environments such as the USA, Singapore, Hong Kong and others.

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So what does this mean for HR?
HR is handling the constant application of regulatory requirements, and it shoulders a considerable burden as a result. HR must be heavily involved in implementing changes because of the constant shift in evolving regulations. Rather than simply implementing regulatory requirements, HR must constantly evolve and develop the right knowledge about regulatory requirements so that the right processes are implemented.

Such regulatory requirements have a significant impact on three major HR domains: payroll, performance management and talent-related subjects such as talent attraction and retention.

The first two points are very closely linked in the context of a regulatory framework that insists upon a link between variable pay and performance. As such, one would think, “Well, HR has dealt with this all along… why is this changing now?”
Conclusion

- There are eight major pillars of remuneration requirements:
  - Remuneration policy
  - Identification of staff
  - Performance assessment
  - Governance
  - Remuneration Cap—1:1 ratio
  - Pay-out process—deferral and payment in instruments
  - Malus/clawback
  - Proportionality principle
- It is becoming difficult to shift toward simple and less complex performance management
- Talent attraction and retention is becoming more challenging.