

Remuneration policies in the financial sector: agreement on the new Capital Requirements Directive rules

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The European Council and Parliament have agreed on new rules covering financial services remuneration as part of the Capital Requirements Directive. These rules have potentially far-reaching implications for all banks and investment firms in the European Union.

Introduction

Following intense negotiations between the European Parliament and governments of member states, a text was agreed on June 30, 2010 to amend the Capital Requirements Directive (commonly named "CRD 3"). These amendments will then be ratified, at which point member states will need to incorporate the new requirements into local regulation by December 31, 2010.

It is to be noticed that most of these requirements have already been introduced in Luxembourg by the Commission de Surveillance du Secteur Financier in its circular CSSF 10/437 (the "Circular") issued early February 2010. However, the Directive does introduce new requirements.

Key remuneration elements of the Capital Requirements Directive

Some of the most significant Directive requirements are summarised below, with differences to the Circular highlighted in blue.

- Directive applicable to all credit institutions and investment firms, with "proportionality" provisions depending on size and complexity of the institution
- Directive requirements applicable as from 2010 bonuses ; though the CSSF confirmed in its FAQ of July 12, 2010 that variable pay due for 2010 and payable in 2011 is out of scope of the Circular, the Directive requirements will have effect as soon as the Directive is transposed into Luxembourg law / regulation ie no later than December 31, 2010
- Requirement that at least 50% of variable compensation be delivered in a mix of shares and contingent capital
- Potential restriction on cash bonuses paid immediately to at most 30% of total variable pay
- Requirement to pay certain "discretionary pensions" in shares and contingent capital subject to a five year retention period ; "discretionary pensions" do not include accrued benefits granted to an employee under the terms of IGSS approved occupational pension schemes
- Ban on guaranteed variable remuneration (eg welcome bonus), other than on recruitment and for at most one year

- The Committee of European Banking Supervisors (“CEBS”) to develop **guidance on the appropriate ratio between fixed and variable pay**
- Risk and compliance officer remuneration to be independent of the performance of business areas they control, and **remuneration of senior risk and compliance officers to be directly overseen by the remuneration committee** (if any)
- **No variable compensation to be paid to directors of institutions that benefit from government intervention, unless this is justified**
- Public disclosure rules have been introduced such as information on the performance criteria on which the entitlement to variable components of remuneration is based and aggregate quantitative information on remuneration ; **in addition CEBS is required to disclose information on the number of individuals per member state in pay brackets of EUR 1 million and upwards, including the business area involved and the main elements of salary, bonus, long-term award and pension contribution.**

Deferral and payment of bonuses

The greatest press attention has been on the “cap” on cash bonuses. Even if the Directive does not expressly impose a cap on the variable pay, on a first reading, the text appears to suggest that for relevant individuals:

- at least 40% of the variable component (out of which at least 50% is to be paid in shares and other instruments reflecting the credit quality of the institution) should be deferred over at least three years; and
- of the remaining 60%, at least half must be paid in an “appropriate balance” of shares and other instruments reflecting the credit quality of the credit institution (interpreted as meaning some form of contingent capital or subordinated debt).

The CEBS is charged with providing guidance on the instruments which can be used as “other instruments” that reflect the credit quality of the institution.

If interpreted this way, this would mean that at most 30% of variable pay (falling to 20% for those in a higher earning category for whom 60% deferral is required) could be paid **immediately** in cash.

Note that requiring pay to be delivered in shares or other instruments is different from deferral. The awards would not be subject to forfeiture, but simply to fluctuations in value due to performance. However, remuneration payable under deferral arrangements vests no faster than on a prorated basis (no “acquired rights”). This will of itself create tax issues and great care will be needed to ensure such awards are not taxable on the individual on grant.

The European Parliament’s press release clearly endorses this interpretation. It is less clear that it is the interpretation endorsed by the member states via the Commission. Indeed, given the hard-won victory of international alignment around the FSB Implementation Standards¹, it would seem surprising if European governments were prepared now to go beyond them in such a sensitive area. Further clarification may emerge in the coming days.

¹ *Implementation Standards of September 25, 2009 relating to the “Principles for Sound Compensation Practices” issued by the Financial Stability Forum on April 2, 2009*

Conclusion

As a reaction to the financial crisis, the European authorities are taking measures to minimize incentives for excessive risk-taking through a Directive which has to be transposed into local regulations within less than 6 months. The requirements of the Directive should be looked at carefully as they may have substantial impacts on a company's remuneration strategy and namely oblige financial institutions to rethink their existing remuneration schemes so as to be compliant with the new rules.

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