



Corporate governance and remuneration rules in the CRR and the CRD IV

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These slides accompany the explanation of the acquis to Albania and North Macedonia and can only be used for that purpose. Their content is subject to further development of the acquis and interpretation by the Court of Justice of the European Union

Agenda

- **Corporate governance (CG) requirements**
- **Remuneration rules**
- **Future framework: the upcoming CRD V and the investment firms Directive and Regulation (IFD/R)**

CRR and CRD IV as a package – CG and remuneration

Directive	Regulation	Level 2 (Delegated Acts)	Level 3 (Guidelines)
<ul style="list-style-type: none">• Organizational structure• Board qualifications and tasks• Risk management• Remuneration• Transparency• Competent Authority oversight of adequacy of CG	<ul style="list-style-type: none">• Public disclosure on corporate governance• Public disclosure on remuneration	<ul style="list-style-type: none">• Criteria for identifying material risk takers ("MRTs")• Features of financial instruments used to pay bonuses	<ul style="list-style-type: none">• Internal governance rules• Suitability (fit & proper) of members of management body• Remuneration• Outsourcing• National discount rate (bonus cap)

Regulatory process in financial services

Level 2 legislation – delegated and implementing acts

- ❑ Level 1 laws (Directive and Regulation) may contain empowerments for level 2 measures to be adopted by the European Commission based on drafts developed by the European supervisory authorities (ESAs) where supervisory expertise is required.
- ❑ Those level 2 measures specify particular aspects of an EU legislative text and aim at ensuring harmonisation.

Regulatory process in financial services

Level 3 – Guidelines

- ❑ The ESAs can issue guidelines.
- ❑ GL aim at establishing consistent, efficient and effective supervisory practices and ensuring the common, uniform and consistent application of Union law.
- ❑ GL are addressed to competent authorities or financial institutions.
- ❑ GL are not legally binding but subject to comply or explain procedure.

CORPORATE GOVERNANCE REQUIREMENTS FOR INSTITUTIONS

(i.e credit institutions and investment firms)

Why specific rules on corporate governance ?

Weaknesses in corporate governance in a number of institutions have contributed to excessive and imprudent risk-taking in the banking sector which has led to the failure of individual institutions and systemic problems in Member States and globally;

Why specific rules on corporate governance ?

- ❑ General and non-binding provisions did not sufficiently facilitate the effective implementation of sound corporate governance practices by institutions;
- ❑ The absence of effective checks and balances within institutions resulted in a lack of effective oversight of management decision-making, which exacerbated short-term and excessively risky management strategies;

What is the purpose of the CG requirements ?

- ❑ To address the potentially detrimental effects of poorly designed internal governance arrangements on the sound management of risk;
- ❑ To ensure effective oversight by the management body, in particular in its supervisory function;
- ❑ To promote a sound risk culture at all levels of institutions and to enable competent authorities;
- ❑ To allow for supervision of the effectiveness of the internal governance processes.

The regulatory framework

In the CRD IV

Article 74 – Internal governance

Article 76 – Treatment of risks

Article 88 – Governance arrangements

Article 89 – Country by country reporting

Article 90 – Public disclosure on return on assets

Article 91 – Management body

Article 95 – Remuneration committee

Article 96 – Publication of governance arrangements on websites

In the CRR: Article 435 (2) – Disclosure of information regarding governance arrangements

The regulatory framework

Guidelines

❑ Guidelines on internal governance

- ❑ Link: <https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance-revised->

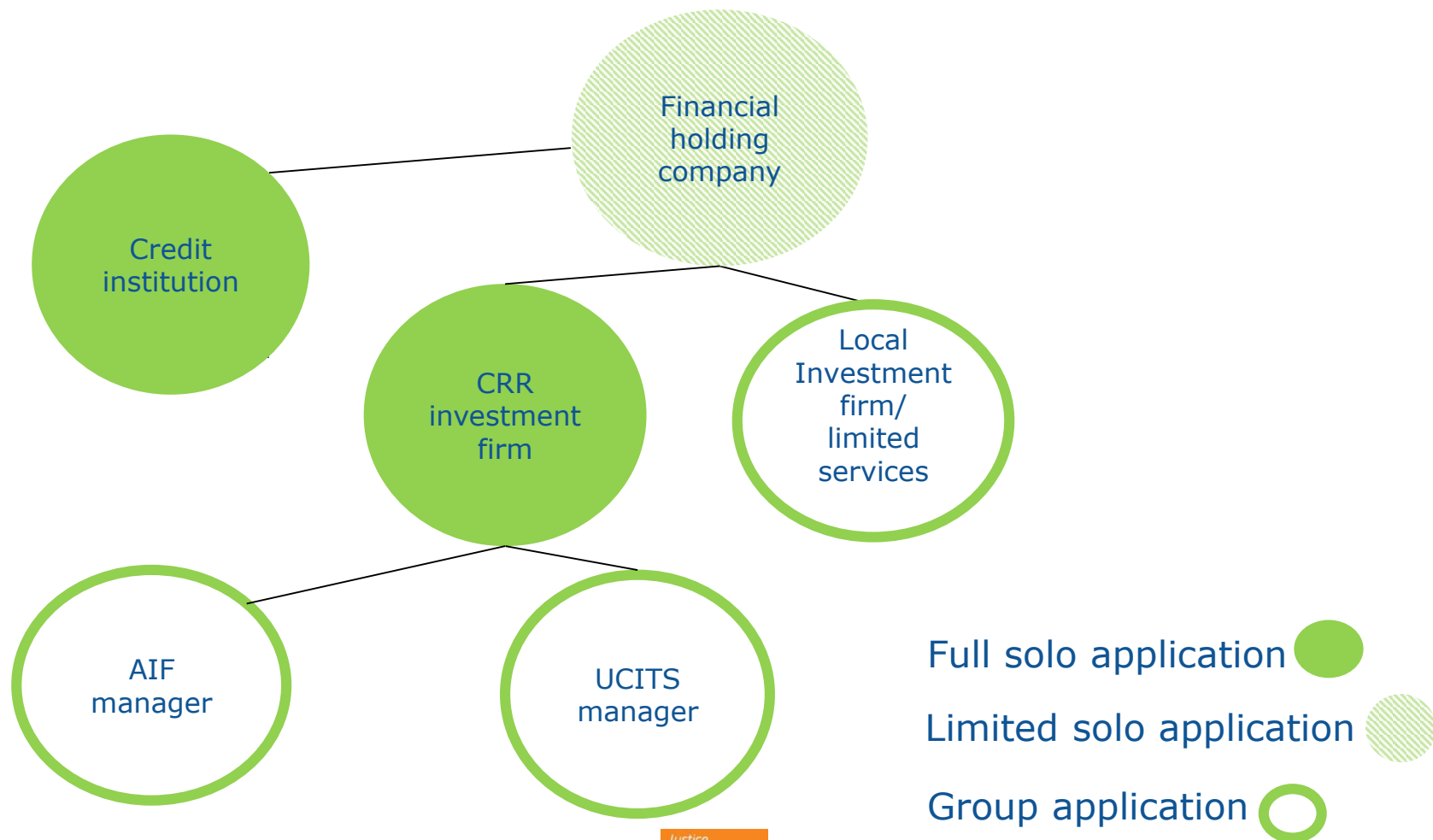
❑ Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body

- ❑ Link: <https://eba.europa.eu/regulation-and-policy/internal-governance/joint-esma-and-eba-guidelines-on-the-assessment-of-the-suitability-of-members-of-the-management-body>

❑ Guidelines on outsourcing arrangements

- ❑ Link: <https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-outsourcing-arrangements>

Scope and level of application



Internal governance

Institutions shall 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 they are 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.

Internal Governance

□ EBA GL on internal governance, e.g.

- Governance framework (organisational framework, know your structure, outsourcing policy)
- Risk culture and business conduct (code of conduct, conflict of interest, internal alert procedures)
- Internal control framework (risk management, internal control functions, risk management function, compliance function, internal audit function)

The management body I (MB)

MB responsibilities

- ❑ Approve and oversee strategic objectives, risk strategy and internal governance;
- ❑ Ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards;
- ❑ Oversee the process of disclosure and communication;
- ❑ Provide effective oversight of senior management;
- ❑ Adopt and review the risks and remuneration policies;

The management body II (MB)

□ EBA GL on internal governance, e.g.

- Board to approve written document describing its responsibilities and duties
- Duties of executive and non-executive (supervisory) board/function to be clearly distinguished
- Board to set, approve and oversee a corporate culture and values (code of conduct)
- Board to constructively challenge information and propositions received

The management body III (MB)

Individual and collective requirements

- ❑ Board members must meet suitability criteria (good reputation, sufficient knowledge, skills and experience) and commit sufficient time to their functions;
- ❑ Board members must act with honesty, integrity and independence of mind;
- ❑ Board composition: collective suitability and diversity;
- ❑ Accountability: may be subject to administrative penalties or banned from exercising a function;

The management body IV (MB)

Fit and proper assessment of members of MB:

□ EBA/ESMA GL on suitability of board members, e.g.

- Process of assessing suitability: at authorisation, at appointment of new members, at material change to the board composition, ongoing
- Independent directors: sufficient number of independent members of supervisory board for significant and listed institutions (otherwise minimum one) + rebuttable independence criteria
- Resources for induction and training of board members

Organisational structure I

- ❑ The role of the committees [for institutions significant in terms of size, internal organisation and activities]
 - Risk committee: advise the MB on the institution's overall current and future risk appetite;
 - Nomination committee: identify candidates to fill MB vacancies;
 - Remuneration committee: prepare decisions regarding remuneration.

- ❑ Separation of function of CEO and Chair

Organisational structure II

- ❑ The composition of the committees [for institutions significant in terms of size, internal organisation and activities]
 - The risk, nomination and remuneration committees shall be composed of members of the MB who do not perform any executive function;
- ❑ Separation of function of CEO and Chair

Organisational structure III

□ EBA GL on internal governance, e.g.

- Majority of board committees (risk and nomination) in G-SIIs and O-SIIs (incl. Chair) to be independent
- In other significant institutions, the risk and remuneration committees should include a sufficient number of member who are independent and should be chaired by an independent member

□ EBA GL on sound remuneration policies, e.g.

- Majority of the remuneration committee in G-SIIs and O-SIIs (incl. Chair) to be independent

Transparency

- ❑ Country-by-country reporting: institutions must disclose annually, specifying by Member State and by third country some tax related information (turnover, profit or loss before tax, tax on profit or loss...);
- ❑ Publication of governance arrangements on websites;
- ❑ Disclosure of information regarding governance arrangements (number of directorships, recruitment policy for members of MB, policy on diversity...).

CRD IV REMUNERATION RULES

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

*Legal nature of a recommendation (Article 288 of the Treaty
on the Functioning of the European Union)*

*A recommendation has no binding force. A recommendation allows
the institutions to make their views known and to suggest a line of
action without imposing any legal obligation on those to whom it is
addressed.*

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

Context

Remuneration practices in the financial sector, particularly in banks and investment firms, have led to excessive risk-taking. These practices contributed, to a certain extent, to significant losses suffered by large financial undertakings and were partly responsible for the October 2008 financial crisis.

This recommendation on remuneration policies was part of the strategy proposed by the communication 'Driving the European recovery', published by the European Commission in spring 2009.

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

Objective

To set out general principles applicable to remuneration practices in the financial services sector which aim at avoiding any excessive risk-taking in this sector, particularly by banks and investment firms.

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

The recommendation applies to:

- ❑ financial undertakings [e.g. credit institutions, investment firms, insurance, reinsurance undertakings, pension funds, collective investment schemes] with their registered office or their head office in the territory of an EU country;
- ❑ remuneration of those categories of staff whose professional activities have a material impact on the risk profile of the company (“material risk takers”, MRTs)

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

- ❑ Remuneration policy in line with the business strategy, objectives, values and long-term interests of the financial company;
- ❑ Remuneration policy should be the result of a balance between fixed and variable components. The fixed component should represent a sufficiently high proportion of the total remuneration allowing the undertaking to operate a fully flexible bonus policy;
- ❑ Where a significant bonus is awarded, the major part of the bonus should be deferred with a minimum deferment period.

Commission recommendation of 30 April 2009 on remuneration policies in the financial services sector

- ❑ The supervisory board should establish the general principles of the remuneration policy of the financial undertaking and be responsible for its implementation;
- ❑ Control functions, human resources departments and external experts should also be involved in the design of the remuneration policy;
- ❑ Remuneration policy should, at least annually, be subject to central and independent internal review by control functions for compliance with policies and procedures defined by the supervisory board.

Remuneration rules in the CRD IV

The rationale

- ❑ Low rate of compliance with the Recommendation in Member States;
- ❑ To put in place a specific and binding framework for credit institutions and investment firms in the wake of the financial crisis;
- ❑ To implement the Financial Stability Board (FSB) Principles for Sound Compensation Practices (cf. Annex)
<http://www.fsb.org/2009/04/principles-for-sound-compensation-practices-2/>

Remuneration rules in the CRD IV

Objectives

- ☐ *To ensure long-term performance alignment;*
- ☐ *To ensure that remuneration policies do not give incentives to take risks which undermine sound and effective risk management and which exacerbate excessive risk taking behaviour;*

The regulatory framework

In the CRD IV

Article 75 – Oversight of remuneration policies

Article 92 – Remuneration policies

Article 93 – Institutions that benefit from government intervention

Article 94 – Variable elements of remuneration

[Article 95 – Remuneration committee]

Article 96 – Publication on websites on how institutions comply with remuneration requirements

In the CRR: Article 450 – Disclosure of information regarding the remuneration policy and practices of the institutions

The regulatory framework

Level 2 legislation

- ❑ Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile ("Material Risk Takers");

<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0604>

- ❑ Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration ("Instruments").

<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0527>

The regulatory framework

Level 3 – Guidelines

❑ Guidelines on sound remuneration policies

- ❑ Link: <https://eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies>

❑ Guidelines on the applicable notional discount rate for variable remuneration

- ❑ <https://eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-discount-rate-for-variable-remuneration>

Remuneration rules in the CRD IV

The CRD IV remuneration rules apply to:

- ❑ Credit institutions and investment firms (i.e institutions);
- ❑ Material risk takers, i.e category of staff whose professional activities have a material impact on the risk profile of the institutions;

Remuneration rules in the CRD IV

Material Risk Takers (cf. Delegated Regulation No 604/2014 of 4 March 2014)

- ❑ Qualitative criteria: e.g. member of the management body, member of the senior management, staff member is responsible and accountable to the management body for the activities of the independent risk management function, compliance function or internal audit function, staff member heads a material business unit (...);
- ❑ Quantitative criteria: staff member's total remuneration \geq EUR 500 000 unless the staff member do not have a material impact on the institution's risk profile.

Remuneration rules in the CRD IV

The design of the remuneration policy – general requirements

- ❑ 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 institution
- ❑ The remuneration policy is in line with the business strategy, objectives, values and long-term interests of the institution, and incorporates measures to avoid conflicts of interests;

Remuneration rules in the CRD IV

The design of the remuneration policy - Governance

- ❑ The institution's management body in its supervisory function adopts and periodically reviews the general principles of the remuneration policy and is responsible for overseeing its implementation;

- ❑ 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;

Remuneration rules in the CRD IV

The design of the remuneration policy – Governance

- ❑ 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;
- ❑ The remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in Article 95 or, if such a committee has not been established, by the management body in its supervisory function;

Remuneration rules in the CRD IV

The design of the variable part of the remuneration – additional general requirements, e.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 institution** and when assessing individual performance, financial and non-financial criteria are taken into account;
- ❑ 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;

Remuneration rules in the CRD IV

The variable part of the remuneration – Deferral – Article 94 (1) (m):

"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;"*

Remuneration rules in the CRD IV

The variable part of the remuneration – Pay out in instruments – Article 94 (1) (I) & Commission Delegated Regulation (EU) No 527/2014

***"a substantial portion, and in any event at least 50 %,"** of any variable remuneration shall consist of a balance of the following:*

(i) shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution;

(ii) where possible, other instruments within the meaning of Article 52 or 63 of Regulation (EU) No 575/2013 or other instruments which can be fully converted to Common Equity Tier 1 instruments or written down, that in each case adequately reflect the credit quality of the institution as a going concern and are appropriate to be used for the purposes of variable remuneration."

Remuneration rules in the CRD IV

The variable part of the remuneration – Bonus cap – Article 94 (1) (g)

(i) the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage;

(ii) Member States may allow shareholders or owners or members of the institution to approve a higher maximum level of the ratio between the fixed and variable components of remuneration provided the overall level of the variable component shall not exceed 200 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage.

Remuneration rules in the CRD IV

The variable part of the remuneration – Malus and Clawback – Article 94 (1) (n)

"Up to 100% of the total variable remuneration shall be subject to malus or clawback arrangements..."

❑ Malus: an arrangement that permits the institution to reduce the value of all or part of deferred variable remuneration based on ex post risk adjustments before it has vested (EBA GL on sound remuneration policies).

❑ Clawback: an arrangement under which the staff member has to return ownership of an amount of variable remuneration paid in the past or which has already vested to the institution under certain conditions. (EBA GL on sound remuneration policies).

Transparency

Institutions shall disclose e.g.:

- ☐ Information concerning the decision-making process used for determining the remuneration policy;
- ☐ The most important design characteristics of the remuneration system;
- ☐ Aggregate quantitative information on remuneration;
- ☐ The number of individuals earning more than EUR 1 million per year;
- ☐ The ratios in relation to the bonus cap;
- ☐ Information on link between pay and performance.

THE FUTURE REMUNERATION FRAMEWORK FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS – A quick preview

The future remuneration framework in the CRR II/CRD V

Context

On 23 November 2016 the Commission proposed amendments to the banking prudential requirements directive and regulation (known as CRD IV/CRR) in order to:

- ❑ strengthen the resilience of the banking sector by introducing more risk-sensitive capital requirements;
- ❑ make banking prudential requirements rules more proportionate and less burdensome for smaller financial institutions;
- ❑ improve banks' lending capacity to support the EU economy.

The future remuneration framework in the CRR II/CRD V

Context

- ❑ Political agreement reached on 4 December 2018;
- ❑ Enter into force is expected around June/July;
- ❑ The CRR II would become applicable 24 months after its entry into force and the CRD V would become applicable 18 months after its entry into force.

The future remuneration framework in the CRR II/CRD V

A more proportionate remuneration framework

Scope

- ☐ Credit institutions
- ☐ Systemic/large investment firms (other investment firms subject to recently adopted investment firms Directive and Regulation);

The future remuneration framework in the CRR II/CRD V

A more proportionate remuneration framework

Most burdensome remuneration requirements – deferral and pay out instruments requirements – can be waived provided that some conditions are met:

- ❑ The institution is not a large institution;
- ❑ The institution's balance sheet does not exceed EUR 15 billion (default threshold at 5 bn).
- ❑ The institution is not subject to any obligations, or is subject to simplified obligations, in relation to recovery and resolution planning;
- ❑ The institution has a small trading book business and limited derivatives position;

The future remuneration framework in the investment firms review

Context – A dedicated framework for investment firms

- ❑ In December 2017 the European Commission adopted a proposal for a regulation and a proposal for a directive to amend the current EU prudential rules for investment firms.
- ❑ The aim of the review is to introduce more proportionate and risk-sensitive rules for investment firms.
- ❑ The two acts amend the existing prudential framework for investment firms set out in the capital requirements directive and regulation (CRD IV/CRR) and in the markets in financial instruments directive and regulation (MiFID2/MiFIR).

The future remuneration framework in the investment firms review

Context – A dedicated framework for investment firms

- ❑ Political agreement reached on 26 February 2019;
- ❑ Enter into force is expected in July or September 2019;
- ❑ The new Directive and Regulation on the prudential supervision/requirements of investment firms would become applicable 18 months after their entry into force.

The future remuneration framework in the investment firms review

Scope – A dedicated remuneration and governance framework for investment firms

- ❑ Only a subset of investment firms (so-called “class 2 firms”, cf Article 23 of the Directive) will have to comply with this new regime;
- ❑ The systemic/large investment firms remain under the CRR/CRD framework;
- ❑ The smallest investment firms (so-called “class 3 firms”) do not fall into the scope.

The future remuneration framework in the investment firms review

A dedicated remuneration and governance framework for investment firms

- ☐ No bonus cap (\neq CRD V);
- ☐ Further flexibility with respect to the instruments to be used to pay out variable remuneration;
- ☐ Waivers for deferral and pay out in instruments provided that the value of on-and off-balance sheet assets is on average equal to or less than EUR 100 million;

The future remuneration framework in the investment firms review

A dedicated remuneration and governance framework for investment firms – Waivers for deferral and pay out in instruments

Possibility for MS to increase the EUR 100 Million threshold up to EUR 300 Million provided that:

- ☐ the investment firm is not one of the three largest investment firms in the Member State it is established;
- ☐ the investment firm is not subject to any obligations or is subject to simplified obligations in relation to recovery and resolution;
- ☐ the size of the investment firms' on-and off-balance sheet trading-book business is equal to or less than EUR 150 Million;
- ☐ the size of the investment firms' on-and off-balance sheet derivative business is equal to or less than EUR 100 Million;

Thank you for your attention.

ANNEX I - FSB Principles for Sound Compensation Practices (2009, FSB Principles)

FSB Principles for Sound Compensation Practices (2009, FSB Principles)

1. Effective governance of compensation

- ❑ The firm's board of directors must actively oversee the compensation system's design and operation;
- ❑ The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended;
- ❑ Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

FSB Principles for Sound Compensation Practices (2009, FSB Principles)

2. Effective alignment of compensation with prudent risk taking

- ☐ Compensation must be adjusted for all types of risk;
- ☐ Compensation outcomes must be symmetric with risk outcomes;
- ☐ Compensation payout schedules must be sensitive to the time horizon of risks;
- ☐ The mix of cash, equity and other forms of compensation must be consistent with risk alignment;

FSB Principles for Sound Compensation Practices (2009, FSB Principles)

3. Effective supervisory oversight and engagement by stakeholders

- ❑ Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action;
- ❑ Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders;