EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK
of 5 August 2010
on implementing rules regarding compensation systems at institutions and insurance companies
(CON/2010/63)

Introduction and legal basis

On 5 July 2010 the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on the draft regulation on the prudential supervision requirements for the remuneration systems at institutions (hereinafter the 'draft regulation on institutions') and the draft regulation on the prudential supervision requirements for the remuneration systems at insurance companies (hereinafter the 'draft regulation on insurance companies').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft regulation on institutions relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft regulations

1.1 The draft regulations aim at implementing the Law on the prudential supervision requirements for the compensation systems at institutions and insurance companies, which had been subject to ECB Opinion CON/2010/41[2]. The draft regulations are the implementing legislation mentioned in paragraphs 1.2 and 2.3 of that opinion. With regard to their legislative background, reference is made to Section 1 of Opinion CON/2010/41. In substance, the draft regulation on institutions largely corresponds to Circular 22/2009 (BA) of the German Federal Financial Supervisory Authority (BaFin)[3], which will be repealed on entry into force of the draft regulation on institutions.

1.2 The draft regulation on institutions distinguishes between (1) requirements that apply to all institutions and the remuneration systems for all their managers and staff; and (2) more demanding special requirements that are only relevant to major institutions and the remuneration systems for

1 OJ L 189, 3.7.1998, p. 42.
2 ECB Opinion CON/2010/41. All ECB opinions are available on the ECB's website at www.europa.eu.
3 See on its content footnote 3 in Opinion CON/2010/41.

their managers and certain members of their staff[4]. According to the draft, an institution is regarded as major if its balance sheet total, on average, has equalled or exceeded EUR 10 billion on the relevant key dates of the last three financial years and the institution determines, based on a risk analysis, that it is major. The BaFin monitors the implementation of proper risk analysis and compliance with the special requirements. Institutions whose balance sheet total, on average, has equalled or exceeded EUR 40 billion on the relevant key dates will generally be regarded as major. This assumption should serve as guidance for the institutions and may be refuted within the context of the risk analysis. Institutions whose balance sheet total has amounted to less than EUR 10 billion on the relevant key dates are deemed not to be major.

1.3 Remuneration systems are deemed to be appropriate if they avoid paying incentives to the managers or staff for accepting disproportionately high risks and if they do not contravene the controlling units' monitoring function. Incentives to accept disproportionately high risks may arise, in particular, through a significant dependence of managers and staff on variable remuneration. At least once a year, the managers must inform the administrative or supervisory body of the design of the company's remuneration systems, so that this body may form its own opinion on their appropriateness.

1.4 The requirements are imposed only on major institutions to reflect the principle of proportionality. Major institutions must determine by means of a risk analysis whether they have staff who are able to create high risk positions. According to the draft, guaranteed variable remuneration is generally not consistent with appropriate risk management and the principle of performance-based remuneration. Consequently, guaranteed variable remuneration of managers and staff who can create high risk positions is only permitted in the context of a new working relationship, and at most for one year.

1.5 Besides the overall success of the institution and the profit contribution by the organisational unit, the individual profit contribution will also be taken into account for the variable remuneration of managers and staff who can create high risk positions, insofar as this is determinable with reasonable effort. At least 40% of the variable remuneration is to be deferred for at least three years and to be paid out *pro rata temporis*. One half of the variable remuneration to be deferred must depend on the sustainable development of the institution[5]. If the performance of a member of staff or of an organisational unit and/or the overall success of the institution does not meet the specified target, or should previous positive profit contributions turn out not to be sustainable, this must result in the variable remuneration, including the amounts deferred, being reduced or cancelled. The risk orientation of the remuneration may not be restricted or equalised by coverage measures or other countermeasures by the managers or staff concerned. A remuneration committee will monitor the appropriateness of the remuneration systems. According to the explanatory

4 This structure is mirrored in the draft regulation on insurance companies.

5 The explanatory memorandum to the draft regulation on institutions assumes that the Financial Stability Board (FSB) Implementation Standards are ambiguous on this point; therefore the possibility cannot be ruled out that the FSB may, in future, clarify that at least 50% of the variable remuneration is to be paid entirely in the form of shares or instruments similar to shares. In this case, it will be necessary to amend the Regulation accordingly.

memorandum to the draft regulation on institutions, the members of the committee must hold a managerial position within their respective organisational units.

2. General observations

2.1 The ECB welcomes the draft regulations as part of a legislative framework aiming at implementing, within the financial services sector, the Financial Stability Board (FSB) principles and standards endorsed by the G20 leaders and intended to enhance the stability and robustness of the financial system[6]. The ECB supports also the relatively broad scope of application of this legislation, which covers not only credit institutions and investment firms, but also insurance companies, encompassing therefore the bulk of the regulated financial services sector.

2.2 In its opinion on the law on the prudential supervision requirements for compensation systems at institutions and insurance companies, the ECB emphasised the importance of fully aligning requirements relating to compensation policies and practices with the international standards on compensation, and with the envisaged revision of Directive 2006/48/EC[7], introducing provisions aimed at ending practices that lead to excessive risk taking. The ECB is of the view that such consistency is essential to ensure the efficiency of the measures taken by Member States to avoid regulatory arbitrage across major financial centres and therefore contribute to the limitation of excessive risk-taking behaviours at the European and global level. In this respect, and as far as credit institutions and investment firms are concerned, the German authorities should ensure an appropriate degree of coherence of their legislative framework with the Union legislation under finalisation, which the Committee of European Banking Supervisors (CEBS) may specify further by elaborating guidelines on sound remuneration policies in the banking sector.

3. Specific observations

3.1 *Proportionality principle*

The ECB takes note of the approach to proportionality adopted by the draft regulation on institutions. In this respect, the ECB is of the view that the special requirements for major institutions should, at least, target all systemically relevant institutions, and that the draft regulation should define this by the size of these institutions, and also by factors such as their interconnectedness or substitutability. Furthermore, and with a view to ensuring a consistent application of the Union legislative framework for the supervisory review of remuneration policies, the ECB stresses the importance for the German authorities of updating their approach to proportionality, if need be, in light notably of the future CEBS guidelines on sound remuneration policies, should these guidelines address proportionality. Overall, the ECB considers of paramount

6 Principles for Sound Compensation Practices of 2 April 2009; Principles for Sound Compensation Practices - Implementation Standards of 25 September 2009. See also Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector (OJ L 120, 15.5.2009, p. 22).

7 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of business of credit institutions, (OJ L 177. 30.6.2006, p. 1).

importance that national jurisdictions maintain a consistent treatment across institutions in the application of the international framework as reflected by the Union legislative provisions on compensation systems at institutions.

3.2 *Aligning the draft implementing legislation with the international framework*

3.2.1 To ensure that the institutions' remuneration policies and schemes are designed in a way that avoids and reduces excessive risk-taking behaviour, the ECB suggests that inconsistencies with the international framework, reflected by the Union legislative provisions currently under finalisation, should be addressed in a timely manner by the German authorities. In this regard, the ECB has identified three key areas for possible improvement.

3.2.2 First, with respect to governance of the remuneration policies, the ECB considers that the general requirements need to be enhanced to ensure effective oversight of the remuneration policies and schemes of the institutions by the administrative or supervisory board, in line with the FSB principles on effective governance of compensation. In the same vein, the requirements relating to the establishment of remuneration committees in major institutions should be strengthened in line with FSB implementation standard 1 and the Union legislation under finalisation.

3.2.3 Second, in the framework of the remuneration systems for major institutions, the provisions on the guaranteed variable remuneration need to be clarified to ensure that guaranteed variable remuneration only occurs in the context of hiring new staff, as highlighted by FSB implementation standard 11.

3.2.4 Third, the legislative requirements in Section 5(5) should be amended with a view to ensuring that at least 50% of any variable remuneration consists of shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long term value creation and the time horizon of risk, as highlighted by FSB principle 8 and the Union legislative provisions under finalisation.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 5 August 2010.

[signed]

The President of the ECB

Jean-Claude TRICHET