Linklaters

THE CHALLENGES OF REMUNERATION POLICIES

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Tracing a path through the remuneration labyrinth

A central element of the European Union's efforts to prevent a repeat of the past decade's financial crisis has been the use of remuneration rules to curb what is perceived as excessive risk-taking by bankers and other employees of financial institutions.

The conference took place at Neimënster

Legislation including the Alternative Investment Fund Managers Directive (AIFMD) and the latest iterations of the Capital Requirements Directive (CRD) and the UCITS regime seeks to eliminate or reduce perverse incentives for employees to follow risky behaviour that can yield short-term profits – and bonuses – but lead to subsequent losses for investors or shareholders.

The basic principle is that no more than 60% of a "risk-taking" individual's bonus should be paid immediately, with the rest spread over the three to five subsequent years; and that at least half the bonus should be paid in financial instruments such as shares rather than in cash. If the institution, business or particular investment products subsequently run into trouble, still unpaid bonus payments may be denied, and in extreme cases the institution should be able to demand repayment of the entire bonus.

Overlapping rules

The multiplication of overlapping and sometimes inconsistent rules and the need by institutions to provide effective incentives within the constraints of the new provisions were the focus of a **Linklaters Luxembourg conference on 14 October entitled "The Challenges of Remuneration Policies"**. Experts from the firm were joined by guest speaker Jean-Paul Gauzès, who played a key role in the AIFMD's passage through the European Parliament, and who provided important insight into MEPs' (Member of the European Parliament) motivations and the vagaries of the legislative process (see article on next page).

As Linklaters managing partner Freddy Brausch notes, it's now four years since the introduction of the first rules in Luxembourg on remuneration in the financial sector through CSSF Circular 10/437, giving firms time to understand the approach adopted by the regulator.

Since 2010 remuneration provisions have been incorporated into a broad range of EU legislation, including the CRD III and IV, AIFMD, MiFID II and UCITS V directives, as well as the forthcoming Solvency II. In all cases the basic rules have been refined and supplemented by the European Banking Authority (EBA) or the European Securities and Markets Authority (ESMA).

The provisions are based on five main pillars, according to managing associate Christian Hertz. First, institutions must draw up a written remuneration policy, implement it effectively and review it at least annually. Secondly, they must identify "risk-takers" that are subject to the tightest restrictions on the level, structure and timing of performance-related bonuses.

Thirdly, bonuses can no longer be based solely on short-term financial criteria, but must incorporate other factors, such as respect for internal procedures, and take a longer-term perspective. For instance, fund manager bonuses may be calculated over a period reflective of the average holding period by investors or the liquidity or portfolio holding period of assets.

Striking a balance

Fourthly, firms must put in place governance mechanisms to oversee adherence to remuneration policies, internal and external transparency provisions, and in the case of larger institutions, remuneration committees. Finally, they must strike a balance between the fixed (salary) and variable (bonus) components of employees' remuneration packages.

Up to now only the CRD IV legislation has set a ceiling on the level of bonuses, according to managing associate Yuri Auffinger, but the European Commission seems to be indicating its preference as a default position for a 1:1 ratio between fixed and variable remuneration.

The principle of proportionality allows institutions and national regulators to provide exemptions to certain rules (although not from the requirement to define a remuneration policy) if their impact in particular cases would be disproportionate, both at the level of firms and individuals.

For example, the CSSF has decided that all banks with balance sheets of less than €5bn should automatically benefit from proportionality; the UK's Financial Conduct Authority (FCA) takes into account issues such as the complexity of the organisation and its investment strategies in determining whether asset managers should be fully subject to the rules. At an individual level, small bonuses – up to €100,000 or 20% of fixed salary – may be exempted from the requirement for bonuses to be spread over five years and at least half of the total paid in the form of financial instruments.

The question of what constitutes fixed and variable remuneration has been highlighted by the practice in the UK of banks awarding 'role-based allowances' that the EBA suspects may be bonuses by another name in order to sidestep the rules. However, Mr Auffinger says the EBA seems prepared to tolerate such payments as long as they are defined in advance and are guaranteed for set periods.

In the case of investment fund management employees, the theory behind payment in financial instruments is that they should receive shares or units of the fund(s) they are involved in running. That may not be possible if the fund is closed-ended or restricted to institutional investors; more broadly, financial institutions in Luxembourg tend not to be listed. In general the CSSF has proved flexible about how the financial instrument component is paid, as long as it is not in cash.

The application of non-payment of awarded bonuses (malus) and especially the clawback mechanisms is complicated in Luxembourg because they are not covered by the Employment Code, and must be incorporated into a watertight contractual stipulation. Mr Auffinger argues that the maximum period during which a bonus can be clawed back should be five years, because this is also the maximum period during which an individual can request the reimbursement of overpaid tax and social security contributions.

Watertight provisions

Complications can arise when the same financial institution, or even the same employee, is subject to potentially contradictory remuneration restrictions under different EU directives. This might entail a calculation of the portion of time allocated to each activity, or to the revenue generated by the individual or the business, in order to determine how the overall bonus should be treated under different regimes.

Most cases of non-respect for remuneration rules are dealt with through 'naming and shaming' of the offending institution, but a range of penalties exists, from a warning or a formal censure to a fine that can reach up to 10% of a company's turnover, or the temporary suspension or definitive withdrawal of authorisation.

Some dates for your agenda

Thursday, 11 December 2014
Breakfast Series session – privacy audits: are you ready?

Wednesday, 21 January 2015
5th Linklaters Luxembourg Magenta Horizons event

Jean-Paul Gauzès on the "imperfect process" of drafting financial legislation

Over the five years to spring this year, Jean-Paul Gauzès was at the heart of the EU's legislative response to the financial crisis and its efforts to devise rules that would reduce the risk of a repeat. As rapporteur of the European Parliament's Economic and Monetary Affairs Committee on major pieces of EU legislation, among others, he oversaw the passage of Directives and Regulations including the AIFMD, and played a key role in shaping the remuneration rules that are being introduced across the EU's financial services legislation.

Where does the notion of "fair balance" between fixed and variable remuneration come from?

The remuneration rules were prompted by the causes of the crisis, including the perception that traders and others were excessively paid and taking undue risk. The Parliament decided to set rules to discourage excessive risk-taking by employees of financial institutions. However, MEPs did not want to penalise European businesses in comparison with competitors in other markets. So rather than hard and fast rules on variable and fixed remuneration, we agreed on the principle of a fair balance between them based on common sense. But because this did not have the desired effect the issue of bonuses was re-opened, and we decided to introduce an arithmetic formula linked to the consent of shareholders.

What did legislators have in mind with the concept of "risk-takers"?

The idea was to identify the sources of systemic risk within financial organisations, but the concept of risk-takers was not always well understood. The president of one large French bank told me that while a comparable British bank had 380 staff classified as risk-takers, the French institution had 3,800. The reason for such a large difference was that, on the French side, some felt they were (or had to be seen as) managers asking to be on the list without realising that their bonus rules would be affected.

The Level 2 legislation entailed much greater precision than we ever intended. That is one of the problems of the European law-making process as it now stands. Perhaps, at times, has the Level 2 process become out of control? Others than the legislator may tend to view Level 2 measures as a means to remedy issues identified in the Level 1 process? Perhaps, did we also over-delegate decisions to the European Commission in the form of delegated acts?

This is an important issue, and the new Parliament should ensure it does not allow as many delegated acts as we seem to have done. But legislation is created under difficult conditions that make it impossible to incorporate higher levels of detail. For example, for the AIFMD, we had only one assistant and one adviser to help us. We simply don't have the resources, unlike US senators who work with large staffs.

Is the EU not encouraging banks to take more risk by increasing the proportion of remuneration paid as fixed salary rather than as a variable bonus?

As a former legal adviser in a bank, I know from personal experience that bankers tend to be more creative than the legal staff, who are always trying to catch up. There is a very real prospect that to increase the variable portion, employers will increase fixed remuneration. An unintended consequence of what we were trying to achieve is that salary levels are as high as before, and arguably are both risky and excessive. The final result is not what we intended. We started with an idea that was simple, but now there is excessive detail and complexity – as is the case with many European rules.

How can institutions apply malus and clawback provisions to bonuses?

The idea was to limit risk by ensuring that payment of the bonus was staged. If harm incurred as a result of taking excessive risk that should have been foreseen. The institution could recover bonus payments that in retrospect appeared excessive. In law there must be a contractual clause, otherwise there is no legal basis for recovery. The contractual provisions must be carefully defined and well balanced, to ensure that the courts do not deem the clause unfair.

Why are there different rules in different pieces of legislation that seek to achieve the same goals?

It's ultimately down to weaknesses in the EU legislative process. The European Commission is responsible for drafting legislation, but different departments do not necessarily take the same approach. The Commission does try to co-ordinate the work of different draftsmen, but then the legislation is submitted to the Council and the Parliament. In Parliament each designated rapporteur has his/her own views, there will be different teams working on each text, and sometimes their wording may turn out differently.

We just don't have enough time to co-ordinate everything completely. We did try to do this at the end of the parliamentary term, but we had so much work over the past five years that we were not able to co-ordinate vocabulary with the necessary precision. Then amendments to the legislation may introduce different wording, and finally, translation can lead to unintended differences too.

SPEAKERS

Freddy Brausch

Freddy Brausch is managing partner of Linklaters Luxembourg and a partner in the firm's Investment Management Group. Mr Brausch studied in Aix-en-Provence and at the London School of Economics, and has been an associate, then a partner with Linklaters and predecessor firms in Brussels and Luxembourg since 1980. He is a member of the Luxembourg bar specialising in legal matters relating to investment management and funds, banking and financial regulation, custody and settlement.

Yuri Auffinger

Yuri Auffinger is a managing associate with Linklaters Luxembourg and a member of the Luxembourg bar. After studying in Louvain, Belgium, Mr Auffinger has practised law in Luxembourg since 2003. He specialises in all aspects of employment law, including pensions and benefits, remuneration policies, company transfers and collective redundancies, and has a strong background in civil and commercial law, including litigation.

Christian Hertz

Christian Hertz is a managing associate with Linklaters Luxembourg and a member of the bar in Paris and Luxembourg. Mr Hertz studied at Edhec Business School in Paris, and has practised law in Paris and Luxembourg, including secondments to Hong Kong and London, since 2003. He has extensive experience in regulatory aspects of traditional and alternative open- and closed-ended investment funds, management entities and service providers, along with expertise in remuneration rules, change of control procedures, microfinance, socially responsible investments and hedge funds.

Jean-Paul Gauzès

Jean-Paul Gauzès is a former practising lawyer and bank executive, and until this year, a member of the European Parliament. After studying economics and law, he was a civil servant in France's education ministry, then a barrister at the French Cassation Court and at the Council of State acting for public and private institutions, before becoming head of legal and tax at an international banking group. As an MEP he acted, among others, as rapporteur of the Payment Services Directive, the Regulation on Credit Rating Agencies and the AIFM Directive.