Banking - Luxembourg

Proportionality principle for banks' remuneration requirements

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Excessive and imprudent risk taking in the banking sector has led to the failure of many institutions, and regulators and governments have identified inappropriate remuneration policies as having wrongly incentivised such risks. However, it may not always be appropriate to apply the same remuneration requirements to credit institutions and investment firms of different sizes. On November 24 2010 the European Parliament adopted the EU Third Capital Requirements Directive (2010/76/EC). This was followed on December 10 2010 by final guidelines from the Committee of European Banking Supervisors (CEBS) on the application of proportionality rules to remuneration.

Implementing circulars

On December 22 2010 the *Commission de Surveillance du Secteur Financier*, Luxembourg's financial regulator, issued Circulars 10/496 and 10/497 on defining capital ratios in order to implement the directive in Luxembourg. On March 11 2011 the regulator added Circular 11/505, which explains in detail the application of the proportionality principle when establishing and implementing remuneration policies that are consistent with sound and effective risk management.

Circular 11/505 applies to credit institutions and investment firms incorporated under Luxembourg law and their foreign branches, as well as to branches of non-EU credit institutions and investment firms. It provides that on the basis of particular risk considerations, financial institutions may disapply certain rules on remuneration and benefit from the proportionality principle, provided that they meet certain criteria. The criteria fall into two categories: those that apply at institutional level and those that apply to specified risk-taking individuals.

Criteria for institutions

Luxembourg credit institutions may apply the proportionality principle based on their size, internal organisation, nature and scope, and on the complexity of the activities that they undertake. They may waive remuneration requirements on two cumulative conditions:

- The credit institution's balance sheet must not exceed €5 billion; and
- The credit institution's capital requirement must be less than €125 million (base 100%) or €1.5625 billion (base 8%).[(1)]

Luxembourg investment firms that are authorised under EU Directive 2004/39/EC to provide investment activities such as dealing from own accounts, underwriting financial instruments and placing financial instruments on a firm commitment basis are not obliged to comply with remuneration requirements if the net result of one of these activities or the global net result of all such activities does not exceed 20% of the global net result before taxation.

If the two conditions are met, the institution in question need not comply with the following requirements under Sections 12(4-1) and (4-2) of Circulars 10/496 and 10/497:

- At least 50% of variable remuneration must be composed of shares or financial instruments, rather than cash;
- At least 40% of variable remuneration must be deferred for at least three to five years;
- Variable remuneration (including any deferred part thereof) can be adjusted and may be paid only if the amount is compatible with the institution's performance; and
- A remuneration committee must be established.

Criteria for individuals

If the annual variable remuneration of a person identified as a risk taker is less than €100,000, a credit institution or investment firm that meets the institutional criteria may apply the proportionality principle to this person.

The CEBS guidelines define 'risk takers' as members of an institution's staff whose professional activities have a material impact on the institution's risk profile, remuneration policies and practices that are consistent with effective risk management. The category of 'risk takers' should include:

- senior managers;
- staff engaged in control functions; and
- any employee whose total remuneration is comparable to that of a senior manager.

The institution may disapply the following remuneration provisions of Section 12(4-1) of Circulars 10/496 and 10/497:

- the requirement to pay part of the variable remuneration in shares or similar instruments, rather than in cash;
- the requirement to defer part of the variable remuneration; and
- the application of performance-related adjustment.

However, the *Commission de Surveillance du Secteur Financier* has stressed that the application of the proportionality principle does not exempt a credit institution or investment firm from defining and implementing a remuneration policy.

The thresholds do not apply automatically. The remuneration requirements may be disapplied only where this is compatible with risk profile, risk appetite and strategy. Financial institutions are required to justify their right to benefit from the proportionality principle.

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