The view from Germany
Workshop agenda

Germany
• Development of current structure in Germany
• What difference will it make?

United Kingdom
• The UK perspective.

Banking: requirements of compensation systems
Development of current legal structure

- FSF Principles for Sound Compensation Practices
- BaFin – updated MaRisk regulations with compensation issue
- FSB Principles for Sound Compensation Practices
- BaFin Consultation document 14/2009
- „Rundschreiben 22/2009 (BA)” – requirements of compensation systems for financial institutions
- BIS – Compensation Principles and Standards Assessment Methodology
- Draft Law on requirements of financial institutes’ compensation systems – final version expected May 2010
Banking: key issues
“Compensation must be adjusted for risk”

• Prior to 2008 compensation systems were not related to risk management and risk governance
• FSF report (among others) identified key risk issues:
  – Mix of qualitative and quantitative required
  – Difficulty of incorporating certain risks that are difficult to measure (e.g. liquidity, reputation, cost of capital)
  – Safeguarding the fairness of risk adjustments
  – Danger of distortion of risk measures
• Key issue has been how to deal with “infrequent but large” losses.

Financial Stability Board
Issued some guidelines

• Substantial proportion of compensation should be variable
• Paid on individual, BU and firm-wide measures
• 40%-60% of variable should be deferred
• Proportion variable increases with seniority
• Deferral period should not be less than 3 years
• Substantial proportion (50%+) of variable should be awarded in shares or share-linked instruments
Bank for International Settlements
Principles, Standards & Assessment Methodology

• Which firms? “significant financial institutions”
• Which employees?
  – Material risk-takers, senior management, risk and control functions
  – Groups of employees who take material risks
• “Effective alignment of compensation with prudent risk-taking”
• Supervisory process must be rigorous and sustained
• Engagement of stakeholders

Banking: requirements of compensation systems
Development of current German legal structure

<table>
<thead>
<tr>
<th>Risk analysis and self-certification</th>
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<tbody>
<tr>
<td><strong>Low Risk</strong></td>
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<tr>
<td>General requirements:</td>
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<tr>
<td>Avoid negative incentives</td>
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<td>Appropriate compensation for business units</td>
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<td>Special requirements:</td>
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<tr>
<td>Variable pay for executives and &quot;risk-takers&quot;</td>
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<td>Compensation committee</td>
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<td>External transparency</td>
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</table>
Draft BaFin regulations
Special requirement for executives and risk-takers

- Appropriate mix of fixed and variable pay (not dependent but incentivising)
- Guaranteed variable pay is (generally) not permitted
- Must take account of company, BU and individual results (including non-financial measures)
- Measured on long-term success parameters taking account of risks, capital and liquidity costs
- Claw-back in case of negative results (company, BU, Individual)
- Pay at risk cannot be "replaced" by other measures
- Minimum thresholds for payout (see example)

Design of variable pay
Minimum requirements

<table>
<thead>
<tr>
<th>Group</th>
<th>Fixed Pay</th>
<th>Bonus (% of fixed)</th>
<th>„Deferred“ part Bonus</th>
<th>Direct Payout</th>
<th>Part reliant on co‘ value</th>
<th>Independent of company value</th>
<th>Company dependent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>300,000 €</td>
<td>210,000 € 70%</td>
<td>126,000 € 42%</td>
<td>84,000 € 28%</td>
<td>70% 37,800 €</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>2</td>
<td>250,000 €</td>
<td>125,000 € 50%</td>
<td>62,500 € 25%</td>
<td>62,500 € 25%</td>
<td>60% 25,000 €</td>
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<td>N/A</td>
</tr>
<tr>
<td>3</td>
<td>200,000 €</td>
<td>60,000 € 30%</td>
<td>24,000 € 12%</td>
<td>36,000 € 18%</td>
<td>50% 12,000 €</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>4</td>
<td>150,000 €</td>
<td>30,000 € 20%</td>
<td>N/A 0</td>
<td>30,000 € 15%</td>
<td>40% 6,000 €</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>5</td>
<td>100,000 €</td>
<td>10,000 € 10%</td>
<td>N/A 0</td>
<td>10,000 € 5%</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Payment period: 60% of total bonus in cash at end of measurement period
Pay-out period: 20% in 3 equal parts over 3 years
Pay-out conditions: 20% at the end of deferral period (stock related)

Deferred Pay-out (Group 3)

<table>
<thead>
<tr>
<th>Period</th>
<th>Pay-out period</th>
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</thead>
<tbody>
<tr>
<td>10</td>
<td>„Non-deferred“ 36,000 €</td>
</tr>
<tr>
<td>11</td>
<td>„Deferring“ bank value dependent 0 € 4,000 € 4,000 €</td>
</tr>
<tr>
<td>12</td>
<td>„Deferring“ bank value independent 0 € 0 € 0 € 12,000 €</td>
</tr>
<tr>
<td>13</td>
<td>Requirements</td>
</tr>
<tr>
<td></td>
<td>- Service in Period t-1</td>
</tr>
<tr>
<td></td>
<td>- Service in Period t-1</td>
</tr>
<tr>
<td></td>
<td>- Service in Period t-1</td>
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Additional requirements of quoted companies

VorstAG

VorstAG
• “Appropriateness” of pay
• Cap for variable pay
• Four year vesting period for stock options
• Liability for non-appropriate pay
• Reduction of payment in case of reduction in worth of the enterprise and restructuring of company
• Non-binding resolution at AGM
• Requirements on public information

Additional requirements of quoted companies

Deutsche Corporate Governance Kodex

DCGK
• Vertical benchmarks
• Take account of negative developments
• No incentives for excessive or inappropriate risk-taking
• Use of independent external compensation expert
Germany: will all the new regulations have the desired effect?

**BaFin draft (formerly MaRisk)**
- Very few banks will declare themselves as “High Risk”
- Will financial institutions move down to the minimum of regulator?
- Would the new regulations have stopped the banking losses of the previous 3 years?
- BaFin requirements on public disclosure likely to be biggest driver of change

**VorstAG**
- Open to interpretation (for example “appropriate” was not defined)
- Will require a few court cases to clarify

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**The UK Perspective**
Regulatory landscape

- The FSA is responsible for implementing the Principles for Sound Compensation Practices issued by the FSB
- Issued Remuneration Code, effective 1 January 2010
- A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.
- Broadly applies to:
  - UK bank or building society that had capital resources exceeding £1 billion on its last accounting reference date; or
  - the firm is a BIPRU 730k firm that had capital resources exceeding £750 million on its last accounting reference date.

Key risk issues identified by the FSA

- Excessive focus on short-term results
- Failure to take account of current / future risks not reflected in performance measurement
- Conflicts of interest for risk function
- Insufficient weight given to non-financial measures of performance
- Cash bonuses with no/minimal deferral
- Lack of long-term alignment
- Revenue based bonus pools
The FSA Remuneration Code

• The Code seeks to address the link between remuneration and risk through one general Rule supported by eight Principles
• Each Principle is backed up by more detailed guidance
• The Principles are summarised below:

<table>
<thead>
<tr>
<th>General Rule</th>
<th>A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 1</td>
<td>Role of bodies responsible for remuneration policies and their members</td>
</tr>
<tr>
<td>Principle 2</td>
<td>Procedures and risk and compliance function input</td>
</tr>
</tbody>
</table>

The FSA Remuneration Code, continued

<table>
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<tr>
<th>General Rule</th>
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</thead>
<tbody>
<tr>
<td>Principle 3</td>
<td>Remuneration of employees in risk and compliance functions</td>
</tr>
<tr>
<td>Principle 4</td>
<td>Profit-based measurement and risk-adjustment</td>
</tr>
<tr>
<td>Principle 5</td>
<td>Long-term performance measurement</td>
</tr>
<tr>
<td>Principle 6</td>
<td>Non-financial performance metrics</td>
</tr>
<tr>
<td>Principle 7</td>
<td>Measurement of performance for long-term incentives</td>
</tr>
<tr>
<td>Principle 8</td>
<td>Remuneration structure</td>
</tr>
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Financial Services Act 2010

- Enacted 8 April 2010
- The Financial Services Act gives wide-reaching powers to the FSA to support the Remuneration Code, including the ability to:
  - require firms to have a remuneration policy consistent with the FSB Principles
  - make rules which prohibit persons ... from being remunerated in a specified way
  - make void any provision of an agreement that contravenes such a prohibition
  - claw back payments made under remuneration deemed as void
- The Act also gives powers to the Treasury on what has to be included in remuneration reports, how information should be set out and what part of the report is auditable
- The proposed regulations in particular include the following disclosure requirements:
  - the number of “relevant executives” whose remuneration in the preceding financial year exceeded £500,000
  - disclosed in bands of £500,000 up to £5m and thereafter in £1m bands
  - such remuneration to be broken down into salary, fees, expenses, bonuses, long-term incentive awards, share options and pension contributions

What does this mean in practice?

"The FSA’s supervisors will be testing rigorously whether firms’ risk management and governance arrangements are in practice delivering the right outcomes"

FSA Turner Review

- Not a box-ticking approach
- Regulators seeking to embed firm-wide risk management and risk governance processes and frameworks
- Significant increase in the scope and role of risk
- Considerable work required to address the new challenges
## Wider Corporate Governance framework
*(Applies to all UK listed companies)*

| Legislation and regulations | • Publicly listed companies are required by law to disclose in their annual reports certain details around executive remuneration, including amounts paid in the last year and the policy behind executive pay  
• Shareholders have an advisory vote on the remuneration report at the AGM  
• Shareholder approval is required for new long-term incentive plans. |
|-----------------------------|-------------------------------------------------------------------------------------------------|
| Combined Code (to be renamed the UK Corporate Governance Code) Financial Reporting Council | • A set of principles of good corporate governance which provide a code of best practice for listed companies  
• Listing Rule requirement that companies disclose how they have complied with the code, and explain where they have not applied the code |
| “Best practice” guidelines Association of British Insurers (ABI) RiskMetrics Pension and Investment Research Consultants Ltd (PIRC) (and others) | • Recommended best practice guidelines published by institutional shareholder bodies  
• No requirement to comply, although typically used as a template by shareholders in assessing the appropriateness of remuneration policies  
• ABI and RiskMetrics are the most influential.  
• Other organisations also provide comment (e.g. PIRC) but these generally have less weight in practice. |