

Implementation of CRD IV – new rules on variable remuneration in banks

On 1 May 2017 the regulation implementing the provisions of the directive of 26 June 2013 known as CRD IV comes into force. Among other things, it introduces new restrictions on the granting and payment of variable remuneration in banks.

Introduction

To date, there has only been limited statutory regulation of variable remuneration in banks. Most of the relevant provisions were included in resolution no. 258/2011 of the Polish Financial Supervision Authority of 4 October 2011 (the "Resolution"), which, in turn, implemented the provisions of the CRD III directive. On 6 March 2017 the Minister of Finance and Development, to implement CRD IV* provisions, issued the Regulation on the Risk Management System and Internal Control System, Remuneration Policy and Detailed Method of Estimating the Internal Capital in Banks (the "Regulation").

Those provisions come into force on 1 May 2017. In accordance with the transitional provisions of the Regulation, they do not apply to variable components of remuneration payable for 2016 or earlier years.

Remuneration policy – application

To date, pursuant to the Resolution, a bank was required to have its supervisory board approve the bank's policy only with regard to variable components of remuneration. Under CRD IV and the Regulation, it is now necessary for the supervisory board to approve the bank's remuneration policy with regard to both fixed and variable components of remuneration.

The literal wording of the Regulation could mean that a bank's remuneration policy and certain additional restrictions on remuneration are to apply to all the bank's employees. However, the Regulation is based on the statutory delegation provided for in the Act – Banking Law, which clearly states that the remuneration policy mentioned

in the Regulation should apply only to those persons whose professional activities have a material impact on the bank's risk profile, which is also in line with the wording of CRD IV. This should be contrasted with the Guidelines EBA/GL/2015/22 (the "Guidelines") of the European Banking Authority ("EBA") on sound remuneration policies which state directly that banks should create remuneration policies applicable to all employees. Consequently, there is a conflict between the Polish legal requirements and the EBA's guidelines in this respect. However, as the Polish Financial Supervisory Authority ("PFSA") undertook to apply the EBA's guidelines, it seems that it will require banks to create remuneration policies that are applicable to all their employees. However, we assume that the restrictions described below will only apply to "Identified Staff" (see below).

§ 24 of the Regulation requires a list of persons to be kept whose activities have a material impact on the risk profile of the bank (known as "Identified Staff"), specified in accordance with Commission Delegated Regulation (EU) No. 604/2014 of 4 March 2014 (the "Delegated Regulation"). As the Delegated Regulation has already been directly applicable in Polish law for some time, banks should already have such lists in place.

Restrictions on variable remuneration for Identified Staff retained

In the same way that the provisions of CRD IV largely reiterate the provisions of CRD III, so the provisions of the Regulation largely reiterate the terms of the Resolution, continuing in this way their application. In particular, the Regulation stated that:

*CRD IV's official title is the Directive of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and prudential supervision of credit institutions and investment firms.

- if the amount of any variable component of remuneration depends on performance, the basis for awarding, determining and paying out that remuneration is an assessment of the performance of (i) the relevant person, (ii) the relevant organisational unit and (iii) the performance of the Polish bank in the area of that person's responsibility, taking into account the performance of the entire Polish bank;
- any variable remuneration for managers of internal audit units, compliance units, legal departments, departments responsible for "second level" risk management and for HR matters must only be linked to achieving the goals associated with the positions they hold. Their remuneration may not be made dependent on the financial results achieved in the areas of the bank's activity that they monitor;
- the performance assessment should cover a period of at least three years;
- any guaranteed bonuses are: (i) to be exceptional, (ii) occur only at the time the relevant person is first engaged by the bank, and (iii) are to be limited to the first year of employment or holding of the position. This is to cover welcome bonuses;
- the total amount of the variable components of remuneration may not restrict the bank's capacity to increase its equity;
- bonuses should: (i) reflect the work, efficiency and quality over the previous three year period during which the relevant person was an Identified Staff member (and where the relevant period for such person lasted for less than three years – for that shorter period); and (ii) be determined so that they prevent rewards for poor performance;
- for banks operating as joint stock companies, at least 50% of the variable component of remuneration has to be awarded: (i) in the form of shares or financial instruments related thereto or, in the case of a bank whose shares are not traded on a regulated market, non-pecuniary instruments corresponding thereto, or (ii) securities that would comprise Tier I and Tier II capital for the bank; the employee may not dispose of these instruments sooner than permitted by the rules laid down by the bank;
- payment of 40% to 60% of any variable remuneration (depending on its amount) must be deferred for three to five years and may be reduced or withheld by the bank if there is a default or risk of a default on certain provisions concerning the bank's financial condition;
- the existing restrictions on granting retirement benefits to Identified Staff and the ban on members of Identified Staff using individual hedging strategies or insurance concerning remuneration and liability have been retained; and
- the rule of transparency of settlement and payment of variable components of remuneration and the special rules concerning banks enjoying state aid have been retained.

Changes to regulations of variable remuneration for Identified Staff

The most important new restrictions on variable remuneration for identified Staff when compared with CRD III and the Resolution are as follows:

- the existing rule that fixed components of remuneration should account for an appropriately large part of total remuneration has been considerably restricted in such a way that the ratio of the variable component to the fixed component may not, as a rule, exceed 1 to 1. It may be increased to a maximum of 2 to 1, but only with the consent of the shareholders' meeting, representatives' assembly or supervisory board in the case of a state bank, whereby:
 - in the case of banks operating in the form of joint-stock companies and cooperative banks, consent is given in the form of a resolution adopted by a 2/3 majority in the presence of persons representing at least one half of the bank's share capital; in the absence of a quorum, a resolution is adopted by a 3/4 majority vote;
 - the bank's management board has to comply with a number of additional formal obligations associated with obtaining such consent, in particular, a certain period in advance of the date of the shareholders' meeting, representatives' assembly or meeting of the supervisory board, as the case may be, the management board should announce an appropriate recommendation as regards the increase. This period is generally 3 weeks but extended to 26 days for any bank that is publicly traded; and
 - the bank may apply a hypothetical discount rate to up to 25% of the variable component (taking into account the guidelines of the EBA), on condition that that part of the remuneration is paid out in instruments that are deferred for at least five years;

- as with payment of the remuneration itself, payment of severances should be withheld, limited or refused in situations of poor performance;
 - the bank is obliged to specify detailed criteria for the withholding, limiting or refusing payment of variable components of remuneration, which should take into account at least those situations where the Identified Staff member concerned: (i) took part in action that resulted in considerable losses for the bank or was responsible for such action or (ii) did not satisfy the appropriate standards for safe and prudent management of the bank;
 - bonuses awarded by the bank to an Identified Staff member in connection with the termination of his/her contract with his/her former employer constitute a variable component of remuneration;
 - the criteria for determining fixed and variable components of remuneration should be clearly separate, whereby: (i) any fixed component should depend on professional experience and the degree of responsibility associated with the position held; (ii) any variable component should depend on balanced and risk-adjusted results or other factors as specified in the remuneration policy;
 - unlike CRD IV, however, the Regulation has left in the rule of proportionality in the Resolution, pursuant to which the bank must apply the provisions based on the legal form in which it operates, its scale of activity, the risk associated with the activity it conducts, its internal organisation and the nature, scope and degree of complexity of the activity it conducts;
 - the remuneration policy in each subsidiary of the bank should comply with the provision set out in this section, taking into account the type of activity conducted by that subsidiary.
- regulate in detail the involvement of the relevant authority of the bank in the process of granting and paying out variable remuneration;
 - specify the rule of proportionality;
 - contain instructions on who qualifies as Identified Staff;
 - contain detailed terms on the certain categories of remuneration, e.g. allowances and loyalty bonuses;
 - regulate the process of awarding, paying out and deferring disbursements of variable remuneration, for example they state that in the case of banks comprising "Material Institutions" the remuneration of members of the management board and senior management should be deferred for at least five years and relate to a considerably larger part of the variable remuneration;
 - specifies rules on retaining variable remuneration in certain circumstances; and
 - develops transparency rule for variable remuneration policies.

Assessment of the amendments

The publication of the Regulation (almost a year and a half after the Banking Law was amended to require it to be issued) should end any dispute as to the application of the relevant provisions of CRD IV to Polish banks.

The Regulation, for the most part, faithfully reflects the relevant provisions of CRD IV. Nevertheless, it is worth noting a material difference – the Regulation does not require that listed banks pay out at least 50% of variable remuneration only in shares, not in other financial instruments. That is an important difference because many banks whose shares are listed on the stock exchange use for this purpose a phantom structure. That is they pay out an amount in cash equal to the value of the shares which would otherwise be issued to pay the bonus at the relevant time. It will be interesting to see how the PFSA reacts to this issue.

As a result of the new restrictions on awarding and paying out variable remuneration described above, it seems critical to introduce an express limit on variable remuneration (determined as a ratio to fixed remuneration in the bank's policies). We predict that in practice this may be a fundamental problem in how a bank's remuneration policy will operate. However, this provision, like other provisions of the Regulation, should be no surprise to banks because the Directive was published more than three years ago.

EBA's Guidelines

It is also worth remembering that the provisions of the Regulation should be read in conjunction with the Guidelines, which should be applied from 1 January 2017.

In particular, the Guidelines:

- contain definitions of fixed and variable remuneration and a number of other definitions material from the point of view of awarding and paying out variable remuneration;

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