RIGA GRADUATE SCHOOL OF LAW

EU Legal Requirements for the Remuneration System of Credit Institutions: Main Objectives and Practical Difficulties

MASTER'S THESIS

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DECLARATION OF HONOUR:

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed) …….

RIGA, 2017

SUMMARY

The financial crisis of 2007-2008, among other things, proved that there is a lack of legal requirements in the sphere of financial institutions in the world and in the European Union, as well. The financial institutions (including credit institutions) did not pay adequate attention to the mitigation of excessive risk-taking by the staff of financial institutions and did not evaluate the coherence between the excessive-risk taking and the incentives provided by the remuneration systems of financial institutions. After the crisis the European Union had to take actions towards eliminating the consequences of the crisis and to reduce risks that something analogous were unlikely to reoccur.

The credit institutions are the main actors between all financial institutions and play a core role in financial system of the European Union. Therefore, for better understanding of the current financial system, it is also important to understand the place of legal provisions on remuneration in the corporate governance of credit institutions and in all macroprudential regulation, as well. The requirements on remuneration for the staff of credit institutions included in the European Union laws after the financial crisis of 2007-2008 have raised many questions, uncertainties and criticisms.

In the Introduction 8 questions are set that are planned to be answered by the Master's Thesis. For achieving the goals of the Master's Thesis, the notion of corporate governance and the place of remuneration policies in it will be evaluated. The development of the legal provisions and the current legal provisions on remuneration in credit institutions of the European Union law will be evaluated, because it is necessary for understanding the main objectives of the provisions. In the last chapter of the Master's Thesis the practical issues associated with requirements on remuneration will be reviewed. Namely, issues regarding determining of the identified staff, the deferral period and clawbacks as the most controversial issues will be discussed. Finally, the current content of variable remuneration and the main reasons for determining the maximum ratio between the fixed and variable remuneration will be evaluated.

In the conclusions of the Master's Thesis answers to all 8 questions highlighted in the Introduction of the Master's Thesis are provided. The general conclusion of the Master's Thesis is that the European Union have an approach on remuneration at the EU level which is overregulated. It is not necessary to apply these provisions to small credit institutions, as well as the criterions for identification of staff are too broad. It would be advisable to apply less requirements on remuneration provisions, but include these requirements in the European Union regulations which have direct effect. This would avoid different interpretations by the Member State. Developments are necessary for the legal provisions on applying more targeted approach toward requirements on the remuneration in credit institutions on the European Union level.

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INTRODUCTION

General overview

The requirements towards remuneration system of credit institutions and investment firms in the European Union (further – the EU) has become one of the core elements of activity of credit institutions after the financial crisis which took place in the years 2007-2008 globally, including the EU (further – the financial crisis of 2007-2008). The financial crisis of 2007-2008 proved that there is a lack of legal requirements in the sphere of financial institutions. This led to a situation that financial institutions (including credit institutions) did not pay adequate attention to the mitigation of excessive risk-taking by the staff of financial institutions and did not evaluate the connexion between the excessive-risk taking and the incentives provided by the remuneration systems of financial institutions.

Since the credit institutions are the main actors between all financial institutions and play a core role in financial systems of each specific the EU Member state and the EU, it is worth evaluating how the current requirements on remuneration in credit institutions affect their activities, how the legal provisions on remuneration are implemented in practice in credit institutions and what the main difficulties and uncertainties are in this regard.

The requirements on remuneration for the staff of credit institutions included in the EU laws after the financial crisis of 2007-2008 have raised many questions, uncertainties and criticisms. Issues concerning the reasons for determining certain requirements, the place of remuneration system in the whole concept of corporate governance, there will be evaluated, since it is not possible to build a structure of corporate governance without adopting of policies regarding remuneration. The main objectives of the current legal provisions and the most controversial or problematic aspects of the main features of remuneration will be also evaluated.

This Master Thesis's main emphasis will be made towards establishing requirements set for credit institutions as part of financial institutions and financial system as a whole. Pursuant to Sub-Part 1 of Part 1 of Article 4 of the Regulation 575/2013 "credit institutions" means the undertaking the business of which is to take in deposits or other repayable funds from the public and to grant credits for its own account.[1] The provisions of the EU law do not distinguish the requirements depending on the size of the credit institution. To be more precise, there are some stricter requirements on systemically important institutions[2]. At the same time, there are no other more specific provisions that would depend on the size of credit institutions. As will be discussed in this Master's Thesis, only the latest developments in the

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 . JO L 176, 27.6.2013, p. 1–337 . http://data.europa.eu/eli/reg/2013/575/oj. Accessed October 25, 2017. (further – Regulation 575/2013).

[2] A systemically important institution· - an EU parent institution, an EU parent financial holding company, an EU parent mixed financial holding company or an institution the failure or malfunction of which could lead to systemic risk (Sub-Part 30 of Part 1 of Article 4 of Regulation 575/2013).

EU law shows that there could be specific, less strict and formal regulations towards "*small*" credit institutions.[3]

In the first chapter of the Master's Thesis the notion of corporate governance and the place of remuneration policies in it will be evaluated, as well as the main reasons for adoption of the systems of remuneration and of the EU laws on remuneration.

In the second chapter the current legal provisions of the EU law will be evaluated and the main objectives behind, because it is necessary for understanding why the legal provisions are as they are.

In the third chapter the practical issues associated with requirements on remuneration will be reviewed. Namely, issues regarding determining of the identified staff, the deferral period and clawbacks as the most controversial issues will be discussed. Finally, the current content of variable remuneration and the main reasons for determining the maximum ratio between the fixed and variable remuneration will be evaluated.

Definitions

It should be recognised that different definitions in different sources regarding remuneration issues in financial institutions and credit institutions as well are used. Therefore, for the clarity the definitions already provided by Directive 2013/36/EU[4] and Regulation (EU) No 575/2013[5] which state as the main legal provisions regarding requirements on remuneration in credit institutions will be used. No separate quotations of all definitions used in the Master's Thesis will be provided. There are different terms used also by the authors of different books and journals. Therefore, for the purpose of the Master's Thesis, these terms will not be changed in the precise quotations if it is possible to understand the main idea of this text.

The main objectives of the Master's Thesis

There are a lot of different questions that could be researched regarding remuneration, its systems and the features of remuneration in credit institutions in the EU. Moreover, the fact that there are a lot of different countries in the EU with different legal systems and economic situation also influences the approach of national authorities toward implementation of the legal provisions of the EU laws. Therefore, the author of the Master's Thesis has identified, in her opinion, the most valuable and interesting questions which will be answered by this Master's Thesis.

The main questions that are planned to be answered by this Master's Thesis are the following:

[3] The European commission press EU Banking Reform: Strong banks to support growth and restore confidence. November, 2016. http://europa.eu/rapid/press-release_IP-16-3731_en.htm. Accessed November 1, 2017.

[4] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/. JO L 176, 27.6.2013, p. 338–436. http://data.europa.eu/eli/dir/2013/36/oj. Accessed October 25, 2017.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 . JO L 176, 27.6.2013, p. 1–337 . http://data.europa.eu/eli/reg/2013/575/oj. Accessed October 25, 2017.

1) What is a place of remuneration requirements in the corporate governance of credit institutions and what is the main characteristic of the current corporate governance?
2) Has the role of credit institutions in the financial crisis of 2007-2008 been correctly evaluated?
3) Should the requirements on remuneration and its policies be regulated by EU laws?
4) Can the national competent authorities fulfil the duties EU laws entrusted to them?
5) Are the EU law provisions on the identified staff appropriate and whether all categories of this staff should be included?
6) What are the main problems associated with the deferred periods and clawbacks?
7) Has the equity linked variable remuneration achieved the goals set by EU laws?
8) Is the maximum ratio necessary for removing the excessive risk taken by the staff of credit institutions?

Methodology

To achieve the set objectives of the Master's Thesis the place of remuneration policies in the corporate governance in credit institutions will be evaluated, because remuneration policies are a part of current system of corporate governance. As well, the development on the provisions on remuneration on the EU level will be evaluated. The historical approach will provide an understanding of the current legal provisions of the EU law, as well as give an understanding of the main objectives behind.

There are different countries in the EU and therefore implementation of the provisions of the EU laws into national laws is important. Therefore, for the objectives of this Master's Thesis the specified problematic aspects detected by the different surveys where are evaluated implementation of these provisions into the laws of the EU Member States will be noted. This approach will also provide the understanding how it is possible to improve the current legal provisions, since the Member States have noted the main difficulties they faced.

To achieve the objectives of the Master's Thesis different reports prepared by the European Commission (further – also Commission) or for the Commission by researchers regarding implementation of the provisions on remuneration in the Member States will be evaluated. The Commission is the main authority of the EU which proposes the changes to legislation, therefore the reports provided by it has a significant role for understanding the objectives and possible developments of these requirements.

CHAPTER 1. THE CORPORATE GOVERNANCE OF CREDIT INSTITUTIONS, THE PLACE OF REMUNERATION SYSTEM IN IT

Corporate governance has always been a complicated issue, because it combines the interests of various involved persons. Corporate governance has been widely discussed since the 1980s and clearly established in doctrine and business practice since the 1990.[6] The Organisation for Economic Co-operation and development in G20/OECD Principles of Corporate Governance stated that

> (C)orporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.[7]

"Effective corporate governance is critical to the proper functioning of the banking sector and economy as a whole."[8] Corporate governance become even more essential topic in the fields of corporate and finance law after the financial crisis of 2007-2008, therefore it is recognised that corporate governance is in the centre of any reform in both subjects.[9] Nevertheless "corporate governance weakness in financial institutions were not *per se* the main cause of the financial crisis"[10], it was recognised that "the corporate governance of financial institutions had played an important role in the crisis, mainly due to the accumulation of excessive risks"[11]. Therefore, at first, the content of corporate governance will be evaluated in this chapter, whereas, the reasons of the financial crisis of 2007-2008 will be evaluated in the next chapter.

Before evaluating the remuneration provisions of EU laws, it is necessary to establish reasons behind the different approaches to remuneration for staff of credit institutions (including setting of variable remuneration) and the place of remuneration system in the corporate governance of credit institutions. In addition, it is necessary to evaluate the chronology of developments in EU remuneration regulations to understand the reasons behind the currents provisions.

1.1. Corporate governance content in credit institutions

1.1.1. General overview

[6] Vincent Ribas-Ferrer. Corporate governance in European listed companies and financial institutions. Athens journal of Law, January, 2016. p.49. https://www.athensjournals.gr/law/2016-2-1-4-Ribas-Ferrer.pdf. Accessed October 25, 2017.

[7] The Organisation for Economic Co-operation and development. G20/OECD Principles of corporate governance. November, 2015: p.9. http://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en. Accessed November 1, 2017.

[8] Basel Committee on Banking Supervision. Guidelines on Corporate governance principles for banks. July 2015. p.3. https://www.bis.org/bcbs/publ/d328.pdf. Accessed November 1, 2017.

[9] Vincent Ribas-Ferrer. Corporate governance in European listed companies and financial institutions. Athens journal of Law, January, 2016. p.49. https://www.athensjournals.gr/law/2016-2-1-4-Ribas-Ferrer.pdf. Accessed October 25, 2017.

[10] The European Commission. Commission staff working document. Corporate governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices. SEC (2010) 669, 2.6.2010., p.3. http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf. Accessed October 25, 2017.

[11] Vincent Ribas-Ferrer. Corporate governance in European listed companies and financial institutions. Athens journal of Law, January, 2016. p.49. https://www.athensjournals.gr/law/2016-2-1-4-Ribas-Ferrer.pdf. Accessed October 25, 2017.

The role of credit institutions is crucial to the economy, because credit institutions are the intermediating funds between different subjects (including consumers, investors and even other credit and investment institutions), the role of credit institutions is crucial in economic growth. As already noted, the identified staff remuneration is closely connected to the corporate governance of credit institutions. Moreover, current approaches to fixed pay and variable remuneration originates in the corporate governance and interest of shareholders and stakeholders, as well, in order to guarantee that the staff of credit institutions act in their best interests.[12] Therefore it is imperative at the outset to evaluate the concept of the corporate governance of credit institutions, in order to comprehend issues of remuneration and the reasons behind the culture and regulations of corporate governance in credit institutions.

The main subject of the Master's Thesis is evaluation of the current requirements towards remuneration at the EU level. Therefore, the approaches of corporate governance in credit institutions in the EU will be discussed. Principles and provisions of law on corporate governance differ greatly across the EU, due to the differences in the structure of financial institutions, including credit institutions, in the main principles of corporate law and commercial law. It is not the aim of this paper to evaluate these different approaches. At the same time the main elements and the outstanding questions in the corporate governance of credit institutions are in general the same – (1) the interests of stakeholders, including shareholders; (2) control mechanisms over the credit institution on a day-to-day basis; (3) systematic risks and adoption of long-term decisions, (4) monitoring staff and incentives for staff; (5) observation of different regulatory provisions and policies etc.[13]

Since there numerous interests involved in the business activities of the credit institutions, it can't be denied that credit institutions have quite specific corporate governance.

1.1.2. A notion of systemic risk in activities of credit institution

Firs of all, it is necessary to evaluate the environment in which credit institutions provide their services, because it will help to understand reasons for constructing the corporate governance of credit institutions as it is now. It should be noted that "the nature of the activities and the interdependencies within the financial entities produces a systemic risk, what may affect stability of the financial sector (…)"[14].. The concept of systemic risk and its importance was restored after the financial crisis of 2007-2008. Systemic risk is explained as a situation when an economic shock or institutional failure, results in a chain of detrimental economic consequences, which can include financial institution and/or market failures.[15] On the opposite side of this approach is the position that "(B)anks have an advantage compared with

[12] Christoper Phelan. Incentive compensation in the Banking industry: Insights from Economic Theory. Paper provided by Federal Reserve Bank of Minneapolis in its series Economic Policy Paper with number 09-1.p.6. https://minneapolisfed.org/~/media/files/pubs/eppapers/09-1/eppaper09-1_incentivecomp.pdf. Accessed October 25, 2017.

[13] Vincent Ribas-Ferrer. Corporate governance in European listed companies and financial institutions. Athens journal of Law, January, 2016. p.49. https://www.athensjournals.gr/law/2016-2-1-4-Ribas-Ferrer.pdf. Accessed October 25, 2017. Basel Committee on Banking Supervision. Guidelines on Corporate governance principles for banks. July 2015. p.2. https://www.bis.org/bcbs/publ/d328.pdf. Accessed November 1, 2017.

[14] Ibid, p.49.

[15] Steven L. Schwarcz. Systemic Risk. The Georgetown Law Journal, 97, 2008, p. 193. https://scholarship.law.duke.edu/faculty_scholarship/1903. Accessed October 25, 2017.

other financial institutions in providing liquidity".[16] Especially banks that are quite active in the interbank market where banks trade liquidity surpluses and deficits. This leads to a possibility easy avoid shocks in each separate credit institution.

Secondly, general liquidity shocks are made less severe by the central bank.[17] This mean that there is also an approach that the system of credit institutions is a self-regulatory and the possibility of systemic risk less severe even without specific regulations. Nevertheless, this does not prevent economic shocks caused from outside the system and does not into account the risk of liquidity, discussed below.

Most probably systemic risk was always present, but there is the question of how much attention it was given before the financial crisis of 2007-2008. Before the era of "systemic risk" issues, it was also recognised that corporate governance of credit institutions that dealt with risk were attributable to each specific credit institution. Risks which influence each specific credit institutions were: (1) credit risk – when a debtor does not fulfil their obligations; (2) settlement risk – when an execution of a settlement fails to take place as expected; (3) counterparty risk – when a counterparty fails to fulfil their obligations; (4) liquidity risk – in two types – market liquidity risk when a credit institution is unable to arrange a deal at a price of the value of a financial instrument in the market; funding liquidity risks – when a credit institution is unable to find funding: (5) market risk –when a risk which occurs due to unfavourable movements in the market leads to decrease in the value of assets of a credit institution: (6) operational risk – when the risk of different losses is due to problems in the internal processes of a credit institution, some external incidents or failures to comply with the provisions of laws.[18] There are many different risks that may influence credit institutions whose main objectives are connected with managing of such risks. It is not possible to agree that before a systemic risk all other risks could affect only specific credit institution. Also before a restoration of a notion of systemic risk, credit institutions could be influenced by different risks which could arise outside credit institutions. Currently it is recognised that interconnectedness between credit institutions is on a such high level that it is not possible to avoid risks that occur outside the specific credit institution.

The question of staff remuneration in credit institutions is closely related to the issues of different risks which affect credit institutions. It is not acceptable that credit institutions are influenced by these risks, but this does not create any consequences to the staff of credit institution. Otherwise there would be unnecessary protection of staff and a risk of excessive risk taking by this staff. Therefore, it is necessary to understand the management of risks in credit institutions and their relevance to the specific activities of the staff of credit institution.

1.1.3. The issues of risk management

[16] Jakob de Haan, Sander Oosterloo, Dirk Schoenmaker. Financial Markets and Institutions. A European perspective, Third edition. (Cambridge: Cambridge University Press, 2015), p.322.Quoted from: P.M.Garber, S.R. Weisbroad. Banks in the Market of Liquidity. NBER Working Paper 3381, 1990.
[17] Ibid, pp.322-323.
[18] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.2. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

Another issue which is connected to the risks mentioned above is risk management by credit institutions. The Basel Committee on Banking Supervision in its Guidelines on Corporate governance principles for banks explained that

> (R)isk management is the process established to ensure that all material risks and associated risk concentrations are identified, measured, limited, controlled, mitigated and reported on a timely and comprehensive basis.[19]

At the same time, it should be noted that the elimination of risks is not the issue, because all profits of credit institutions are sourced from risk-taking activities. The issue is about ensuring optimal-risk taking without endangering the viability of the credit institution.[20] Nevertheless it should be recognised that an issue of "optimal" risk is a notion that does not have clear boarders and that there will always be the question of best way to determine risk. Most probably this also was one of the reasons why before the crisis of 2007-2007 there was little level of attention paid towards these issues. At the same time in the doctrine it is recognised that there is a

> (…) well-known economic distinction between risk and uncertainty. Under uncertainty, the parties can foresee the different possible outcomes, but do not know the distribution of probabilities, because there is no valid basis of any kind for classifying instances. Under risk they know the distribution of probabilities either a priori or statistically.[21]

One of the main subjects of corporate governance is identifying and evaluating risks, in other words, there should be a clear structure of how it is done in a company. It is now recognized that risk functions should have been respected and regarded at the same level as the operational/trade functions.[22] At the same time it is only possible to talk about adequate evaluation of risk after the crisis of 2007-2008.

It is now recognised that one of the reasons for the crisis of 2007-2007 were problems with the remuneration of staff of financial institutions which created incentives for excessive risk taking to be discussed later. It is still a disputed, how much of a role remuneration and excessive risk taking played in the financial crisis of 2007-2008. Nevertheless, it is recognised that "weak risk management at financial institutions may have contributed to the excessive risk-taking that brought about the financial crisis"[23].

From the perspective of corporate governance current EU legal provisions set strict (compared to previous regulations) requirements on how risk management should be proceeded in credit institutions. Moreover. EU law also provides requirements for risk

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[19] Basel Committee on Banking Supervision. Guidelines on Corporate governance principles for banks. July 2015. p.2. https://www.bis.org/bcbs/publ/d328.pdf. Accessed November 1, 2017.

[20] The European Commission. Commission staff working document. Corporate governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices. SEC (2010) 669, 2.6.2010, p.17. http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf. Accessed October 25, 2017.

[21] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.15. Quoted from: F. Knight. Risk, Uncertainty and Profit. NY, Cosmo, 2006, p.225.

[22] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. Cambridge: Cambridge University Press, 2013, p.25.

[23] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.9. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

calculation of risks. For example, Article 293 of Regulation 575/2013 sets out the requirements for risk management system of financial institutions. Directive 2013/36/EU and Regulation 575/2013 set different requirements for determining different risks, measuring them, as well as for organisation of the risk management system in credit institutions.

At the same time such strict regulations have created also an opposing opinion that it is not necessary to create an excessively detailed risk management processes. It is necessary to let credit institutions freely design their systems under the supervisions of boards according to the general requirements of regulatory law and the periodic controls of supervisors over the adequacy of these systems form a safety and soundness perspective.[24] It can be concluded that there is no one common approach towards risk management and the level of regulations of the risk management in credit institutions. There is some sense in such an approach, as will be discussed later, that very strict and formal requirements brake entrepreneurship. At the same time regarding the control of supervisors, as will also be later discussed (see Chapter 2.1.), there is the question whether control and supervisory institutions are always able to function at the adequate level.

It is noted that "proper and timely risk assessment/monitoring has not always been possible (…) due to failure to master the complexity of risk issues"[25], moreover, it is even argued that board members' qualifications defects led to the financial crisis.[26] It is stated that

> "(…) the quality of risk management systems and effective board monitoring over these systems definitely contribute to safety and soundness of financial institution"[27].

1.1.4. Actors of the corporate governance in credit institutions

To understand the system of corporate governance and the reciprocal mechanisms that work in this system it is necessary to discuss the functions of the board, as well as the functions of the other actors of corporate governance.

The most prominent actor in corporate governance is the board, which is regulated in the laws of all countries.[28]It is not the aim of this Master's Thesis to evaluate the different approaches towards the composition of the board. In the context of remuneration issues, it is necessary to understand the main responsibilities of board, as well as to discuss issues of qualification of the board, since as it was already noted that low qualification of board members was one of the reasons for the financial crisis of 2007-2008.

There are two main approaches towards the structure of the board in general; namely, "one-tier" and "two-tier" boards. Both these approaches are used also in the EU. Two-tier board

[24] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.18. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.
[25] The European Commission. Commission staff working document. Corporate governance in Financial Institutions: Lessons to be drawn fit rom the current financial crisis, best practices. SEC (2010) 669, 2.6.2010: p. 19. http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf. Accessed October 25, 2017.
[26] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. Cambridge: Cambridge University Press, 2013, p.8.
[27] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.10. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.
[28] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. (Cambridge: Cambridge University Press), 2013, p.28.

approach is most often used in the EU (for example, in Germany, Austria), whereas one-tier board approach is usually used by Anglo-American legal system countries, for example, the United Kingdom.[29]

The main difference between these two is that in the one-tier board there are executive and non-executive directors in one corporate body with the internal structures of management and control (executive directors perform management functions, whereas non-executive directors perform supervisory functions). Whereas in the two-tier board there are two separate corporate bodies – the management board and the supervisory board. Management board performs the daily management of the company and consists of executives, whereas the supervisory board consists of non-executives and perform supervisory functions over the activities of the management board.[30] There are discussions regarding the best structure of the board, moreover there are questions how effective the one-tier board is from the perspective of the effective monitoring and control of the company.[31] The European Commission also has noted this issue and, for example, has commented in Recital 55 of Directive 2013/36/EU that

> (D)ifferent governance structures are used across Member States. In most cases a unitary or a dual board structure is used. The definitions used in this Directive are intended to embrace all existing structures without advocating any particular structure. They are purely functional for the purpose of setting out rules aimed at a particular outcome irrespective of the national company law applicable to an institution in each Member State.

From the perspective of remuneration provisions, it is not important what type of board structure has been established in the Member State. Most probably there always will be discussions concerning the ideal structure of the board. An understanding how the functions of the board in each of two systems interact and what is a place of remuneration policies and oversight over observance of them in credit institutions is an important issue from the perspective of remuneration issues.

The Guidelines of Corporate governance principles for banks prepared by the Basel Committee on Banking Supervision that set out some of the main functions of the board are to oversee the bank's adherence to the risk appetite, risk policy, risk limits, establishing the bank's corporate culture and values, and to approve the approach of the bank towards capital adequacy assessment process, capital and liquidity plans etc.[32] In connection with these functions it is stated that

> (T)he board is responsible for the overall oversight of management's implementation of the remuneration system for the entire bank. In addition, the board or its committee should regularly monitor and review outcomes to assess whether the bank-wide

[29] Klaus J. Hopt. Patric C. Leyens. Boards models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy. ECGI-Law Working Paper No. 18/2004. Company&Securities Law Review, Vol. 1, 2005: p. 232. https://ssrn.com/abstract=487944. Accessed November 27, 2017.

[30] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. (Cambridge: Cambridge University Press, 2013), p.8.; Encyclopedia of Corporate Social Responsibility. Volume 3. Editor in chief Semuel O. Idowu. Berlin: Springer, 2013, pp. 1778, 2575.

[31] Encyclopedia of Corporate Social Responsibility. Volume 3. Editor in chief Semuel O. Idowu. (Berlin: Springer, 2013), pp. 1778.

[32] Basel Committee on Banking Supervision. Guidelines on Corporate governance principles for banks. July 2015. p.8-9. https://www.bis.org/bcbs/publ/d328.pdf. Accessed November 1, 2017.

> remuneration system is creating the desired incentives for managing risk, capital and liquidity.[33]

This mean that some of the board's functions even not directly connected to the issue of remuneration, are, nevertheless, referable also to remuneration issues, because remuneration policies and execution of them shall be consistent with the long-term strategic objectives and be appropriate for managing risk, capital and liquidity of credit institution.

The issue regarding the qualification of the board as well is important, because, as it was already mentioned, low qualification of the board has been stated as one of the reasons why credit institutions took excessive risk before the crisis of 2007-2008. "Since the board is responsible for reviewing and guiding corporate strategy and risk policy"[34], it was recognised that the boards qualification and skills plays significant role.

Recital 59 of Directive 2013/64/EU says that

> (W)hen appointing members of the management body, the shareholders or members of an institution should consider whether the candidates have the knowledge, qualifications and skills necessary to safeguard proper and prudent management of the institution.

This issue of the qualification of the board is also relevant to remuneration issues, because there also is the view that various regulatory provisions paralyze the best practices of corporate governance and impose additional costs on credit institutions. Nevertheless, these costs could be used by engaging a professional, skilled and qualified board, as well other staff [35] This in its turn would lead to a situation where credit institutions provide good corporate governance without needless regulatory provisions and keep the best corporate practices. Despite such approach being ambitious, there is some sense in this view, because overregulation, as will be later discussed in this chapter, may lead to an increase in the level of corporate governance (contrary to the main objectives of such regulations).

1.1.5. The shareholders-oriented approach and stakeholders-oriented approach, their meaning in the corporate governance of credit institutions

From the perspective of current remuneration issues, it is important to mention two different approaches which are used by credit institutions – the shareholders-oriented approach and the stakeholders-oriented approach. This is relevant to the topic, because the issues of different interests which are involved definitely have influenced also corporate governance, especially after the financial crisis of 2007-2008. Issue of different interests is important in the corporate governance of credit institutions also because of different possible risks involved in the activities of credit institutions.

The shareholder-oriented approach of corporate governance means that the management of credit institution functions in the best interests of shareholders. This approach is usually more common in the Anglo-American legal system. Whereas stakeholder-oriented approach means

[33] The Basel Committee on Banking Supervision. Guidelines on Corporate governance principles for banks. July 2015. p.8-9. https://www.bis.org/bcbs/publ/d328.pdf. Accessed November 1, 2017.
[34] Grant Kirkpatrick. The Corporate Governance Lessons from the Financial Crisis. OECD, Financial Market Trends. p.10. http://www.oecd.org/finance/financial-markets/42229620.pdf. Accessed on November 1, 2017.
[35] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.8. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

that the management of credit institutions functions in the interests of credit institutions as a whole.[36]This notion has been even developed. Now as stakeholders is defined any person or persons which may be affected by activities of credit institutions, as well as competent authorities and a society as a whole.[37]

There is also a question raised in doctrine whether the corporate governance of credit institutions is a type of stakeholder corporate governance.[38] Most probably it is possible to agree to such approach, because as it will be discussed later quite a lot of legal provisions are like a compromise between the different interests of the involved persons.

It is recognised that the EU policy is rather ambivalent and fluctuate between these two approaches just described. The 2011 Green Paper on corporate governance includes explanations on corporate governance that prove that there is not chosen the only approach toward corporate governance in the EU Member States.[39] It is very interesting that in the Study on the CRD IV remuneration provisions it is recognised that

> (…) the relationship between internal governance characteristics and risk-taking is unclear (…) and not yet explored. Specifically the role of the internal control function and its involvement in the definition of remuneration policies has to date been only partially investigated.[40]

The issue of shareholders-oriented approach and stakeholders-oriented approach is important for remuneration systems, because these approaches influence one way on how credit institutions incentivise their staff. These approached may even influence the amount of incentives, because most probably incentives will be higher in case the shareholders-oriented approach is used. At the same time, it seems that the EU has not decided what is the most preferable approach, this will be discussed also in Chapter 2.1.

There are many different interests involved in the operations of credit institutions. Moreover, it is even recognised that the main problem is not the different interests of management and shareholders, but the different interests of management, shareholders and debtors on one side, and society on the other side that arises from the externalities[41] related to systemic risk.[42] This means that the current regulations adopted by the EU legislator may be amended, as well as, may be changes in the current approach of the EU towards these issues. At this moment it can

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[36] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. (Cambridge: Cambridge University Press), 2013, pp.40-41.

[37] Alberto Chilosi, Mirella Damiani. Stakeholders vs Shareholders in Corporate governance. Research Paper, March, 2007: p.12-13. Munich Personal RePEc Archive. https://mpra.ub.uni-muenchen.de/2334/1/MPRA_paper_2334.pdf. Accessed November 1, 2017.

[38] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.19. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

[39] The European Commission. Green Paper. The EU Corporate governance framework. COM (2011) 164 final, 5.4.2011, pp.6, 12. http://www.ecgi.org/commission/documents/eu_corporate_governance_framework_5apr2011_en.pdf. Accessed November 27, 2017.

[40] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. pp.66-67. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[41] Externality - an external effect, often unforeseen or unintended, accompanying aprocess or activity. Oxford Dictionary online. https://en.oxforddictionaries.com/definition/externality. Accessed November 27, 2017.

[42] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p. 28. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

be concluded that corporate governance in credit institutions, and financial institutions as well, are different from the classical notion of corporate governance. Moreover, it can be recognised as a type of stakeholder governance, because of the different interests (even in society) involved in the operations of credit institutions.

1.1.6. Theories of remuneration

In order to review corporate governance in the scope of remuneration issues, it is necessary to review different approaches to variable remuneration. There has always been a need for a specific mechanism to prevent staff from using the resources of a company for their own interests rather than for interests of the owners, investors and credit institution as a whole.

There are usually two ways how this can be approached. First of all, there is the issue of the appointment of the board (irrespectively whether it is on-tier or two-tier board).[43] Namely, the idea by appointing members of the board with executive and supervisory functions, the shareholders achieve a mechanism over how the management board may be supervised. Nevertheless, the problem of incentives for members of supervisory board still exists. Moreover, this approach does not motivate the management board to achieve better results other than performing of their expected duties, as well as the problem of respecting the interests of other stakeholders would remain unresolved.

A second method for insuring that staff respect the interests of shareholders and other stakeholders is to create an appropriate remuneration system. The main concept of this idea is to make remuneration dependant on the company's performance by providing different incentives, for example, direct ownership of shares, stock options, bonuses dependent on the share price.[44] At the same time this issue may cause problems, which will be discussed in the next chapter. Namely, if remuneration is sensitive to the performance of the company, the staff will be incentivised to take excessive risks, since they benefit from better performance, while at the same time the penalties for poor performance are limited.

It can be recognised that both these methods are applied for incitement the staff of credit institutions, because none of them is perfect and does not provide the achievement of the goals of shareholders and credit institutions as a whole.

The remuneration systems for executive and non-executive employees of financial institutions (as well as of credit institutions) came under intense scrutiny after the financial crisis of 2007-2008 (this issue will be discussed in the next chapter). In this chapter the reasons of setting of the remuneration systems will be discussed. This issue is not new, and the financial institutions always have dealt with it, because credit institutions always seek to increase their profit, and, in order to reach of this goal, they need highly motivated executives and employees. For example,

[43] Yannick Hausemann, Elisabeth Bechtold-Orth. Changing remuneration systems in Europe and United States: a legal analysis of recent developments in the wake of the financial crisis. European Business Organisation Law Review, 2010 11(2). p.196.
[44] Ibid, p196.; Peter O. Mulbert. Corporate governance of banks. European Business Organization Law Review, 2009, 10(3), pp.413, 418.

> [T]he bank's objective of maximizing expected return is constrained by the fact that its employees must be inducted to act in the interest of the bank[45]. (…) The bank must create a compensation system that will provide incentives for employees to act in the bank's interests: working actively, investing in those projects that should be funded by the bank (good risks) and turning down those projects that shouldn't (bad risks).[46]

There are different approaches how such systems should be created and the best way how to create them. It is acknowledged that the structure of remuneration system rather than the amount gives (negative) incentives, which leads to and still lead to excessive risk-taking and an overemphasis on short-term results[47].

There are three different theories used to explain the existence of variable remuneration. The main theories are as follow: (1) the agency theory; (2) the market theory; (3) corporate governance theory. The agency theory deals with the problem between the interests of shareholders who own a company and the board who act as an agent for shareholders and has daily control over the company. [48]

> Remuneration and particularly variable remuneration is used to minimize these costs, by giving board members incentives to act in the interest of shareholders. The agency theory uses remuneration as an instrument to resolve the agency problem.[49]

Nevertheless, as will later be discussed in Chapter 1. 2.1., there is the question whether variable remuneration resolves the agency problem, because it may promote the extreme risk taking by the management of credit institution which could lead to decrease of the financial stability of credit institution. Whereas this directly affect the shareholders of credit institution.

The second theory is the market theory which defines remuneration in terms of market mechanism. Namely, this theory deals with supply and demand issues in the labour market (in the widest sense of this term, including also board members which usually do not have the status of an employee). This theory sees remuneration not as an instrument, but as a result of an agreement between parties.[50] A problem with this theory is that it does not explain the reasons for establishing variable remuneration. Of course, it does not exclude it in principle. But variable remuneration, as mentioned, is the result of negotiations according to this theory. It does not deal with issues of how to decrease excessive risk-taking and achieve the goals of the credit institution.

The third theory "considers the level of remuneration as a result of corporate governance."[51]Namely, this theory deals with a power of board members in determining their remuneration in comparison with other involved parties and their powers in determining it. This theory is quite similar to the market theory, because does not deals as much with issues of determining variable remuneration and the way in which it is determined, remuneration is considered as a reward for performance of management duties Currently, despite the fact that

[45] The author of the article used the terms "bank" and "employees', nevertheless these assertions apply to all credit institutions, as well as to non-executive employees and executives.
[46] Christoper Phelan. Incentive compensation in the Banking industry: Insights from Economic Theory. Paper provided by Federal Reserve Bank of Minneapolis in its series Economic Policy Paper with number 09-1.p.6. https://minneapolisfed.org/~/media/files/pubs/eppapers/09-1/eppaper09-1_incentivecomp.pdf. Accessed October 25, 2017.
[47] D.E.M. Kromwijk, W.J. Oostwouder. Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.238.
[48] Ibid, p.239.
[49] Ibid.
[50] Ibid.
[51] Ibid.

it is acknowledged that the agency theory is the most often used[52], it seems that it is not possible to distribute the one theory. The remuneration systems combine features of all these theories, because the corporate governance of credit institutions deals with the interests of shareholders, it should correspond to the market situation in terms of the amount of remuneration and it also has to observe the interests of other stakeholders.

Of course, issue of remuneration and variable remuneration especially is closely related to the motivation of staff of credit institutions. It is worth mentioning that there are also conflicting opinions regarding variable remuneration as an incentive for improved performance, as well as the usefulness of performance-based pay (this is attributed not only to ordinary business, but also credit institutions). In line with this sceptical view management should only receive a fixed salary, because performance-based remuneration enhances performance only on routine tasks, but does not improve it in case where necessary innovative and creative solutions are required.[53]Of course, it could be asked how innovative could the activities of credit institutions be, but this will be discussed in the chapter dealing with the main features of remuneration. Application of different instruments which are used for paying a variable part of remuneration definitely shows that creativeness is also necessary in activities of credit institutions, for example, different allowances were created for evading the requirements set for variable remuneration (see Chapter 3.1.). This approach states that all performance measurement systems are flawed or imperfect. Moreover, in cases where there are rewards for achieving specific goals, this may lead to the situation where unrewarded aspects of duties would not be performed well or even neglected. Of course, there is room for discussions on how well grounded this approach is Nevertheless, this theory could explain why performance-based remuneration lead to the crisis of 2007-2008, by arguing that management of credit institutions focused their activities too narrowly on specifically rewarded goals. This issue is relevant also with the current legal provisions, because remuneration still is closely linked to performance as will be discussed in the next chapter.

1.2. Reasons for implementation of the legal requirements into the EU law (crisis issues) and chronology of early development of them

1.2.1. The issues of the financial crisis of 2007-2008

As previously concluded, remuneration issues in credit institutions are one of the most important components of corporate governance and is a very sensitive topic. There is a question whether there should always be a balance between the interests of management at credit institutions and shareholders, as well as clients, and especially consumers, as discussed above. This question become relevant especially after the financial crisis of 2007-2008.

Therefore, the issue regarding the remuneration of staff of credit institutions is nothing new. At the same time only in this century has the issue of remuneration policies become critical, after the scandals surrounding excessive pay in underperforming financial institutions were revealed.[54] In the simple words, executives, as well as some non-executive employees of financial institutions (this problem is attributable not only to credit institutions) were

[52] Ibid.

[53] Dan Cable, Freek Vermeulen. Stop paying Executives for performance. Harvard Business Review, February 23,2016. https://hbr.org/2016/02/stop-paying-executives-for-performance. Accessed November 1, 2017.

[54] Christoper Phelan. Incentive compensation in the Banking industry: Insights from Economic Theory. Paper provided by Federal Reserve Bank of Minneapolis in its series Economic Policy Paper with number 09-1.p.6. https://minneapolisfed.org/~/media/files/pubs/eppapers/09-1/eppaper09-1_incentivecomp.pdf. Accessed October 25, 2017.

rewarded when owners of financial institutions and later also clients were losing their money. The remuneration systems were designed in a such way that the staff of financial institutions were interested in excessive risk taking instead of avoiding it. Moreover, there were not any clawback and malus provisions prescribed. Therefore, it was recognised that the flawed remuneration structures in financial institutions had contributed to the crisis of 2007-2008 by encouraging short-term risk-taking at the expense of long term security.[55]

After the crisis different assessments was to the main reasons of it were provided. One of the approaches explained that in case executives and other risk takers are incentivised by the performance criteria what influences their remuneration, they will be interested in making more risky decisions that at the end are profitable in the short-term, but threaten the long-term development of the company. A study on the CRD IV remuneration policies stated that "(R)emuneration structures affect financial stability by affecting incentives for both risk-taking and misconduct".[56] Moreover, there were discussions that the unbalanced variable compensation elements had led to undesirable behaviours, such as excessive risk-taking and concentration on short-term results.[57] Despite discussions about how exactly the practices and structures of remuneration contributed to the financial crisis, it is quite widely recognised that they played a central role.[58] It may even not be possible to access the amount of this contribution.

At the same time there are also different approaches towards this issue. Namely, it is noted that while credit institutions operate in a very complex financial services market, most of them are listed in stock exchange, and therefore have a large number of shareholders (for example, Swedbank in Sweden with 300 798 shareholders[59]) not interested in the sustainable development of the company, but in short-term goals (this is explained by the fact that it is easy to buy and sell shares in stock markets, therefore the short-term goals become primary). The risks of operating in financial market are difficult to identify and usually they are out of the scope of the main focus of the company.[60] These are reasons why, in the author's opinion, it is not entirely clear that one of the main reason for the crisis of 2007-2008 was specifically the remuneration of the staff of credit institution. It is also necessary to remember how much different parties are involved in the activities of credit institutions, as discussed before. Not only the staff of credit institutions want to receive a return from it. Therefore, it is not possible to give a clear answer that the remuneration structure as a whole led to the crisis.

From this point of view, the economic crisis which occurred in 2007-2008 is called the "systemic banking crises" and was preceded by credit booms (growth of credit above the

[55] Yannick Hausemann, Elisabeth Bechtold-Orth. Changing remuneration systems in Europe and United States: a legal analysis of recent developments in the wake of the financial crisis. European Business Organisation Law Review, 2010 11(2), p.196.

[56] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.5. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[57] D.E.M. Kromwijk, W.J. Oostwouder. Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.238.

[58] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.15.

[59] Swedbanks shareholders on October 31, 2017. https://www.swedbank.com/investor-relations/swedbank-shares/shareholders/. Accessed November 10, 2017.

[60] Piotr Teklak. The role of non-executive directors in banks and the provisions of guidance on how directors can rectify bank governance. Exeter Student Law Review Volume II, (2016), p. 59.

trend of GDP growth) and asset prices bubble (a rise of of asset prices above their fundamental economic value)[61]. In general, the causes for this crisis were also mentioned: (1) a lack of fiscal discipline among countries; (2) diverging financial cycles – in the EU the cycles was asymmetric because of different countries and their own cycles; (3) diverging competitiveness – capital inflows in Southern Europe and Ireland, as well as fuel investments that have little effect on future productivity growth; (4) Doom loop – large banks in the EU are large in proportion to their home economies. Most banks heavily invested in government bonds. This was the basis for "doom loop" and (5) policy reactions – twofold reaction of the European leaders to the crisis.[62]

It is also unclear how exactly remuneration was a problem and how it contributed to the crisis.[63] Of course, credit institutions differ from other entrepreneurs, because credit institutions are able to increase their riskiness very quickly and this would not be observable to outsiders, including competent authorities and shareholders. In addition, banks are vulnerable to changes in the economy especially in cases there is increasing risk-taking[64]Therefore it is necessary to remember that a way how credit institutions perform their activities is always connected with taking risk. But the question is how this risk is impaired. It seems that in the pre-crisis period there also was a lack of understanding on how to determine and impair the risk (discussed further), but this does not automatically mean that the remuneration system was the main reason for the crisis.

There also raised discussions that crisis was caused by the fact that national competent authorities just were not able to fulfil their main duties. Therefore, this resulted in a lack of control over credit institutions, and was thereby the main reason why the credit institutions went on to take excessive risks. The main aspects of this issues are noted in the following considerations.

Firstly, the competent authorities simply trusted the credit institutions allocating the risks (as well other financial institutions), as well as trusted that credit institutions (and other financial institutions) to deal with this on their own, since the approach of the neoclassical economics theory is that markets are stable and efficient.

Secondly, there is the problem of the asymmetry of information, namely, the operations of the credit institutions are too complex for the regulators to grasp and control them effectively. Thirdly, there are also political implications to this, since credit growth drives asset prices and GDP upwards. There were also rumours that the regulators were instructed not to place too much attention on the activities of the credit institutions.[65]This approach to the reasons for the financial crisis seems well grounded. Therefore, it is necessary to note that sometimes there is no problem with the subjects of supervision and control or with regulations of their activities, but with the ability and willingness of the supervision and regulatory authorities to perform

[61] Jakob de Haan, Sander Oosterloo, Dirk Schoenmaker. Financial Markets and Institutions. A European perspective, Third edition. (Cambridge: Cambridge University Press, 2015), p.323.
[62] Ibid, pp.69-75.
[63] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.7.
[64] Ibid, p.7.
[65] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.15.

their duties. Moreover, the problems with the capacity of the supervision and regulatory institutions are still urgent.

After the crisis the EU had to take actions towards eliminating the consequences of the crisis to reduce risks that something analogous were unlikely to reoccur. In theory there are different approaches how this was to be done. There is the regulatory approach and the supervisory approach to the corporate governance of credit institutions and of remuneration. This would mean that in case of regulatory approach there are detailed legal provisions on the activities of credit institution. In the case of supervisory approach there is an emphasis on the supervisory functions of a specific state institutions.[66] As will be discussed in the next part of the Chapter, it seems that as the EU response to the crisis was a combination of these two approaches. This definitely raises questions as to whether such approach is the most effective and provident.

1.2.2. The development of legal provisions concerning corporate governance and remuneration

In general, the EU applied the three main macroprudential regulatory reactions towards the crisis: (1) capital requirements, (2) remuneration policies and (3) transparency and collective consumer protection.[67] One should keep in mind the relationships between these three regulatory reactions, as well as the issue of different stakeholders' involvement.

One of the earliest documents on corporate governance and remuneration issues was the Basel Committee guidelines "Enhancing corporate governance for banking organisations" in 1999.[6869]As well as OECD issued "The Principles of Corporate Governance" published in 1999 and updated in 2004.[70] Despite the fact that these principles were quite general, they become the standard for creating national state documents on corporate governance, including legal provisions on executive remuneration.[71] Moreover, by the end of 20th century the organisations that worked with financial and corporate governance issues acknowledged that the issues of executive remuneration held vital importance in this area.

From the perspective of the European Union there were recommendations by the European Commission on executive remuneration in the public companies of the Member States issued on 2004[72] These Recommendations developed the concept of disclosure of executive

[66] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.19. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

[67] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the institute for financial services for European Commission's DH JUST. Final report, January 2016. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[68] The Bank for international Settlements, The Basel Committee. "Enhancing corporate governance for banking organisations", September, 1999. https://www.bis.org/publ/bcbs56.htm Accessed October 25, 2017.

[69] The underline for the emphasis's purpose here and further is provided by the Author of the Master's Thesis.

[70] The Organisation for Economic Co-operation and Development. "G20/OECD The Principles of Corporate Governance", 2004. http://www.oecd.org/corporate/principles-corporate-governance.htm. Accessed October 25, 2017. On September 2015 the revision of these principles were made.

[71] Agnieszka Slomka-Golebiowska, Piotr Urbanek. Executive Remuneration Policy at banks in Poland after the Financial Crisis – Evolution or Revolution?. Comparative Economic Research.Vol.17, No.2, 2014, p. 27. https://www.degruyter.com/view/j/cer.2014.17.issue-2/cer-2014-0012/cer-2014-0012.xml. Accessed October 25, 2017.

[72] Commission Recommendation 2004/913/EC of December 14, 2004 on fostering an appropriate regime for the remuneration of directors of listed companies. *OJ L* 385, 29.12.2004., p. 55-59. http://eur-

remuneration in public companies, as well as publicly known criterions on how different incentive programmes are applied and payments made. As it was later acknowledged by the European Commission the effects of these recommendations were minimal.[73]

In 2005 the European Commission adopted the released Recommendation as regards the regime for the remuneration of directors of listed companies.[74] This Recommendation focused on the role and responsibilities of the remuneration committee. This recommendation also provided requirements on the qualification and skills of the board.

On 30 April 2009 the European Commission issued complementing recommendation regarding the remuneration of directors of listed companies.[75] These Recommendations worked with the concept of creation of such remuneration policies that would lead to the growth of the company's incomes in a long-time period, as well as balance between all remuneration components. As well, approaches were developed to the components of the variable remuneration, severance payment and stock-based pay. The new mechanism was a reduction in bonuses or the reclaiming of paid bonuses in cases that had negative financial effects.[76] All these recommendations prove that already at that time the EU institutions acknowledged that the issue of executive remunerations in financial institutions had an impact not only on financial markets, but also on economy in general (there were not serious evaluations of the impact non-executive employees had on financial institutions at that time). In response the following steps were taken.

On April 2009 the European Commission finally prepare also recommendations that dealt specifically with executive remunerations at financial institutions.[77] These recommendations required that current and future risk, cost of capital and liquidity rations should be taken into account in determining the performance of credit institution. A concept of "clawback" was used for the first time (Paragraph 4.6.). The recommendations also required that remuneration should be linked to the performance of credit institution. Recital 5 of this Recommendation stated that

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lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0055:0059:EN:PDF. Accessed on October 25, 2017.

[73] Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Report on the application by Member States of the EU of the Commission 2009/385/EC Recommendation (2009 Recommendation on directors´ remuneration) complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies. http://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A52010DC0285. Accessed October 25, 2017.

[74] Commission Recommendation 2005/162/EC of February 15, 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board. *JO L* 52, 25.2.2005., pp.51-63. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF. Accessed October 25, 2017.

[75] Commission Recommendation 2009/385/EC complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies. *OJ L* 120, 15.5.2009., pp.28-31. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF. Accessed on October 25, 2017.

[76] Agnieszka Slomka-Golebiowska, Piotr Urbanek. Executive Remuneration Policy at banks in Poland after the Financial Crisis – Evolution or Revolution?. Comparative Economic Research.Vol.17, No.2, 2014, pp.27-28. https://www.degruyter.com/view/j/cer.2014.17.issue-2/cer-2014-0012/cer-2014-0012.xml. Accessed October 25, 2017.

[77] Commission Recommendation 2009/384/EC of 30 April 2009 on remuneration policies in the financial services sector. OJ L 120, 15.5.2009., pp.22-27. http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf. Accessed October 25, 2017.

> (C)reating appropriate incentives within the remuneration system itself should reduce the burden on risk management and increase the likelihood that these systems become effective.

At the same time, it was noted that these Recommendations did not provide "meaningful guidance on how regulators shall ensure the remuneration schemes identify and take into account the outstanding risks associated with the performance"[78]. Unfortunately, this problem with unclear provisions on how competent authorities should perform their duties and how it is possible for them to determine all requirements for sound remuneration policies and performance of credit institutions occurred also in the future. Most of the EU Members States did not follow these recommendations at an appropriate level. It was stated that eleven Member States at that time did not even adopt any of the measures set by these recommendations. Only seven had adopted measures that covered the remuneration of all financial institutions. Moreover, there were significant discrepancies in the interpretation of the recommendations.[79]

On 24 November 2010, the Council and the European Parliament adopted Directive 2010/76/EU on capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies (or CRD III).[80] This was the first legislative act adopted by the European Commission regarding the legal provisions on remuneration.

Pursuant to Directive 2010/76/EU financial institutions had to disclose certain information, including information on remuneration policies. The aim of such provisions was to let the national competent authorities control the application of these requirements. A section was added regarding remuneration provisions to Annex V of Directive 2006/48/EC. In this Directive was used a concept of staff whose professional activities have material impact on the risk profile of financial institutions was first time used (Recital 3 of Directive 2010/76/EU).

At the same time the CRD III scheme was also criticized, since it was noted that

> it is very unlikely that the regulators will be able to distinguish between remuneration which encourages "normal" risk taking, which is the core business of banks that found long-term assets with short-term liabilities, and remuneration which encourages "excessive" risk-taking.[81]

Moreover, it was noted that it is unlikely that the regulators would be able to obtain sufficient information about the operations performed by the credit institutions. Obtaining such information would take time, would be extremely expensive, as well as involve complex procedures.

[78] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.12.

[79] The European Commission. Green paper. Corporate governance in financial institutions and remuneration policies. COM (2010) 284 final, 2.6.2010. http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf**.** Accessed October 25, 2017.

[80] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies. OJ L 329, 14.12.2010, pp. 3–35 . http://data.europa.eu/eli/dir/2010/76/oj. Accessed November 1, 2017.

[81] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.16.

> Currently the financial systems will make tracing of the various cash flows and the ultimate allocation of risk very-time consuming by using special purpose vehicles, securisation, tranching of cash flows and widespread use of derivatives.[82]

It can therefore be concluded that there was a big emphasis put on national competent authorities to foresee and determine excessive risk taking. Nevertheless, the practice showed that this system did not work well. Namely, it was noted that "European big banks" had enforced clawbacks dozen of times after adopting this Directive, but none of these risks were picked up by remuneration committees of credit institutions or national competent authorities.[83]The activities which led to excessive risk-taking were determined only after some time after they were already completed. This again demonstrates that it is difficult to foresee and to determine excessive risk-taking activities at the time of their occurrence. Most likely this means that other options should be considered on how to foresee and determine risk at the time when such actions take place (ex-ante risk adjustments).

1.3. Conclusions

It can be concluded that not only financial institutions (and credit institutions as well) were responsible for the financial crisis of 2007-2008. It is reasonable noted in different doctrinal sources that there were a number of culprits responsible for the financial crisis, including governments, central banks, financial regulators (…)[84]. It should be noted that remuneration issues of credit institutions are definitely one aspect of the stability of the financial market and there should be clear provisions on how credit institutions should deal with these issues. However, we should not be overestimate the value of remuneration issues in the structure of financial system, it would not and could not work without the proper legal provisions and observations of them on all levels of the financial system structure.

[82] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.16.
[83] Ibid, p.19.
[84] Dalvinger Singh. The Centralisation of European Financial Regulation and Supervisions: Is there a Need for a Single Enforcement Handbook? European Business Organisation Law Review, 16 (2015). p. 448.

CHAPTER 2 THE CURRENT LEGAL PROVISIONS ON REMUNERATION SYSTEMS FOR CREDIT INSTITUTIONS AT THE EU LEVEL

2.1. Overview of the current provisions at the EU level

The issues on corporate governance as discussed above have quite a long history, and it should be noted that the requirements on remuneration policies regarding risk-taking, structure and ratios of the remuneration are quite a new notion not only from a legal, but also from a financial perspective. It would be right to say that this history of legal provisions on remuneration begins in 2008. It is also necessary to remember that this concept is at the very beginning of its development. Therefore, future developments also may be. As will be later discussed the EU institutions took quite a strong approach toward regulating the activities of financial institutions. Sometimes it was even recognised that the EU institutions may have overreacted to the financial crisis of 2007-2008[85]. This overreaction may have affected entrepreneurship, stifling innovation in the financial sector.[86] This lead also to partial changes in the provisions of the EU laws. The European Commission announced the planned EU Banking reform in November 2016, which would lead also to some changes on remuneration requirements at least for non-complex small banks.[87]

It is necessary to evaluate the current provisions of the EU law which regulate different issues on remuneration of identifies staff, as well as set requirements for remuneration policies, granting of variable remuneration etc.

The so-called "CRD IV" package adopted by the European Commission and parliament was published in the official Journal on 27 June, 2013.[88]Directive 2013/36/EU[89] and Regulation 575/2013[90] are two documents that form the CRD IV package. In recital 1 to Directive 2013/36/EU it is clearly explained that the reason for adoption of this directive and Regulation 575/2013 was the fact that Directive 2006/48/ relating to the establishment and pursuit of the business of credit institutions[91] and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions[92] have been significantly amended on

[85] Jakob de Haan, Sander Oosterloo, Dirk Schoenmaker. Financial Markets and Institutions. A European perspective, Third edition. (Cambridge: Cambridge University Press, 2015), p.73.

[86] Guido Ferrarini. Understanding the Role of Corporate Governance in Financial institutions: A Research Agenda. European Corporate Governance institute, Law Working Paper No. 347/2017, p.2. https://ssrn.com/abstract=2925721. Accessed October 25, 2017.

[87] The European commission press release. EU Banking Reform: Strong banks to support growth and restore confidence. November, 2016. http://europa.eu/rapid/press-release_IP-16-3731_en.htm. Accessed November 1, 2017.

[88] The Official Journal, *OJ L 176, 27.6.2013.*

[89] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/. JO L 176, 27.6.2013, p. 338–436. http://data.europa.eu/eli/dir/2013/36/oj. Accessed October 25, 2017.

[90] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 . JO L 176, 27.6.2013, p. 1–337 . http://data.europa.eu/eli/reg/2013/575/oj. Accessed October 25, 2017.

[91] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. OJ L 177, 30.6.2006, p. 1–200. http://data.europa.eu/eli/dir/2006/48/oj. Accessed November 1, 2017.

[92] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions. OJ L 177, 30.6.2006, p. 201–255. http://data.europa.eu/eli/dir/2006/49/oj. Accessed November 1, 2017.

several occasions. Therefore "(F)or the sake of clarity and in order to ensure a coherent application of those provisions" Directive 2013/36/EU was adopted. This directive is applicable to both credit institutions and investment firms.

Directive 2013/36/EU not only deals with remuneration issues. Recital 2 of Directive 2013/36/EU states that the main objectives of this directive is to coordinate national provisions concerning access to the activity of credit institutions and investment firms, the modalities for their governance, and their supervisory framework. Article 1 of Directive 2013/36/EU as subject matter of it sets that the directive lays down rules concerning:

> "(a) access to the activity of credit institutions and investment firms;
>
> (b) supervisory powers and tools for the prudential supervision of institutions by competent authorities;
>
> (c) the prudential supervision of institutions by competent authorities in a manner that is consistent with the rules set out in Regulation (EU) No 575/2013;
>
> (d) publication requirements for competent authorities in the field of prudential regulation and supervision of institutions".

It is clear that remuneration issues are only part of the systemic approach of the EU institutions on remuneration provisions. Moreover, it proves that not only remuneration of identified staff is responsible for stability of the financial system of the EU, but only one part of it.

It was already noted that after the adoption of the different legal provisions for the elimination of the consequences of the crisis of 2007-2008 and the avoidance of further crisis, there were discussions alleging that the measures adopted were an overreaction to the problems of the financial system of the EU. Recital 14 of Directive 2013/36/EU again confirm this, clearly stating that

> (T)he scope of measures should therefore be as broad as possible, covering all institutions whose business is to receive repayable funds from the public, whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities and to grant credits for their own account.

Therefore, it seems that in general the approach of the institutions of the EU were not targeted, and that it was more general. Definitely it could be justified by the fact that at the very beginning it was hard to determine exactly what measures were necessary and which would work in helping eliminate the consequences of the crisis. The same conclusions could be attributable towards the legal provisions on remuneration. Namely, as will be discussed later, it seems that there was a lack of clear understanding on how to regulate remuneration issues in the financial and credit institutions, as well. Moreover, the latest developments regarding the planned amendments to the legal provisions prove this conclusion [93].

Regulation 575/2013 forms part of CRD IV package and pursuant to Recital 32 of it the main objectives are "to encourage economically useful banking activities that serve the general interest and to discourage unsustainable financial speculation without real added value". In general this regulation in fact consolidates the regulatory capital standards determined by

[93] The European commission press EU Banking Reform: Strong banks to support growth and restore confidence. November, 2016. http://europa.eu/rapid/press-release_IP-16-3731_en.htm. Accessed November 1, 2017.

Basel III with the aim of ensuring their uniform application in the EU Member States.[94]This Regulation sets requirements on higher and better capital requirements, there are provisions regarding liquidity measures to ensure that credit institutions have sufficient liquidity means and it introduces a new regulatory instrument "the leverage ratio" whose main aim is to limit banks from incurring excessive debts on financial markets. Consequently, in this Regulation the remuneration issues are only part of these legal provisions.

In the scope of the remuneration issues this Regulation deals with the requirements towards remuneration policies that will be discussed later, as well as with the elements of variable remuneration (Article 450 of Regulation 575/2013). Recital 97 of Regulation 575/2013 "in order to ensure adequate transparency to the market of their remuneration structures and the associated risk", obliges financial institutions (and credit institutions as well) to disclose information on remuneration policies and practices, and aggregated amounts for identified staff. As noted earlier, there is this obligation to disclose information regarding remuneration policies to all stakeholders, there is a question as to whether this information is comprehensible to all stakeholders, especially to supervisory and regulatory authorities. This issue will be discussed in the next part of the chapter.

After adoption of CRD IV package there were different discussions on the applicability of these provisions, as some of the requirements created uncertainty. Directive 2013/36/EU among other requirements for establishing prudential supervision also set a requirement to identify staff whose professional activities had a material impact on the institution's risk profile. These discrepancies between the identification of the staff whose professional activities had a material impact on an institution's risk profile and the implementation of the requirements of directives happened before, namely, after the adoption of Directive 2006/48/EC (see Recital 3 of Directive 2013/36/EU).

On March 4**,** 2014 the European Commission adopted Commission Delegated Regulation No. 604/2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards and with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.[95]Pursuant to Article 290 of the Consolidated version of the Treaty on the Functioning of the European Union[96] the European Commission has rights to issue delegated regulations which are binding in their entirety and directly applicable in all member States. The fact that the European Commission issued this document as the delegated regulation and not as a directive proves that it wanted to be sure that these qualitative and quantitative criteria for identification of staff were applied uniformly in all Member States. This Regulation provides qualitative and quantitative criteria for identification of such staff. Moreover, pursuant to Article 2 of Delegated Regulation 604/2014 staff who met any of the qualitative criteria or any of the quantitative criteria should be

[94] Summary of Regulation (EU) 575/2013 - ensuring banks and investment firms control risks and hold adequate capital. http://eur-lex.europa.eu/legal-content/en/LSU/?uri=celex:32013R0575. Accessed November 1, 2017.

[95] Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. OJ L 167, 6.6.2014, p. 30–35. http://data.europa.eu/eli/reg_del/2014/604/oj. Accessed November 1, 2017.

[96] Consolidated version of the Treaty on the Functioning of the European Union. OJ C 326, 26.10.2012, p. 47–390. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E%2FTXT. Accessed November 1, 2017.

identified as having a material impact on an institution's risk profile. In other words, the Commission still had a wide approach to remuneration requirements; otherwise there would be a requirement for cumulative quantitative and qualitative criteria.

Some days after the adoption of Delegated Regulation 604/2014 the European Commission adopted another delegated Regulation on March 12, 2014. The Commission adopted Delegated Regulation No. 527/2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as an ongoing concern and are appropriate to be used for the purposes of variable remuneration.[97] The reasons for the adoption of this regulation were quite similar to the reasons for adoption of Delegated Regulation 604/2014.

Sub-clause (ii) of Clause (l) of Article 94 (1) of Directive 2013/36/EU states that at least 50 %, of any variable remuneration shall consist of a balance of the following:

> (i) shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution and
>
> (ii) other instruments within the meaning of Article 52 or 63 of Regulation (EU) No 575/2013 or other instruments which can be fully converted to Common Equity Tier 1 instruments or written down. Therefore it was concluded that the conditions that apply to Additional Tier 1 and Tier 2 instruments are specified in Article 52 and 63 of Regulation 575/2013, while the other instruments referred to in Sub-clause (ii) of Clause (l) of Article 94 (1) of Directive 2013/36/EU which can be fully converted to Common Equity Tier 1 instruments or written down are not subject to specific conditions pursuant to that Regulation as they are not classified as own funds instruments for prudential purposes (Recital 3 of Delegated Regulation 527/2017.

Therefore, the Commission came to the conclusion that specific requirements should be set for different classes of instruments to ensure that they are appropriate to be used for the purposes of variable remuneration, taking into account the different nature of the instruments. It is clear that currently there are many different instruments that can be used for variable remuneration. Moreover, Directive 2031/36/EU does not limit the classes of instruments that can be used for variable remuneration, and there are also possible synthetic instruments (Recital 11 of Delegated Regulation 527/2014). All this demonstrates that the structure of applicable instruments for variable remuneration is complicated and there could be questions to whether this does not affect the transparency of the remuneration system. In the author's opinion this could be a serious risk and raises questions on the need for clearer and a more sound list of instruments for variable remuneration. More detailed evaluation of these regulatory technical standards will be provided in Part 3.2. of the Master's Thesis.

Concerns remained after the adoption of CRD IV package regarding these provisions. Namely, as it was recognised by the industry, as well as all Member States and supervisors, that there are serious concerns about the need for a proportionate application of the

[97] Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration. OJ L 148, 20.5.2014, p. 21–28. http://data.europa.eu/eli/reg_del/2014/527/oj. Accessed November 1, 2017.

remuneration provisions and there were warnings against a "one size fits all" approach.[98] The European Banking Authority, in its opinion, stressed that it was necessary to introduce the possibility of waivers from the application of the rules on deferrals and pay-outs on instruments for institutions that are small and non-complex and for staff that receive a low level of variable remuneration. Moreover, it was estimated by the European Banking Authority that the requirements on deferrals and pay-outs on such instruments may be extremely expensive and burdensome for small institutions and staff with low variable remuneration, because of investments in additional human resources, ID and advisory services. Therefore, it was concluded that application of these provisions was not efficient towards small, non-complex institutions (including credit institutions) and staff with non-material amounts of variable remuneration. In addition, there were some concerns regarding the requirement for listed institutions to use only shares and not share-linked instruments. [99]

In response to these and other concerns regarding the application of CRD IV package, there was a comprehensive proposal of reforms to further strengthen the resilience of financial institutions of the EU announced on November, 2016.[100] A draft directive is prepared amending Directive 2013/36/EU as regard exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.[101] The planned amendments clarified points pursuant to Article 94 of Directive 2013/36/EU on the provisions that apply to financial institutions and their identified staff. An excerpt for those are set out below the thresholds set for derogations. The principles set out in points (l), (m) and in the second subparagraph of point (o) of Article 94 shall not apply to:

> (a) an institution the value of the assets of which is on average equal to or less than EUR 5 billion over the four-year period immediately preceding the current financial year;
>
> (b) a staff member whose annual variable remuneration does not exceed EUR 50.000 and does not represent more than one fourth of the staff member's annual total remuneration.

As well as it is planned to allow also the listed institutions to use share-linked instruments in the process of fulfilling the requirements set by Directive 2013/36/EU. If the amendments regarding the non-application of the requirements of Clause (l), (m) of Article 94 of Directive 2013/36/EU were not applicable to the credit institutions with assets value less than EUR 5 billion. The consequences of such development would be that, for example, at least pursuant

[98] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p. 7. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

[99] The European Banking Authority. Opinion on the application of the principle of proportionality to the remuneration provisions in Directive 2013.36/EU. pp. 7-8. https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf. Accessed October 25, 2017.

[100] The European commission press release. EU Banking Reform: Strong banks to support growth and restore confidence. November, 2016. http://europa.eu/rapid/press-release_IP-16-3731_en.htm. Accessed November 1, 2017.

[101] Proposal for Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regard exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures. https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF. Accessed November 1, 2017.

to the latest data provided by the Financial and Capital market Commission of Latvia, these requirements would be further applicable to only one bank in Latvia – Swedbank.[102] Most probably these developments would influence also other "small economies" of the EU (for example, Estonia, Slovakia and others)[103]. Still it is unclear whether these preconditions are cumulative. At least from the grammatical translation of this draft proposal, it seems that meeting one precondition is sufficient.

It is hard to predict when this draft directive will be adopted and come into legal force, nevertheless these planned amendments clearly shows that the European Commission tends to apply targeted remuneration provisions without unnecessary application of them to all financial institutions. In some way this is an evidence that the EU approach towards the financial crisis 2007-2008 was disproportionate. Moreover, after some time remuneration provisions may narrow again.

2.2. The objectives of the remuneration provisions and the question of their regulation at the EU level

The current provisions on remuneration seek to access objectives that were developed after the crisis 2007-2008. Before evaluating the specific requirements on remuneration policies and remuneration structure it is necessary to evaluate them. This will later help evaluate whether the provisions on remuneration policies and features of remuneration are according to these objectives and whether it is possible to meet them by using the respective requirements towards remuneration structure and policies.

Recital 62 of Directive 2013/36/EU clearly states that "(R)emuneration policies which encourage excessive risk-taking behaviour can undermine sound and effective risk management of credit institutions and investment firms". The European Commission states that remuneration policies should be aligned to risk appetite, values and long-term interests of credit institutions (Recital 63 of Directive 2013/36/EU); a maximum ratio between the fixed and the variable component of the total remuneration should be set to avoid risk taking (Recital 65 of Directive 2013/36/EU); variable remuneration has to be sustainable with regard to the financial situation of the institution (Recital 83 of Directive 2013/36/EU).

In response to the financial crisis measures were taken linking variable remuneration with risk-taking behaviour and its effects to: (1) the individual transaction; (2) the performance of the institution; (3) the financial system as a whole by (4) taking into account qualitative elements of sound banking behaviour.[104]

> In order to achieve these goals: (1) variable remuneration has been transformed into tools which incentivise long-term orientation through deferrals, vesting and

[102] The Financial and Capital Market Commission. Public quarterly reports by banks. http://www.fktk.lv/en/statistics/credit-institutions/bank-public-quarterly-reports.html. Accessed November 1, 2017. The last data available is without the information regarding AS Luminor Bank (the bank after merger of the branch of Nordea Bank AB and AS DnB).

[103] Eurostat. The EU in the world – economy and finance. Data extracted in March, 2016. http://ec.europa.eu/eurostat/statistics-explained/index.php/The_EU_in_the_world_-_economy_and_finance. Accessed 27 November, 2017.

[104] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. pp. 17-18. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

clawback/malus arrangements; (2) a rational and publicly transparent process with board committees and regulatory procedures must be implemented.[105]

Provisions of Directive 2013/36/EU and Regulation 575/2013 contain a wide explanation of what objectives should be achieved. For example, Recital 63 of Directive 2013/3/6/EU states that there should be sound remuneration policies, clear principles of governance and the structure of remuneration. Recital 97 of Regulation 575/2013 states "good governance structures, transparency and disclosure are essential for sound remuneration policies".

The EU definitely has set up clear targets that it would like to achieve. These targets are necessary, however, as has been already noted, the current financial market as a whole is very complicated. Therefore, are concerns as to whether it is possible fully control fulfilment of these requirements and whether the measures chosen are adequate and effective, and also whether these measures allow these objectives to be achieved. As will be discussed later in the next chapter, it seems that the EU has paid more attention to the objectives of remuneration provisions rather than to the measures than on how to achieve these objectives. Of course, provisions set in Directive 2013/36/EU should be implemented in the national laws and therefore Member States should have some discretion on how to achieve the objectives. Nevertheless, this also creates the possibility of different interpretations that could lead to a risk that the objectives have not achieved.

The fundamental question remains as to whether the EU should regulate provisions on remuneration. As previously noted there were significant discrepancies in the approaches taken by the Member States on implementation of different provisions for remuneration (see Chapter 1.2.2.). Moreover, the latest legal developments show a tendency that the European Commission's self-acknowledged broad approach towards remuneration provisions (see Chapter 2.1.).

It might be added that only national competent authorities are able to evaluate their local financial market and therefore to develop appropriate provisions regarding remuneration policies and structures. Since, as already discussed above, there have been observations that national competent authorities are not even able to fulfil their duties on supervision and control over financial institutions, because of a lack of knowledge, financing and staff (see Chapter 1.2.1.). This also is partly due to the fact that here is an imparity of information between credit institutions and competent authorities.

It has been acknowledged by G20 that most financial institutions (including credit institutions) operate cross-border; therefore, also remuneration issues should be regulated at the international level.[106] If there is such approach then credit institutions will have to take into consideration the common legal provisions. Moreover, it is recognised that remuneration should be regulated at an international level (the EU level), otherwise it could trigger a rat race: credit institutions will receive incentives to leave countries were the rules are considered too strict.[107] For example, Dutch legal provisions are stricter and clear on remuneration issues. This gives fewer possibilities for interpretation. This could lead to abandoning of credit

[105] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.18. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[106] The Organisation for Economic Co-operation and development. G20/OECD Principles of corporate governance. p.7. http://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en. Accessed November 1, 2017.

[107] D.E.M. Kromwijk, W.J. Oostwouder. Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.242.

institutions to other countries.[108] From this perspective regulation at the international level is preferable.

As stated before, there are the different approaches towards corporate governance in different EU countries, this is also recognised by the European Commission in its legal provisions (Recital 55 of Directive 2013/36/EU). Shareholders-oriented approach and stakeholders-oriented approaches definitely have dissimilar objectives. Shareholders' interests usually do not correspond to the interests of other stakeholders and *vice versa*. This could be a problem, because it is unclear whether it is possible to cover both shareholders and stakeholders' interests within the same legal provisions.

One opinion that the EU has chosen the shareholders' interests above others, since variable remuneration can be paid out in shares.[109] Clearly, shareholder's value-based variable remuneration is more in the interests of shareholders than in the interests of other stakeholders. From another perspective, the shareholders are the ultimate risk bearers,[110] it could be argued that their interests are primal. This issue also will be discussed in more detail in the next chapter. It is likely that the shareholder's value-based approach has some threats to other interested persons. Nevertheless, it is not possible to agree to the opinion that the EU tends more to cover interests of shareholders.

The fact that after the crisis of 2007-2008 the EU adopted several consecutive bundles of legal provisions on remuneration issues shows that the EU tends to also cover interests of other stakeholders, not only shareholders. It is recognised that

> (R)emuneration provisions are an instrument not only of micorpudential regulation aimed at preventing the costly failure of individual financial institution, but also of macroprudential regulation which recognises the importance of general equilibrium effects and seek to safeguard the financial system as a whole.[111]

As previously discussed, there was a restoration of the notion of systemic risk, hence the EU justified macroprudential regulation on financial system by invoking the possibility of market failure. An issue on remuneration in credit institutions should be regulated at the same level, since it can't be denied that remuneration issues could have an impact on financial stability. Recital 97 of Regulation 575/2013 states that it is necessary to ensure transparency to the market of remuneration structures and associated risks. This also means that the EU tends to show an approach more oriented to stakeholders than shareholders oriented approach. Nevertheless, it is still a question how successful it is in this process. Sometimes it is still unclear whether the EU has a determinate understanding which approach it has chosen or wish to choose in the future. As an example for this uncertainty from the EU's side could be mentioned linking of variable remuneration with paid outs in shares (Sub-Part (j) of Part 1 of Article 94 of Directive 2013/36/EU) which could be evaluated as the shareholders' oriented approach.

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[108] D.E.M. Kromwijk, W.J. Oostwouder. Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.243.

[109] Ibid, p.243.

[110] Comparative Corporate Governance, A Functional and International Analysis. Edited by Andreas M. Fleckner, Klaus J. Hopt. Cambridge: Cambridge University Press, 2013, p.43.

[111] Samuel G. Hanson, Anil K. Kashyap, Jeremy C. Stein. A Macroprudential Approach to Financial Regulation. Journal of Economic Perspectives, Vol 25, No.1, 2011, p.3. http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.25.1.3. Accessed November 1, 2017.

It is clear that the issues on remuneration should be regulated on the EU level. It is even not possible to do otherwise, since the EU would face a "rat race" between the EU Member States on regulations on remuneration. This would not be the EU expected result.

2.3. Conclusion

For summary of the current legal provisions on the EU level, the list of current legal acts which deal with issues on remuneration in credit institutions is provided below:

(i) Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms;

(ii) Regulation No 575/2013 on prudential requirements for credit institutions and investment firms;

(iii) Commission Delegated Regulation No 604/2014 with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile;

(iv) Commission Delegated Regulation No 527/2014 with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration.

Definitely the EU did not face with such a comprehensive financial crisis as it was on 2007-2008. Therefore, also the reaction of the EU was comprehensive, which can be justified by a fact that there were a lot of different risks that occurred after the crisis. The latest developments show that the EU plans to use more targeted approach toward remuneration issues. Moreover, it is clear that there should be the united approach across the EU to the issues of remuneration. The most complicated issue in this case are solutions which are used for achieving the objectives set by the EU legal provisions. Therefore, this will be discussed in the next chapter.

CHAPTER 3 THE PRACTICAL ISSUES OF REMUNERATION POLICIES AND THEIR FEATURES

3.1. The main requirements regarding remuneration policies

3.1.1. The categories of staff affected by the legal requirements toward remuneration

Article 74 of Directive 2013/36/EU states that credit institutions are required to have "(…) remuneration policies and practices that are consistent with and promote sound and effective risk management". Whereas Article 92 of Directive 2013/36/EU deals with the principles of requirements toward remuneration policies. Part 2 of Article 92 of Directive 2013/36/EU states that

> competent authorities shall ensure that, when establishing and applying the total remuneration policies (…) for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile (…).

From these provisions in Article 92 it can be concluded that the requirements toward remuneration policies apply only to the staff of credit institutions that is mentioned in this Part of Article 92. Sub-Part (g) of Part 2 of Article 92 as well states that remuneration policy has to include clear criteria for setting: (i) basic fixed remuneration which reflects the professional experience and organisational responsibility of the staff member; (ii) variable remuneration which reflects a sustainable and risk adjusted performance. Article 94 of Directive 2013/36/EU states the principles that are applicable toward variable elements of remuneration that will be discussed in the next chapter.

Nevertheless, the Guidelines on sound remuneration policies prepared by the European Banking Authority states something different in this regard. Namely, pursuant to these Guidelines the financial institutions are required to have in place a remuneration policy for all staff. Moreover, provisions of Article 92 and partially Article 94 of Directive 2013/36/EU are applicable also to all staff of credit institutions, not only to the identified staff.[112]

The fact that the requirements on remuneration policies are included in the directive and not in regulation, allows the Member States to use appropriate implementation measures for the transposition of the provisions of directives into national law.[113] Whereas the Guidelines on sound remuneration policies adopted by the European Banking Authority are issued pursuant to Article 15 of Regulation 1093/2010[114] that established the European Banking Authority and

[112] The European Banking Authority (further – the EBA) Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. p.25. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017. Pursuant to the Annex I of these Guidelines Sub-Parts c, d, e, j, k of Part 1 of Article 94 of Directive 2013/36/EU are applicable to all staff of credit institutions.

[113] See Part 3 of Article 288. Consolidated version of the Treaty on the Functioning of the European Union. OJ C 326, 26.10.2012, p. 47–390. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E%2FTXT. Accessed November 1, 2017.

[114] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision

Article 74 and 75 of Directive 2013/36/EU that mandate the European Banking Authority to develop such guidelines. These Guidelines are not mandatory for the Member States; at the same time, it is advisable to follow them (otherwise the EU would not impose such a mandate to the European Banking Authority).

The fact that the European Banking Authority has prepared the Guidelines where it is stated that Article 92 and partially Article 94 of Directive 2013/36/EU is applicable to all the staff of credit institutions raised a lot of concerns during the preparatory process. Moreover, some of the Member States even acknowledged that they would not comply with these provisions, because of the approach chosen by the European Banking Authority. For example, France indicated that it would not comply with these Guidelines, since in the opinion of the competent authority of France Articles 92 and 94 should not apply to all staff. [115] Similar objections were also raised during preparation of these Guidelines by the Dutch Banking Association in its Consultation Response. The Dutch Banking Authority indicated that the European Banking Authority had gone beyond its mandate by applying requirements set in Article 92 and 94 of Directive 2013/36/EU to all staff of credit institutions.[116]

This question on the application of specific requirements on remuneration policies to all employees is interesting. It should be acknowledged that the European Banking Authority has acted beyond its mandate, because Part 2 of Article 92 of Directive 2013/36/EU clearly states that the requirements set in Article 92, as well Article 94 of Directive 2013/36/EU shall be applicable towards specific categories of the staff of credit institutions. It is possible to agree to the European Banking Authority that, in general, there should be remuneration policies which are applicable to all staff of credit institutions, but this does not mean that the specific provisions included in Directive 2013/36/EU should be applicable to all staff. Moreover, the approach taken by the European Banking Authority can't be grounded, because incentives that could lead to the excessive risk taking usually are applied to the staff that activities could lead to excessive risk. It is clear that the staff of credit institutions in lower positions would not be incentivised in such way.

3.1.2. The principle of proportionality

It was also noted during the consultation process for the preparation of these Guidelines that the EU included the requirements in directive which means that the Member State have the right to decide how to implement these provisions into national laws and the scope of their applicability. Namely, Article 92 and Article 94 of Directive provides a list of principles whose relevance must be assessed for each institution on the basis of the proportionality principle.[117] It should be noted that Directive 2013/36/EU provides principles that should be

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No 716/2009/EC and repealing Commission Decision 2009/78/EC. *OJ L 331, 15.12.2010,* p. 12–47.. http://data.europa.eu/eli/reg/2010/1093/oj. Accessed November 1, 2017.

[115] The European Banking Authority. Guidelines compliance table. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. https://www.eba.europa.eu/documents/10180/1314839/EBA+Guideline+2015+22-Compliance+Table-GLs+on+sound+remuneration+policies.pdf/8b8ad3a4-30b6-46c2-a239-28608aeab219. Accessed October 25, 2017.

[116] The Dutch Banking Authority. Consultation Response – EBA draft Guidelines on sound remuneration policies – 4 June 2015.p.3. https://www.nvb.nl/media/document/000355_consultation-response-eba-draft-guidelines-on-sound-remuneration-policies.pdf. Accessed November 1, 2017.

[117] European Private Equity & Venture Capital Association. Response to the EBA Consultation Paper "Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and

evaluated by the competent authorities in each Member State. Part 2 of Article 92 of Directive 2013/36/EU states that

> the competent authorities shall insure that (…) financial institutions comply the following principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.

The so-called "principle of proportionality" is applicable in this situation (see Part 4 of Article 97 of Directive 2013/36/EU) which means that the national competent authorities shall evaluate the manner and extent to which the requirements of Directive are applicable. There are two economic rationales behind this principle. Firstly, is the efficiency of financial institutions regulations and the risk of potential distortions of a unitary approach in a financial institutions system composed of a variety types of banks and other financial institutions, since the application of a one-size-fits all approach to banking and financial regulations could lead to perverse effects. The second economic rationale is an approach that the effectiveness of regulations should be related to the degree to which financial institutions contributes to systemic risk.[118]

From the point of view of the principle of proportionality it also should be noted that the Member States apply these provisions in different ways. It was also noted in the Study on the CRD IV remuneration provisions that "there is no consistent approach across the EU regarding the application of waivers"[119]. This is quite a worrying conclusion, because, as was discussed in Chapter 2.1., it is important that the issues on remuneration are applied in the unified way, otherwise there is a risk of a "rat race" between Member States.

For example, the Financial and Capital Market Commission that is a competent authority in Latvia prepared regulatory rules on the basic principles of remuneration policies.[120]Pursuant to Article 1 of these rules they are applicable to all credit institutions in Latvia. At the same time there are only 7 banks of 20 which have assets in the amount more than 2 billion euro.[121]Therefore, it could be questioned whether the Financial and Capital Market Authority has evaluated the application of these regulatory rules to all credit institutions in Latvia at the appropriate level. There is also a question as to whether the credit institutions that could contribute to systemic risk were also evaluated. It seems that the Financial and Capital Market Authority has chosen the easiest way in this case – to apply these provisions to all credit institutions without evaluating of them. As it was noted, since it was concluded that the Member States do not apply provisions of Directive 2013/36/EU in a consistent way, there are concerns that some Member States might take the same simplified approach. Such an approach was not intended by the EU legislator when Directive 2013/36/EU was adopted. This also raises the question that it is necessary to evaluate the necessity and scope of the

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disclosures under Article 450 of Regulation (EU) No.575/2013". 4 June 2016. p.7. https://www.investeurope.eu/media/391222/PAE-response_EBA_draft_guidelines_on_sound_remuneration_practices_040615.pdf. Accessed November 1, 2017.

[118] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. pp. 114-115. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[119] Ibid, p. 116.

[120] Finanšu un kapitāla tirgus komisijas 02.07.2014. normatīvie noteikumi Nr.126 . Normatīvie noteikumi par atalgojuma politikas pamatprincipiem (Regulatory rules on basic principles of remuneration policies). Latvijas Vēstnesis, 131 (5191), 08.07.2014. https://likumi.lv/doc.php?id=267394. Accessed November 7, 2017.

[121] The Association of Latvian Commercial Banks. Banku aktīvi uz 30.06.2017. (The assets of Banks on 30.06.2017. http://lka.org.lv/lv/pdf/06_2017_LV_banku_statistika_www_LV.pdf. Accessed November 1, 2017.

provisions on remuneration which could be included in the legal form of regulation and not the directive. Otherwise there is a risk that there would be no uniform approach to these issues. The EU legislator should understand that clear and specific provisions to clearly defined financial institutions are preferable to discretionary approach provided by directives.

3.1.3. The difficulties associated with the identification of staff

The ability to correctly identify the staff to whom the remuneration policies should apply is also one of the most important questions. After the EU Commission started to take a closer look to at the issues of remuneration in the financial institutions, the problem of the correct evaluation of the staff to whom the remuneration policies should apply immediately arose.

It is clearly stated in Recital 5 of Delegated Regulation (EU) No. 604/2014 that

> the members of the management body have the ultimate responsibility for the institution, its strategy and activities and therefore are always able to have a material impact on the institution's risk profile. This applies both to the members of the management body in its management function who take decisions and to members of the supervisory function who oversee the decision-making process and challenge decisions made.

At the same time Recital 6 of Delegated Regulation (EU) No. 604/2014 distinguishes senior management and senior staff which means that provisions of remuneration policies pursuant to the requirements set by the EU could apply not only to the management of financial institutions (board members and members of the supervisory board), but also to the employees of credit institutions. Namely, Recital 6 states that

> the senior management and senior staff responsible for material business units, for management of specific risk categories such as liquidity, operational or interest rate risk, and for control functions within an institution are responsible for the day-to-day management of the business, its risks, or its control functions.

This issue pursuant to the opinion of the author of the Master's Thesis is controversial, since it is easy to determine the members of the board or supervisory board. Nevertheless, it could be problematic to determine employees that also should be added to the group of identified staff under the EU provisions on remuneration. The criterions for identifying the staff whose professional activities have a material impact on the institution's risk profile are extremely important for the precise and correct identification of such staff members.

It has been noted in the Report of the European Commission that the concerns have been raised by the industry over the material increase in the number of identified staff. At the same time as it is noted by the EU Commission this staff represents only a relatively small part of total staff (2,34% in 2014).[122] It does not mean that this issue is not important, because the identified staff is recognised as those whose activities could lead to excessive risk-taking and can be a cause even for systemic risk.

Delegated Regulation (EU) No. 604/2014 specifies the list of non-exhaustive qualitative and quantitative criterions. This was surely an important step, because, as noted this regulation is

[122] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p.5. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

directly applicable in all Member States, so there is a decreased risk of different interpretations and implementations of the EU provisions. It is stated, for example, as a qualitative criterion that

> Staff shall be deemed to have a material impact on an institution's risk profile where any of the following qualitative criteria are met:
>
> (1) the staff member is a member of the management body in its management function;
>
> (2) the staff member is a member of the management body in its supervisory function;
>
> (3) the staff member is a member of the senior management;
>
> (4) the staff member is responsible and accountable to the management body for the activities of the independent risk management function, compliance function or internal audit function; (..)
>
> (6) the staff member heads a material business unit; (..)
>
> (8) the staff member has managerial responsibility in a material business unit and reports directly to the staff member who heads that unit;
>
> (9) the staff member heads a function responsible for legal affairs, finance including taxation and budgeting, human resources, remuneration policy, information technology, or economic analysis etc.[123]

Article 4 of Delegated Regulation (EU) No. 604/2014 set quantitative criteria for determining such staff. These criteria focus on the amount of total remuneration. Moreover, from Article 2 of Delegated Regulation (EU) No. 604/2014 concludes that the quantitative and qualitative criteria should not be cumulative for determining a member of staff as the identified staff. Nevertheless, it is not so. Part 2 of Article 4 of Delegated Regulation (EU) No. 604/2014 allows credit institutions to exclude a staff member whose total remuneration meets the quantitative criteria, but who carries out professional activities in non-material business unit or has no material impact on risk profile from the identifies staff.

The Commission noted in its last report that still there will be continued evaluation of these criteria, as well as the relatively new criteria still needs to be gained.[124] In the author's opinion, this certainly should be done, but at this stage it is worth to noting some issues which are controversial and raise questions.

For example, it is questionable how the staff members who are responsible for human resources, information technologies can have a material impact on the institution's risk profile. In the author's opinion, the approach of the Commission in this case again was too broad towards remuneration issues.

Moreover, it is possible to exclude a staff member from the identified staff who met a quantitative criteria as mentioned before, but it is not possible to exclude a staff member from the identified staff who met a qualitative criteria. On the one hand, this could be good, since there are less room for interpretation, from another it is not good, because these provisions may be applied too broadly. The Member States of the EU, such as Latvia, apply provisions

[123] Commission Delegated Regulation (EU) No. 604/2014, Art. 3.

[124] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p.5. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

on remuneration policies to all credit institutions without applying the principle of proportionality. This lead to the unnecessary application of legal provisions. Moreover, it requires additional costs from credit institutions for identifying such staff. It would therefore be advisable to at least revalue whether qualitative criteria should be applied to such a wide range of staff.

3.1.4. The application of deferral period

Sub-Part (m) of Part 1 of Article 94 of Directive 2013/36/EU states that "at least 40% of the variable remuneration component is deferred over a period which is not less than three to five years". Pursuant to the conclusions provided in the Study on the CRD IV, remuneration provisions deferral of variable remuneration has been acknowledged as the most effective measure for reducing risk-taking, since it aligns the interests of the identified staff with those of creditors and the long-term performance of the institution.[125] The reasons for applying the deferral period is concealed in the fact that it is almost impossible to recognise and prevent some risks by ex-ante adjustments.[126]

The European Banking Authority in its Guidelines on sound remuneration policies states that financial institutions should determine the categories of identified staff in which the deferral period is longer than the required period of three to five years should apply. Moreover, it is stated that the deferral period for the management body and senior management should be at least five years.[127]

It is not clear why the European Banking Authority decided to choose such an approach and what the goal behind it was. Nevertheless, it is recognised by

> (E)mpirical research on the Icelandic banking collapse and the duration of the financial cycle that mandatory deferral periods of 3-5 years are not long enough to prevent short-termism and excessive risk-taking.[128]

But this does not mean that the European Banking Authority has such a mandate to prolong the deferral period. It is possible that the EU legislator will re-evaluate a necessity to apply longer deferral period, but at this moment, there were no grounds for the European Banking Authority to prolong this term unilaterally. It can be concluded that such ungrounded approach has led some of the Member States not to comply with these Guidelines, as mentioned before. At the end this derogates these Guidelines as a document that may be useful to the Member States and may assist understanding and application of the objectives of Directive 2013/36/EU, as well as Regulation 575/2013.

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[125] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.20. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[126] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.18.

[127] The European Banking Authority (further – the EBA) Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. pp. 69-70. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017.

[128] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.29. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

Moreover, Sub-Part (m) of Part 1 of Article 94 of Directive 2013/36/EU states that

> (…) the length of deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question.

This provision proves that the objective behind is that each credit institutions should independently evaluate what deferral period should be applied towards a specific member of staff. This also means that there could be different deferral periods applied by one credit institutions. This once again proves that the EU legislator did not intend to prolong this term. The EU legislator has even provided a possibility for each institution to evaluate the necessary length of deferral period. Different discussions on prolongation of deferral period have already arisen. The proposal is to set deferral period for 7-10 years and make the requirements on the term of deferral period mandatory. The idea behind is that 3-5 years period is not long enough to prevent the adoption of excessive risk. Moreover, the period of business cycle varies from 10 to even 30 years, thus deferral period should be adjusted at least partially.[129] It could be a reasonable argument to adjust deferral period with the period of business cycle. However, the notion of the business cycle is quite abstract and business cycles could differ between credit institutions, they also could be affected by economic situation and legal provisions of specific Member State. Therefore, it is not a criterion which may be recognised as specific enough and such approach would not be advisable thereof.

As mentioned before, there are discussions on some amendments to Directive 2013/36/EU.[130]One of the concerns is related to the application of deferral period to the identified staff of small financial institutions (including credit institution). It is noted that if the provisions on deferral period would still be necessary to apply to the identified staff of small financial institutions, there is a risk that it would lead to the disappearance of variable remuneration, and this would lead also to the disappearance of the link between pay and performance. These concerns are connected to the fact that small financial institutions have to make considerable investments in human resources, IT and advisory services.[131] This once again proves that no evaluation was done at an appropriate level before the adoption of the requirements on remuneration (this is applicable to Directive 2013/36/EU, as well the previous legal provisions before adoption of this directive). This leads to the conclusion that the EU legislative approach was wider than practically necessary.

3.1.5. The arrangements on clawback

Another interesting provision provided by Directive 2013/36/EU are clawback arrangements. Namely, Sub-Part (n) of Part 1 of Article 94 of Directive 2013/36/EU states that "(U)p to 100% of the total variable remuneration shall be subject to malus and clawback arrangements". Credit institutions set specific criteria for application of these arrangements.

[129] Jay Cullen, Gudrun Johnsen. Promoting Bank Stability Through Compensation Reform: Lessons from Iceland (March 20, 2015). Sheffield Institute of Corporate and Commercial Law Working Paper No. 03/2015. Icelandic Review of Politics & Administration Vol. 11(2) (2015). pp.348-349. https://ssrn.com/abstract=2581733. Accessed on November 7, 2017.

[130]Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p. 8. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

[131]Ibid, p. 8.

Malus and clawback arrangements are explained as ex-post adjustment mechanism where the credit institution adjusts remuneration of the identified staff by reclaiming already paid remuneration (clawback) or reducing deferred part of remuneration (malus).[132]The reasons for clawback adjustments are not provided by the Directive 2013/36/EU, so the practice around the credit institutions in the Member States differs. For example, as reasons for clawback are indicated – financial and non-financial indicators, misconduct, fraud of the specific staff member, negative performance of credit institution, not achievement of adjusted pre-tax profit etc.[133] Sub-Part (n) of Part 1 of Article 94 of Directive 2013/36/EU provide explanations of situations that should be covered by clawback arrangements. But it is necessary to note that these provisions are not self-explanatory. For example, it is difficult to determine what is meant by "appropriate standards of fitness and propriety". On the one hand, with reference to the examples of grounds for clawback, it could be argued again there is no uniform approach towards these provisions in Member States. At the same time, it does not seem that the EU legislator tried to determine clearer situations that could be reasons for clawback.

As well as with the deferred period, the reason for the implementation of clawback arrangements is the fact that some risks can't be prevented by ex-ante adjustments.[134]This mean that, as was recognised in the previous chapter, that credit institutions, as well as competent authorities, are not always able to foresee and determine potential risks. At the same time there are discussions that clawback arrangements also do not protect from excessive risk-taking. Moreover, clawback arrangements would not prevent credit institutions from becoming insolvent if the identified staff of credit institution takes excessive risks that go un-noticed by the competent authorities.[135] It is also noted that clawback rules existed before the Great Recession, but did not prevent it.[136]

It is already recognised that there is a place for some concerns regarding clawback (also malus) and their application, since quite often they are in conflict with the key principles of labour law. Credit institutions have recognised that they were not using clawbacks, because they were contrary to labour law.[137] Some of the competent authorities in the Member States note that clawback is not possible pursuant to their national laws (for example, Sweden), therefore these provisions are not implemented into national law.[138]

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[132] The European Banking Authority (further – the EBA) Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. p. 74. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017. It should be noted that the clarification provided in the Guidelines is not very precise, since does not clarify that in case of clawback the already paid remuneration should be repaid.

[133] Olga Afanasjeva. Executive bonuses clawback in the banking sector. Business Ethics and Leadership, Vol.1, Issue 1, 2017. p.32. http://armgpublishing.sumdu.edu.ua/wp-content/uploads/2016/12/files/bel/issue1/Article_3.pdf. Accessed November 7, 2017.

[134] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.18.

[135] Ibid, p.18.

[136] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. Annex 2, p.78. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.

[137] Ibid, p.27.

[138] The European Banking Authority. Guidelines compliance table. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. https://www.eba.europa.eu/documents/10180/1314839/EBA+Guideline+2015+22-

It should be noted that this issue could be seriously problematic, in light of Recital 69 of CDR IV, because here it is clearly stated that "(T)he provisions on remuneration should be without prejudice to the full exercise of fundamental rights guaranteed by Article 153(3) TFEU, general principles of national contract and labour law (…)". Nevertheless, for example, in Latvia clawback is theoretically possible, since Point 19.3.1. of the Regulatory rules on basic principles of remuneration policies adopted by the Financial and Capital Market Commission of Latvia states that it is possible to reclaim variable remuneration in case it was assigned based on performance data that has been subsequently proved to be intentionally distorted (malicious behavior). At the same time Part 1 of Article 86 of Labour Code provides that an employer has right to claim losses from an employee in case he or she has not performed his work without justified reason or improperly or if losses have been caused with malicious intent of the employee or due to his or her illegal, culpable action or pursuant to Part 1 of Article 79 of Labour Code it is possible to withhold loses from the unpaid remuneration. On the one hand, it is possible to say that the provisions of the Regulatory rules on basic principles of remuneration policies are special legal provisions that pursuant to general principles of law prevail over general provisions. On the other hand, the legal provisions of Labour Code determine a right to reclaim losses, whereas in the case of variable remuneration for the identified staff of credit institutions there is a reclaim of already paid remuneration. Thought clawback is admissible pursuant to Latvian Law, it also should be noted that it does not seem that the Financial and Capital Market Commission of Latvia has evaluated this issue before adopting these legal provisions, otherwise more detailed substantiation for such rights would be included and not just rewritten provisions of Directive 2013/36/EU. Moreover, it should be noted that pursuant to Article 31 of the Labour Code the limitation period in employment legal relationships is two years. [139]This means that after the two-year period credit institutions as an employer would not be able to reclaim the paid amount.

Whereas clawback is definitely not possible in other jurisdictions of the EU, it could not be recognised as an effective measure for eradication of excessive risk taking. Another problem with clawback arrangements is a risk that it is not possible to reclaim the paid remuneration, because a specific member of staff of credit institution does not have enough funds to pay back these amounts or the paid remuneration has been transferred to the bank accounts of relatives or some associated companies. Such activities could be recognised as malicious. Nevertheless, it does not change the fact that it would be almost impossible to reclaim such money. This means that clawback cannot be recognised as an effective measure for the eradication of excessive risk taking. Therefore, the revaluation of the necessity to apply this measure towards the remuneration in credit institutions should be made.

Compliance+Table-GLs+on+sound+remuneration+policies.pdf/8b8ad3a4-30b6-46c2-a239-28608aeab219. Accessed October 25, 2017.

[139] Darba likums (Labour Code) with amendments in force from 16.07.2017. Latvijas Vēstnesis, 105 (2492. 06.07.2001. https://likumi.lv/doc.php?id=26019. Accessed on November 7, 2017.

3.2. Characterisation of the main features of remuneration and their problematic aspects

3.2.1. The differences between the fixed and variable remuneration

The structure of remuneration, the differences between fixed and variable remuneration and especially variable elements of remuneration have left issues unclear. For example, it is stated in the Report of the Commission that different allowances were often wrongly classified as fixed remuneration by the financial institutions.[140] In line with the requirements of this Master's Thesis along with a general description of the main features of remuneration, the following questions will be evaluated which are recognised as the most controversial in this regard – differences between fixed and variable remuneration; problematic aspects of equity-based remuneration, as well aspects of maximum ratio between the fixed and variable components of remuneration.

As discussed, the idea behind establishing variable remuneration is to provide incentives to members of the staff of credit institutions, since, as was discussed, there are always issues of the interests of shareholders. This is also one way how credit institutions are able to attract the most qualified staff members. Moreover, there are also social or public aspect to this issue, because there are also interests of other stockholders involved, what leads to the admissibility of public regulation of these issues (see Chapter 1). At the same time, setting of variable remuneration has created a lot of questions and, as has been discussed before, there are strong concerns that the approach of credit institutions in setting of variable remuneration was also one of substantial reasons for the crisis of 2007-2008.

Recital 64 of Directive 2013/36/EU states that there should be a distinction between variable remuneration and fixed remuneration. Namely, fixed remuneration includes payments, proportionate regular pension contributions, benefits without consideration of performance criteria. Variable remuneration includes additional payments and benefits depending on performance, or on an exceptional basis other contractual benefits, but not such as "those which form part of routine employment packages (such as healthcare, child care facilities etc.). Whereas Sub-Part (g) of Part 2 of Article 92 of Directive 2013/36/EU as well states that remuneration policy has to include clear criteria for setting: (i) basic fixed remuneration which primarily reflects professional experience and organisational responsibility of the staff member; (ii) variable remuneration which should reflects a sustainable and risk adjusted performance, as well as performance in excess of the required.

The requirements for separation of fixed remuneration and variable remuneration have created many questions, as well as attempts to classify payments as fixed remuneration, since there are no legal provisions in Directive 2013/36/EU and Delegated Regulation 527/2014 on the principles applicable towards fixed remuneration, moreover fixed remuneration is not a subject to malus or clawback arrangements (Sub-Part (n) of Part 1 of Article 94). In the Report from the Commission to the European Parliament and the Council it is stated that financial institutions quite often "use so-called role-based allowances, which are treated as

[140] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p.9. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

fixed remuneration (thus allowing more variable remuneration)"[141]It could be added that there are many reasons for credit institutions to classify remuneration as fixed pay and not variable pay.

It is acknowledged in the case-law of the European Court of Justice that, recitals are not binding. At the same time recitals can be used for the interpretation of the legal provision of legal acts.[142]Therefore from a legal perspective after evaluation of Recital 64, as well as Sub-Part (g) of Part 2 of Article 92 of Directive 2013/36/EU it should be clear which payments could be recognised as fixed remuneration and which as variable remuneration if the remuneration policy is transparent and well designed. Nevertheless, as discussed, the contemporary financial market is complex and there is the risk that competent authorities will not be able to determine whether the made payments are specified correctly. Moreover, since pursuant to Sub-Part (g) of Part 2 of Article 92 of Directive 2013/36/EU the remuneration policy should take into account national criteria on wage-setting which would mean that there are quite wide options for interpretation of the afore mentioned provisions, which would lead to the unequal application of these provisions.

The requirements for fixed and variable remuneration also raised concerns that in case the EU would apply too strict, costly and burdensome approach, this could lead the key credit institutions relocating to other jurisdictions. At the same time, it was noted that it is unlikely that this would happen, because there is an interdependence between credit institutions and states. It is possible to agree to this inference. States controlling the currencies in which credit institutions assets and liabilities are denominated. States also control financial stability, and what is in the interests of credit institutions, as well. Moreover, it is clear that also other states outside the EU have macroprudential requirements after the crisis of 2007-2008. Therefore, it was concluded that there is no high risk of such a scenario.[143] It also can be added that the main clients of credit institutions are also based in the same jurisdictions where the financial centres are. Moreover, most probably there also the members of the staff would not be ready to easily move to another jurisdictions outside the EU, since this would be expensive, as well as the costs legally aligning to the legal requirements for credit institution of other state.

It is possible to conclude that, although there are difficulties and uncertainties on application on provisions of remuneration for credit institutions, it does not mean that the approach adopted by the EU is unreasonable. The problem which has occurred is that there is a lack of clarify on identification of the elements of remuneration. Therefore, the EU legislator shall evaluate a possibility on application on more detailed explanations and maybe evaluate a possibility to apply only specific, previously listed instruments as payment measures for variable remuneration.

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[141] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. p. 9. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.

[142] Judgement of 24 November 2005, Deutsches Milch-Kontor GmbH v Hauptzollamt Hamburg-Jonas, C-136/04, ECLI:EU:C:2005:716, para.32.

[143] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.21.

3.2.2. Difficulties on application of performance criteria

Another controversial issue is the performance criteria for determining of variable elements of remuneration. Sub-part (a) of Part 1 of Article 94 of Directive 2013/36/EU states that variable remuneration should be based on the performance of: (i) the individual; (ii) the business unit and (iii) overall results of the credit institution; moreover, financial and non-financial criteria should be taken into account. Since this Article of Directive 2013/36/EU states the principles that should be applied to elements of variable remuneration, the Member States and credit institutions respectively as well apply different criteria for determining the performance of the identified staff.

Moreover, there are also different approaches to which criteria should be first taken into account and the degree of importance between them. Research indicates which criteria are usually used for determining variable remuneration. For both senior managers and other identified staff in 2014 the main criteria was compliance and conduct, which was followed by qualitative firm level criteria, quality of risk management, customer satisfaction etc. [144]. This is interesting in that such criteria as conduct of the identified staff or customer satisfaction are one of the primarily ranked criteria, since all of them are not quantitative criteria and there are very difficult to assess such criteria. Such criteria should be included in the evaluation of performance of identified staff. Nevertheless, it is questionable whether they should be as ranked as primary.

It should be noted that there are no strict provisions on which criteria should be taken into account and which circumstances are for determining variable remuneration. It was also noted that in the Report prepared for the European Commission that "a large variety of performance criteria at the firm, business unit and individual level is used for remuneration of identified staff (…)"[145]. This can be assess taking into account the different sizes of the financial institutions, their legal forms or other reasons. Moreover, larger financial institutions would use more criteria than smaller credit institutions, similar considerations were also noted in this Report. Nevertheless, such a great different criteria (especially when there is no clarity on their reciprocal hierarchy) can cause different problems and create lack of transparency.

There was also criticism expressed by some competent authorities that "the complexity and discretionary nature of these models limits transparency".[146] This criticism is reasonable. As was discussed in the previous chapter, there are the competent authorities that were faced with difficulties on evaluation of remuneration policies; this is applicable also to evaluation of performance criteria. This is one reason why some changes should be considered to the current approach, otherwise there could be difficulties on reaching objectives on how to set such principles for variable remuneration.

It is interested to note that pursuant to the information provided by the major banks, "there is no direct and automatic link between the financial results of an individual employee and his/her level of variable remuneration". Moreover, it is recognised that not only has the

[144] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016.p.32. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[145] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016.p.32. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[146] Ibid, p.33.

individual appraisal been evaluated, but also risk awareness, technical expertise, management of risks, respect of policies and others.[147]This once again prove that for evaluation of performance here are very different criteria and there is no clarity why the specific criteria are included. This is also recognised in the doctrine that "the problem of vague rules is that there is a lot of room for interpretation"[148]. This also does not create a uniform approach over the EU, which definitely is not the goal that should be achieved. Therefore, this proves that the EU legislator shall evaluate a possibility to apply more specific approach toward these issues.

3.2.3. The problematic aspects of equity based remuneration

Of course there are also different quantitative criteria for determining performance of identifies staff, for example: (i) shareholder value – return on equity, growth in earnings per share; (ii) total value of the credit institution – return on assets, return on risk-weighted assets, sales/assets growth; (iii) solvency – regulatory minimum equity ratio, equity/total assets or debt/equity.[149]These are definitely quantitative criteria for evaluating the performances of individual members of the staff, as well as of the credit institution. In the Guidelines prepared by the European Banking Authority are mentioned as examples as the quantitative criteria – risk adjusted return on capital, return on risk-adjusted capital, economic profit, risk-adjusted cost of funding etc.[150]

Nevertheless, as the main problem linked to evaluation of performance is states that

> (…) if variable remuneration is based on the return of credit institution or paid out on equity or equity linked instruments, there is a strong incentive for the managers of credit institution to grow the credit institution via leveraging. If variable remuneration is based on risk-adjusted return on assets or the total value of the credit institution, the incentives of the managers of credit institution would be aligned to the interest of all stakeholders.[151]

The problematic aspect of variable remuneration what is based on equity or paid out on equity or equity-linked instruments is noted also by different legal academics and practitioners. Namely, it was noted that "relying on equity payments presents many difficulties, particularly the manipulation of equity".[152] Moreover, equity payments incentivise leverage and this is

[147] Ibid, p.32.
[148] D.E.M. Kromwijk, W.J. Oostwouder Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.244.
[149] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016.p.32. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[150] The European Banking Authority Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. p.65. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017.
[151] http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[151] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016: p.29. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[152] Jay Cullen, Gudrun Johnsen. Promoting Bank Stability Through Compensation Reform: Lessons from Iceland (March 20, 2015). Sheffield Institute of Corporate and Commercial Law Working Paper No. 03/2015. Icelandic Review of Politics & Administration Vol. 11(2) (2015). p.349. https://ssrn.com/abstract=2581733. Accessed on November 7, 2017.

even more dangerous. Large-scale reliance on equity based remuneration – especially in combination with the use of performance targets, such as return on equity, imposes incentives to manipulate equity levels and increase leverage.

Therefore, it was suggested to restrict equity-related incentives, so they compromise no more than 50% of the total proportion of incentive compensation.[153]It seems that this issue has been noted as one of serious concern, since the European Banking Authority also noted that share price and total shareholder's return do not incorporate explicit risk adjustment and are very short-term. This means that it is not sufficient to capture all the risk of the identified staff member's activities and may require additional risk adjustments.[154] This is definitely one of the most controversial issues at this moment regarding evaluation of performance of the identified staff. Since, as discussed in the Chapter 1, the current legal approach and tendencies in corporate governance of credit institutions show that there is stakeholders-orientated corporate governance in credit institutions, variable remuneration based on equity or paid-out on equity or equity-linked instruments should be limited. Otherwise there is the risk that this would be one way to avoid, or at least impair, the requirements of principles provided by Directive 2013/36/EU.

3.2.4. The principle of the maximum ratio

Sub-Part (g) of Part 1 of Article 94 of Directive 2013/36/EU imposes the principle of the maximum ratio of remuneration packages. Namely, this article states that the variable remuneration shall not exceed 100% of the fixed component of the total remuneration for each individual identified staff member. Member States may set lower maximum percentage, whereas shareholders or credit institution with a permission issued by the Member State may approve a higher maximum level or the ration between the fixed and variable remuneration, but in any case, this level cannot exceed 200% of the fixed component of the total remuneration. It is recognised that maximum ratio requirement is a unique concept in the EU regulatory sphere,[155] while at the same time leading to objections and criticisms. At the same time, it is also necessary to note that even before the implementation of the maximum ration of variable pay, the credit institutions in general had already begun to fix the balance between the fixed and variable remuneration.[156] This could lead to the conclusion that setting of the maximum ratio was even dictated by the industry.

The European Banking Authority has explained in its Guidelines that credit institutions may also set different ratios for different business units, corporal and internal control functions and different categories of identifies staff.[157] It is important to note that it should be borne in mind

[153] Ibid, p.350.
[154] The European Banking Authority Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. p.65. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017.
[155] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016.p.3. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[156] Ibid, p.91.
[157] The European Banking Authority Final. Report. Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013. p.61. https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-

that Directive 2013/36/EU sets the amount of the maximum ratio, but this does not mean that it always should be so, since credit institutions should evaluate what is an appropriate level and not apply the maximum ratio as it is for all identified staff. This evaluation should also help analyse the level of risks and performance of the identified staff once again.

Moreover, the United Kingdom of Great Britain and Northern Ireland (further – the United Kingdom) submitted an action to the European Court of Justice for annulment of some of the provisions of Directive 2013/36/EU under Article 263 of the Treaty of Functioning of the European Union. Namely, the United Kingdom, among others, required the annulment of provisions of Directive 2013/36/EU on setting the maximum ration between the fixed and variable components of the total remuneration. The United Kingdom claimed "the contested measures fail to comply with the principle of proportionality, since they are not suitable for the purpose of achieving the desired public policy objective".[158] The United Kingdom later withdrew its application[159], despite the Advocate General in its Opinion having already stated that the issue on setting the maximum ration was discussed before the adoption and was recognised as one of the appropriate measure for restricting incentivising excessive risk taking, as well an economic and political choice. Therefore, this legislative measure cannot be recognised as manifestly inappropriate and therefore there are no grounds for its annulment.[160] It can be concluded that at least from the legislative perspective such a measure is reasonable.

It should be noted that there were also discussions in the doctrine on this issue. As was discussed before Directive 2013/36/EU was adopted setting concrete measures (as for example, maximum ration) as it became a norm instead of a real maxim.[161]This can lead to a conclusion that also with the current legal provisions could be the same problem. Namely, credit institutions would tend to set this maximum ratio without taking into account whether it should be applied in its maximum level and whether it could be lower. This surely have a negative impact and the main idea for setting such restriction would not be taken into account.

At the same time, there are also comments that there cannot be denied by the fact that the maximum ratio could reduce the difficulties the national competent authorities usually face when they attempt to identify incentives for excessive risk-taking and could avoid the problem of competent authorities taking a passive approach.[162] It is possible only partially agree to these comments. Of course, it is easier to determine whether the variable remuneration does not exceed 100% of the total remuneration rather than evaluate possible risks and incentivisation towards them, since mathematical calculations could be used. Nevertheless, it should not become a rule that competent authorities rely only on mathematical calculations of the maximum ration and not pay the necessary attention to all remuneration policy, its structure and evaluation of risks.

22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b. Accessed October 25, 2017.

[158] Opinion of Advocate General Jaaskinen, United Kingdom of Great Britain and Northern Ireland v. European Parliament and the Council of European Union, C-507/13, ECLI:EU:C:2014:2394, para.92.

[159] Order of the President of the Court of 09 December, 2014. C-507/13, ECLI:EU:C:2014:2481, point 1.

[160] Opinion of Advocate General Jaaskinen, United Kingdom of Great Britain and Northern Ireland v. European Parliament and the Council of European Union, C-507/13, ECLI:EU:C:2014:2394, para.96-98.

[161]D.E.M. Kromwijk, W.J. Oostwouder. Do the European and Dutch Rules on Variable Remuneration of Financial Institutions Match and Can Remuneration Be Regulated on a European Level? European Company Law, No. 6, 2010: p.245.

[162] Andrew Johnston. Preventing the Next Financial Crisis? Regulating Banker's Pay in Europe. Journal of Law and Society, 41 (1), 2014. p.21.

There were also concerns raised that adopting the maximum ratio would lead to an increase of the fixed remuneration (with the aim to allow to increase also variable remuneration) and would also decrease flexibility in times of economic downturns, because credit institutions are committed to pay higher amount of remuneration.[163] Such concerns could be well-grounded, since, as it was already noted, there were attempts to include the role-based allowances in the fixed remuneration to avoid the requirements toward variable remuneration. If there is a higher fixed remuneration, this could increase the costs of credit institutions, as well as this would not let the credit institutions to react to economic changes in time. However, the results of the survey show that "the fixed remuneration of only a small percentage of the identified staff has been increased in order to increase their variable remuneration"[164]. This mean that sometimes the raised concerns have little to do with the reality, and only after some time and evaluation of the results it is possible to determine how effective the new approach was. This is also approved by the latest report of the Commission where it is stated that it is too early to evaluate results of setting the maximum ratio. The results of the Commission showing that concerns regarding the loss of flexibility and the impact on profitability can be considered as unsubstantiated at this moment.[165]

2.5. Conclusions

In the Report for the Commission to the European Parliament and the Council adopted on July, 2016 it was noted that it should be acknowledged that the remuneration provisions are only one element of the regulatory framework adopted by the EU institutions with the purpose of fostering financial stability. At the same time, it is not possible to precisely quantify the impact of the remuneration provisions alone on financial stability (…).[166]The author agrees with this conclusion, because the requirements on remuneration are only one part of different requirements associated with operations of credit institutions. However, it should be noted that the questions raised above show that there are many issues which still need to be evaluated and may even change they relate to practical fulfilling the requirements of remuneration.

[163] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.90. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[164] Study on the remuneration provisions applicable to credit institutions and investment firms. Prepared by the Institute for Financial services for European Commission's DH JUST. Final report, January 2016. p.100. http://ec.europa.eu/justice/civil/files/company-law/external_study_en.pdf. Accessed October 25, 2017.
[165] Report from the Commission to the European Parliament and the Council. Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No. 575/2013. COM (2016), 510 final. pp. 9, 11. http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf. Accessed October 25, 2017.
[166] Ibid, p.3.

CONCLUSIONS

The financial crisis of 2007-2008, among other things, proved that the flaws in remuneration systems weakened the credit institutions in the EU. The legal provisions on remuneration in the EU level which were adopted after the financial crisis of 2007-2008 have set a new approach towards this issue. Of course, these provisions have caused a lot of uncertainty and problems associated with the practical application of these legal provisions. Nevertheless, remuneration issues in credit institutions have become one of the crucial aspects of corporate governance of these institutions. Moreover, the requirements toward remuneration in credit institutions have become a part of the macroprudential regulation of all financial system. These issues have impact not only on specific credit institutions, but also on the financial system of the EU and its Member States as a whole. Therefore, this issue has an important role in the corporate governance of credit institutions and macroprudential regulations on the EU level, as well.

In the Conclusions the answers to the questions put in the Introduction of these Master's Thesis will be summarized.

[1] The current corporate governance in credit institutions has become a mixture of different requirements for providing of interests not only of shareholders, but also other stakeholders. Macroprudential regulation in financial sphere have also impacted the corporate governance of credit institutions.

After the financial crisis of 2007-2008 and increased attention towards the problem of systemic-risk, corporate governance of credit institutions has become increasingly influenced by the legal provisions adopted on the EU level. In fact, systemic-risk has become a justification for imposing strict and burdensome requirements on remuneration in credit institutions. Moreover, the objectives of the requirements show that the current corporate governance has become like a type of stakeholder governance which is not bad, taking into account the important role credit institutions play in the financial system and the economy as a whole.

Nevertheless, the approach taken by the EU institutions after the financial crisis of 2007-2008 toward legal regulations of remuneration in credit institutions is too strict and too general without a clear evaluation of the necessity for applying of them on all credit institutions. The latest developments shows that there could be amendments in this regard towards more specialized approach which would be a positive development.

[2] There is a concept that remuneration of executives and some non-executive employees in credit insitutions led to the excessive risk taking which led to the instability of credit institutions to outside economic shocks. This, in it's turn led to the financial crisis of 2007-2008. At the same time there is no clear answer as to how exactly remunertation practices contributed to the financial crisis of 2007-2008?

It is clear that remuneration policies which incentivise excessive-risk taking are hazardous to the stability of credit institutions. Nevertheles, there are no clear answers provided by the researches on how exactly this has contributed to the financial crisis of 2007-2008. This unfortunatelly has led the EU to an approach on remuneration at the EU level which seems already over regulated and which is not positive from the perspective of the development of enterpreneurship of credit institutions.

[3] It was recognised in the Master's Thesis that there should be clear legal provisions on remuneration at the EU level. Otherwise this could lead to a "rat race" between the Member States of the EU, which is certainly not the objective of the EU authorities by imposing these legal provisions. The current approach used by the Member States also shows that there are significant fluctuations in implementation and performance of the provisions of the EU laws.

Nevertheless, there is still the question of how detailed these legal provisions should be and whether they should be applicable to all credit institutions. In the author's opinion the better approach would be to narrow application of these provisions and apply them according to the EU regulations which have direct effect, as this would avoid different interpretations by the Member States.

[4] The different surveys evaluated in the Master Thesis show that the national competent authorities quite often do not have the capacity, the resources and the knowledge to evaluate remuneration policies of credit institutions and therefore are not able to predict possible excessive risk-taking actions by credit institutions.

Currently credit institutions operate in a very complex financial system. There is imparity of knowledge of the situation between credit institutions and competent authorities. Credit institutions definitely have a better understanding of the structure of their finances and activities. Since the main legal provisions on remuneration are provided in directives, this have led to a situation where the main emphasis is on the national competent authorities implementing these provisions which do not have enough capacity for understanding and evaluating the activities of credit institutions. This problem could be resolved by developing of narrower legal provisions on remuneration which are applicable only to specific credit institutions and are included in the EU regulations and not directives.

[5] The deferral period and adjustments on clawback are both the mechanisms implemented for reducing of risk-taking activities. Nevertheless, both of them have some problematic aspects of application. The deferral period could be from 3-5 years and credit institutions have the option to apply different periods depending on the business cycle, the nature of business and associated risks etc. This is one positive aspect, because it allows the credit institutions to evaluate the specific situation and apply the most appropriate deferral period. The latest developments on the EU level show that there are planned amendments to the legal provisions specifying that they do not apply to small financial institutions (including credit institutions). This is a positive recension, since implementation of remuneration policies requires significant costs. At the same time, this development once again proves that the initial approach of the EU on the remuneration issues was unnecessary broad.

Clawback arrangements were implemented, because it often was not possible to prevent some risks by ex-ante adjustments. Nevertheless, there is the problem that clawback is not admissible pursuant to the national laws of the Member States. This means that clawback cannot be recognised as an effective measure for the eradication of excessive risk taking. Moreover, this leads to the unproportionate application of this measure in the EU. Another problem in this regard is the fact that it could be difficult to reclaim back the amounts already paid, because the identified staff member no longer has the funds anymore or the limitation period imposed by the national laws to reclaim the funds has already passed. Therefore, also from this perspective clawback as a measure for eradication of excessive risk taking does not seem the effective.

[6] The ability to correctly identify the staff to whom the remuneration policies are applicable is of crucial importance. On conclusion in the Master's Thesis is that the criterions set by Delegated Regulation 604/2014 which is directly applicable in the Member States are too broad. Therefore, if too much members of the staff could be identified as the staff members that have a material impact on an institution's risk profile, there are justified concerns that it unnecessarily increases costs of credit institutions. For example, it is questionable whether it is necessary to include the members of the staff who are responsible for human resources or information technologies in the identified staff. Moreover, it is possible to exclude a staff member from the identified staff who met a quantitative criteria, but it is not possible to exclude a staff members from the identified staff who met qualitative criteria. Such an approach reduces possibility of applying the principle of proportionality. The current approach should be re-evaluated. The latest developments show that the Commission already plans to resolve this issue which is a positive development.

[7] There are different performance criteria used for determining the elements of variable remuneration. This can be justified by the fact that credit institutions are of different size, that there are different legal requirements specified by national laws and different economic situations throughout the EU. At the same time, the complexity of these models limits transparency in remuneration policies. Therefore, the amendments on the legal provisions should be made on setting more clear requirements toward performance criteria for determining variable elements of remuneration/

It has been pointed that there are problematic aspects in cases where variable remuneration is based on return of equity or paid out on equity or equity-based instruments, because such approaches gives unnecessary incentives for the manipulation of equity. This creates risk for other stakeholders, because the only winners are shareholders in cases which increase the equity of a credit institution. Moreover, manipulations with equity lead to concealing the real financial situation of credit institution. Therefore, it is possible to agree with scholars that it is necessary to limit or even to prohibit variable remuneration which is based on equity or paid out in equity or equity-based instruments.

[8] Implementation of the maximum ratio between the fixed and variable remuneration is a unique concept of the EU. There are a lot of discussions whether it was necessary and what is the correct measure for setting it. It is possible to agree with observations that setting the maximum ratio leads to becoming the norm without assessing whether it is necessary to use the maximum ratio and whether it is possible to use a smaller ratio.

Although, the concerns raised by researchers the application of the maximum ratio would increase the amount of fixed remuneration did not fulfil. Nevertheless, it is too early to evaluate the influence of the maximum ratio and its effectiveness. At this moment, application of the maximum ratio between the fixed and variable component of the total remuneration seems as a reasonable measure. At the same time, pursuant to the author's opinion, later it would be worth to evaluate a possibility of setting different ratios to different members of the identified staff for making this measure as possible effective.

It can be concluded that future developments are necessary for the legal provisions on applying more targeted approach toward requirements on the remuneration in credit institutions on the EU level.

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