Financial Services Commission

Guidance Note

Remuneration Policies

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Version 2

Please be advised that this Guidance Note is dated and does not take into account any changes arising from the Capital Requirements Directive (2013/36/EU), transposed into local legislation as the Financial Services (Capital Requirements Directive IV) Regulations ("Gibraltar Regulations"), or the Capital Requirements Regulations (575/2013) ("EU Regulations") of the European Parliament and of the Council of 26 June 2013. Where there is a discrepancy between the contents of the Guidance Note and the requirements set in the Gibraltar and/or EU Regulations, the entity is to refer to and comply with the requirements set in the Gibraltar Regulations and the EU Regulations.

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1. Application and Purpose

1.1. This Guidance Note applies to all locally incorporated credit institutions in accordance with the Capital Adequacy Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC which have been implemented in Gibraltar via the Financial Services (Capital Adequacy of Credit Institutions) Regulations, 2007 and Financial Services (Capital Adequacy of Investment Firms) Regulations 2007. The guidance notes shall also be applicable to all third country branches (i.e. non EEA branches).

1.2. The first set of Basel III amendments has been transposed via Directive 2010/76/EU of 24 November 2010 which amended 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.

1.3. The requirements have been transposed into local legislation primarily via amendments to Schedule 5 and 12 of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007.

1.4. The purpose of this guidance note is to set out the requirements that a firm must establish, implement and maintain in respect of its remuneration policies, procedures and practices. These in turn must be consistent with, and promote, sound and effective risk management.

1.5. The requirements are primarily concerned with the risks created by the way remuneration arrangements are structured, not with the absolute amount of remuneration, which is generally a matter for firms' remuneration committees.

1.6. Although the information set out in this guidance note is not applicable to investment firms, investment firms will still need to ensure that:

1.6.1. Governance arrangements are established and that these include a clear organisational structure with well-defined, transparent and consistent lines of responsibility

1.6.2. Effective processes are established to identify, manage, monitor and report the risks it is or might be exposed to.

1.6.3. Adequate internal control mechanisms are established, including sound administration and accounting procedures,

1.6.4. Remuneration policies and practices are adopted that are consistent with, and promote, sound and effective risk management.

2. Remuneration Policies & Governance

2.1. The following shall apply to the following categorise of staff:

2.1.1. Senior management

2.1.2. Risk takers

2.1.3. Staff engaged in control functions

2.1.4. any employee receiving total remuneration which takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile

2.2. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits for staff members as set out in section 2.1 above, firms shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities-

2.2.1. The remuneration policy must be consistent with and promote sound and effective risk management and not encourage risk-taking that exceeds the level of tolerated risk of the credit institution

2.2.2. The remuneration policy must be in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporate measures to avoid conflicts of interest;

2.2.3. The management body, in its supervisory function, of the credit institution must adopt and periodically review the general principles of the remuneration policy and be responsible for its implementation;

2.2.4. The implementation of the remuneration policy must be subject to central and independent internal review, at least annually, for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

2.2.5. Staff engaged in control functions must be independent from the business units they oversee, have appropriate authority, and be remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

2.2.6. The remuneration of the senior officers in the risk management and compliance functions must be directly overseen by the remuneration committee referred to in Section 3 of this Guidance

Note or, if such a committee has not been established, by the management body in its supervisory function;

2.2.7. Where remuneration is performance related, the total amount of remuneration must be based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial and non-financial criteria must be taken into account;

2.2.8. The assessment of the performance must be set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

2.2.9. The total variable remuneration must not limit the ability of the credit institution to strengthen its capital base;

2.2.10. Guaranteed variable remuneration must be exceptional and occur only when hiring new staff and be limited to the first year of employment;

2.2.11. In the case of a credit institution which benefits from exceptional government intervention-

2.2.11.1. Variable remuneration must be strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;

2.2.11.2. The Commissioner will require the firm to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, the establishment of limits to the remuneration of the persons who effectively direct the business of the credit institution; and

2.2.11.3. No variable remuneration must be paid to the persons who effectively direct the business of the credit institution unless justified;

2.2.12. Fixed and variable components of total remuneration must be appropriately balanced and the fixed component represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component. Firms shall set the appropriate ratios between the fixed and the variable component of the total remuneration;

2.2.13. Payments related to the early termination of a contract must reflect performance achieved over time and be designed in a way that does not reward failure;

2.2.14. The measurement of performance used to calculate variable remuneration components or pools of variable remuneration components must include an adjustment for all types of current and future risks and take into account the cost of the capital and the liquidity required. The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;

2.2.15. A substantial portion, and in any event at least 50%, of any variable remuneration shall consist of an appropriate balance of-

2.2.15.1. Shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non- listed credit institution, and

2.2.15.2. Where appropriate, other instruments within the meaning of regulation 15(1A)(a) of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007, that adequately reflect the credit quality of the credit institution as a going concern.

The instruments referred to in this paragraph shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. The Commissioner may place restrictions on the types and designs of those instruments or prohibit certain instruments, as appropriate. This paragraph shall apply to both the portion of the variable remuneration component deferred in accordance with section 2.1.16 and the portion of the variable remuneration component not deferred;

2.2.16. A substantial portion, and in any event at least 40%, of the variable remuneration component shall be deferred over a period which is not less than three to five years and be correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.

Remuneration payable under deferral arrangements shall be paid no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount[1], at least 60% of the amount shall be deferred. The length of the 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;

[1] I.e. exceeding the threshold set out in 5.1

2.2.17. The variable remuneration, including the deferred portion, shall be paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned. Without prejudice to the general principle of contract and employment legislation, the total variable remuneration shall generally be considered contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus[2] or clawback arrangements;

2.2.18. The pension policy must be in line with the business strategy, objectives, values and long-term interests of the credit institution. If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of five years in the form of instruments referred to in section 2.1.15. In the case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in section 2.1.15 subject to a five-year retention period;

2.2.19. Staff members are required to undertake not to use personal hedging strategies or remuneration and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements; and

2.2.20. Variable remuneration must not be paid through vehicles or methods that facilitate the avoidance of the requirements of the Regulations[3].

2.2.21. The principles set out in this paragraph shall be applied by a credit institution at group, parent company and subsidiary levels.

2.3. The ultimate oversight of the remuneration policy shall rest with an institution's management body.

2.3.1. The management body in its supervisory function should maintain, approve and oversee the principles of the overall remuneration policy for its institution. The institution's procedures for determining remuneration should be clear, well documented and internally transparent.

2.3.2. In addition to the management body's general responsibility for the overall remuneration policy and its review, adequate involvement of the control functions is required. Members of the management body, members of the remuneration committee and other staff members who are involved in the design and

[2] the return of performance-related compensation upon the discovery of deficient performance

[3] Financial Services (Capital Adequacy of Credit Institutions) (Amendment) Regulations 2011

implementation of the remuneration policy should have relevant expertise and be capable of forming an independent judgement on the suitability of the remuneration policy, including its implications for risk management.

2.3.3. The remuneration policy should also be aimed at preventing conflicts of interest. The management body in its management function should not determine its own remuneration; to avoid doing so, it might consider, for example, using an independent remuneration committee. A business unit should not be able to determine the remuneration of its control functions.

2.3.4. The management body should maintain oversight of the application of the remuneration policy to ensure it works as intended. The implementation of the remuneration policy should also be subject to central and independent review.

2.4. An institution’s remuneration policy and practices shall be consistent with its risk profile and promote sound and effective risk management.

2.4.1. An institution’s overall remuneration policy should be in line with its values, business strategy, risk tolerance/appetite and long-term interests. It should not encourage excessive risk-taking. Guaranteed variable remuneration or severance payments that end up rewarding failure are not consistent with sound risk management or the pay-for-performance principle and should, as a general rule, be prohibited.

2.4.2. For staff whose professional activities have a material impact on the risk profile of an institution (e.g. management body members, senior management, risk-takers in business units, staff responsible for internal control and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers), the remuneration policy should set up specific arrangements to ensure their remuneration is aligned with sound and effective risk management.

2.4.3. Control functions staff should be adequately compensated in accordance with their objectives and performance and not in relation to the performance of the business units they control.

2.4.4. Where the pay award is performance related, the remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors other than financial performance should be considered. The measurement of performance for bonus awards should include adjustments for all types of risk and the cost of capital and liquidity.

2.4.5. There should be a proportionate ratio between basic pay and bonus. A significant bonus should not just be an up-front cash payment but should contain a flexible and deferred risk-adjusted component. The timing of the bonus payment should take into account the underlying risk performance.

3. Remuneration Committee

3.1. A credit institution which is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

3.2. The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The chairperson and the members of the remuneration committee shall be members of the management body who do not perform any executive functions in the credit institution concerned. When arriving at such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.

4. Disclosure

4.1. The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices of the firm for those categories of staff whose professional activities have a material impact on its risk profile-

4.1.1. Information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of the remuneration committee, any external consultant whose services may have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

4.1.2. Information on the link between pay and performance;

4.1.3. The most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, the deferral policy and vesting criteria;

4.1.4. Information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

4.1.5. The main parameters and rationale for any variable component scheme and any other non-cash benefits;

4.1.6. Aggregate quantitative information on remuneration, broken down by business area;

4.1.7. Aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution, indicating the following-

4.1.7.1. The amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;

4.1.7.2. The amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;

4.1.7.3. The amounts of outstanding deferred remuneration, split into vested and unvested portions;

4.1.7.4. The amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;

4.1.7.5. New sign-on and severance payments made during the financial year, and the number of beneficiaries of such payments; and

4.1.7.6. The amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

4.1.8. For a firm which is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities, the quantitative information referred to in paragraphs 4.1.7.1 to 4.1.7.6 shall also be made available to the public at the level of persons who effectively direct the business of the credit institution.

4.1.9. A firm shall comply with the requirements set out in section 4 of this Guidance Note in a manner which is appropriate to its size, internal organisation and the nature, scope and complexity of its activities and without prejudice to Directive 95/46/EC[4].

4.1.10. The FSC would be willing to receive representations from Credit Institutions who wish to make use of the provision for dispensation from publication of certain information as prescribed by Section 88 of the Financial Services (Capital Adequacy of Credit Institutions) Regulations, 2007 i.e. where the institution considers that the information is not material or the information is proprietary or confidential. Notwithstanding, the credit institution shall state in its disclosures the fact that specific items of information, if any, are not

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[4] Directive 95/46/EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data

disclosed in pursuance of this option, the reason for non-disclosure and it shall publish more general information on the disclosure requirement, except where that information is classified information under the criteria set out in paragraphs 2 and 3 of Part 1 of Schedule 12 of Financial Services (Capital Adequacy of Credit Institutions) Regulations, 2007.

4.1.11. A credit institution shall disclose to the FSC information on the number of its individuals in pay packets[5] of at least EUR 1 million including the business area involved and the main elements of salary, bonus, long-term award and pension contribution. Such disclosures shall be made, in the first instance, via submission of the quarterly supervisory returns.

5. Remuneration structures

5.1 The FSC will not generally consider it necessary for a firm to apply the rules referred to in 5.2 where, in relation to an individual ("X"), both the following conditions are satisfied:

a. Condition 1 is that X's variable remuneration is no more than 33% of total remuneration; and
b. Condition 2 is that X's total remuneration is no more than £500,000.

5.2 The rules referred to in Section 5.1 are those prescribed in this guidance note relating to:

a. Guaranteed variable remuneration (as set out in 2.2.10);
b. Retained shares or other instruments (as set out in 2.2.15);
c. Deferral (as set out in 2.2.16); and
d. Performance adjustment (as set out in 2.2.17).

[5] Total remuneration received including, inter alia, salary, bonus, profit share, benefits etc

Regulatory objectives and principles of good regulation – checklist

Which regulatory objectives are the proposals aimed to facilitate:?	
(a) To promote market confidence;	Yes
(b) The reduction of systemic risk;	Yes
(c) To promote public awareness;	Yes
(d) The protection of the reputation of Gibraltar;	Yes
(e) The protection of consumers;	Yes
(f) The reduction of financial crime, including the funding of terrorism;	No
Do the proposals accord with the following principles of good regulation?	
1. The need to use our resources in the most efficient, effective and economic way;	Yes
2. The principle that the duty to manage a business falls upon the senior management of that business. The Directors of a licence holder, both executive and non-executive have ultimate responsibility for ensuring that the business is properly run and operates in accordance with regulatory requirements;	Yes
3. The principle that a burden or restriction which is imposed upon authorised firms should be commensurate with the benefits expected to result from such action, so ensuring that the Authority is striking the right balance between achieving the statutory objectives and ensuring that the impact on those being regulated is not such as to be counterproductive;	Yes – especially relating to the proportionality provisions which have been included.
4. The desirability of facilitating innovation in connection with regulated activities;	Not applicable
5. The international character of financial services and markets and the desirability of maintaining the competitive position of Gibraltar; and	Yes – disclosure provisions will allow for investors and other stakeholders to make more informed decisions on a level playing field.
6. The need to consider the adverse effects of regulation on competition and consumer choice.	Yes
7. Does this match UK supervisory practices	Yes – is directive led.