

Questions and answers regarding the regulation of remuneration

- Piece of law**
- Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms, as amended (hereinafter only the “Decree”), Annex No. 1a
 - official information of the Czech National Bank of 22 December 2010 regarding the pursuit of business in the financial market by banks, credit unions and investment firms – remuneration, chapter 20/2010 Bulletin of the Czech National Bank (hereinafter only the “official information on remuneration”).

Question Does point 17 of Annex No. 1a to the Decree, respectively the ban on hedging strategies related to remuneration, also apply to the insurance against liability from the performance of a function?

Answer of 21. 3. 2011 According to point 17 of Annex No. 1a to the Decree, a liable entity shall insist that its employees refrain from using hedging strategies associated with their remuneration or liability that could hamper the effects of the risk-focused elements of the principles of remuneration. This is the transposition of the following requirement of Directive 2010/76/EU of the European Parliament and of the Council of 24. 11. 2010, amending Directives 2006/48/EC and 2006/49/EC: “*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.*”

We do not interpret the above principle as a general ban on insuring against liability from the performance of a function, and such insurance is possible unless it leads to the circumventing of the purpose of the regulation of remuneration. The liable entity should therefore always take account of the specific configuration of the individual insurance policies (e.g. who arranges the insurance, the subject of the insurance and the conditions for the payment of an insurance settlement) and their influence on the risk-related elements in the remuneration system, in particular, the use of the *malus* and *claw back* tools (point 12 and 13 of Annex No. 1a to the Decree). If an employee insured himself against the use of the *malus* or *claw back* tool, and/or a case when the liable entity covers damages from insurance without first effectively applying the *malus* and *claw back* tools would, for example, be in contradiction with the provisions of point 17 of Annex No. 1a to the Decree.

To conclude, we can summarise that insurance against liability from the performance of a function in this specific case may be, but need not be, in contradiction with point 17 of Annex No. 1a to the Decree. The answer will depend on the circumstances of the case in question, respectively on the conditions of the insurance policy and the remuneration system of the liable entity.

Question For which period will liable entities first publish information about remuneration according to point 16 of Annex No. 25 to the Decree and inform the Czech National Bank pursuant to Article 216a of the Decree?

Answer of 21. 3. 2011 The Decree, in accordance with Directive 2010/76/EU of the European Parliament and of the Council of 24. 11. 2010, which amends Directives 2006/48/EC and 2006/49/EC, stipulated the effect of the provisions of Article 216a and point 16 of Annex No. 25 to the Decree as of 1. 1. 2011. The applicable provisions will thus first be used during the publication and provision of information for 2011.

We would, however, point out that the Czech National Bank may already request necessary information and materials regarding remuneration on the basis of the Act on the Czech National Bank during 2011.

Question When should a liable entity justify its decision not to apply certain remuneration principles?

Answer of 21. 3. 2011

Liabe entities may choose not to apply some remuneration principles placed in Group III according to the annex to the official information on remuneration of 22. 12. 2010. They must, however, justify this procedure. We expect that during the implementation of the remuneration system the liable entity will document its decision-making processes (including justification) in accordance with Article 10 of the Decree and submit this upon request. The justification should focus on the suitability of the requirement in relation to the liable entity or the individual groups of employees or the remuneration system as a whole (see the proportionality criteria in points 1.8 to 1.10 of the Annex to the official information on remuneration).

Question

To which remuneration, respectively to remuneration for which period, will the regulation of remuneration pursuant to Annex No. 1a to the Decree and the official information on remuneration apply?

Answer of 15. 2. 2011

According to Directive 2010/76/EU of the European Parliament and of the Council of 24. 11. 2010, which amends Directives 2006/48/EC and 2006/49/EC (hereinafter only "CRD III") Member States should transpose remuneration principles with effect from 1. 1. 2011, while these principles are to be applied to all remuneration that has not yet been paid, i.e. even to remuneration that has already been awarded or that should be awarded on the basis of contracts concluded before the effect of the regulation of remuneration.

In connection with CRD III, the Czech National Bank stipulated the effect of the regulation of remuneration in the Decree as of 1. 1. 2011 and issued the applicable official information. Liable entities will thus comply with the remuneration principles from 1. 1. 2011 unless they are prevented from doing so by mandatory provisions of other acts (e.g. the Labour Code or the Commercial Code). For example, an already granted entitlement to remuneration (remuneration granted before 1. 1. 2011) or entitlements that arise after 1. 1. 2011 from contracts concluded before the effect of the regulation are protected by mandatory provisions. In the second case it is important to differentiate between the following: to which amount and form of remuneration the employees have gained legal entitlement from a contract concluded before the effect of the regulation of remuneration and what amount of their remuneration is without any enforceable claim (most commonly the variable component of the remuneration). A stricter regulation that would be fully in accordance with the requirements of CDR III, i.e. which would apply the principles to all unpaid remuneration, would have to be incorporated into sector laws, e.g. in the form of an interim provision.

The Czech National Bank expects that a liable entity will take all steps to ensure that its remuneration system is in accordance with Annex No. 1a to the Decree and the official information on remuneration, while it will be taken into account that amendments to some collective or individual contracts may take longer.

Question

Will the new rules apply to all banks, firms and credit unions in full and without any difference? Or will they primarily affect only the largest banks?

Answer of 15. 2. 2011

The remuneration rules apply to all banks, credit unions and investment firms. However, the manner and the extent of their application will take into account the size, organisational structure, character, scope and complexity of the activity of the liable entity (i.e. the proportionality principle will be applied).

The official information on remuneration divides the rules into three groups. The strictest rules are placed in Group III and apply primarily to liable entities that have a significant market share, i.e. important banks in particular. The principles in Groups I and II, however, must be complied with by all liable entities. More detailed information is available in the Czech National Bank official information on remuneration, which is also available on the website of the Czech National Bank¹.

¹ http://www.cnb.cz/cs/legislativa/obezretne_podnikani/uredni_sdeleni.html

Question **Does the regulation of remuneration also apply to an investment firm that manages the assets of a customer?**

Answer of 15. 2. 2011 The remuneration rules apply to an investment firm that manages the assets of a customer. The investment firm may nevertheless use the proportionality principle and not apply some of the rules at all. In this regard we would refer, in particular, to the official information on remuneration, which explains the proportionality principle and also introduces some exceptions for asset managers.

Pursuant to Article 76 (1) of Act No. 189/2004 Coll., on Collective Investment, as amended (hereinafter only the "ACI"), an investment firm undertaking activities pursuant to Article 15 (3) and (4) of the ACI (portfolio management) shall, in relation to these activities, introduce rules of prudent provision of investment services pursuant to special legal regulations applying to the activity of an investment firm. Article 12 and subsequent of Act No. 256/2004 Coll., on Capital Markets Business, as amended, regulates the rules of prudent provision of investment services. The rules of prudent provision of investment services also include requirements for the governance, including remuneration. The applicable statutory instrument for remuneration is included in Decree No. 123/2007 Coll., as amended by amendment No. 380/2010 Coll., in particular its Annex No. 1a.

Question **Do the remuneration principles of Group III also apply to the subsidiaries of the most important banks?**

Answer of 15. 2. 2011 The principles of Group III are implemented by liable entities with a significant market share, i.e. in particular important banks. The principles are also applied on a consolidated basis and the liable entity (parent company) also applies them to the members of its regulated consolidated group (i.e. to subsidiaries), taking into account the nature of their activities, the influence on the overall risk profile of the parent company and the cohesion of the activities of the consolidated group. As long as this does not result in the circumventing of the purpose of the regulation of remuneration, the parent company may, on the basis of these criteria, decide that it will not apply the principles of Group III to some subsidiaries at all.

If the parent company also applies the principles of Group III in relation to a subsidiary, it will always take into account the specific conditions of their relationship. The following situation can serve as an example. The parent company does not have to set up a remuneration committee at a subsidiary if the competency of the remuneration committee set up in the parent company also covers remuneration at the subsidiary, while it has been ensured that the subsidiary will accept the remuneration principles and the structure of remuneration as defined at the parent company level.

Question **Which body of the liable entity decides on remuneration?**

Answer of 15. 2. 2011 The supervisory body stipulates the basic remuneration principles (the principles of Group I according to the official information on remuneration) which are applicable to all employees, and the specific remuneration principles (the principles of Group II and Group III) according to the official information on remuneration) applicable to a specific circle of employees according to point 1 b) of Annex No. 1a of the Decree. The responsibility for further specification, the supplementing and the application of the principles approved by the supervisory body lies with the board of directors.

Question **How should we interpret point 1.4 of the official information on remuneration that the utilisation of outsourcing mechanisms could be considered as circumventing the requirements of the Decree?**

Answer of 15. 2. 2011 Liable entities should apply the regulation of remuneration to all persons who, over a long period of time, actually perform activities for the liable entity, irrespective of the formal/legal relations. If, for example, the liable entity purposely shifts some key activities to a non-regulated entity through outsourcing, this behaviour could be

considered as circumventing regulation. Legal entities that outsource an activity having a significant influence on the risk profile of the institution will ensure that the remuneration of the outsourcing provider for this activity is in accordance with the regulation of remuneration in the Decree and the applicable official information.

Question

How should the principles be implemented when neither Annex No. 1a to Decree 123/2007 Coll. nor the official information on remuneration precisely stipulate the conditions?

Answer of 15. 2. 2011

Remuneration is an integral part of the governance of liable entities. The principle of the relative freedom of the liable entity in configuring the system applies. The liable entity itself shall stipulate the specific method of the implementation of the remuneration principles taking into account its size, organisational structure, character, scope and complexity of the activity.

Each of the following points can serve as an example of the relative freedom in implementing the system:

- the selection of the employees to whom Group II and III principles will apply – i.e. the procedure for the identification of the employees who have a significant influence on the overall risk profile of the liable entity,
- the method for performing independent internal control – e.g. if this will be performed by the internal audit, the remuneration committee or a different entity,
- the setting of the fixed and the maximum variable components of the remuneration of individual employees or groups of employees,
- the conditions for the use of the *malus* tool – e.g. whether it will also be used at the termination of a relationship with an employee,
- the preconditions for the use of the *claw back* tool – e.g. for how long and under what circumstances the liable entity will use this tool,
- an evaluation of what employee behaviour is in contradiction to the ban on hedging strategies associated with remuneration or the liability of employees.

When selecting the method of implementation, however, the basic aims of the regulation of remuneration must be respected. The liable entity thus, for example, cannot remunerate all employees using only a fixed component of remuneration, which would enable it to not apply the remuneration principles relating to the variable component of remuneration (i.e. the majority of the remuneration principles), because this procedure would be in contradiction with the principle of proper and effective risk management.

The meaning of the answer for its addressees

These answers are an expression of the opinion of employees of the Czech National Bank. A court of law and potentially also the Bank Board of the Czech National Bank could take a differing position. However, during the performance of its supervision over the financial market and within the bounds of the answer and its bases, the Czech National Bank shall consider a procedure in accordance with the answer to be a procedure in accordance with legal regulations, unless circumstances show that the answer is inapplicable to the case in question.

Contact person

Marie Peroutková, marie.peroutkova@cnb.cz