

CSSF Circular 10/437

Interpretation and implementation



Institut Luxembourgeois
des Administrateurs

Remuneration Policy in the Financial Sector

Chambre de Commerce, Luxembourg

May 17th, 2010

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Preliminary remarks

Remuneration systems serve multiple, sometimes competing, objectives, with the following being of general importance across most companies and organizations:

1. Align management interests with shareholders
2. Pay for performance
3. Attract, motivate and retain talent

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Preliminary remarks (cont'd)

Guiding principles for re-designing executive remuneration

- Transparency
- Fairness
- Sustainability
- Judgment, common sense
- Market practice

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To whom does the Circular 10/437 apply ?

1. All financial undertakings registered and based in Luxembourg and their affiliates and subsidiaries abroad
2. All Luxembourg branches of financial undertakings registered and headquartered abroad
3. All members of the administrative and management bodies of financial undertakings (board of directors, executive committee, senior management)
4. Members of staff whose professional activities have material impact on the risk profile of the financial undertaking
5. Single business units as well as the whole organization (“on an individual and consolidated basis”)

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Section IV of the Circular 10/437 applies

only to credit institutions and investment firms incorporated under Luxembourg law or Luxembourg branches of credit institutions and investment firms registered abroad.

For the above-mentioned firms, a more severe reporting process has to be implemented:

- “ Formal assessment of the implementation and report by the statutory auditor (“réviseur d’entreprise”) as part of the long-form report
- “ Disclosure of remuneration policy to CSSF no later than September 30th, 2010
- “ First report to be established for financial year 2010

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The Circular does not apply

- a. to intermediaries and external service providers
- b. to companies with the status of “PSF de support”
- c. to publicly listed companies with non-financial activities

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Structure of the remuneration policy: pay for performance

- “ The remuneration policy has to be consistent with an effective risk management and has to be in line with the business strategy, corporate values and long-term interests.
- “ The remuneration policy has to strike the right balance between fixed and variable remuneration.
- “ Fixed remuneration must be sufficient to operate a totally flexible bonus policy.
- “ The variable compensation has to be defined according a well-established performance measurement process.

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Structure of the remuneration policy: pay for performance (cont'd)

- “ When a significant bonus is paid, the main part of that bonus shall be deferred for a minimum period (3 to 4 years).
 - “ Failure must not be rewarded. Therefore, contractual provisions with regard to early termination etc. have to be drafted very carefully.
 - “ “Clawback” provisions shall allow to require the reimbursement of variable remuneration paid due to misstated or inaccurate results.
 - “ The remuneration policy has to be reviewed and updated on a regular basis.
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Performance measurement

- “ Performance-related variable remuneration shall be paid on the basis of achievement of long-term corporate objectives, individual contribution and overall results.
- “ Performance is to be measured in a multi-year framework (3 to 5 years).
- “ In addition to financial performance, other performance criteria have to be considered, such as compliance with systems, governing standards, best practices or creation of sustainable value for the company.
- “ The criteria for performance-related remuneration have to be disclosed and communicated in advance.

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Governance

- “ In listed companies and larger financial undertakings , the **Board of Directors** establishes the general principles of the remuneration policy. The **Senior Executive Team** (“authorized management”) is in charge of its implementation.
- “ The Board of Directors may be assisted by a Remuneration Committee which should be composed exclusively of Board Members who are not involved in the daily management (“**Non-Executive Directors**”).
- “ Members of the **Remuneration Committee** must have relevant expertise and be capable of forming independent judgment on the suitability of the remuneration policy, including the implications for risk and risk management.

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Governance (cont'd)

- “ The Board of Directors fixes the remuneration of the Senior Executive Team.
- “ The remuneration of members of the Board of Directors who do not participate in the daily management shall not be related to short-term results.
- “ Control functions such as risk management, internal control, compliance as well as human resources shall take part in the design of the remuneration policy.
- “ The remuneration of staff in control functions shall be unrelated to short-term results and independent of the performance of the business areas they control.

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Governance (cont'd)

- “ The financial undertaking may be assisted by external experts when developing and implementing a new remuneration policy.
- “ A regular review (at least every year) of the remuneration policies and procedures by the Board of Directors (or other authorized bodies) is mandatory.
- “ In smaller organizations, the management team is responsible for the establishment and implementation of the remuneration policy.
- “ The Senior Executive Team has to inform all members of the personnel concerned about the remuneration policy and all related procedures, including the performance appraisal process.

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Timing and deadlines

- “ **June 30, 2010** : Implementation of Remuneration Policy according to the Principles of CSSF Circular 10/437
- “ **September 30, 2010** : Disclosure of new remuneration policy to CSSF for financial undertakings falling under Section IV of the Circular
- “ **December 31, 2010** : Completion of review and renegotiation of working contracts of executives with regards to remuneration
- “ Starting from **financial year 2011**: implementation of new principles

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Practical implications

- “ Every financial undertaking under CSSF supervision has to establish an appropriate remuneration policy.
- “ The remuneration policy has to reflect the undertaking’s long-term business objectives and be aligned with an appropriate risk management structure.
- “ The remuneration policy has to be reviewed and updated regularly.
- “ The remuneration policy has to be disclosed to all board members, executives and staff directly concerned as well as to shareholders (publicly listed companies) and to the supervisory authority CSSF.

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Practical implications (cont'd)

- “ Performance-related remuneration requires an appropriate performance measurement and appraisal system that takes into account financial and non-financial performance criteria as well as effective risk management.
- “ Where a substantial part of total remuneration is paid as a variable pay, this variable part should be vested over several years (3 to 4 years).
- “ Although there is no official rule or prescription (yet), variable remuneration can be considered as “substantial” if it represents 40 to 50% of the total compensation.

Practical implications (cont'd)

- “Clawback” provisions should allow to claim back bonus paid on the grounds of misstated or inaccurate results.
- Non-executive remuneration is different from executive remuneration. Non-Executive Members of the Board of Directors are paid for fiduciary oversight, not for company performance.
- A thorough revision of existing executive contracts with specific focus on remuneration is highly recommended.
- External advise can be useful when (re-)defining executive and board compensation and benchmarking against market practice and competition, however companies must carefully select their external advisors and make sure to avoid conflict of interest.