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REGULATION

Remuneration on the management board in financial institutions: Current developments in the framework of supervisory law, labor law, behavioral economics and practice

JULIA REDENIUS-HÖVERMANN
LARS HINRICHS

GenAI

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CAPCO CEO WELCOME

DEAR READER,

Welcome to our very special 60th edition of the Capco Journal of Financial Transformation.

The release of this milestone edition, focused on GenAI, reinforces Capco's enduring role in leading conversations at the cutting edge of innovation, and driving the trends shaping the financial services sector.

There is no doubt that GenAI is revolutionizing industries and rapidly accelerating innovation, with the potential to fundamentally reshape how we identify and capitalize on opportunities for transformation.

At Capco, we are embracing an AI infused future today, leveraging the power of GenAI to increase efficiency, innovation and speed to market while ensuring that this technology is used in a pragmatic, secure, and responsible way.

In this edition of the Capco Journal, we are excited to share the expert insights of distinguished contributors across academia and the financial services industry, in addition to drawing on the practical experiences from Capco's industry, consulting, and technology SMEs.

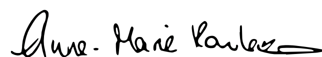
The authors in this edition offer fresh perspectives on the mindful use of GenAI and the implications of advanced GenAI on financial markets, in addition to providing practical and safe frameworks for boards and firms on how to approach GenAI governance.

The latest advancements in this rapidly evolving space demonstrate that the potential of GenAI goes beyond automating and augmenting tasks, to truly helping organizations redefine their business models, processes and workforce strategies. To unlock these benefits of GenAI, I believe that firms need a culture that encourages responsible experimentation and continuous learning across their organization, while assessing the impact of the potential benefits against a strategic approach and GenAI framework.

I am proud that Capco today remains committed to our culture of entrepreneurialism and innovation, harnessed in the foundation of our domain expertise across our global teams. I am proud that we remain committed to our mission to actively push boundaries, championing the ideas that are shaping the future of our industry, and making a genuine difference for our clients and customers – all while ensuring to lead with a strategy that puts sustained growth, integrity and security at the forefront of what we do.

I hope you'll find the articles in this edition both thought-provoking and valuable as you create your organization's GenAI strategy and future direction. As we navigate this journey together, now is the time to be bold, think big, and explore the possibilities.

My greatest thanks and appreciation to our contributors, readers, clients, and teams.



Annie Rowland, **Capco CEO**

REMUNERATION ON THE MANAGEMENT BOARD IN FINANCIAL INSTITUTIONS: CURRENT DEVELOPMENTS IN THE FRAMEWORK OF SUPERVISORY LAW, LABOR LAW, BEHAVIORAL ECONOMICS AND PRACTICE

JULIA REDENIUS-HÖVERMANN | Professor of Civil Law and Corporate Law and Director of the Corporate Governance Institute (CGI) and the Frankfurt Competence Centre for German and Global Regulation (FCCR), Frankfurt School of Finance and Management

LARS HINRICHS | Partner at Deloitte Legal Rechtsanwaltsgesellschaft mbH (Deloitte Legal) and Lecturer, Frankfurt School of Finance and Management[1]

ABSTRACT

In the following article, selected topics in the current implementation of compensation systems for management boards are discussed in more detail, with the focus on the tension that regularly arises in compensation practice between the regulatory and labor law framework, behavioral economics, and (market) practice. To make the presentation more understandable, the regulatory legal bases generally refer to the requirements of CRD VI and cover topics that the national legislators of the individual E.U. member states have implemented in national law with the same content. It is shown that the practice of remuneration systems for management board members in institutions is based on a (mature) legal framework. Individual internal and external dynamic factors influence the further implementation of the remuneration systems for management board members and require a risk-based regular review process of the compatibility of the remuneration systems and their implementation with the regulatory requirements and the operational requirements of the institution, in particular from the updated business and risk strategy. Particularly, when it comes to the specific implementation of performance-related variable remuneration, institutions must take into account the dependence of regulatory requirements on the applicable labor and company law framework and reconcile these in a balanced and practicable manner. The question of whether the current (over)regulation will lead to a "regulatory infarction" in the near future remains to be discussed.

1. INTRODUCTION: THE TWO-TIER STATUS QUO FOR INSTITUTIONS OPERATING IN THE E.U.

From a legal perspective, the status quo on the content of management board remuneration in institutions in the E.U. currently presents a mixed picture:

1.1 The (mature) target picture of the sound compensation regulatory framework

Following several updates over the past 15 years, the (E.U.) legislator has set out a preliminary target for the core regulatory framework conditions for the content of remuneration, which

[1] We would like to thank Dorothea Langhans (research associate at Deloitte Legal) for her support in the preparation of this article.

the E.U. member states have each transposed into national law. The European Banking Authority (EBA) has fulfilled its mandate set by the E.U. legislator [Art. 74 (3) Directive 2013/36/EU, in the version of Directive 2024/1619/EU of May 31, 2024 (CRD VI)] to issue guidelines on sound remuneration policies with regard to the specification of the requirements set out in CRD VI on the content of remuneration systems and remuneration governance, most recently with the follow-up version of the guidelines on sound remuneration policies [EBA/GL/2021/04 of July 2, 2024, EBA-GSR 2.0] and the supervisory authorities of the individual E.U. member states have supplemented the EBA-GSR 2.0 for the application of the law with their own announcements for their own interpretation in their supervisory practice.[2]

The institutions domiciled in the individual E.U. member states (including the subordinate companies of institutions from other E.U./non-E.U. member states and branches of institutions domiciled in non-E.U. member states) have generally come to terms with the legal framework conditions – in particular with the two regulatory purpose considerations on which the legal framework conditions are generally based: (1) the monetary behavioral incentive of the individual employee of the institution and, thus, in particular, also of the management board member (= above all with regard to the incentive set by the variable remuneration components specifically granted), and (2) transparent risk management (= institution only grants affordable variable remuneration in line with the business and risk strategy and with full transparency for all relevant external and internal stakeholders).[3] They have established the key regulatory requirements in the remuneration systems of the management board – and here above all in the variable remuneration components – and have also created (mature) interactions between the relevant stakeholders in the implementation of the remuneration systems in the sense of needs-based remuneration governance.[4]

2.2 Establishment of needs-based (regular) communication between the institutions and the supervisory authorities as well as the auditors, including in the implementation of management remuneration systems – with feedback to the legislator

Supervision, auditing and remuneration practice have generally found a common starting point for regular communication. Among other things, the communication of rules entails an early exchange on the design of individual remuneration components and their implementation that require discussion. Coordination on the implementation of the remuneration systems (and in particular the possible granting of variable remuneration) in crisis situations at the institution is generally constructive, consensus- and solution-orientated.[5] The auditors responsible for auditing the remuneration systems as part of the audit of the annual financial statements are usually involved by the institutions during the year in individual topics and problem areas where changes are required in order to reach a common understanding of a solution and implementation in the remuneration systems that complies with regulatory requirements. The legislator incorporates relevant experiences of remuneration practice from the implementation of the respective regulatory requirements into the remuneration systems and incorporates these into the subsequent amendments to the statutory requirements.[6]

[2] In Germany, BaFin's most recent announcement on the supervisory application of the Remuneration Ordinance for Institutions (Institutsvergütungsverordnung, IVV), which transposes the requirements of CRD VI into German law, "Questions and answers on the remuneration ordinance for Institutions (FAQ IVV)," of June 13, 2024, https://tinyurl.com/y9tf4cet

[3] See Hinrichs, L., A. Kock, and D. Langhans, 2018, "Vergütung nach der Institutsvergütungsverordnung 3.0," https://tinyurl.com/5f2hjctj

[4] This applies in particular to the division of labor between the remuneration control committee in its preparatory activities for the relevant resolutions and other decisions of the supervisory body in the implementation of the remuneration systems, which, above all, due to the increasing technical professionalization of the committee members, includes the technical discussion and debate of the relevant material topics required by the supervisory body prior to their resolution (e.g., in the assessment of the appropriateness of the remuneration systems, in their updating, e.g., in the variable remuneration parameters) to a sufficient extent.

[5] This consensual approach is reflected above all in the supervisory side's intention to ensure a common understanding between the supervisory authority and the institution regarding the specific supervisory measures considered by the supervisory authority; for example, in cases where the supervisory authority imposes a cap or even prohibits and/or sets variable remuneration.

[6] The privileged treatment of variable remuneration of risk takers with an annual amount of no more than €50,000 and no more than one-third of total remuneration, as stipulated by Directive 2019/878/EU (CRD V) in Art. 94 para. 3 CRD VI, resulted from the practical experience of remuneration practice that variable remuneration up to this quantitative amount does not require ex-ante risk adjustment from a standardized perspective through the partial granting over a retention period with malus and claw back testing and a partial granting in parameters aligned with the sustainable performance of the institution in accordance with Art. 94 (1) lit. l, m and o CRD VI in order to achieve the two purpose considerations.

This well-established status is flanked by the ongoing dynamic updating of the regulatory framework for individual content-related design parameters of the remuneration systems and their interaction with remuneration governance, which requires an ongoing and regular review with the verification of any need for modification in the content-related design of the remuneration systems and remuneration governance by the supervisory body and its implementation in remuneration practice; specifically, among other things, through:

- **Updates to the framework conditions directly related to the remuneration systems and remuneration governance:** even if remuneration is no longer the direct focus of legislative activities, the updating of individual legal framework conditions means that there is at least a need for readjustments to individual remuneration system design parameters. Currently, this results, among other things, from the legislative activities for the necessary updating of the remuneration strategy and its operationalization in the remuneration policy with regard to the institutions' risk appetite in relation to ESG risks in accordance with Art. 74 (1) lit. e) CRD VI with the necessary establishment of specific plans with quantifiable targets with regard to the financial risks arising from the short-, medium- and long-term ESG targets in accordance with Art. 76 (2) sentence 2 CRD VI.
- **Increasing complexity of the regulatory and market-related framework conditions for the proper business organization of institutions and their influence on remuneration:** the continuing increase in the complexity of the proper business organization of institutions requires, among other things, a constant further development of the risk strategy and, in particular, risk management and an associated constant increase in the fit and proper requirements for the professional suitability and reliability of managers. This has an impact both on the quantitative level of remuneration for the management board and on the specific structure of the individual remuneration parameters, particularly in the performance parameters of variable remuneration.
- **Focus of the supervisory body's activities on the appropriateness of the specific amount of the total remuneration of the management board members:** the constant – generally quantitatively increasing – development of the total remuneration for the individual management board members requires, among other things, that the assessment of the appropriateness of the specific amount of the total remuneration forms a continued focus of the activities of the supervisory body in the implementation and review of the remuneration systems. The sensitization of the respective supervisory body to ensure quantitative appropriateness results above all from the liability risks of the individual member of the supervisory body from the inappropriate (= unjustifiable in terms of the amount with regard to the relevant assessment parameters) total remuneration[7] and necessitates an increasing concentration of the audit cycles for the regular appropriateness review. Recently, several institutions have begun to condense the regular audit cycle to a period of three years.
- **External influences on the market of institutions and their remuneration systems in the E.U.:** these external influences result from the relaxation of the remuneration law framework in the U.K. following the implementation of Brexit[8] and also from the intensification of the hiring competition for suitable managers between the individual institutions in the institutional market and also between institutions and companies in the financial services sector that are not subject to any special regulatory requirements for the remuneration systems of managers (e.g., private equity market) or, from the perspective of the individual managers, are subject to more generous regulatory requirements compared to the institution-specific requirements.[9]
- **Active involvement of the shareholders/owners of the institution in the organisation of the remuneration systems:** recently, this active involvement in listed institutions has been driven in particular by proxy advisors for shareholders who, in annually published statements (policy guidelines), set out specific expectations

[7] This applies, for example, to the supervisory board of institutions in the legal form of a stock corporation based in Germany under Section 93 AktG.

[8] With effect from 31 December 2023, the legislator abolished the upper limit of 200% for the ratio between variable remuneration and fixed remuneration, which until then also applied to institutions domiciled in the U.K. (https://tinyurl.com/4sxfujpn).

[9] For example, the regulatory requirements for the remuneration systems of the management board members of medium-sized investment institutions in accordance with the national implementing legislation of Directive 2019/2034/EU (IFD) and of capital management companies in accordance with the national implementing legislation of Directives 2011/61/EU (AIFD) and 2014/91/EU (UCITS), there is no absolute upper limit for the ratio between fixed and variable remuneration and, moreover, a more generous option than the requirements for banks to apply the principle of proportionality under supervisory law with the possibility of opting out of individual regulatory requirements on variable remuneration (e.g., on deferral, on variable remuneration). For example, on deferral, the application of malus and claw back regulations and the establishment of the remuneration component based on the sustainable performance of the institution (NWE component)].

and requirements for the content of the remuneration systems, particularly with regard to performance-based variable remuneration[10] and thus significantly influence the voting behavior of shareholders with regard to the "say on pay" decision on remuneration in accordance with Art. 9 of Directive 2017/828/EU and the relevant national legal implementation regulations.[11,12]

This article takes this current status quo as an opportunity to discuss individual selected topics in the current implementation of remuneration systems for management board members in more detail, with a focus on the tension that regularly arises in remuneration practice between the regulatory and labor law framework, behavioral economics and (market) practice. The regulatory legal bases generally refer to the provisions of CRD VI – for reasons of a more comprehensible presentation – and cover topics that the national legislators of the individual E.U. member states have transposed into domestic law with the same content.[13]

2. FIVE BASIC PARAMETERS FOR THE REMUNERATION SYSTEMS OF MANAGEMENT BOARD MEMBERS AND THEIR CURRENT ADAPTATION IN REMUNERATION PRACTICE

In practice, the implementation of remuneration systems and the remuneration governance of management board members continue to focus primarily on the following five basic parameters for the content of variable remuneration and can be summarized with the following practical implications:

2.1 Remuneration strategy as strategic implementation of the business and risk strategy in the remuneration systems – and its operationalization with the fixed and variable remuneration components and the respective specific remuneration parameters

The remuneration strategy forms the strategic core and starting point for the regulatory-compliant and supervisory-compliant implementation of the legal framework for the content of the remuneration systems and remuneration governance [Art. 74 (1) CRD VI]. It must ensure that the institution's objectives set out in the business strategy and the regulatory-compliant management of the risks arising from the implementation of the business strategy in accordance with the risk strategy are (also) implemented in the remuneration systems for the management board members – not only reactively by ensuring that the remuneration strategy is in line with the business and risk strategy of the institution, but ideally also actively from a regulatory perspective by setting remuneration parameters that promote the business and risk strategy.

Institutions must update their remuneration strategy to implement this regulatory requirement. To this end, the supervisory authorities require a standardized process that includes regular risk measurement and assessment of the impact of the management's activities on the institution's risk profile.[14] This risk-sensitive management – as a component of risk management – must include the interaction between the management function of the management board members and the risk profile of the institution and the updating of the needs-based monetary behavior management through the remuneration system. It is operationalized by defining the individual fixed and variable remuneration parameters in the remuneration system of the management board and their respective specific remuneration parameters; in particular in the specific structure of the performance-based variable remuneration. Changes to the business and risk strategy can then require either the readjustment of existing remuneration components and/or remuneration parameters or the – temporary – introduction of new remuneration components and/or remuneration parameters.

Current practical examples of such situational temporary remuneration components include new functional allowances, which can be introduced as fixed remuneration components from a regulatory perspective if they remunerate a temporarily assumed more demanding task, function or organizational responsibility in addition to the regular function under the employment contract. From a regulatory perspective, the introduction of such a functional allowance for the management board is associated with the challenge that the overall responsibility of the institution's management board

[10] See the current versions of the policy guidelines of Glass Lewis (https://tinyurl.com/3pu7smky) and ISS (https://tinyurl.com/ewhh9r87), which are very present in remuneration practice.

[11] In Germany, for example, regulated in Section 120a AktG. For more details on Section 120a AktG, see BeckOGKAG/Hoffmann, edition as at 01.02.2022, Section 120a AktG, margin no. 1 et seq.

[12] On this and on individual listed companies where the shareholders have rejected the management board members' remuneration system on the basis of a corresponding recommendation by the proxy advisors, see only Lünstroth, P., and T. Blumenstein, 2022, "Vorstandsvergütung auf verpflichtend auf dem Prüfstand," https://tinyurl.com/436h6t3w

[13] An overview of the domestic supervisory regulations adopted by the individual E.U. member states to implement the requirements of the CRD is published on the EBA website (https://tinyurl.com/446vesev)

[14] See para. 199 EBA-GSR 2.0.

generally encompasses all operational and strategic topics, regardless of whether these are part of regular operations or have a temporary impact on the institution due to extraordinary internal or external factors – this makes it difficult in practice to distinguish between the "temporarily more demanding" task remunerated with the functional allowance and the fixed (basic) remuneration determined for the overall responsibility of the institution. It is, therefore, only permissible under supervisory law in individual cases if, for example, in the case of a departmental distribution of the individual areas of responsibility in the overall board of directors, individual management board members take on special additional operational tasks that result primarily from external influences and can be sufficiently clearly distinguished from the regular activities in the overall board-related responsibility. Recent practical examples include the granting of a functional allowance for institutions affected by Brexit, including for the extensive coordination with the respective supervisory authorities in the readjustment of business operations associated with Brexit.

This case-by-case adjustment of board remuneration is to be welcomed from a behavioral economics perspective, as it can restore the all-important "alignment of interests" in the context of the existing "principal-agent conflict".[15] The diverging interests of headmasters and agents can otherwise have a negative impact, particularly in the event of "information asymmetries". Examples of how information asymmetries can have a negative impact arise in the situations in question, for example in the form of "hidden actions" or "hidden information". This can be the case if board members act in a way that benefits them on the basis of information made available only to them but not to the headmasters,[16] but use this advantage against the headmasters.

2.2 Determination and derivation of the performance-based remuneration parameters of the variable remuneration from the levels of institution/group, organizational unit and individual performance contributions of the individual management board member with a multi-year assessment period

The performance-based remuneration parameters of the variable remuneration operationalize the guiding principles of the remuneration strategy in the implementation of the remuneration system in the respective reference period. The regulatory requirements stipulate that the assessment parameters such as performance-related targets for the specific reference period must include the levels of the institution/group, the organizational unit, and the individual performance contributions of the individual manager (Art. 94 (1) lit. a) CRD VI) and that the performance assessment must generally take place within a multi-year framework that takes into account the business cycle and the business risks of the institution [Art. 94 (1) lit. b) CRD VI]. The individual targets must contain quantitative and qualitative performance criteria [Art. 94 (1) lit. a) CRD VI], whereby the EBA would also like to see the qualitative performance criteria applied to the levels of the institution and the organizational unit.[17] These graduated regulatory requirements for the content of the performance-based remuneration parameters are intended to ensure that all relevant risks quantified in the on- and off-balance sheet items are taken into account in the measurement of variable remuneration across all financial years.[18] The allocation of the relevant risks in the quantitative and qualitative targets at the individual levels is intended to ensure dedicated risk and behavior management.

In remuneration practice, the implementation of these regulatory requirements for the performance parameters of the management board members is associated with the challenge that the management board members, by virtue of their overall responsibility for the institution under company law, have a management-related responsibility for all significant risks. On the one hand, the organ-related overall responsibility comprises the factual level, according to which the management board must operationalize all substantive

[15] Stadler, M., 2010, "Shareholder activism by hedge funds"; studies from the U.S. have shown that improvements in corporate governance help to reduce agency costs, Millstein, I. M., and P. W. MacAvoy, 1998, "The active board of directors and performance of the large publicly traded corporation," Columbia Law Review, 1283, 1317 f.; see also: Siemens, P., 2023, Die aktienrechtliche Entlastung, Duncker & Humblot Gmbh

[16] In the stock corporation, the principals are only entitled to the information the agents provide to them, Redenius-Hövermann, J., 2019, Verhalten im Unternehmensrecht, Mohr Siebeck

[17] Para. 231 EBA-GSR 2.0.

[18] See para. 220 et seq. EBA-GSR 2.0

issues relating to the institution's business operations as part of operational management.[19] On the other hand, it includes the committee-related level, according to which the individual management board members remain responsible for the overall operational management of the institution even if the individual tasks are allocated on a departmental basis – as is customary in practice – and are, therefore, subject to the organ-related duties to control and monitor the other management board members in the implementation of the management with regard to the departmental allocation of tasks.[20]

This organ-related overall responsibility means that in individual cases, particularly at the organizational unit level, institutions are unable to allocate the relevant risks in a practical manner for behavioral and risk management as required by supervisory law and set suitable targets as assessment parameters for performance-based variable remuneration in order to achieve the aforementioned regulatory purpose. Against this background, individual supervisory authorities accept a combination of the organizational unit levels and the individual performance contributions for the determination of the assessment parameters, with the standardized view that the individual performance contribution and the performance contribution of the organizational unit (may) largely overlap.[21] From a supervisory perspective, the combination of the levels of the institution's/group's objectives and the organizational unit is equivalent to such a cumulative determination of the individual target parameters with regard to the purpose of holistic risk allocation – it can even operationalize the overall responsibility of the body in an even more determined manner and control the mutual monitoring and supervision between the individual management board members of the institution and the individual departments.

From a behavioral economics perspective, care must be taken to avoid "short-termism" in this context. In particular, variable remuneration must not be based on targets that have too short an assessment period. In this respect, recommendation G.10 sentence 1 and G. 10 sentence 2 of the German Corporate Governance Codex (DCGK), which recommend predominantly share-based remuneration and a four-year holding period, are to be welcomed.[22]

2.3 Ex-ante risk adjustment of variable remuneration: Delimitation of negative performance contributions from compensation, proper business judgment rule on the part of management in the assessment of negative performance contributions

According to the legislator's understanding, ex-ante risk adjustment – mirroring the determination of the remuneration parameters – involves considering the change in the relevant risks (up to their occurrence in individual cases) in the respective reference period when determining the performance-based variable remuneration. It essentially comprises, in accordance with Art. 94 (1) lit. n) CRD VI, for the respective reference period: (1) assessment of the specific target achievement for the individual assessment parameters (and here in particular a negative deviation from the agreed targets, "negative target achievement"), (2) assessment of the development of risks and their impact on the economic and financial performance of the institution (and here in particular on the earnings situation), and (3) actions of the individual management board member that are incompatible with the risk strategy and risk management of the institution, insofar as these have had an impact on the risk profile of the institution (negative individual performance contributions of the management board member). If such risks have materialized primarily in the form of negative performance contributions by the institution and/or negative individual performance contributions by the individual management board member, institutions should make a risk adjustment as a reduction in the (total) amount of variable remuneration, which in individual cases may lead to a complete cancellation of the variable remuneration in the respective reference period if the management board member was involved in, or responsible for, behavior that led to significant losses for the institution (Art. 94 (1) lit. n) sentence 5 lit. (i) CRD VI) or has not met the appropriate standards in terms of suitability and behavior [Art. 94 (1) lit. n) sentence 5 lit. (ii) CRD VI)].

In remuneration practice, the implementation of these regulatory requirements from a labor law perspective is associated with the challenge, particularly for the assessment of any individual negative performance contributions of the individual management board member, of assessing

[19] See Fleischer, H,m 2003, "Zum Grundsatz der Gesamtverantwortung im Aktienrecht," Neue Zeitschrift für Gesellschaftsrecht 6, 449-459, on institutions domiciled in Germany in the legal form of a stock corporation with Section 77 (1) s. 1 AktG as the relevant legal source.

[20] See instead of all BeckOGK AktG/Fleischer, edition as at 02/2024, Section 77 AktG margin nos. 53 et seq.

[21] See BaFin FAQ IVV, question 15.

[22] Kremer, T., G. Bachmann, M. Lutter, A. von Werder, and H-M. Ringleb, 2023, Deutscher Corporate Governance Kodex, 9th edition, Beck C. H., G.10 para. 2; see also Siemens (2023)

any reduction in variable remuneration to be made under supervisory law in conjunction with and, at the same time, in distinction to any claims for damages of the institution against the management board member resulting from the (co-) involved or responsible conduct of the management board member and, in the present context, essentially resulting from the breach of the management board member's organ-related duties to properly manage the business.[23] The interplay and delimitation must be assessed on the basis of the purpose of the ex-ante risk adjustment and the granting of corresponding organ-related claims for damages by the institution against the management board member: the ex-ante risk adjustment is intended to ensure the holistic consideration of the change in the allocated risks in the reference period on the variable remuneration and, according to the supervisory model of the legislator and the supervisory authority, should, therefore, be carried out at the starting point in all manifestations and here in particular for any negative individual performance contributions of the individual management board member regardless of fault.[24]

In contrast, the award of the institution's organ-related claim for damages against the individual management board member due to an organ-related breach of duty is based on a compensatory function and is intended to protect the company's assets, and thus ultimately also the shareholders and creditors of the institution, from losses incurred by the institution due to a breach of the organ-related duties of care of the individual management board member in the management of the business.[25] It is subject to the principle of fault[26] in view of the management of the assets of the institution's shareholders as third-party assets associated with the organ-related management and the associated obligation to protect the interests of the individual stakeholders, which in addition to the shareholders also include the employees and the general public, and, therefore, requires at least a negligent or intentional breach of the duty(s) relevant to damages by the management board member (fault-based organ-related liability of the management board member). In this respect, the compensation function of the organ-related claim for damages relating to the protection of the institution's assets overlaps with the ex-ante risk adjustment.

The relevant legal bases under company/labor law for fault-based liability of directors and officers provide the individual director with a liability-free entrepreneurial decision-making scope in accordance with the business/legal judgment rule, according to which the breach of duty giving rise to liability does not exist if the individual director makes the specific management decision on the basis of an uncertain factual situation (business judgment rule) or a legally ambiguous legal situation (legal judgment rule), an ambiguous legal question that is controversial in its legal application and has not been clarified by the highest court (legal judgment rule) on the basis of appropriate decisions for the benefit of the institution.[27] If the specific management decision within the framework of the business/legal judgment rule causes damage to the institution in the further course of time, the management board member can counter the proper application of the business/legal judgment rule with the institution's claim for damages.[28] In view of the overlap between the protective purposes of ex-ante risk adjustment and the compensatory function of the institution's organ-related claim for damages against the management board member, there are strong reasons from a teleological perspective to extend the scope of application of the business/legal judgment rule to individual negative contributions to success by the management board member that include the management board member's involvement in a fact/action, which has led to significant losses for the institution and, in this case group, to deny a reduction of the variable remuneration to the extent of the complete cancellation of the variable remuneration for the relevant reference period if the management board member can invoke the proper application of the legal/business Judgement rule with regard to the management decision relevant to the participation that resulted in the occurrence of the significant loss at the institution.

[23] The legal basis for such claims for damages for institutions based in Germany in the legal form of an AG/SE is Section 93 AktG (in conjunction with Art. 51 Regulation (EC)/2157(2001) (SE Regulation)). Art. 51 VO (EG)/2157(2001 (SE-VO)) or in the legal form of a GmbH Section 43 GmbHG.
[24] See Buscher, A. M., C. von Harbou, V. Link, and T. Weigl, 2018, Verordnung über die aufsichtsrechtlichen Anforderungen an Vergütungssysteme von Instituten, 2nd edition, Schäffer-Poeschel, Section 18 InstitutsVergV marginal no. 119.
[25] See MüKoAktG/Spindler, 2023, 6th edition (https://tinyurl.com/56eyf6td), § 93 AktG marginal no. 1 on this protective purpose of the institution's claim for damages due to a breach of the duty of care of corporate bodies.
[26] See MüKoAktG/Spindler, Section 93 AktG marginal no. 5.
[27] On these legal principles for the application of the business/legal judgment rule instead of all MüKoAktG/Spindler, Section 93 AktG marginal no. 48 et seq.
[28] For this legal consequence of the proper application of the business/legal judgment rule, see MünchKommAktG/Spindler, Section 93 AktG marginal no. 46.

With regard to directors' and officers' liability, the behavioral control of the board member before any damage occurs must be emphasized from a behavioral science perspective. The assertion of claims for damages is crucial here. De lege lata, however, there are considerable enforcement deficits here.[29] In this respect, the use of claw backs to close this gap, which is not required by law but recommended in recommendation G.11 sentence 2 DCGK, is worthy of discussion. Furthermore, the reform of directors' and officers' liability should be considered.[30]

2.4 Ex-post risk adjustment through malus and claw back: Labor law transparency of the possible case groups of claw back cases

The ex-post risk adjustment pursuant to Art. 94 (1) lit. n) CRD IV extends the consideration of the change in the relevant risks in accordance with the ex-ante risk adjustment (up to their occurrence in the individual case) in relation to the respective reference period of the variable remuneration over time (1) when determining the individual retained remuneration components of the variable remuneration granted for the respective reference period (malus test), and (2) when assessing whether the significant changes in the relevant risks over time also affect the variable remuneration components already paid out by the institution for the respective reference period and whether the management board member must repay all or part of the variable remuneration components already paid out (claw back test). The period-related assessment of the ex-post risk adjustment must (only) take into account the changes in risks identified at the time of the respective audit that relate to the specific reference period. The malus or claw back test of the relevant reference period, therefore, does not consider the identified change in relevant risks that relate to other reference periods. The ex-post risk adjustment, therefore, generally (only) covers cases in which the event giving rise to the risk occurs in the relevant reference period and the profit contribution resulting from the change in risk (in particular relevant negative profit contributions of the institution) occurs in the respective subsequent period before the malus or claw back test is carried out.

In remuneration practice, the implementation of ex-post risk adjustment (and in particular the claw back test) is associated with the labor law challenge for many institutions that the labor law framework in individual E.U. member states for contract design with the formal transparency requirement sets restrictive requirements for the content of claw back provisions in the employment contract and, in this context, requires in particular a specification of the relevant case groups in the employment contract that go beyond the abstract requirements of Art. 94 (1) lit. n) CRD VI. In addition, several jurisdictions within the scope of CRD VI have implemented the labor law principle that a remuneration component linked to the performance of work – which the performance-based variable remuneration for management board members already has in view of the mandatory individual targets to be established as performance parameters – is generally earned with the performance of the work and can no longer be withdrawn from the management board member.[31] Against this background, any claw back claims are generally only asserted with restraint in remuneration practice in the relevant jurisdictions.

It must be ensured that any claw back or retention options, for example in the form of a reduction in management board remuneration in accordance with Section 87 (2) AktG, are also considered if the conditions of the offence are met.[32] This is obvious in the context of liability claims due to the interest in restitution, but must also be emphasized at the same time due to its effect on behavior.

2.5 Maximum upper limit for variable remuneration

The regulatory requirements stipulate a general upper limit of 100% for the ratio between the fixed remuneration components and the variable remuneration components [Art. 94 (1) lit. g) (i) CRD VI]. This upper limit can be increased by the shareholders of the institution by resolution to a maximum of 200%, whereby the resolution must be based on a recommendation by the institution (= the management board and the supervisory body) with comprehensive documentation of the reasons and the expected impact of the higher upper

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[29] On the problem of the lack of enforcement of liability claims Redenius-Hövermann/Siemens, ZIP 2020, 145 et seq.

[30] Redenius-Hövermann, J., 2024, "Der Aufsichtsrat," pp. 84, 86, which discusses the initial impetus for the reform of directors' and officers' liability.

[31] See for German labor law judgment of the German Federal Labor Court dated November 13, 2013, 10 AZR 848/12.

[32] On a deficit in this regard, which has become particularly apparent in the context of the COVID-19 pandemic: Redenius-Hövermann, J., and P. Siemens, 2022, "Vorstandsvergütung und ESG – Auswirkungen von ARUG II, Corporate Finance Sonderheft "ESG und Konsequenzen für Unternehmensfinanzierung und Finanzanlagen"," 05-06/2022, S. 140 ff. ZIP 2020, 1585 et seq. In this context, de lege ferenda, the mandatory application of the regulation could also be appropriate.

limit on the requirements for a sound capitalization of the institution [Art. 94 (1) lit. g) (ii) CRD VI]. These substantive requirements for the draft resolution are intended to ensure that the institution's basic financial resources are in line with regulatory requirements (especially with regard to capital adequacy) even if such quantitatively higher variable remuneration is granted to the managers (risk management function) and that the shareholders can make the decision to increase the cap in full knowledge of, among other things, the quantitative risk-related effects on the institution's capital adequacy and the associated risk-bearing capacity (transparency function).[33] In order to ensure the continued fulfillment of these two functions, the continued validity of the resolution and the recitals documented in the draft resolution must be regularly reviewed and a new resolution must be passed if necessary.

In practice, it is primarily listed institutions and other institutions organized under private law with cross-border activities in capital market-oriented business areas that apply a higher cap in the E.U. and then generally use the maximum permissible limit of 200%. One of the challenges for these institutions is keeping track of the specific reasons for the increased upper limit, particularly if the number of beneficiary employees changes over time. Suitable reasons for the increased upper limit can be derived from the business strategy and the associated remuneration strategy as well as from a competitive perspective. The remuneration strategy may provide for an increased upper limit in particular if the variable remuneration system provides for a multi-year participation program with real or virtual shares in the institution in addition to the general performance-based remuneration; this is particularly the case in growth business strategies in which the institution wishes to incentivize the individual manager with a benefit from the participation program and/or wishes to retain the manager in the long term by structuring the program in line with requirements (retention element).

The retention element is also the focus when deriving the specific reason from a competitive perspective. Over time, the institution must demonstrate that the specific reasons underlying the decision to increase the cap also exist during the implementation of the remuneration system; with regard to the transparency function, a regular process is required from a regulatory perspective that includes the regular review of the specific reasons, the number of beneficiary employees, and the impact of the higher (cash) benefits resulting from the higher cap on capital adequacy. If the specific reasons no longer exist, the institution must examine whether there are other reasons suitable for a higher cap in relation to the beneficiary managers and adopt a new resolution to increase the cap by the shareholders. A new resolution is also required if the – operational – parameters for capital adequacy change and, therefore, in particular in the event of a reduction in capital adequacy over time, the higher remuneration payments resulting from the increased cap – still – do not have a negative impact on them from a regulatory perspective. In addition, when implementing the increased cap, institutions must generally bear in mind that the higher total remuneration resulting from the higher variable remuneration component gives rise to corresponding expectations among managers, particularly when negotiating the follow-up employment contract for the subsequent appointment period, and that an increase in the fixed remuneration components of the total remuneration may, therefore, become relevant if the cap is reduced as required from a regulatory perspective.

From a behavioral science perspective, it is important to ensure that the target shifting effect, or the self-service effect and group behavior are contained. Control by the annual general meeting or the supervisory authority as well as transparency through the disclosure of remuneration can contribute to this. However, even behavioral research will not be able to determine an exact maximum limit up to which remuneration can still have a performance-enhancing effect. It must also be ensured that other behaviors, such as the lift effect, are not reinforced by disclosure.[34]

[33] See para. 48 EBA-GSR 2.0.

[34] Redenius-Hövermann, J., 2019, "Verhalten im Unternehmensrecht," p. 106 et seq. with further references.

3. CONCLUSION

The practice of remuneration systems for management board members in institutions is based on a (fully) developed legal framework and generally on a common basic understanding of the institution with the supervisory authority and the auditor regarding the specific content requirements, which generally provides the individual institution with reliable planning security in the further implementation of the remuneration systems from a regulatory perspective.

At the same time, individual internal and external dynamic factors influence the further implementation of the remuneration systems for the management board members and continue to require a risk-compliant regular review process for the compatibility of the remuneration systems and their implementation with the regulatory requirements and the operational requirements of the institution, in particular from the updated business and risk strategy.

In particular, in the specific implementation of performance-based variable remuneration, institutions must observe the dependency of the regulatory provisions with the applicable labor law and corporate law framework parameters and bring these into a balanced and practical harmony. To this end, the individual institution must reflect on the relevant legal considerations for the specific implementation of the regulatory requirements within the labor and company law framework and document them in an appropriate manner (above all in relevant legal opinions).

In terms of legal policy, it remains to be discussed whether the current (over)regulation will lead to a "regulatory infarction"[35] in the near future and whether national and European regulators are, therefore, urgently called upon to make adjustments by way of deregulation.

[35] Roland Koch recently coined this term, see 75 Jahre Grundgesetz – 75 Jahre Soziale Marktwirtschaft – LUDWIG-ERHARD-STIFTUNG E.V. (https://tinyurl.com/52hsxusn) or Mit Planwirtschaft wird Klimapolitik scheitern – LUDWIG-ERHARD-STIFTUNG E.V. (https://tinyurl.com/4ym4u3e3). Wolfgang Schön uses the term of "Regulierungsbankrott", see Fachkräftemangel und Überforderung steigen: Bürokratie in Deutschland (faz.net) (https://tinyurl.com/b5sm6jsd).

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