Homburger

Deep Dive
Measures on Variable Remunera-tion

I. Introduction

On April 10, 2024, the Swiss Federal Council published its report on banking stability (the **Report**). The Report provides for a wide-ranging assessment and evaluation of the Swiss too-big-to-fail regime in relation to the circumstances surrounding the crisis that led to the takeover of Credit Suisse by UBS in March 2023.

The Federal Council aims to increase financial stability by implementing 22 regulatory measures under the Swiss banking supervisory regime in the following six fields of action: (i) Corporate Governance and Prudential Supervision, (ii) Capital Requirements, (iii) Early Intervention and Recovery, (iv) Ensuring Liquidity in a Crisis, (v) Resolution Planning, and (vi) Crisis Organization and Cooperation between Authorities.

This Homburger Deep Dive provides an assessment of the measures on variable remuneration as proposed by the Federal Council in order to supplement and strengthen the Corporate Governance and Prudential Supervision.

II. Background

The remuneration system of financial institutions is frequently the subject of political and public debate, both internationally and in Switzerland, particularly in the aftermath of the 2007-08 financial crisis and the takeover of Credit Suisse in March 2023.

A financial institution's reward system can have an impact on its success. Properly designed, it can enhance employee motivation and performance, thereby contributing to the long-term success of the financial institution. However, an inadequately designed remuneration system carries the risk of moral hazard, creating false incentives that can result in short-term profit-seeking and excessive risk-taking.

Remuneration systems of financial institutions are also instruments of risk control. Consequently, there have been global efforts to regulate remuneration at financial institutions, particularly in the wake of the 2007-08 financial crisis.

It is therefore not surprising that the Federal Council also proposes measures on variable remuneration to increase financial stability.

III. Current Legislative Framework

A. Overview

As of today, the primary provisions and regulations regarding remuneration are found in:

— Articles 319–342 of the Swiss Code of Obligations (**CO**) concerning individual employment contracts;

— Article 95, paragraph 3 of the Federal Constitution, and Articles 732–735d CO pertaining to the remuneration of members of the governing bodies of listed companies limited by shares;

— Articles 21 and 25 of the Federal Act on Financial Services (**FinSA**) regarding the appropriate organization of financial service providers; and

- Article 10a of the Federal Banking Act (**BankA**) concerning regulatory measures in the field of remuneration for Systemically Important Banks (**SIBs**).

B. Individual Employment Contract Law

According to Article 322 para. 1 CO, the employer is obligated to remunerate the employee in accordance with the agreed or customary salary, or alternatively, in accordance with the salary stipulated in the standard employment contract or collective employment contract.

Consequently, the employment contract law permits the parties to determine the design of the salary at their discretion, including the type and amount of the salary.

C. Rules on Remuneration of Members of the Governing Bodies of Listed Companies Limited by Shares

According to Article 95 paragraph 3 of the Federal Constitution, the general meeting must vote annually on the total amount of all remuneration of the board of directors, the executive board and the board of advisors. Furthermore, severance payments, advance payments and other special remuneration to members of the board of directors and the executive board are prohibited. Finally, the articles of association must stipulate the amount of credits, loans and pensions payable to members of the board of directors and the executive board, as well as their profit-sharing and equity participation plans. In addition, the articles of association must set forth the number of mandates that may be accepted by members of the executive board outside the group, as well as the duration of employment contracts of members of the executive board. Any individual who violates these provisions may be subject to both a custodial sentence and a monetary penalty.

This constitutional provision was fleshed out and implemented by the Ordinance of 20 November 2013 against Excessive Remuneration in Listed Companies Limited by Shares (**ERCO**), which was transposed into the CO as part of the revision of the law on companies limited by shares. The measures are divided into three areas: transparency through the remuneration report (Articles 734–734f CO), shareholders' co-determination rights in votes on remuneration at the general meeting (Articles 735–735b CO) and the prohibition of unauthorized remuneration (Articles 735c and 735d CO).

D. Articles 21 and 25 FinSA

Article 21 FinSA requires financial service providers to ensure compliance with the duties of conduct set forth in the FinSA through internal regulations and an appropriate organization of operations. This requires that the financial service providers must not offer or pay any remuneration to employees or agents that could lead to conflicts with the rules of conduct under the FinSA.

According to Article 25 FinSA, financial service providers are obligated to implement appropriate organizational measures to prevent conflicts of interest that could arise from the provision of financial services or any disadvantages for clients as a result of conflicts of interest. Article 25 lit. e Ordinance on Financial Services (**FinSO**) specifies that the remuneration system must not create any incentives for employees to disregard statutory duties or to conduct themselves in a manner detrimental to clients.

E. Article 10a BankA

Article 10a BankA stipulates that if a SIB or its group parent company is granted direct or indirect state aid from federal funds despite the implementation of the special requirements, the Federal Council shall simultaneously order measures in the area of remuneration for the duration of the support claimed. In particular, the Federal Council may prohibit the payment of variable remuneration in whole or in part or order adjustments to the remuneration system.

F. FINMA Circular 2010/1

FINMA Circular 2010/1 on remuneration schemes represents a summary of the supervisory practice of FINMA, outlining ten principles as minimum standards for design, implementation and disclosure of remuneration systems at financial institutions:

- Principle 1: The board of directors is responsible for the design and implementation of a remuneration policy. It issues remuneration rules that cover all employees of the financial institution.
- Principle 2: The remuneration scheme is simple, transparent, implementable and with a long-term orientation.
- Principle 3: The financial institution's independent control functions and experts are involved in designing and applying the remuneration policy and rules.
- Principle 4: The structure and level of total remuneration are aligned with the financial institution's risk policies and designed so as to enhance risk awareness. The remuneration should be in proportion to a person's strategic or operational responsibility and the risks they take or are responsible for. All significant risks attributable to a person's sphere of influence must be considered in this context. Neither the nature of the remuneration nor the criteria applicable for its allocation must create any incentive for the taking of inappropriate risks or for the violation of applicable law, regulations, internal rules or agreements.
- Principle 5: Variable remuneration is funded through the long-term economic performance of the financial institution.
- Principle 6: Variable remuneration shall be granted according to sustainable criteria that reflect the financial institution's business and risk policies. A serious violation of internal rules or external provisions shall result in a reduction or forfeiture of variable remuneration (malus).
- Principle 7: Deferrals must be structured in a manner that links remuneration with the future development of performance and risk. Deferred remuneration must be structured in such a way as to promote optimally the risk awareness of the beneficiaries and encourage them to operate the business in a sustainable manner. The time period should be based on the time horizon of the risks the beneficiary is responsible for. For members of senior management and individuals with relatively high total remuneration, as well as individuals whose activities have a significant influence on the risk profile of the financial institution, the deferral period should be a minimum of three years. The greater the responsibility of a beneficiary and the greater their total remuneration, the greater the percentage of their remuneration that shall be deferred. For members of senior management, for individuals with relatively high total remuneration, and for individuals whose activities have a significant

influence on the risk profile of the financial institution, a significant percentage of remuneration is to be subject to deferred payment.

— Principle 8: Control functions are remunerated in a way so as to avoid conflicts of interest.

— Principle 9: The board of directors shall report annually on the implementation of the remuneration policy.

— Principle 10: Any deviation from these principles is permissible only in justified exceptional circumstances and must be disclosed (“comply or explain” approach).

The objective of FINMA Circular 2010/1 and the principles listed therein is to ensure that remuneration systems at financial institutions do not create incentives for the taking of inappropriate risks.

The implementation of FINMA Circular 2010/1 is only mandatory for banks that are required to maintain equity capital in the amount of at least CHF 10 billion. All other banks are not required to implement the circular, but the circular recommends that they consider its principles as best practice guidelines for their remuneration schemes.

G. No Definition of Bonus under Swiss Law

Swiss law does not contain any specific provisions defining or regulating variable remuneration (bonuses). While individual employment contract law refers to the terms "*salary*" (cf. Article 322 CO) and "*gratification*" (cf. Article 322d CO), the rules on remuneration of members of the governing bodies of listed companies limited by shares use the term of "*remuneration*" (cf. Articles 734 et seq. CO).

FINMA Circular 2010/1 defines variable remuneration as follows: "*Any part of the total remuneration, the granting or the amount of which is at the discretion of the firm or which is contingent on fulfilment of predefined conditions. This includes remuneration contingent on performance or meeting certain targets such as brokerage fees or commissions. Sign-on payments or severance payments also fall within the scope of the definition of variable remuneration*."

Consequently, variable remuneration (bonuses) is a generic term for a variety of total remuneration instruments that supplement employees' basic remuneration. Depending on the objectives, the models can be based on different parameters such as performance, turnover or profit, different time horizons, and can take different forms.

H. Distinction between Salary and Gratuity

Under Swiss law, variable remuneration is either a salary component or a gratuity component. This distinction is of great importance, since the gratuity regime is much more flexible for the employer than the one applicable to salary elements. While salaries are typically considered to be owed unconditionally, gratuities may be subject to conditions (including, but not limited to, malus).

In general, variable remuneration is regarded as a gratuity rather than a salary component if the employer has reserved discretionary powers in determining it. This means that the variable remuneration must not be fixed or objectively determinable and depend on the employer's goodwill. However, if the variable remuneration is determined or objectively determinable, the employee is entitled to it. In this instance, the employer is obligated to fulfil their obligation to remunerate the employee in accordance with the agreed terms. The variable remuneration must be considered a variable component of the salary. The extent to which such discretion exists must be determined by interpreting the employment contract, including any remuneration plans, which form an integral part of the employment contract. Even if the employer has discretion in determining the variable remuneration, it may be considered a salary component if it is significantly higher than the annual salary. This is because gratuities must remain ancillary to the salary. However, in the case of very high incomes, the criterion of accessoriality does not apply.

I. Possibility of Malus and Clawbacks under Swiss Law

Swiss law does not contain a general provision that would permit the imposition of a malus or clawback on variable remuneration. Pursuant to Article 10a BankA, the Federal Council is authorized to instruct a SIB or its group parent company to cancel or reduce the variable remuneration of their employees in the event that they have received direct or indirect state aid. However, due to the specific wording of Article 10a BankA ("*to prohibit the payment of variable remuneration in whole or in part*"), its applicability is currently limited to remuneration that has not yet been paid out.

Consequently, Swiss law currently does not provide for a statutory clawback. Nevertheless, Swiss labor law permits the recovery of remuneration already paid out (clawback), provided that the following conditions are met: (i) the remuneration in question qualifies as a gratuity and not a salary, (ii) the employer has expressly reserved the right of recovery, and (iii) this right of recovery is a valid part of the individual employment contract or a separate agreement on variable remuneration.

Under Swiss law, claims arising from employment contracts are subject to a limitation period of five years. Therefore, any clawback claims may also be subject to a five-year limitation period, beginning from the date of the clawback event.

IV. Measures Suggested by the Federal Council

The Federal Council proposes the following measures:

- **New requirements for remuneration systems**: The introduction of a legal basis for requirements for remuneration systems for SIBs and potentially all banks to prevent false incentives.
  - **Clear conditions for payment of variable remuneration**: The remuneration system would establish a clear connection between the remuneration provisions and the financial institution's risk-taking, thereby promoting risk-responsible behavior. The remuneration provisions would be linked to a possible senior managers regime, which has yet to be introduced.
  - **Extending deferrals of variable remuneration by introducing retention periods:** The postponement of the remuneration of variable components would reduce the probability of misconduct while also encouraging employees to remain at the same institutions for longer periods, thus enabling the monitoring of performance over a longer duration. Furthermore, this would permit the cancellation of variable remuneration that

has already been allocated but not yet paid (malus) to be carried out with greater ease.

- **Clawbacks:** Clawbacks would permit financial institutions to recover remuneration that has already been paid, subject to certain conditions (clawback events). The clawback would be exercised by the financial institution, either of its own initiative or at the direction of the FINMA. Without limitation, it is proposed that the Federal Council can oblige a SIB that has received state aid from federal funds to clawback variable remuneration.
- **Sanctions**: The primary responsibility for penalizing employees for misconduct would lie with the financial institutions themselves, through remuneration-related measures. Only if a financial institution fails to do this, would FINMA intervene.
- **No Remuneration Cap ("Bonus Cap"):** The Federal Council determined that capping or even banning variable remuneration would not be an effective measure and might even have drawbacks based on empirical evidence.

— **Senior managers regime:** Introduction of a senior manager regime for SIBs in particular. A senior manager regime is designed to ensure that responsibilities are assigned, documented and fulfilled at the senior management level. This includes members of the board of directors and executive management, as well as in the case of larger institutions, lower-level managers with significant decision-making authority.

V. Assessment

Currently, Switzerland has some of the strongest “say-on-pay” rules of any jurisdiction. However, there are – with a few very specific exceptions (e.g., Articles 21 and 25 FinSA and Article 10a BankA) – no statutory regulations on variable remuneration, particularly with regard to violations of supervisory law. FINMA Circular 2010/1 is based on general standards relating to organization and, as a codified supervisory practice, is not legislative in character. It is general in nature and does not, for example, cover all aspects of the corresponding FSB principles.

The introduction of an explicit legal basis would allow the fundamental requirements for remuneration systems and the supervisory authority’s intervention options to be defined and strengthened, thus improving the prevention of misconduct caused by false incentives. This measure would involve raising selected provisions of FINMA Circular 2010/1 to a higher regulatory level. When implementing remuneration system requirements, it is essential to clarify the relationship between the new provisions and existing labor law provisions to avoid contradictions and friction. The Federal Council has not yet determined whether the proposed legal basis will be applicable only to SIBs or to other financial institutions as well. As part of the implementation process, it will be essential to ensure that the requirements are tailored to the specific situations of various categories of banks, taking into account their size, complexity, and risk profile. In other words, small and low-risk banks with a simple business model should be subject to minimal requirements, while large and risky institutions with a heterogeneous business and organizational model must expect stricter obligations.

The implementation of deferral of variable remuneration through the introduction of retention periods would bring Switzerland into alignment with many other jurisdictions. However, the Report does not make any specific proposals on the design of the retention periods. In this context, it is important to note that empirical evidence indicates that extending the retention period may result in higher remuneration for the most senior executives of financial institutions.

The implementation of clawback provisions would serve to discourage excessive risk-taking while appealing to the public's sense of fair play. However, the Report does not make any specific proposals on the design of such clawbacks. Furthermore, the positive effects of such provisions should not be overestimated. Firstly, the empirical evidence on the impact of clawbacks is limited and is primarily based on data from the USA and from industries outside the financial sector. Secondly, there is some evidence that clawback provisions lead to higher executive remuneration. Thirdly, clawback provisions have only been successfully enforced in a few cases in the financial industry worldwide, due to numerous legal challenges.

The Federal Council's decision not to implement a cap on variable remuneration ("Bonus Cap") was a prudent one. Empirical evidence suggests that such a cap would likely lead to an increase in fixed salaries at financial institutions, which could limit the scope for cost-cutting, particularly in the context of a crisis. Furthermore, it is possible that capping variable remuneration could eliminate its positive effects on entrepreneurial activity, resulting in financial institutions not performing to their full potential. Another potential consequence is that skilled and talented employees may relocate to jurisdictions where such restrictions do not exist or be employed in another location and seconded to Switzerland.

The introduction of a senior managers regime is inspired by the financial market regulation in the United Kingdom. This allocation of responsibilities, combined with the possibility of appropriate sanctions (e.g., a reduction in variable remuneration or industry ban) against the senior manager concerned, would facilitate accountability for both FINMA and the financial institutions. Given that the sanctions would be focused on remuneration-related measures taken by the bank itself, it is clear that the senior managers regime would have to be closely interlinked with the remuneration system. The Federal Council has not yet determined whether the proposed senior managers regime will be applicable only to SIBs or to other financial institutions as well. In our opinion, the senior managers regime should focus on SIBs, given the far-reaching consequences of the failure of such a financial institution.

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