Update on CRDIII Implementation: Part 2 Convergence of EU Regulations

By Lex Verweij
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On 10 December 2010, the Committee of European banking Supervisors (CEBS) published the final guidelines on implementation of the Capital Requirements Directive (CRD)III remuneration regulations in the EU and on 17 December, the UK Financial Services Authority (FSA) published the associated Revised Remuneration Code.

Whilst CEBS has set guidelines which apply to all EU member states, the FSA Remuneration Code is the relevant interpretation of these guidelines for institutions operating in the UK. The CRDIII will come into effect as of 1/1/2011 for all EU member states. Implementation in other EU member states will follow a similar path as the UK and so far we have not seen material differences (although there are some local nuances). Both Germany and France are drafting laws which will cover the CRDIII as of 1/1/2011. Other states will implement the CRDIII as part of the banking oversight mandate of their Central Banks (e.g., Netherlands, Belgium, Spain, Italy).

Certainty on some of the major differences / issues

After months of speculation, we now have certainty on a number of aspects of the CRDIII.

- The FSA has now, in-line with the CEBS, adopted the principal that 50% of both the total upfront and total deferred amount for code staff should be awarded in shares or non-cash based alternative instruments. This is separate to the requirement of a 40-60% individual deferral for Identified or Code staff.
- Guaranteed bonuses can no longer be granted to either identified or non identified staff. The one exception is for new staff in their first year of employment at the institution.
- Severance payments, benefits and pensions are all explicitly included within the scope of the provisions and hedging is outlawed.
- Both the CEBS and the FSA have defined specific conditions for proportionality. Though the exact numerical requirements in the CRDIII can not be changed in any way by an individual member state, the implementation of the CRDIII does allow for proportionality to warrant exemption from some of the rules. This proportionality is based on the size, scope, complexity and risk of the institution and to a certain extent, allows institutional and individual exemptions from specific aspects of the regulations.

However, we still have not received guidance on the non-cash based instruments. Much of the speculation is about instruments such as Contingent Convertible bonds (CoCo's) as this instrument is directly addressed in the original Basel documentation on Capital Requirements. Given that these instruments are expensive (interest bearing with a risk premium) and that the market might not be overly enthusiastic about investing in CoCo's, we do not expect this alternative to be as widely applied as was speculated. Much more likely (particularly in the short term), is that firms who are not listed will create phantom or stock appreciation rights instruments with additional capital ratio and profitability measures attached to the pay-out.

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Summary of CEBS and FSA

Following our initial alert on the CRDIII, below we have summarised some of the main aspects of both updated documents where we now find more detailed definitions and guidelines. There are some differences in definitions, but both documents are well aligned. Where applicable, we have quoted the document (FSA or CEBS) that appears to be most clearly defined on the specific issue.

Scope and implementation of CRDIII

- Credit Institutions and Investment Firms—the remuneration rules are applied proportionally to the risk, size and complexity of the firm. (CEBS and FSA, see FSA table below) For EU based firms and EU staff of foreign firms who were in scope last year, the rules apply to any remuneration paid out after 1/1/2011. (CEBS and FSA)
- For firms new to the regulatory scope, a transition will be applied where certain aspects of the regulations (e.g., share based 50% of remuneration for non listed firms and deferral practice) will have to be implemented during 2011. (FSA)
- A subsidiary firm can be assessed independently on proportionality from the Parent or the Group level. (FSA)
- For foreign branches of EU based firms in countries where remuneration rules generally are not applied locally, branches can be exempted from the rules based on proportionality unless they represent potential systemic risk. (CEBS)

Remuneration rules for identified staff (code staff in UK)

- 50% of variable pay should be awarded in shares or an alternative non cash based instrument.
- 40-60% of variable pay should be deferred for 3 to 5 years, where 60% should be applied to the higher bonuses (this is only within the identified staff population).
  - **Difference** - FSA considers £500k variable as a "higher bonus." CEBS advises firms to rank bonuses from high to low and determine which group is clearly paid at the higher end.
- Additionally, the overall deferral percentage should be 50% on average for the whole indentified staff group.
- Deferral can only have a malus applied to vesting and no upside potential other than the share price appreciation on the equity deferral.
- An appropriate retention period should be applied to both the upfront 50% in shares or alternative instruments and to all vested deferrals.
- The combination of rules may result in a 20% maximum 'cash' incentive for some code staff.

Determination of who falls within identified/code staff

- The CEBS Identified staff definition: executives, senior management and heads of control staff, as well as risk takers who are paid at the same level.
- The FSA Code staff defines this level of pay as a minimum of £500k total remuneration with a minimum of 33% in variable pay ('de minimis' condition).
- CEBS advises to rank staff on remuneration and consider the higher ranked staff by compensation as potential risk takers.

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Disclosure

Contrary to expectations, the disclosure rules have been universally agreed. As a result, institutions must disclose remuneration aggregated by division for senior management and material risk takers including information on the performance link and design characteristics of the plan (criteria, measures, fixed vs variable, amounts and forms of awards, deferred and vested, sign on, severance, etc.). On an individual level, the year's highest severance payment must be disclosed. Local implementation may lead to some differences in disclosure practices.

Proportionality

Both CEBS and FSA allow for proportionality to be used in determining exceptions to the regulations. In essence, this means that some firms will be exempted from some aspects of CRDIII due to their nature and size.

Note however that for identified staff within an 'in scope' institution, the minimum amount of deferral is 40-60% and the minimum deferral period remains 3 years.

The FSA has produced a useful table where institutions are classified in Tiers noting which rules can be 'disapplied':

Tier/ capital resources in £	Disapplied Rules (additional per Tier)
Tier 1: Banks over 1bn BIPRU (Banking, Building society and Investment firms within Prudential supervision) Investment firms over 750 mi or third country BIPRU with assets over 25bn	- Remco might not be necessary for a firm with overseas parent. UK branch would however need the capability to act in an independent manner - 'De minimis' individual exemption
Tier 2: Banks/Building societies between 50mi and 1bn BIPRU Investment firms between 100 and 750 mi or third country BIPRU with assets between 2 and 25bn	- In some cases unlisted firms may be exempted from shares or alternative non cash based instruments
Tier 3: Any bank, building society and full scope BIPRU investment firm that does not fall in tiers one or two and all third country BIPRU firms that are not in Tier one, two or four	- Deferral requirements, however encouraged to use them to ensure alignment with effective risk management - Performance adjustments for risk and cost of capital
Tier 4: All limited licence and limited activity firms (including third country BIPRU firms with such permissions)	- These firms can consider appropriate level of profit based measurement and risk adjustment and multi year performance framework in line with business activity and firm complexity

Risk alignment and adjustment

Though much of the public attention so far has been on the deferral rules and how this affects cash pay-outs to identified staff, the regulations on risk adjustment and alignment are far more complex and sometimes even more impactful on the reward programs of an institution.

Based on the FSB principles from 2009, both the CEBS and the FSA have expressed their expectations regarding the risk alignment of policies, governance of performance and reward, and specific measures to increase the robustness of 'ex ante' bonus calculations at the institutional and individual level. The regulators provided clarity around some of the definitions in this area - for example, the need to include run off costs in the calculation of profits or the use of return on risk weighted assets.

In addition to these documents, a consultation paper written by the Basel Committee on banking Supervision in October 2010 gives useful guidance on the topic of risk alignment methodologies as a follow up to the FSB principles. Though not formally part of the CRDIII implementation, these guidelines will greatly influence how national supervisors, including the US Federal Reserve Bank will implement risk alignment methodologies.

Based on these guidelines, below we have summarised our recommendations for best practices within the financial services industry.

Aspect	Best practice Basel document	Comments
Governance and culture	An effective Board with support from a Remuneration Committee. Culturally embedded expectations about acceptable and unacceptable behaviour and practices.	Emphasis on a culture where HR processes for recruitment, promotion and appraisals are based on a holistic framework of sustainable performance including behavioural and compliance aspects.
Risk adjustment and performance	Ex ante: economic profit, cost of capital including VaR, and risk weighted return on assets to determine bonus pool allocations as well as qualitative measures. Ex post: deferral with malus applied to tail end risk and performance outcomes.	A substantial group of firms have been applying these adjustments for quite sometime, however we expect to see adoption by an increasing number of firms. A decision on bonus allocation is a delicate process involving quantifiable and non quantifiable criteria. A firm can still decide to cross subsidise business activities as long as the overall bonus allocation is sustainable and justified given the firm's overall performance and risk profile and the discretionary process is transparent and documented. In addition, we expect that remuneration awards will increasingly be based on benchmarking compensation beyond market rates including profitability and risk weighted performance to ensure that pay-outs are justified from a performance and risk profile perspective

Conclusion

Now that the regulations for the EU are aligned, the first challenge for institutions will be to determine exactly how they should apply these regulations to their organisation. Once this step is complete, the organisation will need to then implement these regulations within the time frame applicable to them. Depending on how proportionality affects an institution, the regulations will have a significant impact on ensuring the following:

1. Performance management including the process for calculating and awarding variable pay adheres to the risk alignment requirements;

2. Variable pay is in line with the deferral and equity requirements (in 2011 or 2012) for Identified/Code staff.

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McLagan is supporting clients in all financial sectors around the world as they work to implement the regulations in the most practical and effective way. We have specific benchmarking information available on compensation and risk weighted performance and insight into the interpretation of the regulations that allows us to help firms establish a sustainable approach to pay for performance. ■

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Lex is also involved in advisory work for the FSB, CEBS and national regulators in Europe to help improve alignment between the regulators. He can be reached at +44 (0)20 7680 3809 or lverweij@mclagan.com.

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