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Bonus Cap

Capital Requirements Directive IV

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INTRODUCTION

Negotiators for the European Parliament and European Council reached a provisional agreement on 27 February 2013 on changes to the Capital Requirements Directive (CRD IV), primarily focused on moves towards the implementation of Basel III.

Included in these proposals is the cap on bank bonuses that European Union (EU) politicians have been pushing for. There are still details to be fleshed out; the agreement needs to be set down in writing, EU finance ministers and the European Parliament must ratify the final rules, and aspects of implementation require the European Banking Authority (EBA) to develop new guidance. In the meantime, this Alert summarises the main terms and considers some of the likely impacts.

WHAT HAS BEEN AGREED?

Bonuses will be capped

- The maximum ratio of variable pay to fixed pay will be 100%. This can be increased to 200% with the approval of shareholders.

The bonus cap can be increased if shareholders agree

- Increasing the cap beyond 100% requires a vote in favour from at least 66% of shareholders if shareholders holding at least 50% of shares participate in the vote, or 75% if shareholder turnout is lower.
- The cap cannot be increased any higher than 200%.

The cap will apply to remuneration for performance during 2013

- These rules are expected to be effective from 1 January 2014 and apply to remuneration in respect of performance during 2013.
  Note: Some countries (e.g., UK) have suggested a later effective date (e.g., 1 July 2014, which would take pay for 2013 out of scope), though even if that was agreed it is thought that a few countries would still look to adopt by 1 January 2014.

In practice the scope will vary by jurisdiction and for European vs non-European firms

- The new rules are expected to apply to Identified Staff – the employees that have the most ability to directly influence the risk profile of the firm.
  Note: Separately, the EBA has been consulting on a new Identified Staff definition, based on the level of credit or trading authority compared to firm-wide risk-weighted assets, targeting greater consistency between firms. Any new definition is likely to increase the number of Identified Staff.
- Applies to the global operations of banks headquartered in the EU and European Economic Area (EEA), and employees in the European operations of non-EU/EEA banks.
- CRD applies to 'credit institutions' but in implementing the rules some countries have extended some or all of the rules to other financial services firms like asset managers or insurance companies (e.g., the Netherlands, Germany, UK).
  Note: Switzerland is not part of the EU or EEA but has so far closely followed European regulations. Given the recent vote on executive pay in Switzerland, it is likely that, at least to some extent, the CRD IV bonus cap will be followed as well.

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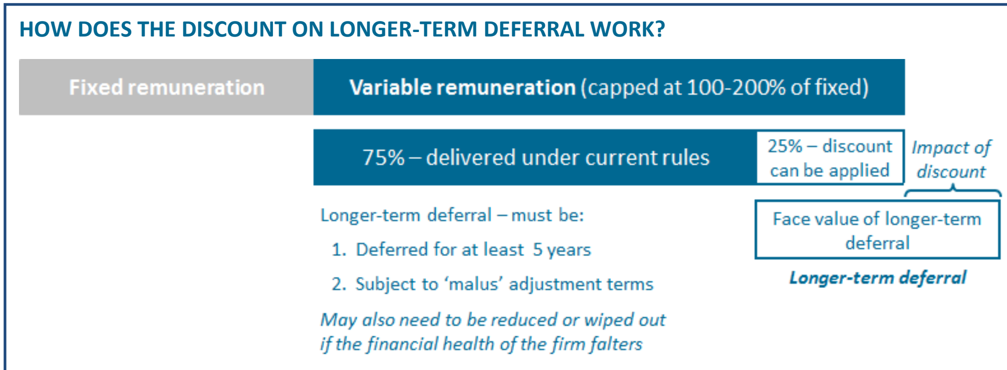
Certain longer-term deferrals can be included at a discount

- If longer-term instruments, deferred for at least 5 years, are used as part of variable pay then firms can include these instruments at a discount to face value when applying the cap.
- The discount can be applied to up to 25% of total variable pay.
- The EBA is to provide more guidance on the longer-term instruments and discount rates, taking account of risk and inflation.
- The instruments are likely to be fully subject to risk-adjustment rules (malus) and may need to be in a form that is reduced or wiped out if the financial health of the firm falters.
- However, European member states will not be obliged to allow the longer-term instruments to be included at a discount. The likelihood is that there will be national differences, with some countries not offering this facility at all.

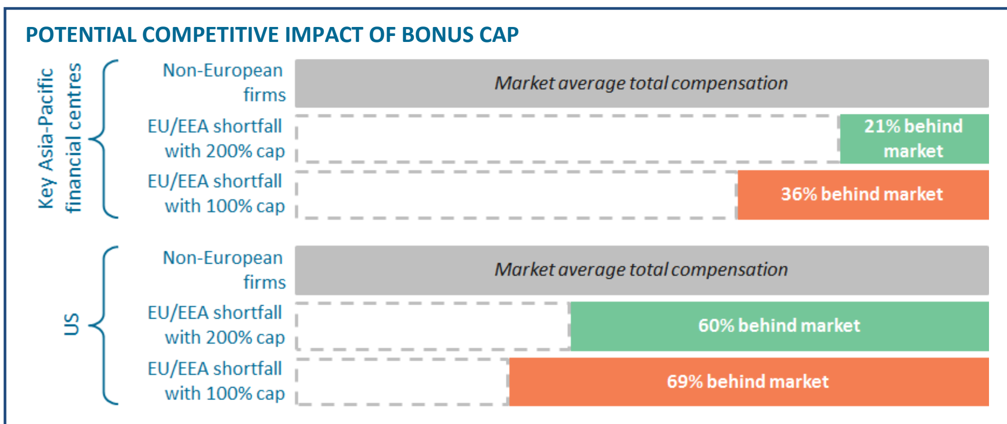


Definitions of fixed and variable pay are likely to change

- Existing EBA guidelines say that fixed pay is all payments or benefits that do not consider performance criteria and variable remuneration is payments or benefits that depend on performance.
- CRD IV may adjust these definitions, potentially including any employee benefits in excess of those required by law as part of variable pay.

WHAT WILL THE IMPACT ON REMUNERATION BE?

Capping variable pay with no other changes will reduce total compensation levels, of course – and arguably this is one intention of European policy-makers. However, this creates its own risks.



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Above we show the potential impact on total compensation competitiveness for large international banks. The coloured bars represent how far behind market compensation the larger Europe-based firms would fall on average, assuming for illustration that the European banks impose a 100%-200% cap on variable remuneration globally across all Managing Directors, while non-European banks cap only their Europe-based MDs.

Meeting caps by cutting bonuses would leave European banks extremely uncompetitive outside Europe, compared to firms where the cap does not apply globally. These differentials – averaging as much as a 69% in the US market – are very significant and would surely result in some key staff moving to non-European firms.

Even within Europe there will be competitive distortions. These rules focus on banks, so in many European jurisdictions other financial services firms will be less constrained. Banks may lose staff impacted by the cap to competitors on the sell-side or in shadow banking. Although European banking-style pay regulations are being extended to other financial services sectors (via directives / regulations such as AIFMD, UCITS V, Solvency II, MIFID and EMIR), these are running on varying timelines and to date include no bonus cap.

European banks will be compelled to act to retain staff.

IS THE ANSWER TO INCREASE FIXED PAY TO STAY COMPETITIVE?

This would be the simplest response to maintain competitive total compensation, in effect 'rebalancing' the pay mix from variable towards fixed. Care is needed to avoid potential knock-on cost impacts on pensions and other benefits if increasing base salary.

Raising fixed pay to maintain prior-year total compensation levels would maintain overall costs but accelerate cost recognition. Applying a 100% bonus cap for impacted employees within Banking & Capital Markets, whilst keeping total compensation whole for incumbents, might result in a short-term increase in the cost-income ratio for the largest global banks of around 3%. That said, previous market shifts in pay mix have taught us that this need not be on a 1-for-1 basis; people value fixed pay, which can be relied on, more than variable pay.

However, there is a fundamental issue with this approach. Historically bank revenue has been volatile but by cutting bonuses firms can also reduce costs year-on-year to take account of changes in performance. Increasing fixed pay would materially increase firms' fixed costs and reduce their ability to manage costs in line with performance. At a time when banks, regulators and governments are all focused on reducing the risks in the banking sector this would work against that goal.

Increasing fixed pay could reduce firms' ability to withstand shocks to the financial system.

SO HOW CAN THIS ISSUE BE MITIGATED?

One possibility is to use fixed pay that is deferred and can be reduced or wiped out in certain circumstances. The definition of fixed vs variable pay under CRD III focuses on whether remuneration is subject to performance but regulators may accept as fixed pay awards of deferred compensation that is forfeited in certain circumstances.

Some form of 'bail-in bond' would be one approach; the value of deferred salary is fixed unless certain financial triggers are reached (e.g., the firm's Core Tier 1 equity falls below a hurdle), at

which point the value of the bond drops to zero. Looking at the US, in recent years some firms have introduced 'Salary Stock', in effect awarding fixed pay in the form of deferred shares, some of which are subject to potential reduction or forfeiture based on firm-wide or individual performance.

It may be possible to deliver fixed pay in a form that can be reduced or removed if financial performance warrants, allowing the firm to reduce fixed costs when appropriate. Several of our clients in Europe are considering this approach and might seek approval from their regulators to implement such plans.

WHAT ABOUT USING MORE LONGER-TERM INSTRUMENTS?

The provisional CRD IV agreement provides for longer-term instruments to count against the bonus cap at a notional discount to face value, provided they are deferred for at least 5 years. Up to 25% of variable pay can be delivered in this way. The EBA is due to provide guidelines on this.

Within those guidelines, the EBA is tasked with defining a discount rate that takes into account factors such as inflation and risk, but also with considering how to incentivise the use of these instruments. A discount focusing on inflation and risk is likely to be relatively modest, and any upside payable on the instruments may off-set the discount. But the desire to incentivise the use of these instruments may result in higher discounts, with a correspondingly greater impact on the face value of instruments that may be awarded.

However, this EBA guidance is likely to take time to develop and publication may well stretch into 2014. If so, it is unclear how different national supervisors would address this, and whether they would allow the use and discounting of longer-term instruments for payments in respect of 2013 performance. The CRD IV negotiations also saw differing views on these instruments between countries, so it is possible that differences in treatment will arise in the national transposition process, with some countries potentially choosing not to allow a discount at all.

The longer-term instruments will allow slightly more compensation to be awarded within the cap but the requirement for the EBA to publish guidance and the likely differences in approach between countries will increase complexity.

WHAT OTHER APPROACHES COULD BE CONSIDERED?

Interestingly, the AIFMD regulations for alternative investment funds consider carried interest and co-investment plans exempt from the variable remuneration deferral requirement. This is primarily because they are not considered to be performance related pay, rather a purely symmetric sharing of returns between the investor and the manager. Following this logic, which is aligned to the FSB principles on symmetry of compensation and risk, carried interest structures could be considered. It is worth noting that CRD III and the CRD IV discussions to date have not directly addressed carried interest structures.

AIFMD also provides another interesting possibility – the adoption of a partnership structure. The European Securities & Markets Authority's (ESMA) guidelines on remuneration under AIFMD state that dividends and other distributions that partners receive as owners of a fund sit outside the AIFMD remuneration guidelines. There is a good chance that the EBA would view these structures in the same way for banks. If so, a bank with a partnership structure

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could distribute profits to partners outside the cap (and also outside remuneration rules on deferral, shares/instruments and so on).

That said, care would be needed, particularly for a firm that was moving to partnership from some other ownership structure. ESMA's AIFMD guidance includes anti-avoidance rules specifying that a partner/dividend mechanism intended to circumvent the remuneration rules will be disregarded, so the remuneration rules will still apply. Other remuneration regulations often include broad anti-avoidance rules.

However, a true symmetric relationship between partners and outside investors, through capital at risk, time horizon and dividend distribution, would at least in principle align with the intentions of regulations going back as far as the original FSB Principles in April 2008.

So potentially firms might look to adopt a partnership structure, in which case profit distributions could be paid to partners outside the bonus cap. But any such change has to stand up to the scrutiny of regulators (who may start from a position of scepticism). A persuasive argument is likely to need to reflect a deep change, not just of ownership structure but with alignment from top to bottom, including all aspects of the firm or business unit's culture and corporate governance. Also, dividends are not corporate tax deductible and so may prove an expensive alternative to remuneration.

WHAT ARE THE LIKELY LONG-TERM IMPACTS OF THE CRD IV REMUNERATION RULES?

We believe that in the long term these changes will contribute to holistic and cultural changes that will affect employees across the broader banking industry and, most likely, financial services as a whole.

More immediately we may see some migration of talent within financial services towards business areas where there are fewer remuneration restrictions. Already, through the 2012 year-end cycle, there have been examples of this reported in the media. Similarly, some firms may consider relocating certain business areas or desks to regions outside the bonus cap's jurisdiction. However, these relocations always prove quite difficult to realise.

WHAT SHOULD FIRMS BE DOING?

The final wording of CRD IV is still under development. After it has been finalised and agreed by the European Council and European Parliament it must be translated, and will then be signed and published in the EU Official Journal. Each country will then have to transpose the rules into their own legislative and regulatory frameworks. The EBA will develop its guidelines on longer-term instruments, as well as Regulatory Technical Standards on Identified Staff and CoCos / bail-in bonds.

It will be some time before all of the detail becomes clear. CRD III saw the Committee of European Banking Supervisors (now superseded by the EBA) publish their final guidelines on 10 December 2010, just 21 days before CRD III came into effect. We would advise firms not to wait for the details. In the meantime, firms can begin to prepare themselves, so when the rules are finalised they are in a position to quickly decide on the right response.

If firms wish to exceed the default 100% cap, shareholder approval is required at a general meeting. Most Annual General Meetings (AGMs) fall in Q2 each year so firms should consider

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whether to pre-emptively seek approval at the 2013 AGM. Waiting for next year, when the rules will be clearer, might require firms to delay reward communications until after the 2014 AGM. The other alternative is to call an Extraordinary General Meeting (EGM) during 2013, after the rules are finalised, but it is unusual to call an EGM solely around pay and doing so is more complex and costly.

The following considers the approach firms should undertake.

KEY STEPS TO CONSIDER:

Diagnosis

- Review historic ratios of variable pay to fixed pay across the Identified Staff population to determine how many people this might affect.
- Review actual historic variability of pay and consider how much is truly variable.
- Model possible costs (e.g., cost of raising fixed pay to maintain total remuneration under a 100% cap or 200% cap) to give some baseline costings.
- Carry out market analysis to consider pay competiveness implications, especially outside Europe.

Explore the fundamentals

- How do we want our senior staff to be rewarded, based on our business model, our strategy, reputational factors and our ability to pay?
- If a cap above 100% is appropriate, how likely are shareholders to accept this proposal and how do we set out our justification for this? When should we seek approval?
- Are there employees at the cusp of the cap?
- Have we identified the appropriate Identified Staff population?

Develop plans to mitigate impact

- Reduce variable pay levels?
- Adjust salaries or fixed pay to partially offset reductions in variable pay?
- Consider how any fixed pay increases might best be structured to avoid knock-on cost implications and increasing risk?
- Consider more profound changes, such as changes in ownership structure, including the implications for business strategy, culture and values, people strategy and reward?
- Focus on the key messages to impacted staff – what are the behavioural implications of any changes?
- Develop plans to manage potential attrition?

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