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The Impact of CRD IV on Compensation

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INTRODUCTION

The Capital Requirements Directive, CRD IV, is poised to restrict incentive compensation for an important segment of banking employees. As a result, a number of firms are struggling to structure attractive reward packages so they can continue to compete effectively for talent with firms that will not be covered by this legislation. Should CRD IV be implemented as currently drafted, code staff bonuses will be capped at 1x fixed pay. There is still a chance that shareholders will vote for an exceptional cap of 2x fixed pay which would improve the ability to compete but would still leave European firms at a substantial disadvantage to non-EU peers for staff outside of Europe.

COPING STRATEGIES

Coping strategies are aimed at ensuring that compensation is competitive enough to retain talent yet flexible enough to adjust compensation spend to business results, which protects the financial health of the organization and shareholder value.

To achieve this, most organizations will likely consider the following steps:

1. Apply for the exceptional 1:2 cap, where appropriate
2. Develop new compensation structures tied to business results

APPLYING FOR 1:2 EXCEPTION

Most firms will apply for the 1:2 ratio exception covering code staff roles instead of going with 1:1 for all. Because this exception must be approved by shareholders for most EU-listed firms, a business case to go with the proposal will be essential.

A proposal based on an analysis of historic variability in compensation (e.g., how much of "variable" actually varies on a year-to-year basis) and identifying which portion of code staff actually exceeds 1:2 on a regular basis will identify the business activities and roles that might warrant an exception to the 1:1 ratio cap. This proposal should also be substantiated by international market best practices in variable pay for these roles.

To ensure that the total compensation costs do not exceed the shareholders' perspective of affordability, most firms have already started communicating targeted payout ratios (e.g., employee compensation as percentage of revenues) to shareholders.

While the final definition of code staff is not available yet, the analysis can be done on the basis of the latest consultation guidelines by the European Banking Authority on the material risk taker regulatory standard and then modified when the final regulatory standards are published in Q1 of 2014.

A description of the business mix of the firm, relevant market practices and targeted payout ratio will substantiate the proposal and identify the actual percentage of staff submitted to the shareholders for the 1:2 exception. It is expected that the 1:2 proposal can be submitted during a normal Annual General Meeting as a separate resolution, taking into account the CRD IV voting requirement on qualified majority.

THE BUSINESS CASE FOR ADJUSTING FIXED PAY

Though other options may be available, most firms will likely increase fixed pay through base salary increases or allowances. In general, smaller increases will be delivered through base salary, but where reward amounts are more substantial, allowances in cash and / or stock will be a more typical practice.

For firms that have already shifted a portion of incentive pay into fixed pay over the past few years, it will be necessary to determine if there is still capacity to move incremental

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compensation into fixed pay. Firms must carefully evaluate whether there is a large enough buffer that will allow an increase in fixed compensation without potentially overshooting desired total compensation levels in a low performing year. Firms need to undergo a rigorous process, in order to ensure that any transfer of incentive pay into fixed compensation is sensible, and likely to benefit the firm longer term. Towards this end, we have prepared a blueprint for reviewing, and making this determination:

RECOMMENDED METHODOLOGY

I. Segment Business	IV. Measure Per Capita Distribution
II. Assess Funding Methodology	V. Stress Test Minimum Total Comp
III. Determine Appropriate Pools	VI. Consider Salaries Below Minimum Tot Comp

As a fundamental starting point, it is critical that firms review how they fund compensation for each line of business / product. Without considering what the total compensation opportunity should be in a good year and a bad year it is impossible to determine how to increase fixed pay. Likewise, it is impossible to properly calibrate total compensation opportunity without ensuring that the overall compensation pool for a business is funded competitively. Many firms are beginning a deeper focus on what their firm-wide funding rate should be, CRD IV notwithstanding, so this line of inquiry is timely for a variety of reasons.

The best approach to this process is to break down a firm into its component parts, and consider the funding rates for each product. Factors such as capital usage, value of individual versus franchise, and others have helped drive funding rates in the marketplace. A review of these rates, across a spectrum of historic performance for a firm, as well as an exhaustive stress test of "what if" scenarios, married together with a market perspective on how the broader industry funds these products, will give a firm and its shareholders a sense of the fair and reasonable aggregate compensation for a product. The funding rates for individual products can be added up, to ensure that the overall funding rate for the firm is competitive, given the mix of business they are pursuing. Once the review of funding rates has been completed, a firm should be armed with an overall aggregate compensation target for each product for a typical year, an outstanding year, and a catastrophically bad year. All of these scenarios are essential to ensure that fixed pay levels do not overshoot business results.

Once the aggregate pool has been set, a firm may consider distribution strategies / scenarios. Assuming the firm is staffed competitively; consider what kind of total compensation this plan can provide to the individual employees in a line of business. How competitive does this pay appear? In a good performing year? In a bad one? For each line of business, consider these new targets against what has been paid historically. The next step is rather simple – review what kind of total compensation the firm can deliver to a business in a low performing year, and see if this amount is greater than current fixed pay rates.

If the business can fund total compensation using a scientific, market competitive funding approach that is materially higher than the current fixed pay rates in a low performing year, then it appears there is opportunity for low-risk increases to fixed pay. To be clear, these increases may not be consistent per title, but more tailored to historic total compensation levels per employee.

BROADER INDUSTRY IMPACT

Interestingly, while these regulations are generally seen as creating significant challenges for European firms, some firms not covered by these regulations envision their own challenges and competitive advantages: Will they be forced to increase fixed pay as well, in order to attract talent?

WHY WERE FIXED PAY RATES ADJUSTED IN THE PAST

In 2008, several of the largest international banks adjusted fixed pay rates for a variety of reasons:

- To assure employees who received diminished bonuses that they could count on a higher minimum level of compensation, going forward

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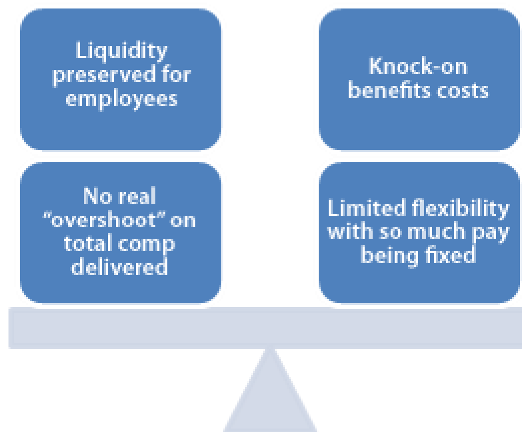
- To ensure adequate liquidity for employees who would have greater mandatory deferrals due to current and future regulations
- Because of the tacit understanding in Banking / Capital Markets that some portion of the bonus was not really reward, but rather quasi-fixed pay that was simply delivered later
- The public backlash against bonuses
- Fixed pay rates had been flat for the officer population for a long time

FIRM SATISFACTION WITH PAST INCREASES

One would think that the biggest concern in pushing incentive pay into fixed pay would be raising fixed costs above intended total compensation rates. That has largely not happened. The biggest concern firms now cite is the limited amount of flexibility they have, because so much of the available compensation fund is already committed. It is important to note that several firms that have increased fixed pay in the past now do have some regrets, and are modifying their approaches to salary administration. In light of these concerns, some of the drive to raise rates may be tempered.



CONSIDERATIONS POST CHANGES

Should a firm undergo this review, and consider moving ahead with increases to fixed pay, the following are important considerations:

- The process of determining fixed pay structure should be carried out with some thought and care. Firms will need to balance the appetite for uniformity and standardization with the value of considering individual lines of business, future compensation opportunities, and specific needs to compete. Firms will need to consider internal communication around who received fixed pay increases and who did not.
- Differentiation of fixed pay increases designed to incentivize and reward outstanding performance and competencies, in addition to changes in role performed, may become more prevalent
- In adjusting fixed pay upwards it will be important to consider whether there is any scope to deliver incentive pay in poor performing years. If there is not, the new structure of reward may require a partnership-like approach, with material risk takers aligned with group-wide performance versus the performance of their own business lines.
- Is it possible to sell employees on the idea that since fixed pay is more valuable than variable pay, then the trade from variable to fixed ought to be at a discount?
- The burden of administering this may be substantial

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A challenging economy, media and shareholder pressures and new regulations continue to change the face of the financial services industry, particularly within Banking and Capital Markets. Reward practices are keeping pace with or pre-empting these developments, but more changes are imminent. The industry coped with CRD III-linked adjustments to reward structures but the EU directive to cap incentive pay poses the most fundamental challenge to Human Resources professionals and reward programs to date.

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