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Regulatory Update

EBA Consultation on Guidelines on Sound Remuneration Policies

By McLagan and New Bridge Street

10 March 2015

WHAT'S HAPPENED?

On 4 March 2015, the European Banking Authority (EBA) published a consultation paper on draft guidelines on sound remuneration policies. These guidelines seek to clarify how firms and regulators should interpret the remuneration rules in CRD IV. The proposed text updates guidelines previously published by the Committee of European Banking Supervisors (CEBS – the forerunner to the EBA) about pay regulation under CRD III.

WHICH FIRMS ARE AFFECTED?

The guidelines are relevant to all firms subject to CRD IV, including banks (large and small), building societies and approximately 1,000 IFPRU investment firms.

WHAT ARE THE HEADLINES?

BENEFIT OF PROPORTIONALITY SIGNIFICANTLY REDUCED - MORE FIRMS SUBJECT TO VARIABLE PAY RESTRICTIONS

As a result of the EBA's reinterpretation of the principle of proportionality, all CRR firms[1], irrespective of their size and complexity will be required to apply every CRD IV remuneration principle in full in future. This means that all Material Risk Takers (MRTs) in CRR firms will be subject to the "payout process rules" – which require that 40-60% of variable pay is deferred, 50% of pay is in instruments, and all variable pay is subject to malus and clawback provisions – and the variable pay cap.

This will hit small banks, which have previously escaped the cap, and a sizeable number of IFPRU investment firms, which currently benefit from the proportionality protection conferred on them by the FCA. All level 3 IFPRU investment firms, for example, are permitted to disapply the payout process rules, and the variable pay cap under the FCA's current interpretation of the CRD IV pay rules.

Mindful of the impact of this development on the competitive position of the IFPRU investment firms it regulates, the FCA has urged them to respond robustly to the EBA during the consultation process that closes on 4 June. If the EBA's approach is ratified, asset managers will have most work to do to be compliant with the EBA's remuneration guidelines by the beginning of 2016, particularly as they imply an even more stringent interpretation of the CRD IV Directive than is currently being applied by banks. The EBA will only consider exempting small, non-complex CRR firms that do not extensively rely on variable remuneration or MRTs

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who receive only a low amount of variable remuneration from the payout process rules. The EBA is clear, however, that the variable pay cap will not be subject to the proportionality principle.

In a widening of its rules on consolidation**,** the EBA is additionally proposing that all firms that are subsidiaries of CRD IV banking or investment groups should also be caught by its pay rules. This may include BIPRU firms which are currently required only to comply with CRD III requirements (applied proportionately) as well as other non-Code firms. In such cases, the consolidating institution must ensure that subsidiaries within the group, which are not subject to CRD IV, apply the group-wide remuneration policies to all staff. Sector specific requirements such as 50% of deferral in fund units will still apply as well.

Significantly, MRTs within non-CRD subsidiaries will only be affected by the variable pay cap if they are deemed to have a material impact on the group's risk profile *on a consolidated basis,* i.e., where a member of the management board of the subsidiary is also a member of the group management board.

REMUNERATION PAY IS EITHER FIXED OR VARIABLE, NO THIRD CATEGORY SUCH AS ALLOWANCES

The variable pay caps (100% or 200% of fixed pay) resulted in many firms introducing new forms of allowances designed to boost the fixed component of pay as a means of meeting the cap restrictions while maintaining an element of flexibility. The proposed guidelines set out detailed criteria for whether particular aspects of remuneration should be classified as fixed or variable and makes the point that there is no “third category” with any pay that does not meet its definition of fixed pay to be classed as variable.

Banks will be required to justify the classification of allowances as "fixed pay" particularly where, for example they are paid only to MRTs or they are paid in shares. In reality banks aim to continue to use allowances, and they will make any necessary amendments to bring them in to line with EBA requirements.

There are however variable remuneration elements which are not included in the cap, e.g., dividends on vested shares or equivalent ownership interests.

LTIP INCLUDED IN BONUS CAP CALCULATIONS IN YEAR OF VESTING AND TSR ALONE IS NOT CONSIDERED SUFFICIENTLY RISK ADJUSTED

Performance-based long-term incentive plans (LTIPs) will be included in bonus cap calculations for the year of vesting, not the year of award. The valuation methodology to be applied is not explicitly outlined in the guidelines, but we have confirmed with the EBA that it is intended to reflect the share/instrument price at vesting. In addition, TSR is not considered a risk adjusted measure without some additional measure for risk. This approach is contrary to PRA current guidance and will require adjustments to the majority of existing LTI plans. This may lead to the demise of LTIPs as we know them as front loading compliance with the cap will no longer be possible.

The consultation closes on 4 June 2015 and finalised guidelines are expected to be implemented by the end of 2015 “to ensure that all institutions apply them for the

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performance year 2016 and onwards." Although the EBA's guidelines are not final, the FCA "strongly encourages firms to consider them, the likely impacts on their business, and respond to this consultation."

MCLAGAN/NEW BRIDGE STREET VIEW

The proposed guidelines give both firms and regulators much to consider with both being forced towards a one-size-fits-all solution that allows limited scope for pragmatism or reason. Firms should quickly begin to review their practices against the proposed guidelines to provide an assessment of the implications. Over recent years changing regulations have resulted in many firms making constant adjustments to their pay approaches resulting in increasing complexity. This latest round may provoke some to consider more radical changes to compensation design as opposed to another round of amendments.

McLagan/New Bridge Street will continue to review the developments closely and work with clients to determine the potential impact of these changes.

SUMMARY OF FURTHER IMPLICATIONS

Area	Implication
Governance	
Increased rigour and oversight required for the adoption, implementation and maintenance of remuneration policy.	Increased responsibility for management body in its 'supervisory function' to oversee adoption of appropriate remuneration policy. Parent companies will be responsible for ensuring remuneration committees are set up for subsidiaries when required. Chair and majority of the members of the committee should be independent.
Shareholder Involvement	
Whilst the EBA will allow a parent body to approve an increase in variable pay awards for subsidiaries caught by CRD IV, the parent will need to ensure that it has the support of its shareholders in order to grant such approval.	This has significant implications for firms headquartered outside the EU. To avoid having to seek approval for any future exception to the regulations, the request for approval will most likely be formulated as an approval to adhere to local regulations whilst maintaining global compensation policies rather than a specific approval for the exception to the ratio at 1:2.
Deferral Period	
The EBA has proposed longer minimum deferral periods for senior managers in significant banks (five years versus the current 3 to 5 years).	Deferral is shorter than the PRA's proposals in its July 2014 consultation paper of seven years for senior managers and five years for all other MRTs.

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Area	Implication
Retention Period	
The recommended retention period for instruments paid as variable remuneration, has been extended to one year.	Retention is longer than the six months which is typical in the UK and in line with most other EU countries. Members of the management body or senior managers in significant firms should be subject to even longer retention periods – for upfront awards, for example, this should be as long as the combined length of the deferral and retention period for deferred instruments, i.e., five and a half years.
Variable Pay	
Institutions must have a fully flexible policy on variable remuneration.	A fully-flexible policy on variable remuneration for MRTs must be in place which reacts appropriately to changes in performance. Bonus pools need to be set and based on performance criteria and risk considerations, not on the basis of meeting remuneration demands.
Instruments	
The EBA encourages the use of a balance of share and capital based instruments in variable pay schemes so as to align pay outcomes with the interests of shareholders, creditors, bondholders and other stakeholders. Fixed pay can be paid out in financial instruments as an amount. Carried Interest is variable but excluded from the ratio calculation if return is pro rata with other investors.	Where shares or bail-in capital instruments are available to firms they are required to prioritise their use over value based, share-linked instruments (such as SARs or synthetic shares). The EBA has not, however, stipulated in what proportion share and capital based instruments should be used. Pro rata returns through carried interest are excluded from the calculation. If firms choose to remunerate executives through some form of partnership share-ownership structure, it is unclear to what extent the returns are excluded from remuneration and/or the calculation of the ratio.
Guaranteed Variable Remuneration	
A guaranteed bonus will not count towards the variable pay cap in the first performance period when it is awarded when hiring new staff before the first performance period starts.	This will likely lead to a decrease in retention for top performers
Material Risk Takers	
The responsibility for identifying MRTs lies ultimately with the group entity. The process must be performed even by entities not subject to CRD.	Potential increase in number of MRTs. Persons on secondment from a third country parent company might be captured under the new guidelines.
Maintaining a Sound Financial Base	
Remuneration (upfront and deferred variable) must also be taken into account for capital and liquidity planning purposes.	Firms must be able to demonstrate that award, pay-outs (e.g. guaranteed variable) and vesting of variable remuneration (including malus and clawback) are not detrimental to maintaining a capital base.

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Dividends and Interest	
No dividend or interest allowed on deferred in instruments. Dividends are not part of remuneration, if not used as circumvention of requirements.	Note that firms will not be permitted to pay any interest or dividends on instruments which have been awarded as variable remuneration under deferral arrangements - either during or after the deferral period (in lieu of amounts payable during the deferral period).

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[1] A 'CRR' firm is a credit institution or an investment firm which is subject to CRD IV. In the UK, CRR firms include banks, building societies and approximately 1,000 IFPRU investment firms, including investment managers, wealth managers, brokers etc. IFPRU investment firms are defined by their MiFID client activities such as holding client money.

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