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# EBA CRD IV remuneration guidelines: One year's grace

On 21 December 2015, the European Banking Authority ("EBA") published its final guidelines on sound remuneration policies under the Fourth Capital Requirements Directive. The new guidelines apply from 1 January 2017. They state that the maximum 2:1 ratio of variable to fixed remuneration should apply to all CRD IV firms and cannot be disapplied using proportionality. If the UK decides to "comply" with this guideline rather than "explain" non-compliance, this would effectively impose a "bonus cap" on many UK investment firms for the first time. The EBA has also proposed legislative changes to CRD IV. If implemented, these would be mandatory changes which could result in many UK investment firms needing to comply with the other "pay-out process" rules for the first time.

## BACKGROUND

In 2010, the Committee of European Banking Supervisors ("CEBS") (the EBA's predecessor) issued guidelines on interpretation of the remuneration requirements in the then Third Capital Requirements Directive. These contained a schedule expressly contemplating that certain firms could "neutralise" certain rules on the basis of "proportionality" provisions in the Directive. In light of these guidelines, regulators in over 2/3 of EU Member States (including the UK) introduced guidance which expressly permitted investment firms to disapply the so-called "**pay-out process rules**". These are the rules which require: (a) 40% - 60% of variable pay to be deferred over at least three years; and (b) 50% of variable pay to be in instruments such as shares in the firm, as opposed to cash. The CEBS Guidelines remained in place when CRD IV was introduced in 2014 and the UK regulatory guidance remained largely unchanged.

In March 2015, the EBA published a consultation paper setting out proposed replacement guidelines. The EBA surprised everyone by adopting the position that all CRD IV remuneration rules had to be applied to all CRD IV firms, and that the EU legal doctrine of "proportionality" could not be used to justify the disapplication of the pay-out process rules. You can find our earlier briefing note on the EBA's consultation paper here.

## FINALISED GUIDELINES AND OPINION ON PRINCIPLE OF PROPORTIONALITY

The EBA has now published its final guidelines. You can find the final guidelines here , along with a summary of the vigorous feedback to the consultation. The new EBA guidelines will not come into force until 1 January 2017. The guidelines were proposed under Article 16 of the EBA founding regulation, which requires national supervisors to comply or explain non-compliance within 2 months of issuance of the guidelines. National supervisors who "comply" are likely to require them to be applied in respect of full performance periods beginning on or after 1 January 2017.

The EBA has at the same time published an opinion addressed to European legislators, calling for changes to CRD IV pay rules, in order to make them more targeted. You can find the opinion here. We recommend that the guidelines and the opinion should be read together as they have been published as a single package.

### THE BONUS CAP

The EBA states in the revised guidelines that one particular rule cannot be neutralised on the grounds of proportionality, and should not be the subject of any new exemption. That is the bonus cap – the rule which sets a maximum ratio of variable remuneration to fixed remuneration for affected staff at 1:1 (or 2:1 with a shareholders' vote). Depending on their pay practices, this is likely to be bad news for many firms subject to CRD IV who do not currently apply the "*bankers'*" bonus cap. This covers smaller banks, MTF operators, brokers and asset managers subject to CRD IV (such as those with permission to hold client money or assets in connection with MiFID business or CLO/CDO managers).

For the purposes of the bonus cap, the EBA clarifies that carried interest and long-term incentive plans ("LTIPs") should be valued in the year of award. The earlier consultation proposal was ambiguous on this point.

### PROPORTIONALITY MORE GENERALLY

The EBA received 127 vociferous responses to the consultation, almost all of which objected to its reading of proportionality in the March consultation paper, and many of which were supported by detailed legal argument. The EBA acknowledges that national supervisors uniformly supported the position taken by firms that making significant changes to the interpretation of the proportionality doctrine at this stage would have imposed significant cost burdens on smaller and less complex institutions without leading to corresponding improvements in risk management practices.

The EBA has omitted from the final guidelines its most controversial statement that all pay-out process rules must be applied by all CRD IV firms, using the stated numerical criteria as a minimum requirement (e.g. 40-60% deferral, 50% paid in instruments). However, the EBA has also deliberately omitted any reference to "neutralisation" being permitted. The finalised guidelines follow a middle ground, reciting some of the proportionality language from the Directive: that firms and supervisors should consider a combination of the firm's size, internal organisation and the nature, scope and complexity of an institution's activities when applying the requirements in a proportionate manner. The EBA has also set out additional criteria to be taken into account when assessing proportionality. The EBA's position on proportionality in the finalised guidelines on its face allows Member States largely to continue with their current approaches.

### PROPOSED CHANGES TO PROPORTIONALITY: LEGISLATIVE PROPOSAL

The EBA has also proposed legislative changes which would alter the way in which pay regulation will apply to firms, by creating new explicit statutory exemptions for certain firms from the pay-out process rules (and from another rule relating to the payment of discretionary pension benefits to leavers in instruments, as opposed to cash).

The EBA suggests that these new exemptions should be made available to: (a) institutions which are "small in terms of their on-balance-sheet and off-balance-sheet activities and non-complex"; and (b) staff (even of large and complex institutions) who receive low levels of variable remuneration. The EBA suggests that it could be given a mandate to set specific criteria. It is reasonable to suppose that such criteria might be harder to satisfy than those which trigger current national waivers.

These changes would require primary legislation, which may take some time to pass, and which would be subject to political debate. It is not a foregone conclusion that the European legislative institutions will necessarily agree to these changes. It seems that, if the law is changed as the EBA suggests, those new exemptions will be the only way for firms to conclude that they may disapply particular remuneration rules. Any firm not qualifying for the new exemptions would be obliged to apply each and every remuneration rule in full. (The EBA contemplates that the key proportionality provision in the existing CRD IV should be amended to remove any argument that remuneration rules need only be applied generally "to the extent" proportionate.)

So, in the round, the outcome is worse for CRD IV firms than the status quo, but not quite as bad as the EBA had proposed in its consultation.

## APPLICATION TO GROUPS

The EBA provides guidance on the application of the remuneration rules to groups containing CRD IV firms. It requires subsidiaries within the scope of prudential consolidation to have remuneration policies consistent with the CRD IV requirements, at least for identified staff whose activities have a material impact on the group's risk profile. On the other hand, there is a clear statement that EU subsidiaries of non-EU parents need not try to apply pay regulation to their non-EU parents or sister companies.

## NON-CRD IV FIRMS

Groups containing only non-CRD IV firms (such as AIFMs, UCITS management companies and CRD III brokers/asset managers) will take some comfort from the fact that the EBA does not rehearse its preferred reading of the existing legislation, which had put it at odds with its fellow European Supervisory Authority, the European Securities and Markets Authority. Nonetheless, it is still possible that the European Commission could seek to align approaches to proportionality, and to the regulation of remuneration more generally, across the various regimes through potential legislative amendments in the medium term.

## USE OF SHARE-LINKED AWARDS AS OPPOSED TO SHARES

The EBA supports calls for listed institutions to be able to use share-linked instruments, as well as simple share awards, to satisfy the rule requiring payment of variable remuneration in instruments. This will also require primary legislation.

## GOVERNANCE

The final guidelines contain helpful recognition that not all firms affected by pay regulation adopt a dual board structure (common in some parts of the EU but not in the UK), and there is a little more flexibility than before as to the way in which proper remuneration governance can be achieved.

## WHAT HAPPENS NEXT?

The guidelines are addressed to firms, but also to Member State competent authorities who must consider whether to adopt them on a "comply or explain" basis. It remains to be seen whether the UK and other Member State authorities will comply with the guidelines in their entirety. Brokers and asset managers subject to CRD IV in particular may argue that the UK should not comply with the application of the bonus cap to them. Decisions must be made by competent authorities within two months of the guidelines being published on the EBA website after translation into the official EU languages – i.e. at some point during Q1 or Q2 2016.

Attention also turns to the European Commission to see whether it will respond to the EBA's call to initiate new primary legislation, and what form that legislation might take. As stated at the outset, it will be difficult to apply the guidelines as the EBA seems to intend without this.

## CONSULTATION ON GUIDELINES FOR REMUNERATION POLICIES IN RELATION TO RETAIL BANKING SERVICES

Separately, on 22 December 2015, the EBA also published a consultation paper on its draft guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services, which is available here. This consultation will be relevant to firms that provide services such as deposit accounts, credit facilities, payment services or e-money services to consumers. It contains requirements for the implementation of remuneration policies and procedures in connection with such services that are designed to reduce conflicts of interest and staff misconduct which could result in consumer detriment.

## LOOKING FURTHER AHEAD

The European Commission is also currently pursuing a wide-ranging consultation on pay regulation, and has separately commissioned a report from a think-tank on the same subject. The Commission must report to the European Parliament and Council on these matters by the end of June 2016.

On 14 December 2015, the EBA published a wide-ranging report on the future of prudential regulation for investment firms (covering pay regulation, regulatory capital, liquidity and prudential reporting), available here. This paper may ultimately form the basis for future pay regulation reform.

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