Clients&FriendsMemo

The EBA's New Remuneration Guidelines: Expanding the Scope of the Bonus Cap

14 January 2016

Introduction

On 21 December 2015 the European Banking Authority ("**EBA**") published its final guidelines on sound remuneration policies (the "**Guidelines**"), together with its opinion on proportionality (the "**EBA Opinion**").

The Guidelines and EBA Opinion are likely to be of particular relevance to a number of smaller regulated investment firms, since the EBA's intention is that they will no longer be able to disapply the so-called "bonus cap" on the basis of "proportionality".

Legislative Background

The Capital Requirements Directive (the "**CRD IV Directive**")[1] requires EU Member State national regulators (the "**national regulators**") to establish remuneration policies for "institutions" (and at group level). The "institutions" concerned (sometimes referred to as "**CRD IV firms**") are "credit institutions" (mainly EU banks) and "investment firms" within the meaning in the Capital Requirements Regulation[2].

The CRD IV Directive mandated the EBA to issue guidelines on sound remuneration policies; the national regulators (such as the UK Financial Conduct Authority ("**FCA**") and the UK Prudential Regulation Authority ("**PRA**")) and institutions are required to make every effort to comply with the guidelines[3].

EBA Consultation Paper and the Previous Guidelines

The Guidelines to a large extent follow the draft guidelines published in the EBA Consultation Paper on 4 March 2015 and so many of the guidelines are broadly in line with those expected.

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1 Directive 2013/36/EU.

2 Regulation (EU) No 575/2013.

3 Article 16(3) of Regulation (EU) No 1093/2010.

Application from 1 January 2017

The Guidelines will apply from 1 January 2017 (not from 1 January 2016, as proposed in the draft guidelines) and will then replace the remuneration guidelines published by the EBA's predecessor body, the Committee of European Banking Supervisors, in 2010. The FCA has confirmed that "*Firms will not need to change their existing pay practices for the 2016 performance year.*"

National Regulators Must Confirm That They Will Comply or Explain Why They Will Not

The Guidelines will be translated into the official EU languages and published on the EBA website. Within two months of the publication of these translations, the national regulators are required to confirm whether they will comply with the Guidelines. If a national regulator does not comply, or does not intend to comply, it must inform the EBA, stating its reasons.

Other EU Remuneration Guidelines

We note that the EBA Guidelines are not the only EU remuneration guidelines: in 2013 the European Securities and Markets Authority ("**ESMA**") published remuneration guidelines for investment firms under the MiFID[4] framework, and separately, for fund managers, under the AIFMD[5] regime. ESMA is also preparing remuneration guidelines for UCITS V[6] fund managers.

The UK Remuneration Codes

The UK rules on remuneration are contained in five separate Remuneration Codes, which apply to different types of UK regulated firms:

(i) the FCA's IFPRU Remuneration Code (which applies to CRD IV firms);

(ii) the FCA's AIFM Remuneration Code (which applies to full-scope UK Alternative Investment Fund Managers);

(iii) the FCA's BIPRU Remuneration Code (which applies to non-CRD IV firms);

(iv) the FCA's Dual-Regulated Firms Remuneration Code (which applies to CRD IV firms that are dual regulated by the FCA and PRA); and

(v) the PRA's CRR Remuneration Code (which applies to PRA regulated CRD IV firms).

The FCA Remuneration Codes are contained in the Senior Management Arrangements, Systems and Controls Rulebook in the FCA Handbook. The EBA Guidelines will, in due course,

4 Directive 2004/39/EC.

5 Directive 2011/61/EU.

6 Directive 2014/91/EU.

be reflected in those UK Codes applying to CRD IV firms. The FCA's IFPRU Remuneration Code is the UK Code to which this note refers.

The Proportionality Principle

Perhaps the key issue for most CRD IV firms is the application of the proportionality principle. The CRD IV Directive requires national regulators to ensure that their remuneration policies should require institutions to comply with the principles set out in the Directive "*in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities".* There has not been a common approach across the EU as regards the application of the proportionality principle. A number of national regulators, such as the FCA, have interpreted the phrase "*to the extent that is appropriate*" as permitting the disapplication of parts of the remuneration requirements to certain firms on the basis of proportionality.

The UK's Approach to Proportionality

Under existing FCA guidance, many of the provisions in the IFPRU Remuneration Code do not apply to smaller CRD IV firms on the grounds of proportionality.

In July 2015, the FCA published General Guidance on Proportionality in relation to the IFPRU Remuneration Code. For the purpose of this Code, firms were divided into three proportionality levels primarily determined by the extent of the firm's authorisation. For example, firms classified by the FCA as "IFPRU limited licence firms"[7] are designated as "proportionality level three" firms. The FCA's view has been that it would normally be appropriate for a firm in proportionality level three to disapply the remuneration rules requiring: (i) the use of retained shares or other instruments; (ii) deferral of a proportion of variable remuneration; and (iii) clawback. Significantly, the FCA also said in this General Guidance that it may be appropriate for such firms to disapply the "bonus cap" (please see below).

The EBA's Opinion on Proportionality

The second document published by the EBA on 21 December 2015, was an Opinion in relation to the differing interpretations of the proportionality principle across the EU Member States. The EBA is of the view that it is necessary to establish a more harmonised approach to the application of the remuneration requirements and to provide legal clarification regarding the proportionality principle by way of amending the CRD IV Directive in order to:

1. exclude certain small, non-complex institutions from the requirements to apply the remuneration principles regarding deferral and payment in instruments for variable remuneration; and

[7] This includes firms which have a MiFID permission for "placing of financial instruments without a firm commitment basis" but do not have the MiFID permissions for "dealing on own account" or "underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis".

2. to limit the scope of those remuneration principles as regards staff who receive low amounts of variable remuneration, including in large institutions.

The intention is, therefore, that these elements of the remuneration requirements will be subject to exemptions on the grounds of proportionality, which will be implemented on a statutory basis as a result of changes to legislation at the EU level.

The EBA wishes to move away from the way in which many national regulators currently use the proportionality principle to disapply aspects of the remuneration requirements to certain firms. The EBA has therefore proposed deleting the words "*and to the extent that*" in the CRD IV Directive, which refers to applying the remuneration principles to institutions "*in a manner and to the extent that is appropriate to their size, internal organisation….*". The EBA notes that this is in order to remove any doubt about the need for all institutions to comply with all of the remuneration principles, subject only to such exemptions as are set out in the Directive.

The "Bonus Cap" – Background

The CRD IV regime requires a distinction to be made between fixed remuneration, which should primarily reflect relevant professional experience and organisational responsibility, and variable remuneration which should comprise all components linked to performance or, in exceptional cases, other contractual elements that do not form part of routine employment packages.

The CRD IV Directive provides that institutions are to set the appropriate ratios between the fixed and the variable component of total remuneration, whereby the variable component must not exceed 100% of the fixed component for each relevant individual. The CRD IV Directive permits Members States to allow shareholders or owners of the firm to approve a higher ratio, provided that the variable element is no more than 200% of the fixed component.

The FCA's IFPRU Remuneration Code reflects these "bonus cap" requirements. However, as noted above, firms covered by that Code have been able to disapply the bonus cap if they meet the relevant proportionality criteria in the FCA guidelines. The EBA Opinion addresses this issue.

The EBA's Opinion and the "Bonus Cap"

The EBA Opinion clarifies that the application of the "bonus cap" should not be subject to any waivers or exemptions on the grounds of proportionality. The EBA states that waivers of the ratio between variable and fixed remuneration should not be introduced for institutions falling under the scope of CRD IV.

The EBA says: "*The so-called bonus cap is easy to apply and does not create additional administrative costs. The cap ensures that no inappropriate incentives for risk-taking can be provided.*"

The consequences of the EBA's views on this are that all CRD IV firms will be subject to the bonus cap. As explained below, since the remuneration requirements also apply at group level, this will also have implications for other group firms.

Applicability of the Remuneration Requirements to Members of the Consolidated Group

The CRD IV Directive already provides that the remuneration policies established by the national regulators are to be applied to "*institutions at group, parent company and subsidiary levels, including those established in offshore financial centres*".

As the Guidelines say: "*In accordance with the CRD, institutions have to apply the remuneration requirements at group, parent and subsidiary levels, including within subsidiaries that are not themselves subject to the CRD. Remuneration policies of different group entities within the scope of prudential consolidation should be consistent with the group's remuneration policy set by the consolidating institution.*"

All CRD IV firms have to identify the staff whose professional activities have a material impact on the individual institution's risk profile. The identification has also to be performed at consolidated levels and within subsidiaries which are not themselves subject to the CRD IV regime. As the EBA notes, the primary responsibility for the identification process for the consolidated levels, and in subsidiaries which are not themselves subject to the CRD IV regime, lies with the consolidating EU institution.

In its analysis of the comments received on the consultation paper which accompanies the Guidelines, the EBA notes this group wide applicability:

"*Consequently the specific remuneration requirements of the CRD are to be applied to their identified staff who have a material impact on the group's risk profile. This also includes staff in subsidiaries in third countries.*"

So the EBA has made it clear that the Guidelines not only apply to CRD IV firms, but also to other consolidated group firms which are not themselves subject to the CRD IV Directive.

Application of the FCA IFPRU Remuneration Code

Similarly, the IFPRU Remuneration Code already applies at group, parent undertaking and subsidiary undertaking levels, including those subsidiaries established in a country or territory which is not in an EEA State.[8] In addition, the IFPRU Remuneration Code applies to the activities of the UK branches of non-EEA financial services firms.

[8] The EEA, being the European Economic Area, which consists of the EU Member States and Norway, Iceland and Liechtenstein.

Conclusion and Future Developments

The points in the Guidelines that are likely to be of most concern to CRD IV firms are the EBA's pronouncements on removing the ability of national regulators, such as the FCA, to allow the disapplication of many of the remuneration principles to certain firms on the basis of the proportionality principle. This will be of particular significance to CRD IV firms (and to their groups) in respect of the application of the bonus cap. The EBA wishes to ensure that all CRD IV firms comply with the bonus cap.

However, the changes to the CRD IV Directive proposed in the EBA Opinion still have to pass through the EU legislative process and the Guidelines will not be applicable until 2017. In the meantime, the FCA and PRA will need to address the points raised in the Guidelines and make any necessary changes to the relevant UK Remuneration Codes. The FCA has issued a statement noting that, in conjunction with the PRA and the UK Treasury (which drafts UK financial services legislation), it will review the changes proposed by the Guidelines and their application to the UK market, and will consult on any necessary changes to its domestic rules and guidance. The full implications of the Guidelines for UK CRD IV firms will only become clear once the UK Remuneration Codes have been amended.

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