Bankers' Bonus Cap: Where Are We Now?

By Andrew Stanger and Christopher Fisher[1]

We covered the forthcoming bankers' bonus cap, as contained in the Fourth Capital Requirements Directive (CRD IV), in detail, and discussed the other remuneration provisions of CRD IV, in our July 2013 legal update. In summary, the bonus cap will restrict the variable remuneration of relevant staff to a maximum of the amount of their fixed remuneration, or, with shareholder approval, two times the amount of their fixed remuneration, and will thus represent a major change to the remuneration structures of many affected institutions.

The provisions apply to banks, and some MiFID investment firms, headquartered in the European Economic Area (EEA), even in respect of staff not located in the EEA, and also to the EEA subsidiaries of institutions headquartered outside the EEA.

This update contains a brief summary of the main developments in relation to the bonus cap, and other remuneration provisions of CRD IV, since we put out our July update, focussing on implementation in the UK.

July 2013 - FCA Consultation on CRD IV for Investment Firms

On 31 July 2013 the FCA put out a consultation paper (CP13/6) on their proposed changes to the FCA Handbook as a result of the implementation of CRD IV. The proposed changes cover the remuneration provisions of CRD IV, other than those that relate to the bonus cap.

Largely, the changes are effected by copying out the wording of CRD IV into the Remuneration Code (SYSC19A of the FCA Handbook) without change, although the accompanying guidance is updated to reflect the changes. One interesting point from the changes relates to the new requirement to ensure that any of the total variable remuneration (not just deferred variable remuneration) is subject to malus or clawback arrangements (SYSC19A.3.51A). There has been no addition to the guidance to indicate that firms in proportionality level three (broadly, firms that previously fell in proportionality tiers three and four) may disapply this rule – although the existing guidance states that it will normally be appropriate for such firms to disapply the rules on retained shares, deferral and performance adjustment. It is not clear whether this is an oversight, or it is intended that this provision should not be disapplied by those firms, or they are waiting for guidance to be produced by the European Banking Authority (EBA) on the point.

Shortly afterwards, in August, the PRA produced a consultation paper on the implementation of CRD IV (CP5/13), although this does not address remuneration issues.

July 2013 – EBA Consultation on Draft Regulatory Standards for Instruments Used for Variable Remuneration

The European Banking Authority (EBA) published a consultation paper dated 29 July

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2013 on the classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of CRD IV.

One of the requirements of CRD IV (Article 94(1)(l)) is that a substantial proportion, and in any event at least 50%, of any variable remuneration shall consist of a "balance" of shares or share-linked instruments, and "where possible" other instruments qualifying as Additional Tier 1 instruments or Tier 2 instruments (as defined in the Capital Requirements Regulation) or "other instruments which can be fully converted to Common Equity Tier 1 instruments or written down, that in each case reflect the credit quality of the institution as a going concern and are appropriate for the purposes of variable remuneration".

The directive mandates the EBA to prepare draft regulatory technical standards (RTS) on classes of instruments that satisfy these requirements for instruments other than shares and share-linked instruments.

A full summary of the proposals is beyond the scope of this alert, but we would highlight the following points:

- to ensure that instruments reflect the credit quality of the institution as a going concern, strictminimum triggers for write-down and conversion of instruments are proposed;
- to ensure that instruments are appropriate for the purposes of variable remuneration, instruments should have a sufficient maturity to cater for deferral and retention mechanisms, and distributions should adequately reflect market conditions for comparable instruments;
- to meet this latter concern, a significant portion, being not less than 60%, of the instruments should be issued publicly or privately to other investors, or if instruments are used for the sole purpose of variable remuneration, a cap should be set on the distributions paid. The EBA will finalise the draft RTS at the beginning of 2014, taking into account consultation responses and the opinion of the Banking Stakeholder Group, and submit them to the European Commission by 31 March 2014. The Commission then has to decide whether to adopt or amend the RTS, and the Council or European Parliament can veto it. It could thus take some months before these procedures are concluded and the relevant legislation adopted and published.[2]

September 2013 – UK Legal Challenge

On 25 September the UK government lodged a legal --challenge with the European Court of Justice on the bonus cap.

The bonus cap was strongly resisted by the UK during the negotiations for CRD IV, and the government does not think the bonus cap provision, which was implemented without any assessment of its impact or supporting evidence, is "fit for purpose" —to improve stability across the banking system. The challenge also covers various legal issues regarding the compatibility of the bonus cap with the EU Treaty and the powers delegated to the EBA, which the government believes go well beyond its remit of setting technical standards. It is important to note that the UK's legal challenge does not give institutions an excuse to delay the implementation of the bonus cap. The challenge does not suspend the coming into force of the bonus cap provision, and it will not be resolved until long after the bonus cap becomes effective: it can take around two years for the Court of Justice to hear a legal challenge. The UK will be implementing the bonus cap, as required by European law, by the beginning of 2014.

However, the challenge does give a strong indication of the UK government's view, and there is the expectation that this may be reflected in a lenient interpretation of the bonus cap in the UK by the relevant regulators.

October 2013 – PRA and FCA Consultation on the Bonus Cap

Following the announcement of the UK Government's legal challenge, and in recognition of the fact that the challenge will not delay implementation, the PRA and FCA issued consultation papers in relation to changes to their respective Remuneration Codes to accommodate the bonus cap in the UK (and, for the PRA, all the CRD IV remuneration provisions). The approach has generally been to do the minimum possible to comply with the directive, and, as for the earlier FCA consultation, the proposed rule changes largely copy out the CRD IV wording without amendment. Any discretions left to member states have been exercised so as to give maximum flexibility.

The PRA consultation paper includes no new guidance on how the proportionality principle may apply to permit firms to disapply the bonus cap. Their original proportionality guidance (LSS8/13) published in April 2013 states that it may be appropriate for BIPRU limited licence firms and BIPRU limited activity firms to disapply the ratios between fixed and variable components of total remuneration (see paragraph 32 of the guidance), in the context of the CRD III requirement for firms to set appropriate ratios.

The FCA, however, does include proposed guidance on the application of proportionality to the bonus cap (see paragraphs 2.13 to 2.21 of their consultation paper). Given that all relevant firms currently prudentially regulated by the FCA fall into proportionality level 3, the effect of this guidance would be that all firms would generally be able to disapply the bonus cap, unless they are treated as being level 1 or 2 because they are part of a group—in which case the group is likely to be PRA-regulated.

For more details, see the FCA's CP13/12 and the PRA's CP8/13.

October/November 2013 – FCA Regulated Firms Remaining on CRD III Rules

CRD IV contains a discretion for regulators to allow certain limited-licence investment firms to remain on CRD III rules (BIPRU). The FCA has, following the July 2013 consultation, decided to exercise this discretion, and in October wrote to potentially affected firms, which, if they would meet the relevant criteria going forward, could notify the FCA of this and remain on the CRD III rules.

As some firms which the FCA did not contact may also benefit from this discretion, the FCA published details on its website on 19 November 2013 of the criteria to be met, and the process to be followed if a firm considers those criteria are met, in order to remain on the CRD III rules.

October 2013 – EBA Consultation on Discount Rate

The EBA published a consultation paper dated 23 October 2013 containing draft guidelines on the applicable notional discount rate for variable remuneration, provided in Article 94(1)(g)(iii) of CRD IV.

Under Article 94, member states may allow institutions to apply a discount to up to 25% of variable remuneration for the purposes of calculating the bonus cap, provided that the variable remuneration discounted is in the form of instruments that are deferred for a period of not less than five years. The EBA is mandated to prepare and publish guidelines on the discount rate to be applied by 31 March 2014.

The draft guidelines set out a proposed methodology for applying the discount, and in particular contain a formula for calculating the discount rate to be applied. This formula is based on the inflation rate, the interest rate for EU government bonds, the number of years over which the instruments are deferred, the number of years in any additional retention periods and

the number of years in the vesting period of the tranche concerned.

The formula will need to be applied separately to each element of deferred variable remuneration (with each tranche of an award with a different vesting date being treated separately), so this could lead to a substantial amount of calculation.

The requirement for an award to be deferred over a period of at least five years does not prevent tranches of that award vesting prior to five years, although vesting cannot be faster than on a pro-rata basis. For a retention period to affect the discount rate, it needs to be at least two years.

It is beyond the scope of this alert to consider the detail of the formula. The draft guidelines contain various examples applying the formula: one of these shows that for an award which vests after five years and has a two-year retention period, the unadjusted value of the award is discounted by a little over a half, from €20,000 to €9,228.

Assuming the 25% portion of the variable remuneration was discounted down to zero (it wouldn't be far off this if awards were deferred for the ten years suggested by the Parliamentary Commission on Banking Standards), this would give a theoretical maximum for variable remuneration of two and two-thirds times fixed remuneration.

What's Next?

The revised Remuneration Code provisions (from both the PRA and FCA) will be finalised in December, as they will come into force on 1 January 2014. It is anticipated that the text will be published in time for a final review by interested parties.

However, there will still be missing pieces of the jigsaw after the commencement date. In particular:

- the EBA is due to deliver the draft RTS on identified staff (following the consultation process started in May 2013) to the European Commission by 31 March 2014: it will then be some time before the RTS is adopted (with or without amendments);
- the EBA is also due to deliver the RTS on appropriate instruments (referred to above) by 31 March 2014, and again it will be some time before the RTS is adopted;
- the final guidelines on the discount rate are to be published by 31 March 2014; and
- we understand that the EBA will revise the Guidelines on Remuneration Policies and Practices originally published by its predecessor body, CESR, towards the end of 2014: no draft of these revisions has yet been published.

Given that the bonus cap provisions apply to bonuses paid in relation to services or performance from the year 2014 onwards (so, generally, the 2015 bonus round will be the first affected), firms should be able to work with this timetable.

In the longer term, the European Commission, in close conjunction with the EBA, is required to review and submit a report on the remuneration provisions of CRD IV to the European Parliament and the European Council by 30 June 2016. This report is to take into account international developments, and have particular regard to the provisions' efficiency, implementation and enforcement, and the impact of the bonus cap in relation to competitiveness and financial stability and also in relation to staff working for non-EU subsidiaries.

The UK government's legal challenge, which may well cover similar ground to this report, could be underway at the same time as the EBA's review. It remains to be seen whether one will influence the other.

Endnotes

[1] Kevin McDonald's work as counsel in Mayer Brown's Chicago office focuses on complex commercial finance transactions, in which he represents financing institutions as well as businesses

obtaining financing, in both domestic US and cross-border markets. Craig Reimer represents institutional administrative agents, secured lenders, indenture trustees, pension funds, insurance companies, Fortune 100 companies and other creditors in all aspects of out-of-court workouts, financial restructurings and bankruptcy proceedings.

[2] It is not uncommon for it to take approximately five months from the EBA submitting its draft legislation to the Commission to it being published in the Official Journal of the EU, but the process could take as long as ten months.

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