Regulatory Update
EBA Publishes Final Guidelines on Sound Remuneration Policies under CRD IV

23 December 2015

Alongside the Guidelines¹ (effective from 1 January 2017), the EBA has published a separate Opinion on proportionality², proposing that:

- The bonus cap be applied to all firms subject to CRD IV
- Proportionality be permitted to allow disapplication of deferral and instrument requirements
- Listed institutions be able to use share-linked instruments (rather than real shares)

The revised Guidelines provide that:

- LTIP awards be valued on grant for purposes of the bonus cap
- No dividends or interest accrues on deferred awards
- Ultimate shareholder approval required for 2:1 bonus cap extension
- Carried-interest counts towards the bonus cap at award
- Retention periods are extended

What happened?

The European Banking Authority (EBA) published its final guidelines on sound remuneration policies under CRD IV (Guidelines) on 21 December 2015. Following a strong industry response to the first draft of the Guidelines that was published in March 2015, there have been changes to the original text. Most notably, proportionality is not addressed in the Guidelines; instead a separate Opinion that is addressed to the European Commission (EC), European Parliament and Council has been published. The EBA’s Opinion on proportionality confirms that the EBA will provide guidance to the EC on potential changes to the text of the Directive to clarify how proportionality is to apply.

How you can respond

For direct consultation on further implications, please contact us.

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Which firms are impacted?

The Guidelines are relevant to all firms subject to CRD IV, including banks (large and small), building societies, some asset managers and designated investment firms. Overseas branches and subsidiaries of EU headquartered firms will also be subject to CRD IV as per the Guidelines.

When do the Guidelines come into force?

The Guidelines will take effect from 1 January 2017, a year later than stated in the draft Guidelines. The UK regulators have already confirmed that application will be for the 2017 performance year and that no changes will be required for the 2016 performance year. Once the Guidelines have been translated into the languages of Member States, national regulators will have two months to confirm whether they will comply with the Guidelines. Note that it is not yet clear when any changes to the underlying Directive to accommodate and clarify proportionality will be made. The EC, the European Parliament and Council must agree to the changes proposed, which could be a protracted process.

What are the headline points for firms?

To provide more consistency across the EU, the EBA is proposing legislative amendments to the CRD IV text which extends the bonus cap to all firms, allows national regulators to exclude small, non-complex institutions from the deferral and payment in instrument requirements, and allows listed firms to use share-linked instruments rather than shares.

Certain firms, including asset managers, may be concerned that the text does not link the dis-application of proportionality to the nature of business undertaken; suggesting that larger firms may not be allowed to dis-apply any requirements.

Whilst many of the Guidelines’ requirements remain unchanged from the draft, the EBA has altered its position on some of the matters identified as important by firms. The table below illustrates the final position for some of these key issues and the likely impact for the industry overall.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Position in Final Guidelines</th>
<th>Overall Scale of Change Required</th>
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</thead>
<tbody>
<tr>
<td>Performance based LTIPs</td>
<td>Awards treated as variable pay in performance year for which they are awarded (provided award based on consideration of prior performance). Vesting no sooner than one year after performance testing.</td>
<td>LOW</td>
</tr>
<tr>
<td>Deferral periods</td>
<td>Deferrals of 3-5 years, 5 years for senior management in significant institutions.</td>
<td>LOW</td>
</tr>
<tr>
<td>Retention periods</td>
<td>Minimum retention period for shares/instruments extended from 6 to 12 months (unless specific conditions met).</td>
<td>MID</td>
</tr>
<tr>
<td>Dividends and interest on deferred awards</td>
<td>Dividends and/or interest cannot be paid, or accrued, during deferral periods.</td>
<td>HIGH</td>
</tr>
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Shareholder involvement  For subsidiaries, the parent will need to ensure that it has the support of its shareholders in order to grant approval for the bonus cap to be extended from 1:1 to 2:1.

Identified staff  More onerous process and governance requirements for identification of those having a material impact on a firm’s risk profile.

Retention awards, guarantees, buy-outs  Clarity around treatment of awards, particularly for bonus cap and deferral requirements.

Allowances  Restrictive criteria to map as fixed pay for purposes of the cap remain unchanged from draft Guidelines and EBA’s Opinion on use of allowances.

Carried interest  Carried-interest is variable pay and where not representing a pro-rata return on a recipient’s investment, is valued at award for the purpose of the bonus cap.

Severance pay  Will be categorised as variable remuneration but elements do not need to be included in the cap. Detailed guidance provided. Shareholder approval of maximum possible level required.

Proportionality

The EBA’s position on proportionality in the March 2015 draft Guidelines would have required CRD IV firms of all sizes to apply the CRD IV remuneration principles in full, without exemption or exclusion. This generated a strong industry response, as firms faced having to apply all of the so-called ‘pay-out process’ rules to all identified staff. Since the inconsistent application of the principle of proportionality has led to an ‘uneven playing field’ across the EU, the EBA recommends that legislative amendments are made to the text of CRD IV itself to ensure a more consistent interpretation and application of remuneration principles across Member States.

The EBA acknowledges that it may be appropriate to exclude ‘small, non-complex institutions’ from the deferral and payment-in-instruments requirements, echoing its statements in its report on investment firms which was published on 15 December 2015. In both that report and the Opinion, the EBA identifies only these two requirements as provisions that could be dis-applied. As yet, there is no indication of how ‘small’ and ‘non-complex’ is to be determined for this purpose.

However, many firms will be concerned that neither the Opinion nor the report on investment firms mentions the bonus cap as a requirement that could be dis-applied. Instead the EBA recommends legislative changes to the CRD IV text that would require all firms - regardless of their size and nature or scope and complexity of activities - to be subject to the 1:1 fixed to variable ratio (2:1 with shareholder approval).

Although the Opinion is clear, the status and application of proportionality for firms is likely to remain uncertain for some time. The EBA has stated that it will provide the EC with guidance by June 2016 on how the text of CRD IV might be amended to accommodate proportionality. The EBA’s Opinion likely indicates the tenor of this guidance,

and potentially the kind of amendments to be made to the Directive text. However, until the EC acts on the EBA's June 2016 recommendations, the final position and timing will remain unclear.

**Next steps for firms**

Firms should review their practices against the Guidelines to provide an initial assessment of the implications. Firms who are currently ‘dis-applying’ certain remuneration provisions (e.g. UK Level 3 firms), should consider the potential application and impact of the Guidelines and the Opinion, and how best to adjust to ensure alignment with the regulations from 1 January 2017, if necessary.

**How can Aon Hewitt’s Talent, Reward and Performance team help?**

For many firms, navigating the increasingly complex regulatory environment has proved challenging; from interpreting the impact of evolving local and global regulatory demands and aligning policy, to driving transformative change. Leveraging market leading data, insight and expertise, McLagan and New Bridge Street - part of Aon's Talent, Reward and Performance Group - are uniquely positioned to partner with you to enhance understanding, manage risks and develop solutions built around your needs.

**Regulatory Alignment Review**

We help firms review their compliance with remuneration regulations. Our proprietary tools help our industry experts assess clients’ regulatory alignment, uncovering current gaps and future risks. Their keen insight helps clients to adapt to a changing landscape and keep on top of current and proposed regulations.

**Remuneration Architecture Review**

We support companies design and implement reward structures that support their strategic goals whilst remaining compliant with regulatory requirements.

**Fact-Based Advice**

Our business is built on data. Each of our regulatory assignments is underpinned by proprietary market data and trends, ensuring you have access to accurate, relevant and complete information.

**Industry Practice**

We have long-term partnerships with virtually every leading global financial services firm enabling us to provide the breadth and depth of data and insight to build understanding.

**Multi-Disciplinary Approach**

Our experienced staff include accountants, lawyers, talent, reward and performance experts. Our diverse teams ensure we consider your business issues holistically.
About McLagan

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About New Bridge Street

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