15 October 2014

EBA Report

On the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances

I. Reasons for publication

1. Since the introduction of requirements relating to financial institutions' remuneration policies in 2010, there have been further developments in the legal framework and additional requirements were then introduced by Directive 2013/36/EU (Capital Requirements Directive (CRD), which is part of the latest legislative package of measures known collectively as CRD IV). This introduced a limit on the variable remuneration of 100% of the fixed remuneration (200% with shareholders' approval). To ensure that there is compliance with the variable remuneration limit, it is vital to map the remuneration correctly into these two categories.

2. Trends, potential risks and vulnerabilities in how institutions are complying with the principles on remuneration policies across the EU need to be identified at an early stage in order to safeguard financial stability and ensure there is consistent, efficient and effective application of the CRD. The EBA is entrusted with monitoring and assessing such developments and potential threats to the stability of the financial system. To this end, the EBA can request all necessary information from the competent authorities, organise and conduct peer reviews to assess the effectiveness and the degree of convergence reached in the enforcement of the provisions adopted to implement Union law, and investigate a particular type of financial institution, type of product or conduct.

3. The EBA is monitoring closely the developments of remuneration practices within the EU and is mandated with several tasks in this area. Appropriate remuneration policies are an important tool for aligning the incentives for staff with the risk strategy and profile of the institution. Inappropriate remuneration policies were identified as one underlying factor of the financial crisis.

4. The framework established under the earlier CRD package (CRD III) aimed to ensure there were appropriate remuneration policies, but did not include the definition of fixed and variable remuneration nor a limit on the ratio between the variable and fixed component of total remuneration as now provided for by Articles 92(2)(g) and 94(1)(g) of the CRD. This definition was however part of the CEBS Guidelines on remuneration policies and practices which were published in December 2010.

5. Following the adoption of the CRD IV, a number of institutions across the EU have recently changed their remuneration policies and introduced 'allowances' which they treat as part of the fixed remuneration paid to staff. The introduction of allowances has led to a widening of the scope for granting variable remuneration, alongside an increase in the supposedly fixed remuneration. As part of its market monitoring and assessment tasks, and in response to a request made by the European Commission on 12 February 2014, the EBA has launched an investigation into the nature of these allowances and their compliance with CRD IV provisions. For that purpose, the EBA has collected information from all competent authorities in order to analyse the types and use of these allowances.

6. The EBA has analysed the responses provided by the competent authorities and has also used institutions' disclosed remuneration reports and other publicly available information. The EBA's findings are presented in this report and will be taken into account when updating the guidelines on remuneration policies and practices.

II. Contents

7. When designing the CRD IV rules, the European co-legislators clearly intended to make sure that remuneration policies do not encourage excessive risk-taking and that the proportion of variable remuneration is limited so that that the sound and effective risk management of institutions is not undermined. These rules aim to protect and foster financial stability in the European Union. The co-legislators thus set out in Articles 92 and 94[1] of the CRD certain requirements for the remuneration policies of institutions and for the variable remuneration of staff whose professional activities have a material impact on an institution's risk profile ('identified staff').

8. This report is structured as follows:

   - description of the different types of allowances;
   - common features of role-based allowances;
   - EBA's analysis of role-based allowances;
   - conclusions and way forward.

III. EBA's considerations

Allowances observed and categorisation thereof

9. After the new regulatory requirements were published in the CRD, innovation from the industry side was seen with the introduction of new 'role-based allowances'. Allowances are additional payments or benefits paid in addition to the traditional contractual fixed remuneration (basic salary) and the performance-related variable remuneration (bonus) and they differ depending on why they are granted. Nevertheless, the EBA found major similarities between all of them as, in general, institutions tend to consider all allowances as fixed remuneration and argue that they are not based on performance.

10. The EBA has reviewed a range of bank's' remuneration practices across the EU regarding allowances. Where remuneration practices were identified that needed further analysis, the EBA followed up on these practices in more detail with the relevant competent authorities. Among the 28 Member States, six competent authorities reported the use of 'role-based' or

[1] The CRD IV provisions relevant for the analysis within the report can be found in Annex I

'market-value' allowances[2] by institutions in their banking system. In all these six jurisdictions, these allowances were reported as part of the banks' fixed remuneration.

11. Allowances which are part of routine employment packages, as mentioned in recital 64 of the CRD, and which are solely linked to the family or personal situation like childcare, regular pension contributions on top of the mandatory regime, travel allowance, and health insurance, were excluded from further analysis. These allowances remain classified as fixed remuneration when they are granted in a non-discretionary way to staff, are not performance-related and do not encourage risk-taking. Such allowances already existed in the past.

12. The EBA requested additional information from four competent authorities and received details about the use of role-based and market-value allowances in 39 institutions. As remuneration policies apply on a group level, this sample of major institutions represents a material part of the European banking sector and the investment banking sector in particular.

13. The market-value and role-based allowances observed are not part of routine employment packages and fall in the following two generic categories:

    a. Allowances used to increase the basic fixed salary in situations where staff work abroad and receive less remuneration than they would be paid on their local employment market for this position (market-value allowance). This allowance is paid i) on a non-discriminatory basis to all staff; ii) in particular, when they work abroad temporarily or in a different position with a remuneration level requiring adjustment from the contractual one to reflect pay levels in the relevant market; and iii) the level of additional payments is determined by predetermined criteria. This type of allowance which is granted consistently and based on predetermined factors in the above situations, where the duration of the allowance is tied to the duration of the situation, does not seem to be problematic.

    b. Allowances used to top up the fixed remuneration of some identified staff including executive directors, according to their role, function, seniority, managerial responsibilities or influence in the institution. Such allowances were introduced in particular where the performance-related variable remuneration would otherwise exceed 100% of the fixed remuneration (200% with shareholders' approval). In order to increase the amount of fixed remuneration which is taken into account when calculating the ratio between fixed and variable remuneration, institutions considered these allowances as fixed remuneration. The purpose of such allowances compared to an increase of the basic fixed salary is to maintain sufficient cost flexibility in total remuneration. This type of allowance is the focus of further analysis in this report.

Common features of role-based allowances

[2] The label may differ according to the institution: 'role-based pay, staff allowance, adjustable role allowance, fixed pay allowance', etc.

14. Most of the role-based allowances observed have all or many of the following characteristics:

    a. they are presented to the competent authorities as additional contractual fixed remuneration but are not included in the basic salary and are not pensionable (where national law allows);

    b. they are initially granted for a limited period of time (usually one year, in some cases for longer periods);

    c. they are based on role and responsibility, seniority of staff or the level influence of the staff in the institution;

    d. they are not explicitly based on performance criteria;

    e. they are based on the potential risk of departure of the individual (e.g. to retain key staff);

    f. they are based on strategic value of staff (e.g. remuneration for a head of unit);

    g. they are paid only to a few identified staff members selected on a discretionary basis, and in particular are limited to cases where the variable remuneration might exceed 100% (200% with shareholders' approval) of the fixed remuneration;

    h. they are reviewed by institutions periodically (for most of the sample this is annually or quarterly, but the conditions allow for a review at any time);

    i. payments are subject to the institution's discretion and they can also adjust future payments of the allowance up or down or cancel it; institutions often mention reasons for such adjustments, e.g. changes to role, responsibilities or external factors such as the business or economic environment, or any other reason;

    j. future payments of the allowance are often subject to a forfeit clause and no payments will be made after notice is given or received by staff;

    k. they are partly or fully paid in instruments and the amounts paid in instruments are subject to retention periods;

    l. staff are usually informed of such allowances by a letter which, in general, has to be countersigned; by doing so, staff in most cases agree explicitly to the terms of the allowance when it is granted, including that it can be withdrawn.

15. Most of the conditions applied (in particular, the discretionary elements) are typical conditions used for variable remuneration.

16. In a few other cases, the conditions of role-based allowances do not explicitly refer to the possibility of adjustments. In these cases, the allowance is granted as a fixed amount and sometimes for a period which depends only on whether the staff member stays in the same role or position.

17. Such allowances may allow institutions to exclude parts of the salary from pension rights and possibly redundancy payments depending on the national labour and contract law.

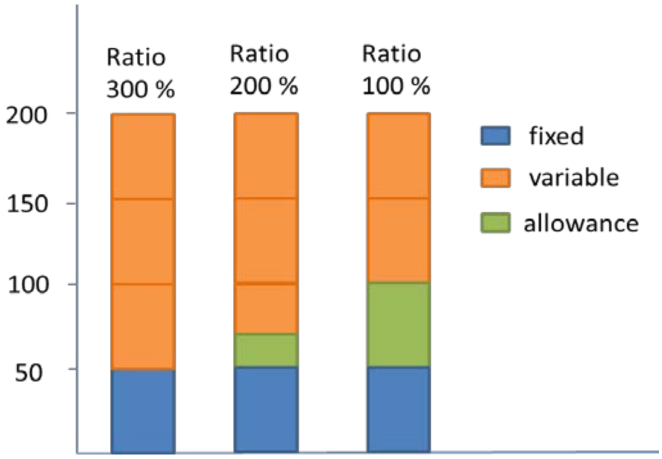
Effects and analysis of role-based allowances

18. Institutions have created role-based allowances which are not explicitly related to performance and are linked to the position and organisational responsibility of staff, and they consider such role-based allowances as fixed remuneration, although they can be adjusted using other conditions or with the full discretion of the institution.

19. The EBA analysed in detail the common features of the above-mentioned role-based allowances which were only awarded to some identified staff in the institutions.

20. Without that additional element of supposedly fixed remuneration or if such role based allowances were effectively considered as variable remuneration, the EBA's understanding is that the remuneration policies would not comply with the limit on the variable remuneration being 100% of the fixed component of remuneration (200% with shareholders' approval). The situation before and after the introduction of such allowances is indicated in the graph below. This also assumes, by way of an example, that before the CRD IV, a ratio of 300% between variable and fixed remuneration was in place. An allowance, where considered as fixed, would reduce the ratio, while the total amount of remuneration would remain stable. The first bar of the chart represents the situation before the adoption of the CRD IV; the other two bars represent the situation with a ratio of 100% and 200% between the variable and the fixed remuneration respectively, including allowances that supposedly are considered as fixed remuneration.

Figure 1: Effect of allowances on the ratio between components of remuneration



21. The analysis of role-based allowances is not about whether or not a benefit can be granted, but about its categorisation in accordance with the regulatory framework, i.e. whether it should be considered as variable or fixed remuneration and whether, after the correct mapping of all remuneration elements, the institution complies with the maximum ratio under CRD IV provisions. If remuneration elements are unduly assigned to fixed remuneration this circumvents applicable regulatory requirements for variable remuneration.

Categorisation of role-based allowances

22. Under the CRD, remuneration is either fixed or variable; there is no third category of remuneration. Where remuneration is variable and is paid to identified staff, all the requirements of Article 94 of the CRD must also be met, in addition to the general requirements contained in Article 92 of the CRD. To this end, institutions' remuneration policies should set out clear, objectively predetermined and transparent criteria to assign all remuneration components either to the fixed or variable categories.

23. When analysing role-based allowances, the distinction between the fixed and variable component of the remuneration set out in Article 92(2)(g) of the CRD must be read together with the recitals, and in particular recital 64, in a way that is in line with the objectives of the CRD, formulated in Articles 74(1) and 92(2)(a), that remuneration policies should be consistent with and promote sound risk management and should not encourage excessive risk-taking.

24. Under Article 92(2)(g) of the CRD, the remuneration policy, taking into account national criteria on wage setting, should make a clear distinction between fixed and variable remuneration. Under the CRD, variable remuneration comprises all components linked to performance or, in exceptional cases, other contractual elements that do not form part of routine employment packages. Fixed remuneration takes into account the professional experience and organisational responsibility of staff.

25. It is common under national labour and contract laws in the EU that fixed remuneration can only be changed with the consent of the employee or in collective bargaining and that it is paid over the full length of the contract. The amount may change with promotions or be renegotiated. National labour law may under some exceptional conditions allow unilateral changes by the employer.

26. To achieve the result prescribed by the above-mentioned provisions and to qualify as fixed remuneration, the conditions for granting a role-based allowance and the amount thereof should be predetermined, permanent (i.e. maintained over time for the specific role and organisational responsibilities), not provide incentives for risk-taking, be without prejudice to national law and be non-revocable.

27. In addition, the wording used in Article 92(2)(g) of the CRD clearly indicates the nature of payments that can or cannot be adjusted, i.e. 'variable' or 'fixed' respectively . The word 'fixed' indicates that this part of remuneration should not be subject to variations over time, without prejudice to specific circumstances provided for in national labour law, other than by the renegotiation of the basic salary between the parties.

28. Taking all the above into account, the EBA has found the main characteristics of role-based allowances as described below.

29. Where amounts of role-based allowances are granted that can be reduced, suspended or cancelled by institutions on a discretionary basis, the amount paid is neither predetermined nor permanent but is revocable.

30. Where amounts of role-based allowances are granted for a limited period of time which does not depend on whether the staff member continues to fulfil a certain role, the amount paid is not permanent.

31. Where allowances contain a forfeit clause, under which the allowances are not paid to staff after giving or receiving notice, the amount is neither predetermined nor permanent as it would not be paid in the same way as fixed basic salary for the full period of the contract.

32. Where role-based allowances are linked to the economic environment or other proxies for performance, although they look to be unconnected to the individual institution's or business unit's performance, there is in fact a link between the economic environment and the performance of the institution, as shown during the financial crisis. Hence such allowances are considered as performance-related variable remuneration.

33. Where role-based allowances include 'other contractual elements' mentioned in recital 64 of the CRD which do not form part of routine employment packages, they also constitute variable remuneration. Terms which allow discretionary changes are considered as 'other contractual elements'.

34. Role-based allowances which are discretionary, where the amount is not predetermined, which are not transparent to staff, or are not permanent (i.e. not maintained over a period tied to the specific role and organisational responsibilities for which the allowance is granted), are not in line with the above principles for fixed remuneration derived from Article 92(2)(g)(i) of the CRD. They fall instead under variable remuneration as defined under point (ii) of the same paragraph and must therefore comply with the requirements set out in Article 94 of the CRD.

35. In addition to the question of whether role-based allowances should be considered as variable or fixed remuneration, the remuneration policy including such allowances must be consistent with and promote sound and effective risk management as required under Articles 74 and 92(2)(a) of the CRD.

36. Staff cannot assume that the amount of the role-based allowance is fixed remuneration in a similar way as basic salary over the long term as it can be expected that in years where the institution does not perform well, allowances may be reduced, cancelled or not renewed. As no criteria for the review or adjustments are set or made transparent, the remuneration policy is neither predetermined nor transparent and does not guide staff behaviour. To avoid remuneration reductions in a downturn, staff might take additional or even excessive risks to try to ensure that an allowance is maintained.

37. Some role-based allowances might only have been introduced to comply with the bonus cap introduced by the CRD IV while retaining some cost flexibility. Cost flexibility is of importance where the performance of the institution or a business unit is no longer considered adequate. When there is the need for cost flexibility, the review of allowances would usually take

account of the costs and benefits of an allowance and the performance of relevant business units.

38. For the reasons set out above, remuneration policies which include discretionary role-based allowances and therefore lack certainty and transparency, might contain inappropriate incentives for risk-taking. These allowances are also at least indirectly linked to performance as they are intended to retain cost flexibility. Such allowances do not promote sound and effective risk management and are not in line with Articles 74 and 92(2)(a) of the CRD.

Conclusions and way forward

39. The EBA is of the view that taking into account the above analysis, role-based allowances which are discretionary, not predetermined, not transparent to staff or not permanent should not be considered as fixed but should be classified as variable remuneration, in line with the letter and purpose of the CRD. The amounts paid are not fixed, are not permanent (i.e. not maintained over a period tied to the specific role and organisational responsibilities for which the allowance is granted), are not set out in a predefined objective manner, nor are they transparent to staff and therefore they do not promote sound and effective risk management but are based on other contractual conditions which do not form part of routine employment packages.

40. Following the publication of this report, institutions which use such discretionary role-based allowances will be expected to treat them as variable remuneration and change their remuneration policies so that they comply with the requirements for variable remuneration in Article 94 of the CRD. Competent authorities are expected to ensure that institutions classify discretionary role-based allowances appropriately and implement the necessary changes in line with CRD requirements on remuneration. The EBA is developing guidelines on remuneration. While work on these is still ongoing and will be open to public consultation, the guidelines will be based on the analysis and findings of this report and will provide more specific criteria for the allocation of remuneration components to either fixed or variable remuneration and the supervisory treatment of allowances.

41. In line with Article 161 of the CRD, the EBA will work closely with the European Commission in reviewing the provisions on remuneration , including identifying where the legislation requires further reinforcement, e.g. by requesting disclosures of newly introduced remuneration components. A report on this review is due to be submitted by the Commission to the European Parliament and the Council by 30 June 2016.

Annex I – relevant CRD provisions

Recital 64 of the CRD makes clear that ‘a distinction should be made between fixed remuneration, which includes payments, proportionate regular pension contributions, or benefits (where such benefits are without consideration of any performance criteria), and variable remuneration, which includes additional payments, or benefits depending on performance or, in exceptional circumstances, other contractual elements but not those which form part of routine employment packages (such as healthcare, child care facilities or proportionate regular pension contributions). Both monetary and non-monetary benefits should be included.’

Article 92(1)(a) of the CRD requires that the remuneration policy of the institution is ‘consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the institution’.

Article 92(1)(g) requires that the remuneration policy of the institution ‘taking into account national criteria on wage setting, makes a clear distinction between criteria for setting:

(i) basic fixed remuneration, which should primarily reflect relevant professional experience and organisational responsibility as set out in an employee’s job description as part of the terms of employment; and

(ii) variable remuneration which should reflect a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee’s job description as part of the terms of employment.’

(iii) Article 94(1)(g)(i) requires that ‘the variable component shall not exceed 100% of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage.’

Article 94(1)(g)(ii) establishes that ‘Member States may allow shareholders or owners or members of the institution to approve a higher maximum level of the ration between the fixed and variable components of remuneration provided the overall level of the variable component shall not exceed 200% of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage.’

Article 94(1)(q) requires that ‘variable remuneration is not paid through vehicles or methods that facilitate the non-compliance with this Directive or Regulation (EU) No 575/2013.’

The Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards sets out qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile (RTS on identified staff).