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The EU Bonus Cap and Restrictions on the Use of Role-Based Fixed Allowances

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On 15 October 2014 the European Banking Authority (“EBA”) issued a report on the use of role-based fixed allowances by various financial institutions within the European Union (“EU”) affected by the EU bonus ratio cap. Role-based fixed allowances are essentially payments based on an individual’s role, responsibilities or seniority which are treated by the institution as fixed rather than variable remuneration for the purposes of the EU bonus ratio cap. The EBA is taking a very strict view as to when such allowances can properly be categorised as fixed remuneration. Assuming that regulatory authorities amend local rules to reflect the EBA’s views, financial institutions which have already implemented such allowances may need to revisit the structure of such allowances and make adjustments as necessary. The EBA expects regulators to ensure that institutions have updated their remuneration policies to reflect the report by 31 December 2014.

Background – the EU Bonus Cap and the Use of Allowances

EU Directive 2013/36/EU (known as “CRDIV”) came into effect on 1 January 2014. One of the most controversial aspects of CRDIV was the limit on variable remuneration that could be paid to certain key staff. Financial institutions are prohibited from paying such staff any amount of variable remuneration that exceeds 100% of fixed remuneration, although this limit can be increased to 200% with shareholder approval.

In light of this cap, a number of EU financial institutions sought to implement “role-based fixed allowances” as an additional form of fixed remuneration thereby enabling a greater amount of variable remuneration to be awarded within the bonus cap. These allowances take various forms but, in broad terms, such allowances tend to have some or all of the following features:

- the payments are usually fixed for a limited period of time;
- the payments are fixed and made by reference to an employee’s role, seniority, managerial responsibilities or influence in the institution;
- the payments are not explicitly based on performance criteria;
- the payments are based on the strategic value of staff and tend to be paid to a few identified staff members on a discretionary basis, particularly where a staff member’s variable remuneration might otherwise exceed the bonus cap;
- the payments are subject to review by the institution periodically (often annually or quarterly);
- the payments are subject to the institution’s discretion and the institution can adjust future payments up or down or cancel them (and reasons for such adjustments are often matters such as changes to the individual’s role, responsibilities or external factors such as the business or economic environment);
- future payments are subject to a forfeiture clause and no payments would be made after notice of termination has been given or received by the employee;
- payments are often made in shares or other non-cash instruments and may be subject to retention periods; and
- employees are usually informed of such allowances by a letter which they generally must countersign to agree to the terms of the allowance.

In response to concerns that such allowances were a disguised form of variable remuneration intended to circumvent the bonus cap, the EBA launched an investigation earlier this year into the nature and use of such allowances and this culminated in the report released on 15 October 2014. Only a relatively limited number of EU countries had institutions which reported the use of such allowances (six in total). The EBA gathered information from regulatory authorities in four of those countries and received details in relation to 39 institutions.

The EBA’s Analysis of Role-Based Allowances

The EBA reaffirmed that, under CRDIV, remuneration is either fixed or variable and there is no third category. A firm’s remuneration policy should make a clear distinction between fixed and variable remuneration.

Recital 64 to CRDIV 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, childcare facilities or proportionate regular pension contributions). Both monetary and non-monetary benefits should be included”.

In addition, Article 92(1)(g) of CRDIV requires that the remuneration policies of institutions must make a clear distinction between the criteria for setting (a) fixed remuneration “which should primarily reflect relevant professional experience and organizational responsibility as set out in an employee’s job description as part of the terms of employment”, and (b) variable remuneration “which should reflect a sustainable and risk adjusted

performance as well as performance in excess of that required to fulfill the employee's job description as part of the terms of employment".

In addition, Article 94(1)(q) of CRDIV 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".

For a role-based allowance to be categorised as fixed remuneration, the EBA indicates that the conditions for granting the allowance and the amount payable must: (i) be predetermined; (ii) be permanent (*i.e.*, maintained over time for the specific role and organisational responsibilities for which the allowance is granted); (iii) not provide incentives for risk-taking; (iv) be without prejudice to national law; and (v) be non-revocable. In addition, the allowance must not be subject to variations over time, other than by agreement between the parties (or as otherwise provided by applicable national law).

In particular, the EBA noted that:

- where the amount of the allowance can be reduced, suspended or cancelled by an institution on a discretionary basis, the amount is neither predetermined nor permanent but is revocable;
- if the amount of the allowance is granted for a limited period of time which does not depend on whether the employee continues to perform a certain role, the amount paid will not be regarded as permanent;
- where the allowance contains a forfeiture clause, under which the allowance is not paid if the employee gives or receives notice of termination of employment, the amount will not be regarded as predetermined or permanent (since it would not be paid in the same manner as base salary for the full period of employment);
- where the allowance is linked to the economic environment or other "proxies for performance", there is in fact still a connection to the economic environment and the performance of the institution albeit that, on the face of it, it may appear unconnected to the performance of the individual or the relevant business unit; as such, it will still be considered as performance-related variable remuneration; and
- terms which allow institutions to make discretionary changes to allowances will mean that the allowance is viewed as variable remuneration.

Next Steps/Implications

The EBA expects that institutions which have used discretionary role-based allowances will adjust their remuneration policies so that they are in line with CRDIV requirements on remuneration. In addition, the EBA expects national regulators to ensure that, by 31 December 2014, relevant institutions have updated their remuneration policies to reflect the EBA's views so that discretionary role-based allowances are characterised as variable remuneration. That said, the report by itself does not carry any legislative authority, although we would expect national regulators to require affected institutions to pay due regard to the EBA report.

The EBA will issue revised CRDIV remuneration guidelines (originally published in 2010) which will be based on the report and will set out more specific criteria on the characterisation of remuneration as either fixed or variable remuneration and the treatment of allowances. These revised guidelines are expected to be published by the EBA later this year or early next year.

Many major financial institutions have already implemented various types of role-based allowances in advance of the usual bonus round in the first quarter of 2015. As stated above, the EBA expects local regulators to ensure that, by 31 December 2014, institutions have updated their remuneration policies to reflect the EBA's views. Assuming that local regulators do amend relevant rules by that deadline, there would be an issue as to whether, in relation to the bonus round in the first quarter of 2015, regulators would regard fixed allowances granted during 2014 (and prior to

the introduction of such revised rules) as compliant or not. At least in the UK, we would expect regulatory authorities to be sensitive to the issue of retrospectively declaring allowances granted prior to the introduction of such revised rules as non-compliant, but at this stage the point is not certain.

Although the EBA did not issue an outright prohibition on the use of fixed allowances, whether or not they continue to be used remains to be seen. We suspect that they will continue to serve a purpose not least because, even when allowances are structured to comply with the EBA's views, they still allow financial institutions to deliver remuneration which is fixed in nature (and thereby giving more headroom to award variable remuneration whilst staying within the bonus cap) but which will not count for the purposes of other employee benefits (*e.g.*, pension, life insurance etc.) or severance payments (although in some EU countries the employer's ability to have the allowance not count for such purposes may be constrained by local employment laws). In addition, to the extent that employees may move to different roles (or are relocated to jurisdictions where CRDIV does not apply) such allowances may still be useful in that it should be possible to withdraw them on any such change or relocation without affecting their categorisation as fixed remuneration.

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