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European Commission Consultation on CRD IV Remuneration Requirements

Response from the Employment Lawyers Association

14 January 2016

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INTRODUCTION

1) The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent claimants and respondents in courts and employment tribunals. It is not ELA's role to comment on the political or policy merits or otherwise of proposed legislation, rather it is to make observations from a legal standpoint. Accordingly in this consultation we do not address such issues. ELA's Legislative and Policy Committee is made up of both barristers and solicitors who meet regularly for a number of purposes including to consider and respond to proposed new legislation.

2) The Legislative and Policy Committee of ELA set up a sub-committee under the co-chairmanship of Alistair Woodland, Clifford Chance LLP and Fraser Younson, Squire Patton Bogg LLP to consider and comment on the consultation paper from the European Commission on CRD IV Remuneration Requirements. Its report is set out below. The members of the sub-committee are listed at the end of this paper.

CONSULTATION QUESTIONS

2. MAXIMUM RATIO RULE

2.1 IMPACT OF THE MAXIMUM RATIO RULE ON COMPETITIVENESS

2.1.2 What impact, if any, of compliance with the Maximum Ratio Rule have you observed on the COMPETITIVENESS of the undertakings concerned? Please provide as much as possible factual, concrete and verifiable elements that support your answer. If you ticked more than one box above, please make sure to distinguish as relevant.

In respect of all of the undertakings listed under question 2.1.1, we have observed through discussions with our clients and colleagues that compliance with the Maximum Ratio Rule may in some circumstances place firms subject to the Maximum Ratio Rule at a competitive disadvantage in the recruitment context.

Examples include where firms subject to the Maximum Ratio Rule are competing for talent with firms which are not covered by CRD (either because they are not credit institutions or investment firms or because they are located outside of the geographical jurisdiction of CRD). To remain competitive in terms of total potential compensation, CRD firms are having to offer higher fixed pay, with the unintended consequence that fixed remuneration (whether paid as base salaries or by other means e.g. role-based allowances) for material risk takers has increased. Such an increase could potentially (i) limit the extent to which remuneration is performance-sensitive; and (ii) make clawback of remuneration more difficult.

We have also seen firms (whatever their categorisation above) with complex group structures and different business lines grapple with the application of CRD consolidation to business lines which have a greater affinity to businesses whose remuneration (and regulatory capital base) is less regulated than those subject to CRD. For example, firms with fund manager or private equity businesses within their CRD consolidation group are at a disadvantage when these businesses are required to adopt the same remuneration rules as their investment bank parent company. This places such businesses at a competitive disadvantage against competitors outside the CRD framework.

Our work with individual and corporate clients who are not covered by CRD (e.g. private equity funds), tells us that individuals working in the financial services industry are looking increasingly to move to roles outside of credit institutions and investment firms.

In respect of EEA subsidiaries of EEA parents covered by CRD, the differing applications of the Maximum Ratio Rule between Member States sometimes leads to difficulties for firms in implementing group-wide remuneration policies. This may in turn impact on the competitiveness of the undertakings concerned.

Examples of this include subsidiaries in the Netherlands and Belgium which have a different (more restricted) cap on variable pay than required by the Maximum Ratio Rule. This also leads to problems for internationally mobile employees moving within the EEA, who are faced with conflicting pay regimes within the single market. This may, in turn, impact on the competitiveness of EEA subsidiaries of EEA parents covered by CRD, when compared with subsidiaries of non-EEA parents not covered by CRD. Whilst it may be appropriate for Member States to retain discretion as to implementation of such caps beyond that required in the Maximum Ratio Rule (not least in light of article 153(5) of the Lisbon Treaty), one potential effect of this is to increase the inequality in remuneration practices with the EEA. This in turn may give rise to increased regulatory arbitrage by material risk takers working within the EEA with a corresponding detriment to some firms and Member States as a consequence.

We are aware of firms (particularly those who are established in the EEA and therefore directly subject to the Maximum Ratio Rule) carrying out detailed reviews of the locations of their headquarters, subsidiary and branch operations in order to assess whether the benefits of being established in the EEA outweigh the perceived negative impact of the Maximum Ratio Rule (and other rules on remuneration set out in CRD IV). However, we note that such reviews of the location of headquarters are not based solely on considerations of remuneration-related regulations but on the regulatory burden in general.

2.2 IMPACT OF THE MAXIMUM RATIO RULE ON FINANCIAL STABILITY

2.2.2 *What impact, if any, of compliance with the Maximum Ratio Rule have you observed on FINANCIAL STABILITY? Please provide as much as possible factual, concrete and verifiable elements that support your answer. If you ticked more than one box above, please make sure to distinguish as relevant.*

One unintended consequence of the Maximum Ratio Rule (particularly in respect of CRD firms based in the UK) has been a significant increase in base salaries for material risk takers, which in turn has reduced the amount subject to deferral (and therefore to malus and claw-back). This position will be exacerbated as a result of the position adopted by the EBA in their Final Guidance on Sound Remuneration Policies under CRD IV (the "**EBA Guidance**") which significantly curtails the ability of firms to use "allowances" and in particular, prevents firms from classifying allowances as part of fixed pay where the allowance is subject to forfeiture. An increase in base salaries will increase firms' fixed costs, which may in turn affect financial stability.

We note that firms able to recruit with lower fixed pay have much more flexibility in managing costs in the event of any adverse change to their businesses without reducing headcount. In contrast, firms with higher fixed pay may in such circumstances have little option but to terminate the employment of material risk takers as a way of managing fixed costs (because of the difficulty in adjusting base salary unilaterally). This may in turn increase litigation risk for firms which may impact on financial stability.

By their nature, role-based allowances are fixed pay and not subject to risk adjustment, and so the points made above in relation to rising salaries apply equally in respect of the practice of paying role-based allowances to material risk takers.

2.3 IMPACT OF THE MAXIMUM RATIO RULE ON STAFF WORKING OUTSIDE THE EEA

2.3 What impact, if any, of compliance with the Maximum Ratio Rule have you observed on staff working effectively and physically in subsidiaries established outside the EEA of parent institutions established within the EEA?

The impact of the Maximum Ratio Rule on staff working effectively and physically in subsidiaries established outside of the EEA parent institutions established within the EEA is most keenly felt by firms during recruitment, where the application of the Maximum Ratio Rule (and other remuneration rules set out in Articles 74 to 76, 92 to 96, 104, 109, 162(3) and recitals 62 to 69 of CRD IV) is thrown into stark relief when compared with the remuneration practices of firms operating outside of CRD in Asia and the United States.

The CRD remuneration rules represent a challenge to non-EEA headquartered firms, which are often unwilling to allow the CRD requirements of their EEA subsidiaries to drive the structuring of the remuneration for non-EEA subsidiaries, despite an instinctive commercial desire to remunerate on a consistent basis globally. For example, for many large non-EEA headquartered firms, it is important for commercial reasons that remuneration plans are structured on a global basis by business lines, rather than by reference to particular jurisdictions. However, the stark differences between the CRD rules and rules in non-EEA countries (in particular the Maximum Ratio Rule) mean that it has become increasingly difficult for such firms to operate a consistent global remuneration policy.

We have observed that large firms with an internationally mobile workforce whose employees either have dual roles in EEA and non-EEA jurisdictions or who are assigned outside of the EEA for periods of time are confronted with particularly complex remuneration design issues. This is perhaps even more acute where an employee is asked to move within a group (say) from a non-EEA parent outside of CRD to an EEA subsidiary which is within the scope of CRD.

We have also seen some EEA-headquartered banks which, in relation to their non-EEA subsidiaries, can be faced with two sets of remuneration rules which either leave little room for manoeuvre or which can directly conflict with each other. For example, EEA-headquartered banks with operations in Russia may find themselves subject not only to Russian regulatory rules (which require that for material risk takers a minimum of 40% of the total remuneration must be paid in variable remuneration) but also EU requirements (which impose the bonus cap on variable remuneration of 100%/ 200% of fixed remuneration).

Finally, we acknowledge that the EBA's position on group context articulated in its final Guidelines (at paragraph 72) may moderate the impact of the Maximum Ratio Rule on staff working outside of the EEA, but the effects of this change in the EBA's approach remain to be seen.

3. EFFICIENCY OF THE OVERALL CRR AND CRD IV REMUNERATION PROVISIONS

In CRD IV, rules on remuneration are set out in Articles 74 to 76, Articles 92 to 96, Article 104, Article 109 and Article 162(3), and in recitals 62 to 69. In CRR, Article 450 and recital 97 cover rules on remuneration. The objective of the remuneration rules is to avoid that remuneration policies encourage excessive risk-taking behaviour and thus undermine sound and effective risk management of credit institutions and investment firms. They aim at aligning remuneration policies with the risk appetite, values and long-term interest of credit institutions and investment firms, in order to remedy regulatory loopholes, which induced a number of managers, especially before the crisis, to an excessive risk-raking approach. The ultimate goal is to protect and foster financial stability within the Union.

3.1 Against this background, how would you assess the efficiency of the following remuneration rules of CRD IV and CRR? Please always back up your views with specific evidence:

3.1.1 *The requirement set out in Article 94(1)(a) CRD that the assessment of performance is based on a combination of the individual's performance (taking into account financial and non-financial criteria), the performance of the business unit concerned and of the overall results of the institution; the requirement set out in Article 94(1)(b) CRD that the assessment of the performance is set in a multi-year framework.*

Our experience as advisers to relevant institutions is that firms have had little difficulty applying the requirement that variable compensation is assessed by reference to a range of financial and non-financial metrics. We do think there is a lack of understanding generally about what is meant by the requirement the "*assessment of performance is set is multi-year framework*": in practice, financial institutions still conduct an annual bonus process and make an assessment of performance in the year under review only (and we note that there are potential contractual difficulties in moving from an annual bonus cycle). Further clarification of the meaning of this particular provision would be welcomed.

3.1.2 *The requirement set out in Article 94(1)(m) CRD to defer at least 40% of the variable remuneration.*

Again, our experience as advisers to relevant institutions is that firms have had little difficulty applying this requirement. We would however make these observations:-

(i) it is not clear from the directive text whether the deferral requirement has to be applied to each instance of variable remuneration awarded over the course of a year, or whether the 40% threshold should simply be assessed in relation to total variable compensation awarded in respect of any one performance year;

(ii) as set out above,. the amount subject to deferral (and therefore the effectiveness of this rule) has been negatively impacted by the bonus cap.

3.1.3 *The requirement set out in Article 94(1)(l) CRD to pay out at least 50% of variable remuneration in instruments, whereby there will be a balance of shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution, and where possible other instruments adequately reflecting credit quality of the institution as a going concern.*

In our experience there are some instances where the activities of a third country parent company are at a significant remove from the institution applying the CRD remuneration provisions, and in those circumstances, the requirement for listed institutions to pay at least 50% of variable remuneration in shares in the listed parent is somewhat unhelpful (since the share price may change independently of the performance of the CRD firm, and/or the activities of the individual material risk taker). In these circumstances, the use of other instruments more closely aligned to the CRD institution would be more appropriate. Whilst we welcome the proposal made by the EBA in their opinion of 21 December 2015 (the "**Opinion**") that listed institutions be permitted to use "share-linked instruments", we think listed CRD firm ought to be given the flexibility to use other instruments more closely aligned to the performance of the CRD firm and the individual concerned.

Where institutions cannot (owing to their legal structure) issue shares, requiring them to issue "equivalent non-cash instruments" creates an additional risk for these firms (since they cannot provide employees with actual shares, they cannot readily hedge against the additional cost that may be associated with an increase in the value of the underlying instrument). Additional costs are incurred by these firms given the need to "value" the share linked instrument. These additional costs could be avoided if firms were able to award cash over the deferral period (but subject to malus).

3.1.4 *The requirement set out in Article 94(1)(n) CRD that up to 100% of the variable remuneration is subject to malus and claw back.*

Scope: Art 94(1)(n) CRD offers no guidance as to the application of malus/claw back provisions, save that they should apply to up to 100% of total variable remuneration. It would further assist if certain minimum criteria were specified, so that disparate standards/practices do not emerge across (or even within) member states; in particular, the periods to which the malus and claw back provisions should be applied. We recognise that the EBA Guidelines offer some guidance, but that these are necessarily also broad (and as a result, do not address the question of disparate practices emerging across member states).

Clawback: Specific guidance on what steps are required to recover sums would be welcome. For an existing employee it may be relatively easy for an employer to recover sums paid (e.g. exercising a right to deduct the relevant amounts from salary payments). Reclaiming sums from ex-employees is likely to be more problematic; and if an employee refuses to repay, the costs of taking enforcement action may be disproportionate to the amount being reclaimed. The problem could be exacerbated for employees who are outside the jurisdiction.

Penalty: There is a substantial risk that malus/claw back provisions will be subject to the "penalty" rule in the UK. We understand that similar rules apply across the majority of common law and civil law jurisdictions in the EU; see for example Res (78)3 of the Committee of Ministers of the Council of Europe.

Unlike many civil law jurisdictions, under the common law rule (for example, that applicable in the UK) the clause is unenforceable if the sum due under it is disproportionate. A provision will not be upheld if it imposes a detriment on the individual out of all proportion to any legitimate business interest of the employer in the enforcement of the individual's primary duties. Art 94(1)(n) leaves the specific criteria to be applied to the individual institutions, but offers two specific situations, including where the individual has "failed to meet appropriate standards of fitness and propriety". But those standards are broad and a breach of them may have caused the institution to suffer no loss at all.

It would assist legal certainty if Art 94(1)(n) specifically made clear the types of factor to be taken into account by the CRD firm in determining that any sums be withheld/recovered from an individual, including the relevance of the losses which that individual has caused or may cause the institution.

Tax: Art 94(1)(n) requires arrangements to apply to up to 100% of total variable remuneration. It is unclear whether the individual should lose that sum or the employer recover that sum. These are not the same thing given the incidence of tax. The issue was highlighted in the recent UK decision in *Martin v HMRC*: an employee has the right to claim back tax where a sum has to be repaid but only if s/he has sufficient taxable earnings for the relevant year against which to offset negative taxable earnings. So if the employee is not earning for some or part of the year in which clawback is operated, s/he may be unable to claim back the applicable tax and so lose more than 100% of the original remuneration.

3.1.5 *The requirements set out in Articles 94(1)(f) and 94(1)(g) that fixed and variable components of remuneration are appropriately balanced; that the fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component; and that the variable remuneration cannot exceed 100% (or 200% with shareholders' approval) of the fixed remuneration*.

In our experience, the option to set variable remuneration at the higher 200% level is useful and frequently taken up across a wide range of institutions. Where there is take-up of the higher ratio, the ratio is almost always set at 200% for all identified staff.

The reasons commonly given for taking up the higher level ratio include the ability to be flexible depending upon performance, and that rationale fits with the policy objectives underlying CRD IV. Similarly, the option is taken up in order to formalize a link between pay and performance not simply to reward exceptional performance but also to motivate. This is seen as particularly important by institutions now that it has been confirmed by the EBA Guidance that role-based allowances are permitted in only limited circumstances.

Where the performance criteria include the institution's general strategy and acceptable risk levels, the award of remuneration at the higher rate is not in conflict with the underlying prudence requirements of CRD IV. In the UK, the FCA expressly requires that when making the recommendation to shareholders, the firm details the expected impact on the requirement to maintain a sound capital base. In our experience, it is commonly stated that the amounts of variable remuneration do not significantly impact the firm's capital base.

Other reasons for taking up the higher level ratio relate to the desire to remain competitive with EU and international peers, and to be able to recruit and retain high quality staff in particular at the senior level. In London, we understand that there has already been some impact on the competitiveness in relation to the ability to retain and recruit senior personnel as against international financial centres outside the EU (for example, New York and Hong Kong.

The general practice in relation to variable remuneration is that there is at least a significant role for the exercise of discretion including the discretion to pay no bonus at all. The trend over recent years has been to make variable remuneration entirely discretionary. Where the exercise of discretion is challenged, the UK courts have shown a strong inclination to respect the wide ambit of discretion on the part of the paying institution. The imposition of the ratio has not affected the ability or preparedness of institutions to pay no bonus at all, in appropriate circumstances. Similarly, the option of the higher ratio has not had that effect.

3.1.6 *The requirement for significant institutions to establish a remuneration committee (Article 95 CRD) as well as a risk committee (Article 76 CRD) which shall assist in the establishment of sound remuneration policies and practices.*

Many UK firms have long had remuneration committees. The CRD IV rules has caused relevant firms to formalise and extend the remit of those committees, specifically with respect to decisions regarding malus and clawback. In other firms, the requirement to establish remuneration committees has generally been considered sensible.

Institutional investors have noted that under CRD IV, remuneration committee members bear a significantly increased regulatory burden. This impacts both the make-up of those committees and the costs of maintaining them, particularly given the now wider definition of Code Staff following the publication by the EBA of the Regulatory Technical Standard relating to Identified Staff.

In our experience, the remuneration committee related requirements of CRD IV will be most burdensome where separate remuneration committees are required to be established within various entities within a single group. The EBA Guidelines indicate that "significant" firms will be required to establish their own remuneration committees. In addition to being administratively cumbersome, this requirement appears to be inconsistent with the CRD IV principle that firms should establish and apply a group-wide remuneration policy. Furthermore, firms that are head-quartered outside of the EEA may not be used to the requirement to form a remuneration committee and so the impact of CRD IV will be greater on them. In our view, with respect to both EEA and non-EEA firms, remuneration committee responsibilities can be discharged effectively by a group-wide committee at parent level. This approach would encourage firms to treat staff consistently (subject to relevant local laws), and would also ensure that the remuneration policy is informed by the group-wide context.

Again, in our experience, firms have generally regarded the requirement to establish risk committees as sensible. Guidelines place an emphasis on the role of the risk committee and its interaction with the remuneration committee. This reflects recent regulatory and market practice, which has increasingly focussed on the wider remuneration decision-making and governance processes within firms.

3.1.7 *The requirements set out in Article 96 CRD and Article 450 CRR on the public disclosure concerning remuneration policy and practices.*

With respect to disclosures pursuant to CRD IV, as the relevant disclosures are aggregated, our view is that they are unlikely to affect individual behaviours. Instead, they encourage remuneration committees to have more input into bonus pools in order to ensure that the amounts being paid in aggregate are not seen to be excessive when compared to the performance of the firm. Equally, with respect to severance payments, firms will no doubt be keen to not be in a position where they could be said to be "rewarding failure" by awarding disproportionate sums to leavers.

In our experience firms do not take issue with disclosing general data in respect of all employees and specific data in respect of their most senior employees. However, the requirements could create issues where a firm is required to make a disclosure in respect of a small group of staff, in particular, where it may then become possible to identify (in broad terms) the remuneration of particular individuals. The disclosure of such data could be used by firms to formulate offers in order to poach staff from their competitors, thereby inducing breaches of contract and equitable duties. Further, such disclosure could potentially conflict with firms' privacy and data protection obligations, and it is important that the disclosure requirements on firms are compliant with those obligations.

3.2 *How would you assess the overall efficiency of the remuneration rules of CRD IV and CRR collectively? Also, please indicate whether you have identified any lacunae in the existing rules. Please back up your views with specific evidence.*

Overall it is our assessment that the remuneration rules introduced by CRD III (subsequently developed into CRDIV) support the generally objective of ensuring that remuneration policies do not encourage excessive risk taking behaviour, and that practices such as deferral and payment in instruments have now become engrained in banking culture in the UK. However, the introduction of the Maximum Ratio Rule has significantly undermined the effectiveness of those measures as it has resulted in significant increases in fixed pay as outlined throughout this paper, impacting on the extent to which institutions can apply performance adjustment and claw back to a large proportion of remuneration.

In terms of lacunae or other problems faced, it is often impossible for institutions to treat employees (or former employees) consistently. Specifically:

1. In the case of firms that are headquartered outside of the EEA, employees within the EEA are likely to be subject to different rules to those based outside of the EEA. Unless the firm elects to take a CRD IV compliant approach in respect of all of its operations, there may be an inconsistency of treatment and approach to remuneration across the group.

2. With respect to performance adjustment, legal and/or practical constraints may prevent consistent treatment of former and current employees. For example, in cases involving historic wrong-doing, firms can often only take action against those employees who remain with the firm and not those who have left: a current year bonus can be adjusted in light of historic events whereas adjustment in respect of a former employee will be difficult unless they have any deferred awards. Requiring firms to apply malus and clawback over a significantly longer period could go some way to addressing this issue, but in the case of former employees malus will typically only apply where individuals have retained deferred awards, and there are greater practical difficulties with enforcement of clawback in relation to former employees.

3. In some instances, local employment laws limit the ability of CRD firms to take into account historic misconduct as a basis for operating malus or clawback.

A connected but as yet unresolved issue relates to "buy-outs", ie the practice whereby a firm compensates an employee for any bonus forfeited on account of them leaving their previous firm. Buy-outs can (inadvertently) lead to departing employees avoiding accountability for their past acts. Options to address this issue include: (i) prohibiting buy-outs; (ii) prohibiting forfeiture for leavers such that malus could continue to be applied (albeit this is likely to be expensive for firms); (iii) allowing the previous firm to influence any malus adjustment of the buy-out; or (iv) relying on clawback, which is legally problematic and (as it would not apply to the buy-out) would relate to the wrong bonus. We understand the UK's Prudential Regulation Authority intends to consider option (iii) in more detail, but clearly an EU wide solution to this issue would be preferable.

Members of ELA Sub-committee
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