The European Banking Authority ("EBA") has today published its final guidelines on sound remuneration policies (the "Guidelines"), which are due to come into effect from 1 January 2017. These Guidelines will replace the existing guidelines prepared by the EBA's predecessor, the Committee of European Supervisors ("CEBS"), in December 2010. A link to the Guidelines can be found here: https://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-sound-remuneration-policies-and-its-opinion-on-the-application-of-proportionality

Without question the biggest development is the EBA's view on proportionality. In the draft Guidelines, the EBA stated that the way that regulators have currently enforced the proportionality provisions in the Directive (by allowing certain requirements to be "neutralised" for certain institutions or groups of staff) was not, in their view, permitted under the Directive. To address this issue, the Guidelines are accompanied by an opinion written by the EBA and addressed to the European Commission, Parliament and Council (the "Opinion"). In the Opinion, the EBA maintains their previous position, but recommends that a legislative process is undertaken to amend the Directive to make it clear that certain firms are able to apply proportionality in a manner that allows them not to comply with minimum deferral and use of shares - that is to continue to be applied in the way currently operated. Clearly, this is good news for those currently operating proportionality either at a firm-wide level (i.e. "level 3" firms in the UK) or for certain individuals (through "de minimis" provisions in the UK).

However, the news is not all good. The EBA is explicit in its Opinion that this should allow for the disapplication of the rules on deferral and payments in instruments, but not to the cap on variable pay (the "bonus cap"). This will mean that all firms who are subject to CRD4, regardless of size or licence, will be required to apply the bonus cap for their Material Risk Taker ("MRT") population. There are further concerns for the asset management community - the drafting of the Opinion strongly implies that the expectation would be that firms could not apply proportionality purely due to the nature of the business that they undertake. This could potentially mean that larger investment firms would no longer be able to rely on the application of proportionality in respect of the CRD 4 remuneration requirements. The Guidelines are also explicit that a subsidiary of a significant institution could not apply proportionality, which would essentially remove the re-tiered status of a number of asset management businesses of large banks in the UK. At the same time, the EBA report last week proposed a new approach to the prudential supervision of investment firms, which could potentially increase the number of investment firms subject to the remuneration requirements of CRD4.

The Guidelines themselves are long (at 172 pages) and contain a number of changes from the draft published earlier this year in March, that will be welcome to many firms, including changes to the treatment of long-term incentives and the use of share-linked instruments. However, other areas, including prohibition on the payment of dividends during deferral periods and tougher language on the use of allowances remain. More detail on the key aspects of the Guidelines are set out below.

Perhaps reflecting the delay in publication, and also the controversial nature of the recommendations on proportionality, the deadline for compliance with the Guidelines has been moved from 1 January 2016 to 1 January 2017. Once the process of translating the Guidelines into the various European languages has been completed, Member State regulators (the PRA and FCA in the UK) will have a two month period in with they are required to confirm whether they will comply with all or parts of the Guidelines - this period will probably conclude at some point in late spring or early summer. After this, it would be expected that any required changes to local regulation will be made (which in the UK would be operated through a consultation on changes to both the PRA Rulebook and SYSC 19A and 19D). However, the "comply or explain" process only applies to the Guidelines. The change on proportionality is a proposed change to the Directive itself. This means that the timing remains uncertain - changes will need to go through the full legislative process in Europe with agreement from the Commission, Council and Parliament. It is clear that the EBA intend to provide support to ensure that this change is made as soon as possible, presumably so that it can be enforced by 1 January 2017. However, it is distinctly possible that the legislative process to amend the Directive could take longer than the EBA desires and may not be complete by the end of 2016. Once this legislative change is made, unlike the Guidelines, there will be no ability for local regulators to choose not to comply unless they choose to legally challenge the Directive itself. Clearly the final requirements remain uncertain and will likely be subject to significant debate in Europe. However, it seems likely that, once agreed, there will be little flexibility for local regulators to take a different approach. As a result, those impacted should begin planning now on how they will manage the commercial impact of these changes.

Although the proposed changes to proportionality rules as set out in the Opinion are a matter for legislative process rather than the Guidelines, there is a requirement in the Guidelines that the bonus cap should apply to all MRTs. If the PRA/FCA wishes to continue with its current proportionality regimes it would need to to indicate its intended non-compliance with that part of the Guidelines pending legal clarification. Given the timing of this decision (probably late spring or early summer) it is likely to be a matter of the utmost political sensitivity.

Summary of key areas within the final Guidelines

The Guidelines contain many detail provisions that we shall report on in more detail in the coming days. However, the key areas, other than proportionality, likely to be of interest to firms are as follows.

- ***Long-term incentives:*** Changes have been made to the wording of this section so that long-term incentives can now be treated as variable remuneration for the performance year in respect of which they are awarded, rather than the year they vest. This allows UK-style long-term incentives to continue to operate. However, there is a requirement that for this treatment to apply, the award should be based on some consideration of prior performance. It remains to be seen what level of pre-grant performance variability will be required to satisfy this test. There is a further requirement that the award can vest no earlier than one year after performance is tested. The requirement for performance prior to grant clearly cannot be met for an award of long-term incentives to a new hire at the start of their first performance year. In this case the award must be measured against the bonus cap in respect of the final year of the performance period, and the vesting clock starts ticking at this date as well. Broadly our reading is that this will allow UK-style long-term incentives to continue to operate, albeit with some added complexity.
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- ***MRTs:*** Considerable additional requirements have been included on the governance of identification of MRTs as well as the process for disapplication. Although many larger firms will likely already be broadly compliant this does add considerably to the work for smaller firms. In addition, the EBA have reinforced the requirement in the Regulatory Technical Standard that identification must occur on both a consolidated and solo basis - this could add to the number of MRTs. Both of these areas are more significant given the proposed changes to proportionality which will mean that all MRTs are subject to the bonus cap, regardless of the size of the institution.
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- ***Shareholder involvement:*** For UK listed firms, there are further requirements on the information now required to be submitted to shareholders, although in practical terms this may not lead to significant levels of change given existing UK rules. However, the biggest concern will be for non-EEA listed firms, as the EBA clearly intend that firms seek approval from their ultimate public shareholder in order to allow the bonus cap to be extended from 1:1 to 2:1.
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- ***Instruments:*** The EBA are proposing changes to the Directive in order to allow firms to use share-linked instruments rather than real shares, recognising the practical challenge of this for many. However, the requirement to restrict payments of dividends remains and firms will now not be able to pay dividends or interest to MRTs on any shares during deferral periods (although our initial reading is that this will be permitted during retention periods).
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- ***Deferral and retention periods:*** The requirement for deferral of 5 years for senior management in significant institutions remains in the Guidelines, but associated additional retention periods for this group have been removed. Given existing UK requirements for 7 year deferral for Senior Managers, this is unlikely to significantly impact most in the UK. However, the Guidelines will also require firms to extend retention periods to 1 year from the 6 months currently permitted in the UK for the most senior staff.
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- ***Retention, guarantees and buy-outs:*** The EBA have significantly clarified the treatment of these awards and firms will likely particularly welcome the explicit exclusion of guaranteed variable pay from bonus capping and deferral requirements (although it is not certain that the

UK, or other local regulators, would choose to adopt this view). However the language on buy-outs is ambiguous and could suggest a more restrictive approach to these awards in the future.

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- ***Allowances:*** The requirements in this area are unchanged from the draft guidelines and, unsurprisingly, aligned to the prior EBA opinion. Ultimately, the provisions will allow for allowances to continue to be operated, but in a restrictive way. Firms will in particular need to consider how to meet requirements that allowances should be given to all equivalent roles to meet the definition of fixed pay

We will be analysing the detail set out in both the Guidelines and Opinion over the coming days. We will be circulating further information soon, together along with our perspectives on the impact and implications. However, if you have any questions in the meantime, please do let me know.
