

Global Financial Services

Capital Requirements Directive introduces new remuneration code

The European Council and Parliament have agreed on new rules covering financial services remuneration as part of the Capital Requirements Directive. These rules have potentially far-reaching implications for all banking and investment management firms in the European Union.

Introduction

Following intense negotiations between the European Parliament and governments of member states, a text was agreed on 30 June to amend the Capital Requirements Directive. These amendments will then be ratified, at which point member states will need to incorporate the new requirements into local regulation.

Key remuneration elements of the Capital Requirements Directive

- Extension of scope to all “credit institutions” and “investment firms”, for 2010 bonuses but with “proportionality” provisions depending on size and complexity of the institution
- Addresses issues of governance, remuneration structures and risk-adjusted performance measurement
- Potential restriction on cash bonuses to at most 30% of total variable pay
- Requirement that at least 50% of variable compensation be delivered in a mix of shares and contingent capital
- Requirement to pay certain “discretionary pensions” in shares and contingent capital subject to a five year retention period
- Ban on guarantees, other than for new recruits during their first year
- Committee of European Banking Supervisors (CEBS) to develop guidance on the appropriate ratio between fixed and variable pay
- Risk and compliance officer remuneration to be independent of the performance of business areas they control, and remuneration of senior risk and compliance officers to be directly overseen by the remuneration committee
- Aggregated public disclosure requirements for senior managers and risk takers
- No variable compensation to be paid to directors of institutions that benefit from government intervention, unless this is justified

New additions to the remuneration requirements

Many of the most extreme proposals originally being considered have been discarded, delegated to CEBS for consideration, or made subject to local regulator interpretation and proportionality assessments. However, the Directive does introduce new requirements. The most significant of these are summarised below.

i. Scope

The requirements now apply to all “credit institutions” and “investment firms”. This means that in practice all banks, building societies, broker-dealers, asset managers, and hedge funds will need to consider the implications of the proposals. However, it is important to realise that the text contains important wording relating to proportionality - “...institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities” - which could give significant latitude to local regulators to interpret the scope of the new rules in a sensible and proportionate manner.

ii. Deferral and payment of bonuses

The greatest press attention has been on the “cap” on cash bonuses. On a first reading, the text appears to suggest that for relevant individuals:

- at least 40% of bonus should be deferred over at least three years; and
- of the remaining 60%, at least half must be paid in an “appropriate balance” of shares and other instruments reflecting the credit quality of the credit institution. The CEBS is charged with providing guidance on the instruments which can be used as “other instruments” that reflect the credit quality of the institution.

If interpreted this way, this would mean that at most 30% of variable pay (falling to 20% for those in a higher earning category for whom 60% deferral is required) could be paid immediately in cash. Note that requiring pay to be delivered in shares or other instruments is different from deferral. The awards may not have to be subject to forfeiture, but simply to fluctuations in value due to performance. While the remuneration code emanates from Brussels, the implementation for Irish based financial services entities will require careful consideration. This is particularly the case regarding the tax treatment for recipients given the various local tax avoidance measures which can apply in deferral/forfeiture cases..

The requirement to use a mix of shares and contingent capital instruments is a new departure. Further clarification is likely to emerge in the coming weeks. This is an area where the local regulator interpretation of the requirements will be crucial.

iii. Exceptional government intervention

Any institution which benefits from exceptional government intervention will need to provide an explanation, if variable compensation is paid to its directors.

iv. Fixed-variable mix

Institutions will be required to establish appropriate ratios of fixed to variable remuneration. CEBS is charged with producing guidance and criteria for establishing what appropriate ratios should be for a given institution.

v. Pensions

“Discretionary pensions” would need to be held in contingent capital instruments for a period of five years after the termination or retirement of a relevant individual. In this context the definition of “discretionary pension” appears designed to catch bonus payments delivered in the form of a pension contribution or discretionary augmentations. The provisions do not appear to be designed to capture standard pension plan arrangements.

The technical complexity of implementing these requirements in cases where discretionary augmentations are made would seem to be formidable, given the complex interactions with pensions and tax law.

vi. Performance variation

There is a new requirement that “subdued or negative financial performance of the firm can result in reductions in current variable compensation and payouts of amounts previously earned through malus or clawback arrangements”. This would suggest that deferred compensation should be subject to genuine performance variation. While deferred share arrangements could still meet this requirement, it is possible that cash deferral plans would not do so. Again this is likely to depend on local regulator interpretation.

vii. Remuneration of control functions

There is now a requirement for remuneration of senior risk and compliance officers to be directly overseen by the remuneration committee and remuneration of staff in control functions should be independent of the performance of the business areas they oversee. One immediate concern this may raise for organisations is that it may have the unintended consequence of control functions being seen less as part of the teams they work with, thus weakening the second line of defence.

viii. Guarantees

Guarantees should be exceptional and occur only in the context of hiring new staff and be limited to the first year. The new rule embeds the asymmetry that has already occurred in practice between firms hiring and seeking to retain staff. The hiring firm is free to offer buy-outs and one-year guarantees, but retention awards are not permissible for the individual’s existing employer. When combined with increased deferral requirements (and consequent reduced liquidity) this may have the effect of making it harder to retain key staff.

ix. Capital

There is a requirement that variable compensation costs must not limit an institution’s ability to maintain a strong capital base.

x. Disclosure

New public disclosure rules have been introduced for aggregated remuneration of staff. However, detailed banded disclosure is only required in the case where local regulators have no requirements to make public disclosures.

Contacts

If you would like further information in relation to the issue outlined above, please call your local PwC contact, or alternatively any of our Reward team listed below:

Mary O’Hara	+353 1 792 6215	mary.ohara@ie.pwc.com
Gerard McDonough	+353 1 792 6170	gerard.mcdonough@ie.pwc.com
Pat Mahon	+353 1 792 6186	pat.mahon@ie.pwc.com
Sean MacHale	+353 1 792 7631	sean.machale@ie.pwc.com

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