Regulatory brief

A publication of PwC's financial services regulatory practice

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EU bonus cap: The net widens

Overview

Yesterday, the European Banking Authority ("EBA")[1] proposed Guidelines widening the application of the EU bonus cap. Most significantly for banks, the Guidelines stamp out the use of certain "allowances" that regulators thought were being used to circumvent the bonus cap. The Guidelines take effect on January 1, 2016, so we expect national supervisors to apply them to compensation for the 2016 performance year.

The EU bonus cap is part of the Capital Requirements Directive IV ("CRD IV") that became effective across the EU on January 1, 2014. It limits bonuses paid to senior managers and other "material risk takers" to no more than 100% of their fixed pay generally, or 200% of their fixed pay with shareholders' approval.[2] Concerned about talent retention, EU-based banks since last year have engaged in a variety of practices to lessen the impact of the provision, often by using allowances in lieu of bonuses. These allowances, although generally classified by banks as fixed pay, can nonetheless be re-adjusted upward or downward every year.

The EBA issued a non-binding opinion in October 2014 which clarified the criteria for categorizing compensation as either fixed or variable. Consistent with that opinion, the Guidelines mandate that compensation (including allowances) be classified as fixed only if it is predetermined, transparent to the employee, not dependent on performance, and maintained over a period tied to specific roles or responsibilities (among other criteria).

To further prevent circumvention of the bonus cap, the Guidelines require banks to document reasons for categorizing allowances as fixed compensation if the allowance meets specified criteria that suggest it is being utilized as a substitute for variable pay.

This **Regulatory brief** additionally offers our views on (a) the expanded scope of the bonus cap (to now clearly include certain asset managers), (b) the US impact, and (c) what will happen next.[3]

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[1] In addition to supervising the EU's banking system, the EBA is a rulemaking body.

[2] See PwC's *Regulatory brief, EU bonus cap: Proposed expansion curtailed* (December 2013).

[3] The EU bonus cap receives more detailed treatment in PwC UK's *Revisions to the EBA's remuneration guidelines* (March 2015).

Expanded scope – more banks and asset managers

The Guidelines clarify that the bonus cap must be applied, without exception, to all entities within a parent company, even to an entity that is not itself subject to CRD IV. Therefore, entities (such as asset managers) that may have enjoyed an exception will have to comply with the bonus cap, despite being governed by other regulations impacting compensation (e.g., the Alternative Investment Fund Managers Directive or the Undertakings for Collective Investment in Transferable Securities Directive).[4] However, only "material risk takers" whose activities impact the consolidated parent company's risk profile (rather than just the entity's) are affected.

The Guidelines also bring virtually all banks into the scope of the bonus cap, whereas previously many smaller banks had been deemed exempt. Furthermore, in cases where the cap's requirements have been adapted to a bank's unique characteristics (thus subjecting the bank to less strict requirements), the Guidelines clarify that certain minimum thresholds (e.g., duration of bonus deferrals) cannot be breached.

The US impact

The bonus cap and the Guidelines apply to US employees of EU-based banks, in either a branch or subsidiary of the EU bank. The Guidelines also include provisions specifically addressed to these employees, requiring that particular forms of compensation automatically be categorized as fixed – e.g., cost of living adjustments for living abroad. The Guidelines also generally apply to employees of US banks who are located in the EU.

US-based employees of US banks may one day face restrictions on their compensation as well, if some in the Federal Reserve System have their way. In 2011, US regulators issued a proposal that would have required banks with over $50 billion in assets to defer 50% of bonuses paid to executive officers, and to review and approve incentive-based compensation paid to non-executive officers who individually have the ability to expose the institution to a substantial amount of risk. This proposal was never finalized, but recent comments by Federal Reserve Governors Powell and Tarullo, and by New York Fed President Dudley, indicate renewed US focus on the topic. They suggest measures that would go beyond the 2011 proposal, such as claw back provisions.

What's next?

After the EU comment period closes on June 4, 2015, the Guidelines will likely be finalized in time for the proposed January 1, 2016 effective date. Within two months from the publication of the final Guidelines in 2015, each national regulator in the EU must confirm whether it applies (or intends to apply) the Guidelines, and if not provide the reasons. The EBA is responsible for publishing a list of non-compliant nations and for indicating how it intends to ensure that these nations will come into compliance.

Regarding a possible US proposed rule on compensation, we do not believe there is currently consensus among US regulators about what it would look like. A new US proposal would take time and would very likely not include prescriptive provisions like the EU bonus cap.

[4] See PwC's *Regulatory brief, EU bonus cap: Restrictions nearly final for asset managers* (March 2014).

Additional information

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