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European Banking Authority
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Dear Sirs

EBA Consultation Paper (CP 2015/03): Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU ("CRDIV") and disclosures under Article 450 of Regulation (EU) No 575/2013

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Question 5 - Proportionality

The EBA's draft guidelines on the interpretation of the remuneration 'principles' set out in Articles 92 to 94 CRD IV conclude that the CRD no longer provides for any explicit provision that allows the "neutralization" of certain of these principles for smaller or non-complex institutions. For the reasons referred to below, this characterisation of the issue is unjustified given the wording of the legislation itself, which does include explicit provision of that sort and explicit acknowledgment that the 'principles' are not appropriate (at least in the specific terms in the Directive) to every institution to which CRD IV applies.

We note that the EBA has contacted the European Commission services for clarification as to whether the principle of proportionality would allow, under certain conditions, for full or partial waivers of some or all of the remuneration principles and in particular their minimum

quantitative thresholds. The European Commission has apparently responded that the remuneration requirements have to be applied without exemptions and exceptions to all institutions and that in particular the provisions referring to the deferral arrangements, the pay-out in instruments and the application of malus leave no room for exceptions or exemptions. In effect (absent some identifiable legislative change), the EBA asserts that the guidelines adopted some five years ago by its predecessor were unlawful and that the Commission failed to identify this until specifically asked by the EBA in the context of the current Consultation for interpretive assistance. We regard such an assertion as unsustainable.

The EBA clearly acknowledges the potentially very significant impact that its proposed approach will have. Given the importance of the issue it is surprising that the legal basis for the EBA's decision to overturn existing guidance is not more fully explained and justified having regard to the terms of the Directive and its recitals. As it is, the EBA appear only to assert a changed legal approach apparently supported by correspondence with the European Commission services that is not disclosed.

We have not identified any substantive legislative change at all, and not even any language from the Commission in its proposal for CRD IV for the kind of policy change that is implicit in the interpretation suggested by EBA in the Consultation. Further, the reading of these provisions put forward by the EBA is contrary to the plain words used on the face of the Directive itself, and would (in effect) retrospectively rewrite the basis on which the legislature (i.e. the Council and the Parliament) applied the Proportionality Principle required for legislation by the Protocol to the TFEU to CRD IV (itself reflected in text adopted in the Directive). Accordingly there is no sound legal basis for adopting the changed approach to the interpretation of these provisions set out in the Consultation and we would urge the Authority to reconsider.

Finally, we note the EBA's view at the public hearing on 8 May that (i) exemptions require clear wording in directives and (ii) the wording in CRD is not clear enough to create an exemption – if full neutralisation was intended it should have been specifically spelt out. We do not agree with this view for the following reasons:

- For the reasons explained in this paper, we consider the "*to the extent*" wording to be sufficiently clear to allow the full disapplication of certain principles for certain firms.

- The EBA's view highlights the point that if there had been an intention to change the application of proportionality under CRD III it should have been specifically spelt out in CRD IV, which it was not (and the Commission's proposal for CRD IV reinforces that view).

- In October 2013 (after CRD IV had been finalised) the EBA held a proportionality workshop which still envisaged the neutralisation of rules. It is inconceivable that the EBA would have done so if the EBA (or the Commission) viewed this as an impermissible interpretation. This suggests that the current approach had not actually been contemplated at the time CRD IV was drafted.

The following paragraphs set out our reasons for these conclusions in more detail.

(i) There has been no change in the operative drafting of CRD IV when compared with CRD III

In December 2010 the Committee of European Banking Supervisors ("CEBS") (the predecessor of the EBA) published its Guidelines on the remuneration provisions contained in CRD III.[1] Paragraph 19 of the CEBS Guidelines stated that

> *"Proportionality operates both ways: some institutions will need to apply more sophisticated policies or practices in fulfilling the requirements; other institutions can meet the requirements of the CRD in a simpler or less burdensome way."*

And that:

> *"The application of the proportionality principle may lead however to the neutralization of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the institution."*

In our view both of these statements properly reflect, and are supported by, the explicit provisions of CRD III. A comparison of the operative provisions of CRD III and CRD IV reveal no material differences that would necessitate a different reading of wording in CRD IV which dictates proportionality. In particular both directives make use of two concepts in the language – both complying "in a way" and "to the extent that" is appropriate to the organization concerned. The EBA's approach either ignores "to the extent that", or inaccurately interprets it as being the same as "in a way that". We understand that this differentiation of language is not confined to the English text.

(ii) The EBA's approach is not consistent with, or justified by, the provisions of CRD IV

Recital 66 in the preamble to CRD IV provides:

> *"The provisions of this Directive on remuneration should reflect differences between different types institutions in a proportionate manner, taking into account their size, internal organization and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles."*

This recital contemplates that remuneration provisions in CRD IV may be implemented by national authorities in a way that results in the disapplication of requirements particularly in the case of investment firms. Generally it is necessary to interpret European legislation in a way that gives effect to and is consistent with Recitals. The EBA's approach does not do this, in particular given the following points.

Recital 66 is reflected in the drafting of certain of the substantive provisions, in particular article 92(2):

"Competent authorities shall ensure that, when establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, institutions comply with the following principles in a manner <u>and to the</u>

[1] Directive 2010/76/EU amending Directive 2006/48/EC.

extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities" [Underlining added]

In the light of Recital 66, the words underlined require national authorities to consider whether any of the principles that follow are disproportionate in certain circumstances. The most obvious meaning for "to the extent that" necessarily requires consideration of the non-application of certain principles to certain entities. The description of the specific provisions in the remainder of article 92(2) and in articles 93 and 94 as "principles" further reinforces the need for national authorities to implement the provisions in a way that gives effect to proportionality as reflected in Recital 66 and the chapeau in article 92(2). To do otherwise ignores the language of Recital 66 and is contrary to the natural meaning of the words of the legislation.

Article 94 of CRD IV that sets out principles relating to variable remuneration has to be implemented:

> *"…under the same conditions as those set out in Article 92(2)"*

This can only mean that in implementing the provisions in article 94, including the bonus cap and pay process payout principles, national authorities should do so in a way that meets the need for proportionality including through the non-application of principles where this is justified by the conditions described in article 92(2). Not to do so would ignore a number of those conditions.

(iii) The EBA's approach lacks legal coherence

The EBA has taken into account the resolution of the European Parliament of 3 July 2013 on reforming the structure of the EU banking sector.[2] The extent to which this resolution has caused the EBA to change the approach to proportionality is not clear. However the resolution is not a legislative change and, while an appropriate view for the EBA to take account of, is not a basis for changing the EBA's legal interpretation of CRD IV.

Article 161(2) of CRD IV requires the European Commission in close co-operation with the EBA to submit a report by 30 June 2016 together with a legislative proposal if appropriate on the provisions on remuneration with particular regard to:

> *"(a)… any lacunae arising from the application of the principle of proportionality to those provisions".*

The reference to "lacunae" arising through the application of proportionality is consistent with the proportionality leading to the non-application of certain of the remuneration principles resulting in gaps in implementation that the Commission may view as undesirable and to the development of further legislation to address such perceived deficiencies.

We agree that the EBA should consider the extent and the manner of application of the principles, and has a proper role in making guidelines about those aspects of implementing the Directive obligations. We accept that there is some proper scope for debating and revising the way proportionality is applied – and acknowledge that a policy review may lead to adjustments to the calibration of that proportionality. However, the EBA's proposed approach seeks to rewrite explicit legislative provisions, and so is inconsistent with the envisaged review of the implementation of CRD IV.

[2] Page 12 of the Consultative Paper.

(iv) The EBA's exchange of letters with the Commission does not justify the EBA's conclusions

The recently disclosed exchange of letters between the EBA and the Commission (letters dated 8 January 2015 and 23 February 2015) does not provide any additional substance to the EBA's assertions as expressed in the EBA's Consultation Paper. The exchange appears to assume that the impact of "extent" is novel for CRD IV, which is plainly inaccurate. The Commission's letter rightly points out that it is not for the EBA to rewrite legislation. That is, in summary, the key to the points made in this document.

Question 8: Are the requirements regarding categories of remuneration appropriate and sufficiently clear?

As a preliminary issue, we anticipate that some Member State governments may take the view that the legal basis for section 11 is unclear, since article 153(5) of the Lisbon Treaty excludes pay from the EU competencies. Further, in seeking to define what constitutes fixed and variable remuneration, section 11 of the Draft Guidelines seems to go beyond the remit of CRD4 which instead focuses on introducing the right balance between the two categories of remuneration.

Setting to one side the potential competency issue, we agree that there is merit in ensuring that categories of remuneration are sufficiently clear and appreciate that it is the EBA's intention to ensure that the bonus cap is not circumvented by an overly elastic category of fixed remuneration. However, we expect that the provisions of section 11 may cause problems for credit institutions and investment firms.

For instance, normal salary would not satisfy all the criteria specified in paragraph 117 in all circumstances and yet salary is considered by many to be one of the most vanilla types of fixed remuneration:

- The requirements in paragraphs 117(a) and (b) that in order for remuneration to qualify as fixed pay, both the conditions for its award and its amount must be predetermined and non-discretionary would not be satisfied in relation to any discretionary salary increase in the United Kingdom, where both the question of whether an increase should be awarded and the amount of any such increase are generally determined at the sole discretion of the institution.

- The requirement in paragraph 117(e) that in order for remuneration to qualify as fixed pay, both the conditions for its award and its amount must be non-revocable and the permanent amount only be capable of change following collective bargaining or following renegotiation in line with the national criteria on wage setting is not appropriate to the labour market in the United Kingdom where wage setting is most often a matter of individual negotiation between employer and employee rather than following collective bargaining.

- Salary does not always satisfy the requirement in paragraph 117(f) that in order for a payment to qualify as fixed pay, it must be the case that the payment cannot be reduced, suspended or cancelled by the institution - in the UK, it is not unusual for employers to reserve the right to suspend or reduce salary in certain circumstances, including, but not limited to, instances of extended leave or in circumstances where a payment of salary which is to be made as a payment in lieu of notice is reduced to take into account any remuneration earned by the employee through other employment during a prescribed period after termination.

If the final EBA Guidelines provide for the same fixed set of criteria as those set out in paragraph 117 of the Draft Guidelines, then in order to allow these criteria to be applied in practice and policed effectively by local regulators, we believe that the final Guidelines would need to leave it open to local regulators in certain circumstances to conclude that an element of remuneration is fixed pay notwithstanding that it fails to satisfy each of the criteria in paragraph 117, such as for example where the regulator wishes to designate normal salary as an item of fixed pay despite it failing to meet all of the criteria set out in the Guidelines.

Question 9: Are the requirements regarding allowances appropriate and sufficiently clear?

We welcome the clarification in paragraph 118, which seeks to ensure that 'allowances' which are part of routine employment packages and which have historically been paid as an element of fixed pay (long before the bonus cap was introduced) will continue to be considered as fixed remuneration.

In relation to expatriate allowances, we anticipate that credit institutions and investment firms may find paragraph 119 difficult to apply in practice. It is unclear whether certain types of expatriate allowance for internationally mobile employees (such as housing and school allowances) fall within the definition set out in the Guidelines. More generally, the 'consistency' test set out in paragraph 119(a) may be a challenge for smaller firms which may not have a standard expatriate policy in place.

One unintended consequence of sections 11 and 12 is likely to be that the base salaries of material risk takers are increased, resulting in these senior individuals having less risk aligned pay packages, particularly given the impact that paragraphs 117 and 122-125 will have on the use of role-based allowances.

In light of these issues, we query whether the EBA's aim in relation to allowances could be achieved by an alternative route, namely by providing in the final EBA Guidelines that a failure to satisfy one (or more) of the eight criteria set out in paragraph 117 would create a presumption of variable pay, but that this presumption could be rebutted if, when looked at in the round and in the context of the spirit of CRD4 and the Guidelines, the arrangement should properly be considered as fixed remuneration. Such an approach would be more likely to allow the Guidelines to be operated effectively in practice.

Question 10: Are the requirements on the retention bonus appropriate and sufficiently clear?

The requirements relating to retention bonuses seem clear but we note that there is an apparent lack of symmetry between the EBA's approach in the Draft Guidelines to retention bonuses in section 12 and that in respect of guaranteed variable remuneration in section 13. Whilst retention bonuses are clearly stated in section 12 to be subject to the bonus cap and the other structural requirements of variable pay, section 13 indicates that the same is not true of guaranteed variable remuneration.

The CLLS would welcome confirmation in the Final Guidelines that this difference in approach of the EBA to these two types of remuneration is based on the fact that the relaxed requirements in relation to guaranteed variable remuneration are limited to guaranteed variable remuneration in the first year of employment.

The CLLS does not propose to express a view on the appropriateness of the requirements on retention bonuses.

Question 15: Are the provisions on deferral appropriate and sufficiently clear?

In our view the provisions in relation to deferral are sufficiently clear. The CLLS does not propose to express a view on the appropriateness of the proposal to increase the length of the deferral period applicable to variable remuneration from three to five years for significant institutions.

Question 16: Are the provisions on the award of variable remuneration in instruments appropriate and sufficiently clear? Listed institutions are asked to provide an estimate of the impact and costs that would be created due to the requirement that under Article 94(1)(l)(i) CRD only shares (and no share linked instruments) should be used in parallel, where possible, to instruments as set out in the RTS on instruments. Wherever possible the estimated impact and costs should be quantified and supported by a short explanation of the methodology applied for their estimation.

In light of the legal and practical complexities of using alternative capital and debt instruments as variable remuneration, the EBA's approach in section 17.4 to share-linked or other non-cash instruments appears pragmatic. However, we consider that the EBA's definition of 'availability' of instruments in paragraph 250 is somewhat circular, which may lead to a lack of clarity. For instance, to what extent are firms which have already issued certain instruments required to use these as variable remuneration? Also, it is not always the case that listed institutions are able to deliver shares to employees, for example because of prospectus requirements, and it is not clear how this issue should be addressed. Will listed banks be able to use phantom share awards or similar instruments instead of actual shares? Paragraph 248(a) of the Draft Guidelines indicates that listed institutions would not be permitted to use such instruments as variable remuneration. It is not clear to us why and on what basis this prohibition is required. In our view, the use of actual shares will entail a number of disadvantages (for example, for US employees for whom it will be extremely difficult to open the relevant custody account with European banks due to the US Foreign Account Tax Compliance Act and other restrictions) and there is no underlying regulatory reason of which we are aware which makes the use of shares better from a risk alignment perspective than phantom share awards.

Further, we note that depending on the form of the instruments, their use to deliver variable remuneration is likely to create some challenges – for example, providing liquidity to employees on vesting and valuing those instruments for tax and other purposes. Arguably, the use of instruments is likely to further reduce the perceived value of deferred remuneration in the hands of firms' staff and thereby potentially drive up overall remuneration levels.

An absolute prohibition on paying dividend equivalents on the vesting of share awards runs against the grain of current equity plan market practice. The prohibition also appears inconsistent with the EBA's approach to carried interest arrangements. Further, it is not clear why such a prohibition is required. If the payment of dividend equivalents on vesting is banned, this effectively removes the alignment of awards with shareholders during the vesting period and is most likely to result in institutions increasing the number of shares subject to the award in order to make up for the lack of dividends. If structured appropriately, such as by ensuring that dividend equivalents are held in escrow and only paid out upon vesting (as is typical), the perceived issues with paying dividend equivalents could be addressed while still ensuring that employees' interests remain aligned with shareholders.

Question 17: Are the requirements regarding the retention policy appropriate and sufficiently clear?

In our view the requirements regarding retention policy are sufficiently clear. The CLLS does not propose to express a view on the appropriateness of the proposal to increase the length of the retention period applicable to instruments used to deliver variable remuneration from six months to one year.

Question 18: Are the requirements on the ex post risk adjustments appropriate and sufficiently clear?

We do not propose to express a view as to the appropriateness of the EBA's requirements on ex post risk adjustments. We note that the draft EBA Guidelines expand the list of criteria institutions should set for the application of malus or clawback to include the conduct of staff where they contributed to a regulatory sanction. In our experience, this is in line with emerging practice in the rules of financial institutions' deferred compensation plans.

We note that the provisions of paragraph 17.7.1 will help to bring clawback practice in other Member States closer to the requirements in the United Kingdom, where detailed guidance has been issued on the conditions under which clawback and malus should be applied, including a specific rule for clawback. This having been said, it needs to be recognised that clawback is difficult to enforce in practice and is prevented or discouraged by national labour laws in a number of Member States.

We welcome the EBA's recognition that the extent to which an ex-post risk adjustment is needed depends on the accuracy of the ex-ante risk adjustment in paragraph 268. This acknowledges that ex-ante adjustment is often a legally more straightforward and practically efficacious way of dealing with the occurrence of any of the factors listed in paragraph 270 than the operation of ex-post adjustments.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at karen.anderson@hsf.com, or Peter Richards Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, in the first instance.

Yours sincerely

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