European Regulatory Snapshot: CRD IV Bonus Cap Likely Set to Stay

1 December 2014

Introduction

The CRD IV package, comprising the Capital Requirements Directive IV[1] (CRD IV) and the Capital Requirements Regulation[2] (CRR), sets out requirements in relation to the remuneration policies and practices of financial institutions, including a "bonus cap" whereby variable pay is capped at 100% of total fixed pay or, with shareholder approval, 200% of total fixed pay.[3] On 20 November 2014, the Advocate General delivered his widely anticipated opinion on the United Kingdom's legal challenge seeking annulment of the bonus cap and other remuneration-related provisions in the CRD IV package. In his Opinion, the Advocate General suggested that all the United Kingdom's pleas should be rejected and the Court of Justice of the EU (ECJ) dismiss the action.[4] While the Opinion is not legally binding on the ECJ, whose judgment had been expected in early 2015, UK Chancellor of the Exchequer George Osborne has publicly stated that the United Kingdom will no longer pursue the legal challenge since it looks clear that there are *"minimal prospects for success"*.[5] With these developments, it now seems likely that the CRD IV bonus cap is set to stay.

This client memorandum summarises the principal considerations of the Advocate General in his Opinion on the United Kingdom's legal challenge. It then considers how the legal challenge ties in with other recent developments relating to the CRD IV bonus cap, including the Opinion and Report published by the European Banking Authority (EBA) on 15 October 2014 following its "investigation" into the use of "role-based allowances" in the EU banking sector.[6]

The United Kingdom's Legal Challenge to the Bonus Cap

In September 2013, the United Kingdom brought an action before the ECJ against the European Parliament and the Council of the European Union, asking the ECJ to annul the bonus cap and other remuneration-related provisions in the CRD IV package. The European Commission intervened in support of the Parliament and the Council. Following a hearing on 8 September 2014, the ECJ

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[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. The Directive can be found **here**.

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. The Regulation can be found **here**.

[3] Article 94(1)(g) of CRD IV. EU Member States have discretion to set a *lower* maximum percentage than the 100% set out in CRD IV as well as to decide whether shareholders should be allowed to approve a higher percentage, but in any case not higher than 200%.

[4] Opinion of Advocate General Jääskinen delivered on 20 November 2014 in Case C-507/13 – *United Kingdom v Parliament and Council*. The Opinion can be found **here**. The ECJ is helped by nine "advocates general" whose job is to present opinions on the cases brought before the Court. They are required to do so publicly and impartially.

[5] Letter dated 20 November 2014 from Chancellor Osborne to Mark Carney, Chair of the Financial Stability Board. The letter can be found **here**.

[6] This memorandum follows our memorandum of September 2014 providing a snapshot of the EU regulation of remuneration in the financial services industry as of that time. That memorandum can be found **here**.

published a press release with a summary of the Advocate General's Opinion on 20 November 2014[7] and the Opinion itself was made public shortly thereafter.

The Advocate General's Opinion

In his Opinion, the Advocate General suggested that the ECJ should reject each of the United Kingdom's pleas, including those relating to the validity of the bonus cap, which lay at the heart of the legal challenge. In particular, the Advocate General considered:

Bonus cap

The United Kingdom contested the choice of Article 53(1) of the Treaty on the Functioning of the European Union (TFEU), a provision which supports the freedom of establishment, as the legal basis for the CRD IV bonus cap. According to the United Kingdom, the bonus cap falls within the field of social policy and should have been based on Article 153(2) TFEU. However, since measures relating to *"pay"* are excluded from the social policy provisions under Article 153(5) TFEU, the adoption of a bonus cap would have fallen outside the competence of the EU legislature.

The Advocate General did not agree with the United Kingdom. Crucially, he took the view that the term bonus "cap" is actually a misnomer. CRD IV contains provisions indexing variable remuneration to fixed remuneration in respect of individuals whose professional activities impact on the risk profile of financial institutions by whom they are employed. This arrangement should be described as a *"maximum fixed ratio for variable remuneration"* rather than a *"cap on bankers bonuses"*.[8] While the fixing of remuneration levels may fall outside the competence of the EU legislature,[9] CRD IV does not impose any limit on the total level of pay since there is no limit to the amount of fixed pay so that the ratio set between fixed and variable pay can attach to any sum of money which the financial institution is prepared to pay by way of fixed salary. The Advocate General concluded that CRD IV only establishes a structure for remuneration in order to avoid excessive risk taking, which is a legitimate objective to ensure that freedom of establishment of financial institutions and free provision of financial services based on single authorisation and home-country control can function safely in the EU internal market.[10]

The United Kingdom also argued that the bonus cap breaches the principles of proportionality and subsidiarity. However, subject to respecting procedural requirements, the Advocate General considered that the EU legislature possesses a wide margin of discretion when assessing whether an EU measure adheres to these principles.[11] The adoption of the bonus cap involved economic and political choices that would have had to be *"manifestly inappropriate"* if the legislative measures concerned were to be annulled.[12]

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[7] ECJ Press Release No 154/14 of 20 November 2014. The press release can be found **here**.

[8] Paragraph 3 of the Advocate General's Opinion.

[9] Article 153(5) TFEU and paragraphs 114-117 of the Advocate General's Opinion.

[10] Paragraph 121 of the Advocate General's Opinion.

[11] Paragraph 103 of the Advocate General's Opinion.

[12] Paragraph 98 of the Advocate General's Opinion.

Retrospective effects

The United Kingdom contended that the bonus cap is retrospective in its effect and, as such, breaches the principle of legal certainty.[13] While EU Member States were to implement CRD IV into national law with effect from 1 January 2014, the bonus cap applies to remuneration for services provided or performance from the year 2014 onwards, *"whether due on the basis of contracts concluded before or after 1 January 2014"*.[14]

The Advocate General considered that CRD IV is not a retroactive measure. In particular, the actual right of the employee to receive remuneration only arises, at the very earliest, when he or she provides the services or demonstrates performance worthy of a bonus, not when there was an agreement to do so.[15] It was also noted that the bonus cap had received wide media attention and the final CRD IV was published in the Official Journal on 27 June 2013, leaving ample time to prepare for the new rules taking effect in 2014.[16]

Extraterritorial effects

The United Kingdom contended that the bonus cap infringes upon a customary international law principle against extraterritoriality insofar as it applies to EU financial institutions at group, parent company and subsidiary levels, including entities established outside the EU. The Advocate General found this plea inoperative in the absence of a specific challenge to the relevant provisions of CRD IV, which afford the extraterritorial effects.[17] Separately, it was considered that no principle against extraterritoriality, as relied on by the United Kingdom, had been manifestly infringed upon only by subjecting foreign group companies of EU financial institutions to the EU regulatory framework.[18]

Conferral of powers on EBA

The United Kingdom submitted that the conferral of certain powers on EBA was *ultra vires*.[19] CRD IV provides for EBA to develop draft regulatory technical standards (RTS) specifying (i) the classes of instruments that are appropriate to be used for the purposes of variable pay[20] and (ii) qualitative and appropriate quantitative criteria to identify the "material risk takers" who are subject to the bonus cap and other CRD IV remuneration rules.[21] The United Kingdom

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[13] The United Kingdom also contended that other provisions in the CRD IV package infringe the principle of legal certainty. For a full account of the plea, see paragraphs 66-90 of the Advocate General's Opinion.

[14] Article 162(3) of CRD IV, as amended by a corrigendum published in the Official Journal on 2 August 2013. The Corrigendum can be found **here**.

[15] Paragraph 75 of the Advocate General's Opinion.

[16] Paragraph 89 of the Advocate General's Opinion.

[17] Paragraphs 32-33 of the Advocate General's Opinion.

[18] Paragraphs 36-42 of the Advocate General's Opinion.

[19] The United Kingdom also objected to the conferral of powers on the European Commission, however, the Advocate General took the view that only the challenge to the powers of EBA was elaborated with sufficient detail to enable the ECJ to assess their legality. See paragraph 51 of the Advocate General's Opinion.

[20] Article 94(2) of CRD IV. Based on EBA's draft, final standards have been adopted by the European Commission by way of Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration. The Delegated Regulation can be found **here**.

[21] Article 94(2) of CRD IV. Based on EBA's draft, final standards have been adopted by the European Commission by way of Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. The Delegated Regulation can be found **here**.

submitted that the conferral of such powers on EBA entailed the *"taking of strategic decisions or policy choices"*.[22]

However, the Advocate General took the view that no binding decision-making power is conferred on EBA as its draft RTS cannot pass into law unless adopted by the European Commission that may accept, reject or modify them as the case may be.[23] Furthermore, the Advocate General considered that CRD IV itself lays out the essential elements for the RTS in question and that strategic and political choices have been taken in the basic legislative act rather than in measures elaborated by EBA and adopted by the European Commission.[24]

Disclosure requirements

In addition to the various challenges to the CRD IV bonus cap, the United Kingdom contested the validity of some remuneration related disclosure requirements. CRR requires financial institutions to disclose, *inter alia*, their ratios between fixed and variable pay set out in accordance with the bonus cap and the number of individuals being remunerated €1 million or more per financial year, broken down into pay bands. EU Member States or competent authorities may also require disclosure of the total remuneration for each member of the institution's management body or senior management.[25] In particular, the United Kingdom argued that the latter provision infringes upon the right to privacy and EU data protection law.

Again, the Advocate General did not agree with the United Kingdom. In the case at hand, it was relevant that disclosure of total remuneration on an individual level does not apply to all "material risk takers", but only to management or senior management, and does not occur automatically, but is subject to a request from EU Member States or competent authorities, who will need to comply with EU data protection law in making any such request. The financial institution may challenge the legality of the request before a competent judicial authority, like any other national decision applying EU law and affecting fundamental rights of individuals.[26]

Recent Developments and Next Steps

The Advocate General's Opinion is not legally binding on the ECJ, whose judgment had been expected in early 2015. However, H.M. Treasury has published a letter dated 20 November 2014 from Chancellor Osborne to Mark Carney, Chair of the Financial Stability Board (FSB) stating that it now looks clear that there are *"minimal prospects for success"* with the legal challenge so the United Kingdom will no longer pursue it.[27] It therefore seems likely that the CRD IV bonus cap is set to stay and focus should shift from debate about the existence of the cap itself to its implementation, including the mapping of remuneration into the categories of fixed and variable pay.

[22] Paragraph 54 of the Advocate General's Opinion.

[23] Paragraphs 56 and 64 of the Advocate General's Opinion.

[24] Paragraphs 61-62 of the Advocate General's Opinion.

[25] Article 450(1) of CRR.

[26] Paragraphs 47-49 of the Advocate General's Opinion.

[27] Letter dated 20 November 2014 from Chancellor Osborne to Mark Carney, Chair of the Financial Stability Board.

EBA Opinion and Report on Role-Based Allowances

Essential to the application of the bonus cap is the distinction between "fixed" and "variable" pay on which CRD IV only provides limited guidance.[28] Earlier this year and in response to a request from the European Commission, EBA launched an "investigation" into the use of "role-based allowances" (RBAs) that are intended to be treated as fixed pay. On 15 October 2014, EBA published an opinion,[29] addressed to the European Commission and the competent authorities, together with an annexed report on its findings.[30]

In accordance with CRD IV, the remuneration policies of financial institutions should make a clear distinction between fixed and variable pay. In its Opinion and Report, EBA indicated that this distinction is linked to the bonus cap and there is no scope for a "third category" of pay.[31]

"Allowances" are generically described by EBA as additional payments or benefits paid on top of the traditional fixed remuneration (basic salary) and the directly performance-related variable remuneration (bonus).[32] Whether an allowance qualifies as fixed or variable pay for purposes of the bonus cap depends on the specific characteristics. For example, "market-value allowances" that are used to increase the basic fixed salary in situations where staff work abroad temporarily and receive less remuneration than they would be paid on their local employment market for this position should not be problematic, provided they are granted consistently and based on predetermined factors where the duration of the allowance is tied to the duration of the situation.[33]

The particular focus of EBA's investigation was the RBAs that are used to top up the fixed remuneration of some staff, including executive directors, according to their role, function, seniority, managerial responsibilities or influence in the financial institution. While RBAs take various forms, EBA found a number of common characteristics, including:[34]

- The payments are linked to the role and responsibility, seniority or level of influence of staff and are not explicitly based on performance criteria.
- The payments are not part of basic salary and are not pensionable.
- The payments are initially granted for a limited period of time.
- The payments can be reduced, suspended or cancelled by the financial institution on a fully discretionary basis or are based on other contractual conditions, which do not form part of a routine employment package.

To achieve the purpose of the CRD IV bonus cap and promote sound and effective risk management, EBA indicated in its Opinion that the following conditions must be complied with, if RBAs are to qualify as fixed pay:[35]

- The payments must be predetermined;

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[28] See in particular recital 64 of CRD IV.

[29] Opinion of 15 October 2014 of the European Banking Authority on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances (EBA/Op/2014/10). The Opinion can be found **here**.

[30] Report of 15 October 2014 on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances. The Report can be found **here**.

[31] Paragraphs 7-9 of EBA's Opinion and paragraph 22 of EBA's Report.

[32] Paragraph 10 of EBA's Opinion.

[33] Paragraph 13(a) of EBA's Report.

[34] For a full list of common characteristics of RBAs observed by EBA, see paragraph 14 of EBA's Report.

[35] Paragraph 13 of EBA's Opinion.

- The payments must be transparent to staff;
- The payments must be permanent, i.e., maintained over time and tied to the specific role and organisational responsibilities;
- The payments must not provide incentives to take risks; and
- The payments must be non-revocable (without prejudice to national law).

EBA has opined that, where competent authorities are aware of the use of RBAs that do not comply with these conditions, EBA expects them to use "*all necessary supervisory measures*" to ensure that financial institutions' remuneration policies are updated by 31 December 2014 to reflect EBA's opinion that such RBAs should be classified as variable remuneration and that payments of such RBAs are not causing financial institutions to contravene the bonus cap.[36]

Concluding Remarks

Since the CRD IV bonus cap seems set to stay, focus can now be on the practical implementation of the cap and other parts of the CRD IV remuneration regulation. To this end, EBA's updated guidelines on remuneration policies and practices will be keenly awaited. While work on these is still ongoing and will be open to public consultation, EBA has noted that the guidelines will be based on the analysis and findings of its Report of 15 October 2014 on the use of RBAs and will provide more specific criteria for the allocation of remuneration components to either fixed or variable pay and the supervisory treatment of allowances.[37]

Remuneration in the financial services industry continues to be discussed. Most recently, Chancellor Osborne has expressed concerns about developments that appear to be driving up fixed pay, which cannot easily be cut in times of financial distress nor currently be made subject to claw-back in cases of serious misconduct.[38] Given the global nature of the banking industry, Chancellor Osborne calls for global remuneration standards and specifically sees a need to consider how compensation schemes can still achieve the objective of supporting sound risk taking in jurisdictions such as the EU where the balance is said to have shifted toward fixed remuneration.[39] Thus, while policy makers seem to broadly agree on the policy goal – curbing excessive risk taking that may destabilise financial markets and institutions[40] – the debate about the shape of the regulation will likely continue.

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[36] Paragraph 15 of EBA's Opinion.

[37] Paragraph 40 of EBA's Report.

[38] In support of his view, Chancellor Osborne cites the FSB's 2009 *Principles for Sound Compensation Practices*, which stated in the related implementation standards that a *"substantial proportion of compensation should be variable"*; the United Kingdom Parliamentary Commission on Banking Standards' 2013 report *Changing Banking for Good*, which indicated that *"there are distinct advantages to a significant proportion of banking remuneration being in variable rather than fixed form"*; and Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority Andrew Bailey, whom the Chancellor describes as having *"consistently argued that higher fixed compensation increases risks to financial stability by raising a bank's fixed cost base and reducing its ability to adapt to difficult trading conditions."*

[39] In his letter, Chancellor Osborne also notes, *"In addition, I will ask the Fair & Effective Markets Review to consider this issue as part of its work on responsibilities, governance and incentives. As set out in its recent Consultation Document, incentives play a critical role in the Fixed Income, Currency and Commodity Markets. Ensuring that firms incentivise employees to behave in the right way is essential to restoring public trust in financial markets."*

[40] As noted by the Advocate General in paragraph 23 of his Opinion, the United Kingdom, on the one hand, and the Parliament, Council and Commission, on the other hand, did not seem to disagree on the need to combat excessive risk taking that may destabilise financial markets and institutions. Rather, the United Kingdom's fundamental concern and main cause of the legal challenge seems to be whether the CRD IV bonus cap can appropriately achieve this policy objective.

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