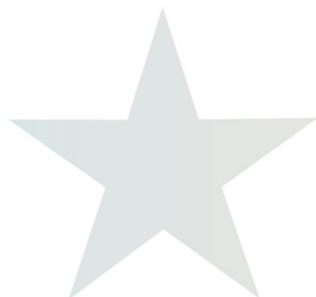


# Consultation Paper

Draft Guidelines

On the applicable notional discount rate for variable remuneration under  
Article 94(1)(g)(iii) of Directive 2013/36/EU



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# Consultation paper on draft guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU

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## 1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

### Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 18.01.2014. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

### Publication of responses

Please indicate clearly in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

### Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the [Legal notice section](#) of the EBA website.

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## 2. Executive Summary

The European Banking Authority is consulting on draft guidelines on the applicable notional discount rate for variable remuneration which may be applicable pursuant to Article 94(1)(g)(iii) of Directive 2013/36/EU 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 consultation period ends on 18 January 2014.

Directive 2013/36/EU establishes that the variable component shall not exceed 100% of the fixed component of the total remuneration for those categories of staff whose professional activities have a material impact on the risk profile of the institution. Member States may set a lower maximum percentage. A higher ratio of up to 200% may be allowed, subject to shareholder approval.

For the purpose of calculating the ratio between the variable and fixed component of remuneration, Member States may allow institutions to apply a discount rate, the subject of these guidelines, to a maximum of 25% of the variable remuneration, provided it is paid in instruments that are deferred for a period of not less than 5 years, or to a lower amount prescribed by national law.

The EBA has combined four relevant factors to calculate the discount rate. The national annual inflation rate, the average interest rate of EU government bonds to take account of opportunity costs and inflation risk, a nominal factor to provide for incentives for paying variable remuneration in instruments which are deferred for a period of at least five years and a nominal factor to provide for incentives to apply additional retention periods. The last two factors depend on the length of the actual deferral and retention periods.

The discount rate calculated on the basis of the above factors ensures that the ratio between the variable and the fixed component of total remuneration is calculated in accordance with Directive 2013/36/EU. These factors provide for appropriate incentives for the use of long-term deferred instruments and longer retention periods; these elements should lead to more long-term orientated remuneration frameworks and facilitate prudent risk taking decisions.

In accordance with its mandate, the EBA will finalise the draft guidelines at the beginning of 2014, taking into account the responses to the public consultation and the opinion of the Banking Stakeholders Group.

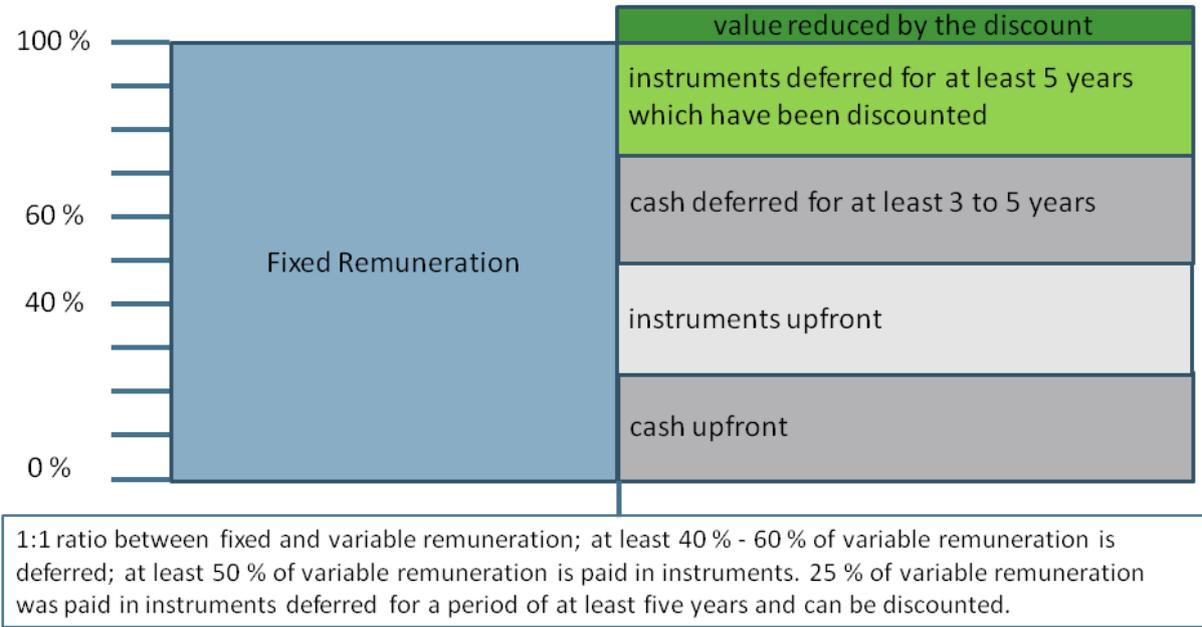
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## 3. Background and rationale

### Legal background

1. Article 94(1)(g)(i) of Directive 2013/36/EU (CRD) provides that ‘the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage’. Article 94(1)(g)(ii), first subparagraph, provides that ‘Member States may allow shareholders or owners or members of the institution to approve a higher maximum level of the ratio between the fixed and variable components of remuneration provided the overall level of the variable component shall not exceed 200 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage.’
2. Article 94(1)(g)(iii), first subparagraph, of CRD provides that ‘Member States may allow institutions to apply the discount rate referred to in the second subparagraph of this point to a maximum of 25% of total variable remuneration provided it is paid in instruments that are deferred for a period of not less than five years. Member States may set a lower maximum percentage.’
3. Pursuant to Article 162(3) of CRD ‘the laws, regulations and administrative provisions necessary to comply with Article 94(1)(g) shall require institutions to apply the principles laid down therein to remuneration awarded for services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013.’
4. The second sub-paragraph of Article 94(1)(g)(iii) provides that EBA ‘shall prepare and publish, by 31 March 2014, guidelines on the applicable notional discount rate taking into account all relevant factors including inflation rate and risk, which includes length of deferral. The EBA guidelines on the discount rate must specifically consider how to incentivise the use of instruments which are deferred for a period of not less than five years.’
5. Recital 65 of the CRD recalls that ‘with a view to encouraging the use of equity or debt instruments which are payable under long-term deferral arrangements as a component of variable remuneration, Member States should be able, within certain limits, to allow institutions to apply a notional discount rate when calculating the value of such instruments for the purposes of applying the maximum ratio. However, Member States should not be obliged to provide for such a facility and should be able to provide for it to apply to a lower maximum percentage of total variable remuneration than set out in this Directive. With a view to ensuring a harmonised and coherent approach which guarantees a level playing field across the internal market, EBA should provide appropriate guidance on the applicable notional discount rate to be used.’
6. EBA’s predecessor CEBS has published guidelines on Remuneration Practices and Policies. The general concepts of variable and fixed remuneration, deferral, vesting and retention are part of those guidelines and apply in the scope of the EBA guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU.

Figure 1: Schematic overview of remuneration components under a 1:1 ratio



Considerations regarding a discount rate

- 7. In these guidelines, in line with the wording of CRD, discount rate is understood as the factor by which the amount of variable remuneration is multiplied to obtain its discounted value. Generally speaking, a discount rate is understood to be the interest rate which is used to discount future amounts of cash flows in a multi-period model; it is often denoted 'r'. Generally speaking, a discount factor is equal to  $b=1/(1+r)$ . The future amount of cash flows must be multiplied with the discount factor 'b' in order to obtain the net present or discounted value and is referred to in this guidelines as discount rate.
- 8. The discount rate, if implemented by the Member State, can be applied to the variable remuneration of staff whose professional activities have been identified as having a material impact on the institution's risk profile, for the purpose of calculating the ratio between variable and fixed remuneration. For the identification of staff the regulation on criteria to identify staff whose professional activities have a material impact on the institutions risk profile will need to be applied once it has entered into force.<sup>1</sup> Since the maximum ratio applies to single staff members, the discount rate needs to be applied to the variable remuneration which is paid to a single staff member as well. The discount rate can be applied only to variable remuneration paid in instruments that are deferred for five or more years. However, there is no obligation for the institution to make use of the discount rate. According to the CRD deferred variable remuneration must not vest faster than on a pro-rata basis.

<sup>1</sup> This regulation will be based on the draft technical standards prepared by the EBA. The consultation on these draft technical standards can be found on the EBA website at <http://www.eba.europa.eu/regulation-and-policy/remuneration/draft-regulatory-technical-standards-for-the-definition-of-material-risk-takers-for-remuneration-purposes>.

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9. The EBA has considered in line with its mandate the relevant factors as indicated within the CRD for the calculation of the discount rate, and the incentive effects derived from the payment of deferred variable remuneration in instruments.
  10. The extent to which the deferred part of remuneration may work as an incentive mechanism depends on what is, for the employee, the perceived value of this deferred remuneration when it is awarded. That is the discounted value of remuneration which will only be obtained in the future. How a staff member perceives the discounted value may differ between individual staff members. In general the perceived value depends on several factors: e.g. the expected return on another investment; the immediate financial needs the employee has; personal preferences; the risks of not being able to receive the full amount of deferred remuneration in the future, the reduction of the value due to inflation and the uncertainty about future inflation rates. However, not all such elements are relevant for the discount rate. For example, claw back and malus mechanisms, which are part of the remuneration framework and are supposed to reduce the awarded remuneration if the institution or the staff member does not perform well, should not lead to an increase of the discount rate.

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#### 4. Draft guidelines on the applicable notional discount rate for variable remuneration under Article 94(1)(g)(iii) of Directive 2013/36/EU

In between the text of the draft guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

##### Status of EBA Guidelines

1. This document contains draft guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC ('the EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to whom guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

##### Reporting Requirements

3. According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by [dd.mm.yyyy – two months after issuance]. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.
4. Notifications will be published on the EBA website, in line with Article 16(3).
5. Institutions to which these guidelines apply shall report, in a clear and detailed way, whether they comply with these guidelines, in accordance with Article 16(3) of the EBA Regulation and Section 5 of Title I of these Guidelines.

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## Title I - Subject matter and definitions

1. Article 94(1)(g) of Directive 2013/36/EU<sup>2</sup> requires institutions to set appropriate ratios between the fixed and the variable component of total remuneration for the categories of staff whose professional activities have a material impact on the risk profile of the institution (identified staff)<sup>3</sup>. The maximum ratio between the variable and the fixed part of the total remuneration is limited to 100%. Member States may allow the ratio to be increased to a maximum of 200%.
2. These guidelines set out the calculation and application of the discount rate referred to in Article 94(1)(g)(iii) of Directive 2013/36/EU. Member States may allow institutions to apply the discount rate for the purposes of calculating the ratio between variable and fixed components of remuneration to a maximum of 25% of total variable remuneration, provided it is paid in instruments that are deferred for a period of not less than five years.
3. The guidelines apply to institutions which make use of the possibility to apply the discount rate for the purpose of calculating the ratio between the variable and fixed components of remuneration, and to competent authorities in Member States which have implemented the possibility to apply the discount rate.
4. For the purpose of these guidelines the discount rate is the value by which a nominal amount of awarded variable remuneration which vests in the future is multiplied in order to obtain its discounted value. The discounted value is then used for the calculation of the ratio between the fixed and the variable components of total remuneration for identified staff.

## Title II – Requirements regarding the discount rate for variable remuneration

### 1. Variable remuneration which can be discounted

5. Institutions can discount up to a maximum of 25%, or a lower percentage prescribed by national law, of total variable remuneration. Only variable remuneration which is deferred for at least five years and is paid in equity or debt-instruments or instruments linked to such instruments which are eligible for the purposes of variable remuneration in accordance with Article 94(1)(l) of Directive 2013/36/EU should be discounted. This includes parts of the deferred variable remuneration that vest during the deferral period. Variable remuneration cannot vest faster than on a pro-rata basis. Retention periods are taken into account within the calculation of the discount rate, as set out in section 2.<sup>4</sup>

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<sup>2</sup> 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 investment firms, amending Directive 2002/87/EC and repealing Directive 2006/48/EC and 2006/49/EC. OJ L 176, 27.6.2013, p. 338.

<sup>3</sup> Staff should be identified applying the regulatory technical standards on criteria for the identification of staff whose professional activities have a material impact on the institutions risk profile.

<sup>4</sup> The concepts of deferral, retention and vesting are explained in more detail under point 4.4 of the Guidelines on Remuneration Policies and Practices which are available on the EBA website at: <http://www.eba.europa.eu/documents/10180/106961/Guidelines.pdf/a3ab77c9-980f-4994-b2cd-397413b77084?version=1.0>

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6. The amount of variable remuneration which can be discounted should be calculated on the basis of the total nominal amount of variable remuneration as set out in the EBA's Guidelines on Remuneration Policies and Practices.

Q 1: Is the scope of variable remuneration which can be discounted sufficiently clear?

## 2. Elements included in the calculation of the discount rate

7. The discount rate should include the following four factors: inflation, interest rate for EU government bonds, an incentive factor linked to the use of long-term deferred instruments and an incentive factor linked to the use of additional retention periods as set out in the following paragraphs of this section. For paragraphs 8 to 10 the most recently available data should be used when remuneration is awarded.
8. For remuneration awarded in a Member State one of the following should apply:
  - a. if the remuneration is paid in the currency issued by the Member State where the staff member mainly works, the factor for inflation is the average annual rate of change for the HICP published by Eurostat<sup>5</sup> for this Member State;
  - b. if the remuneration is paid in a currency issued by another Member State or a third country, institutions should use equivalent official statistical data available for the country issuing the currency or should use the HICP rate applicable for the Member State in which the staff member mainly works.
9. For remuneration awarded in a third country<sup>6</sup> the following should apply:
  - a. if the remuneration is paid in a currency issued by a third country, institutions should use equivalent official statistical data available for the country issuing the currency or should use the HICP rate applicable for the EU parent institution;
  - b. if the remuneration is awarded in a currency issued by an EU Member State, institutions should use the HICP rate applicable for the EU parent institution.

Q2: Is the suggested factor to consider inflation appropriate?

10. The average interest rate for long-term EU government bonds is the average yield on a government bond with a residual maturity of around ten years, as published by Eurostat.<sup>7</sup>

Q3: Is it appropriate to consider the rate for EU government bonds within the discount rate as a proxy for the opportunity costs of deferred remuneration and for inflation risk?

11. The incentive factor for deferred variable remuneration paid in instruments deferred for five years is ten percent. The factor should increase by two percentage points for each additional full year of deferral.

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<sup>5</sup> Harmonised Indices of Consumer Prices (HICPs). The rate referred to can be accessed via the following link: <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00118&plugin=1>

<sup>6</sup> 'Third countries' refers to countries which are not Member States of the Union

<sup>7</sup> <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=teimf050&plugin=1>

Q4: Is the incentive factor for the use of long-term deferred variable remuneration appropriate?

12. The incentive factor for a retention period which follows a deferral period of at least five years is two percent for a retention period of at least two years. The factor should increase for each additional full year of retention by one percentage point.

Retention of vested instruments is an important element in the design of the long-term incentive structure of variable remuneration. Longer retention periods create an incentive for the employees for prudent behaviour even after the awarded remuneration has vested, and links the variable remuneration to the performance of the institution, which is influenced by decisions on risks taken in the past. By imposing longer retention periods, remuneration is better aligned with the long-term interest of the institution.

Q5: Is an additional incentive factor for the use of retention periods for long term deferred instruments appropriate?

### 3. Calculation of the discount rate

13. Institutions should calculate the applicable discount rates for different parts of variable remuneration which are subject to different deferral, vesting and retention arrangements and apply the discount rates accordingly. Institutions should use the applicable deferral and retention periods documented within their remuneration policy.
14. The applicable discount rate equals one divided by the sum of one plus the four factors set out in section 2, raised to the power of the number of years of the vesting period, as shown in the formula below. The vesting period is the period after which the variable remuneration vests. For this purpose the vesting period should be rounded to the lower full integral number. For pro-rata vesting, institutions may also use a present value formula as described in the Annex, Example 2.

Q6: Is the calculation of the discount rate sufficiently clear?

#### Formulas for the calculation of the discount rate

$$\text{discount rate} = \frac{1}{(1 + i + g + id + ir)^n}$$

- i = inflation rate of the Member State or third country
- g = interest rate for EU government bonds, EU average
- id = incentive factor for use of long-term deferral
- ir = incentive factor for retention
- n = number of years of the vesting period

The application of the formulas is further explained in Examples 1, 2 and 3 in the Annex to these guidelines.

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#### 4. Application of the discount rate

15. The discount rate should be applied to the variable remuneration of an individual staff member.
16. The discount rate should be applied to a maximum of 25% of the variable remuneration or a lower value prescribed by national law paid in instruments that are deferred for at least five years.
17. Institutions should calculate:
  - a. the sum of all components of variable remuneration which are awarded to an individual staff member;
  - b. the amount of (a) which is paid in instruments and deferred for a period of not less than five years; and
  - c. the amounts in (b) for which different discount rates apply.
18. In order to calculate the discounted variable remuneration the applicable discount rate should be applied by multiplying it with the respective part of variable remuneration.
19. For the purpose of calculating the ratio between the variable and the fixed component of remuneration, the total variable remuneration is the sum of all discounted amounts of variable remuneration and the non-discounted variable remuneration.

Q7: Is the application of the discount rate sufficiently clear?
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#### 5. Documentation and transparency

20. Institutions should document the calculation and use of the discount rate.
21. Institutions should keep a record of the fixed and variable components of remuneration awarded to a staff member, the parts of variable remuneration paid in instruments which are deferred for five years or more, the applied discount rate and the ratio between the variable and fixed component of total remuneration.
22. Institutions are required, in accordance with Article 16 of Regulation (EU) No 1093/2010/EU, to report, in a clear and detailed way, whether they comply with these guidelines. Institutions should provide information on the discount rates together with the disclosures required regarding the remuneration policy under Article 96 of Directive 2013/36/EU and Article 450(1)(d) of Regulation (EU) No 575/2013. In particular, institutions should disclose the following on a country by country basis:
  - a) the use of the discount rate;
  - b) the extent to which the discount rate is used (the maximum being its application to 25% of the total variable remuneration or a lower value depending on national law);
  - c) the number of identified staff to whom the discount rate applies; and

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d) the average of the applied discount rate.

Q8: What additional costs would be triggered by the documentation and transparency requirements?

## 6. Supervisory review of the discount rate

23. When competent authorities review the remuneration framework of an institution, they should review how the discount rate is calculated and applied to the variable remuneration which was awarded to identified staff.

## Title III – Final Provisions and Implementation

24. The guidelines apply for the purpose of the calculation of the ratio between the variable and the fixed component of total remuneration awarded for performance and service year from 2014 and onwards.

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## Annex – Examples of how the discount rate for variable remuneration is applied

Calculation of the discounted part of variable remuneration (dvr) for the purpose of calculating the ratio between the variable and fixed component of remuneration:

$$dvr = \frac{vr}{(1 + i + g + id + ir)^n}$$

Where:

dvr = discounted variable remuneration;

vr = variable remuneration subject to the discount (max 25% of total variable remuneration provided it is paid in instruments that are deferred for at least 5 years);

i = inflation rate in percentage;

g = interest rate for government bonds EU average in percentage;

id = incentive factor for use of long term deferral in percentage;

ir = incentive factor for retention in percentage;

n = number of years of the vesting period.

The total variable remuneration is the sum of the discounted part of variable remuneration and the non-discounted part of variable remuneration.

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## Example 1

Assume for this example that the Member State in question has allowed institutions to apply a discount rate to a maximum of 25% of total variable remuneration. Assume also that the institution's shareholders have not approved a higher maximum ratio than the one provided for in Directive 2013/36/EU.

The institution would like to award a staff member, who receives EUR 135 000 as fixed remuneration, an amount of EUR 150 000 as variable remuneration. The staff member in question is identified staff and we are considering remuneration awarded for the performance year 2014. The ratio variable/fixed remuneration is in this case above the 1:1 ratio. However, this ratio is compatible with Article 94(1)(g) CRD due to the ability to apply the discount rate to the portion of variable remuneration paid in instruments deferred for a period of at least five years.

The structure of the variable remuneration would in this example be as follows:

- EUR 20 000 of the variable remuneration would be paid in instruments deferred for five years with a retention period of two additional years,
- EUR 10 000 would be paid in instruments deferred for six years with a retention period of three years,
- the remainder of the total variable remuneration would be paid upfront, not in instruments or would be deferred for a shorter period of time than five years.

In this example, no pro-rata vesting is considered. The amounts of EUR 20 000 and EUR 10 000 paid in instruments vest in full after five and six years, respectively.

Based on variable remuneration of EUR 150 000, a maximum amount of EUR 37 500 could have been discounted (which represents 25% of the total variable remuneration of EUR 150 000), if it were to be paid in instruments deferred for more than five years. However, in this example, only EUR 30 000 fulfil both these conditions and only this amount can be discounted.

### **Factor for inflation (i)**

Assume the last available HICP rate for this Member State is 2%.

### **Factor for EU government bonds (g)**

Assume the last available average rate for EU government bonds with a maturity of around 10 years as published by Eurostat is 2.73%.

### **Incentive factor long term deferral (id)**

For the EUR 20 000 deferred for 5 years the incentive factor is 10%.

For the EUR 10 000 deferred for 6 years the incentive factor is 12% (10% + 2% for each additional full year).

### **Incentive factor for retention (ir)**

For EUR 20 000 the incentive factor is 2% (retention of at least two years).

For EUR 10 000 the incentive factor is 3% (2% + 1% for each additional full year).

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**Length of the vesting period (n)**

For EUR 20 000 the vesting period is 5 years.

For EUR 10 000 the vesting period is 6 years.

The discounted variable remuneration for the above example 1 is calculated as follows:

**Amount of EUR 20 000 deferred for 5 years with 2-year retention:**

$$\frac{20\,000}{(1+0.02+0.0273+0.10+0.02)^5} = 9\,228.21$$

**Amount of EUR 10 000 deferred for 6 years with 3 year retention:**

$$\frac{10\,000}{(1+0.02+0.0273+0.12+0.03)^6} = 3\,394.55$$

The sum of the discounted variable remuneration = EUR 12 622.76

**The total variable remuneration for the purpose of calculating the ratio between the variable and fixed component of remuneration and the ratio between variable and fixed components of remuneration is calculated as follows:**

The amount of variable remuneration that can be discounted because it is paid in instruments deferred for at least a period of five years is EUR 30 000. However, different discount factors have been used because the vesting and retention periods applied to the amount of EUR 20 000 are five and two years, respectively, while the vesting and retention periods applied to EUR 10 000 are six and three years, respectively. These two amounts vest in full at the end of the deferral period, hence the vesting period equals the deferral period. There is no pro-rata vesting in this example. The total amount of the discounted part of variable remuneration equals EUR 12 622.76, resulting in a total amount of variable remuneration for the purpose of calculating the ratio between variable and fixed remuneration of EUR 132 797.96; that is (150 000 - 30 000 + 12 622.76). The ratio between variable and fixed components of total remuneration in this example is  $(132\,622.73/135\,000) \times 100 = 98.24\%$ .

To sum up, under the assumptions and the conditions set out above, the institution will be able to award a staff member receiving EUR 135 000 in fixed remuneration EUR 150 000 as variable remuneration within the 1:1 ratio for variable and fixed remuneration.

Q9: Is the example 1 sufficiently clear and helpful to understand the application of the guidelines?
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**Example 2**

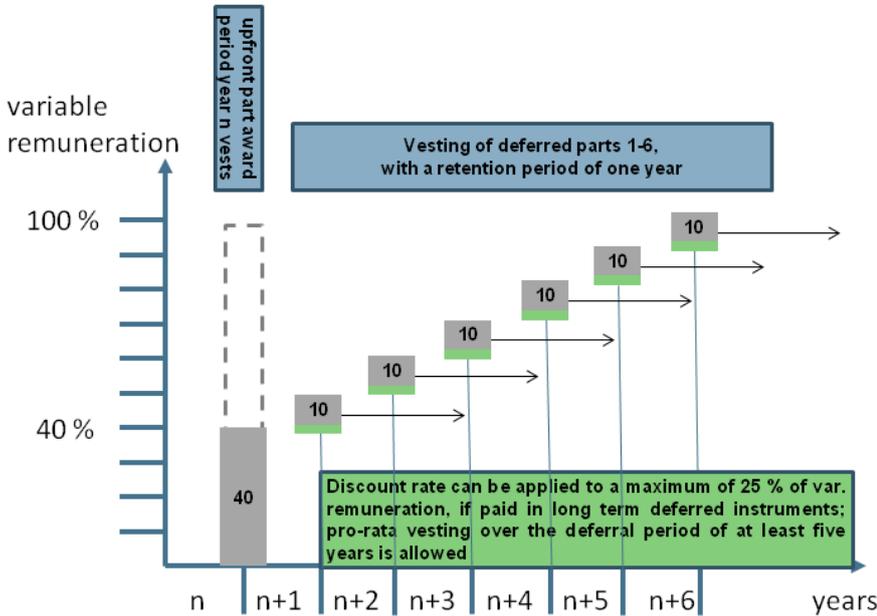
Assume that in a Member State, the institution would like to award a staff member (identified as material risk taker) who receives EUR 135 000 as fixed remuneration, an amount of EUR 150 000 as variable remuneration. The same assumptions regarding the Member State's transposition of the Directive (maximum 25%), shareholders' approval for ratio higher than 1:1 (none) and performance year (2014) apply as under Example 1.

The structure of the variable remuneration is as follows:

- 60% of the total variable remuneration, i.e. EUR90 000, would be deferred for six years and would vest pro-rata over this period, with a twoyear retention period for variable remuneration paid in instruments,
- EUR 37 500 of this variable remuneration is deferred for a sixyear period and with twoyear retention, would be paid in instruments. This implies that every year, an amount of EUR 6 250 paid in instruments would vest.

In this example, pro-rata vesting is considered. The discount rate can be applied to a maximum of 25% of the total variable remuneration, provided it is paid in instruments deferred for a period of at least five years.

**Figure 2: Schematic overview of deferral and retention arrangements and the application of the discount rate to variable remuneration paid in instruments deferred for six years and with pro-rata vesting.**



40 % of total variable remuneration paid upfront; 60 % of total variable remuneration deferred for six years with even spread and two years retention

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**Factor for inflation (i)**

Assume the last available HICP rate for this Member State is 2%.

**Factor for EU government bonds (g)**

Assume the last available average rate for EU government bonds with a maturity of around 10 years as published by Eurostat is 2.73%.

**Incentive factor long term deferral (id)**

For a deferral period of 6 years, the incentive factor is 10%+2%=12%.

**Incentive factor for retention (ir)**

The incentive factor is 2% as the retention period is two years.

**Length of the vesting period (n)**

Pro-rata vesting of the portion of variable remuneration paid in instruments deferred for six years EUR 37 500, implies that every year EUR 6 250 vests. Hence, in the formula for the discount rate, n=1 for the EUR 6 250 vesting after the first year, n=2 for the portion vesting after two years, n=3 for the portion vesting after three years, and so on until n=6 has to be used.

The discounted variable remuneration for the above example 2 is calculated as follows:

In this example, EUR 37 500, which represent 25% of the total variable remuneration is paid in instruments deferred for at least 5 years and can be discounted.

**The discounted value of the amount of EUR 37 500 of variable remuneration deferred for 5 years with 1-year retention and pro-rata vesting is the sum of the following six values:**

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^1} = 5\,264.04$$

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^2} = 4\,433.63$$

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^3} = 3\,734.21$$

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^4} = 3\,145.13$$

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^5} = 2\,648.97$$

$$\frac{6\,250}{(1+0.02+0.0273+0.12+0.02)^6} = 2\,231.09$$

The sum of the discounted variable remuneration is EUR 21 457.07 (5 264.04+4 433.63+3 734.21+3 145.13+2 648.97+2 231.09).

In case of pro-rata vesting, the calculation can also be done using the present value formula:

$$dvr = vrpr * \frac{(r^n - 1)}{n * (r - 1)}$$

dvr = discounted variable remuneration

vrpr = pro-rata amount of variable remuneration (in the above example 6 250)

r = 1+i+g+id+ir (i= inflation rate; g = rate for government bonds, id = incentive factor deferral; ir= incentive factor retention)

n = length of the deferral period

**The total variable remuneration for the purpose of calculating the ratio between the variable and fixed component of remuneration and the ratio between variable and fixed components of remuneration is calculated as follows.**

The amount of variable remuneration that can be discounted, because it is paid in instruments deferred for a period of at least five years is EUR 37 500. However, different discount factors or the present value formula have been used, because this amount vests pro-rata over the six-year period. The total amount of the discounted part of variable remuneration equals EUR 21 457.07, resulting in a total amount of variable remuneration for the purpose of calculating the ratio between variable and fixed remuneration of EUR 133 957.07; that is (150 000 - 37 500 + 21 457.07). The ratio between variable and fixed components of total remuneration in this example is (133 957.07/135 000)\*100 = 99.23%.

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If the EUR 37 500 had vested in full after the six-year deferral (no pro-rata vesting) and with the two-year retention, the discounted amount of the total variable remuneration would have been EUR 13 386.54.

$$\frac{37\,500}{(1+0.02+0.0273+0.12+0.02)^6} = 13\,386.54$$

The ratio fixed/variable remuneration would be equal to  $(125\,886.54/135\,000)*100 = 93.25\%$ , which is lower than the one obtained with pro-rata vesting.

Q10: Is the example 2 sufficiently clear and helpful to understand the application of the guidelines?
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### Example 3

The following example is based on a given amount of fixed remuneration of EUR 100 000 and shows how to calculate the maximum possible amount of variable remuneration which could be awarded if 25% of the variable remuneration is paid in instruments that are deferred for five years with a two-year retention period, assuming that the full amount vests at the end of the deferral period. The inflation rate and interest rate for government bonds provided under Example 1 are used. The same assumptions regarding Member State's transposition (25%) of the Directive, shareholders' approval for ratio higher than 1:1 (none) and performance year (2014) apply as under Example 1.

In this example, the total variable remuneration that can be paid is up to a maximum of 100% of the fixed components of remuneration and the maximum variable remuneration that can be discounted is 25% provided it is paid in instruments that are deferred for at least five years.

Hence, we can write the following equation:

$$fr = 0.75 * tvr + \frac{0.25 * tvr}{(1 + i + g + id + ir)^n}$$

fr = fixed remuneration  
tvr = total variable remuneration  
i = inflation rate;  
g = interest rate for government bonds EU average;  
id = incentive factor for use of long-term deferral;  
ir = incentive factor for additional retention;  
n = length of the vesting period.

By replacing the corresponding amounts considered in this example for each variable in the equation above, we obtain:

$$100\,000 = 0.75 * tvr + \frac{0.25 * tvr}{(1 + 0.02 + 0.0273 + 0.10 + 0.02)^5}$$

fr = 100 000  
i = 2%, factor for inflation  
g = 2.73% factor for government bond interest rate  
id = 10% , factor for five year deferral,  
ir = 2%, factor for two years retention,  
n = 5, length of vesting period.

Solving the previous equation for tvr, we obtain:

$$tvr = \frac{100\,000 * 2.17}{0.75 * 2.17 + 0.25} = 115\,579.23$$

For the above example, the maximum variable remuneration which can be paid if 25% of the variable remuneration is discounted is EUR 115 559.82.

Q11: Is the example 3 sufficiently clear and helpful to understand the application of the guidelines?

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## 5. Accompanying documents

### 5.1 Draft Cost-Benefit Analysis / Impact assessment

1. Article 16(2) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council) provides that any Guideline developed by the EBA shall be accompanied by an Impact Assessment (IA) which analyses 'the potential related costs and benefits'. The Impact Assessment should provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.
2. This note outlines the Impact Assessment (IA) regarding the draft Guidelines on the applicable notional discount rate for variable remuneration under Article 94 (1)(g)(iii) of Directive 2013/36/EC of the European Parliament and of the Council on access to the activity of credit institutions and prudential supervision of credit institutions and investment firms (CRD).

#### 5.1.1 Problem definition

3. Remuneration policies and practices should be consistent with effective risk management to ensure that staff members behave prudently and should set incentives that ensure that staff member's personal objectives are aligned with the long-term interests of the credit institution. To this end, the CRD requires that 40-60% of the variable remuneration is deferred. In addition, a maximum ratio between variable and fixed components of total remuneration was introduced. Variable remuneration shall not exceed 100% of the fixed remuneration of a staff member who has a material impact on the institution's risk profile (200% with shareholders' approval).
4. Member States may allow institutions to apply the discount rate to a maximum of 25% of variable remuneration provided that it is paid in instruments that are deferred for at least 5 years. The application of this provision is subject to national discretion and Member States may choose not to apply this provision or to set a ratio lower than 25%.
5. The application of the discount rate has the consequence of reducing the value of variable remuneration to be considered in the calculation of this ratio, allowing institutions which apply the discount rate to actually pay out variable remuneration which exceeds 100% (200% subject to shareholders' approval) of the fixed remuneration. The applicable discount rate should consider all relevant factors, including inflation rate and risk and should provide incentives for the use of long-term deferred variable remuneration.
6. The provisions regarding the discount rate were added at a late stage in the legislative process leading to the adoption of the CRD. The Commission did not evaluate this specific issue in the impact assessment accompanying its proposal for CRD, because it was not included in the original proposal.

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*Issues addressed by the GL and objectives*

7. The CRD requires that EBA, in preparing guidelines on the applicable notional discount rate, should take into account all relevant factors including inflation rate and risk, which includes the length of deferral. The EBA GL shall specifically consider how to incentivise the use of instruments which are deferred for a period of not less than five years. Beside the explicitly mentioned factors, EBA has considered other relevant factors, e.g. the retention period and staff turnover.
8. Consistently with the mandate, EBA proposes a discount rate which takes into account the following factors:
  - a. inflation rate;
  - b. the average interest rate for EU government bonds with a maturity around 10 years to consider opportunity costs of remuneration which is only available at a later point in time and inflation risk;
  - c. an incentive factor for the use of long term deferred instruments;
  - d. an incentive factor for the use of longer retention periods.
9. The guidelines also set out how the discount rate should be applied.

#### 5.1.2 Technical options considered

10. The EBA understands that the term 'risk' within the above mandate refers to inflation risk and not to the risk profile of the institution.
11. The EBA has considered the following technical options:

*Options considered regarding inflation rate and inflation risk:*

12. Inflation reduces the value of the remuneration which will be paid out in the future. The Euro area is subject to a common monetary policy with an inflation target set by the European Central Bank to keep inflation rates for the Eurozone below, but close to, 2% of the Harmonised Indices of Consumer Prices (HICP) in the medium term. Most national central banks in non-eurozone Member States also have an objective of price stability.
13. Temporary shocks to volatile components of inflation (for instance commodity prices) tend to affect heavily short-term expectations, as such shocks cannot be counteracted by monetary policy within short time horizons and can lead to considerable volatility in inflation. Until now, in the Eurozone, long-term inflation expectations have been broadly insensitive to the propagation of temporary shocks<sup>8</sup>.

- ▶ **Option A – Using the inflation rate measured by the Harmonised Consumer Price Index (HCPI)**
  - Sub-option A1 – Using the inflation rate for the European Union

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<sup>8</sup> [Assessing the anchoring of longer-term inflation expectations](#), p65 – ECB Monthly bulletin, July 2012.

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- Sub-option A2 – Using inflation rate for the Member State in which remuneration is awarded

14. Inflation is measured by HCPI which is publicly available and is calculated by Eurostat. While the use of a uniform inflation rate throughout the EU would lead to a harmonised discount rate, national inflation rates may differ significantly (Eurostat data from June 2013 shows an average annual inflation rate between 0.3% and 4.3%<sup>9</sup> among Member States). The inflation rate can span outside these limits for non-EU countries, affecting further the remuneration awarded outside the EU. To accommodate the different inflation rates among the Euro area, non Euro area and non EU third countries, Option A2 was retained. For third countries, it is important to consider in which currency the remuneration is awarded as this has a significant influence on the effect inflation would have on the remuneration awarded to a staff member located in one country, but who is receiving remuneration based on a different currency.

15. Current inflation rates as well as inflation rate forecasts are available from Eurostat, the European Central Bank and national authorities, for single Member States and the European Union. Long-term inflation expectations are surveyed quarterly in the ECB Survey of Professional Forecasters (SPF) and the Euro Zone Barometer and biannually by Consensus Economics. Financial indicators of inflation expectations are available in some countries by determining the break-even inflation rates (BEIRs), calculated as the yield spread between nominal and inflation-linked bonds. There is currently a significant uncertainty surrounding the inflation outlook perceptible both in professional surveys and in financial market indicators. Nevertheless, on balance, available evidence from both survey data and financial market indicators suggests that euro area long-term inflation expectations remain firmly anchored at levels consistent with price stability<sup>10</sup>.

16. Variable remuneration which is awarded in instruments deferred for at least five years can be discounted under this guideline. For a period of at least five years, it is appropriate to consider the risk of rising inflation rates. Any inflation rate forecast may differ, over the period of the forecast, from the **future observed** inflation rates. Although available long-term estimates contain a high level of forecast uncertainty it might be appropriate to use, as an alternative measure, an inflation rate forecast which is higher than the current inflation.

► **Option B – Using the inflation rate implied in financial instruments**

17. Market participants when pricing instruments take into account several factors, including inflation rates and inflation risk. If there were a risk-free financial instrument, the price would be influenced mainly by the inflation rate future evolution. EU government bonds have a zero risk weight<sup>11</sup> within the credit risk regime. Looking at historic interest rates it can be assumed that market rates take account of the inflation risk and credit risks.

18. The sub-option A2 regarding the current inflation rate and option B with respect to the inflation risk have been retained.

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<sup>9</sup> [Eurostat News release](#) – June 2013

<sup>10</sup> [ECB Annual report 2012](#), Box 3 p39-42.

<sup>11</sup> The EU member states retain the discretion of applying a 0% weight on EU government bonds

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*Options considered regarding incentives to use long term deferred instruments and additional incentive periods:*

- ▶ **Option C1 – Explicit factor to incentivise long-term deferral period when using instruments to pay variable remuneration.**
- ▶ **Option C2 – Explicit factor to incentivise the use of additional retention periods.**
- ▶ **Option C3 – Calculation of the discount rate which takes into account the length of the deferral period.**
- ▶ **Option C4 – Allow additional discount depending on the type of instrument used.**

19. The CRD requires considering the length of deferral periods within the guidelines and aims to incentivise the use of instruments which are deferred for a period of five years or longer. It is therefore appropriate to introduce a factor which should increase the discount rate with time, if instruments are deferred for a period of five years or longer. To this end and to provide incentives to defer remuneration for longer periods, the EBA propose to add a factor of 10% for variable remuneration deferred for five years and to add a further two percentage points for each additional year of deferral.

20. Retention of vested instruments is an important element in the design of the long-term incentive structure of variable remuneration. Longer retention periods create an incentive for the employees for prudent behaviour even after the awarded remuneration has vested and link the variable remuneration to the performance of the institution, which is influenced by decisions on risks taken in the past. By imposing longer retention periods, remuneration is better aligned with the long-term interest of the institution. Therefore, additional incentives should be granted if instruments which are deferred for more than five years are subject to additional retention periods after the deferral period has ended. In addition by using longer retention periods the possibility to claw back remuneration is increased. However, as such periods are usually shorter and the amounts are already vested the incentive factor should be lower than the one for deferral. A retention period of one year could be considered as the minimum which should be applied, hence only the use of longer retention periods of at least two years should be incentivised.

21. A discount rate should be applied for every year to consider the effect of inflation and other relevant factors for the complete period. As the discount rate is expressed as an annual rate, it is appropriate to raise the respective factor to the power of the number of years of the deferral period. The retention period should not be considered as staff would receive the distributions paid under the instrument during such period, while no distributions should be paid during the deferral period in accordance with the Guidelines on Remuneration Policies and Practices.

22. Institutions can use different instruments for paying variable remuneration. While share prices have the potential to increase or decrease, the prices of debt instruments are more likely to react more moderately and have a higher down-side risk compared to the potential of increasing values. The levels of distributions paid are also different; hence, one could consider differentiating the discount factors for different instruments. However, a differentiation would add complexity to the application of the remuneration framework and would trigger additional implementation costs. All instruments must be appropriate for the use of variable remuneration

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and must be subject to a remuneration policy, including deferral and retention periods. It cannot be validated that one class of instruments would provide better incentives for prudent risk taking. Instruments would be affected by inflation in the same way. Option C4 was therefore not retained.

23. Option C1, C2 and C3 have been retained.

*Options considered regarding opportunity costs*

- ▶ **Option D1 – Market rates, e.g. rate for 10-year EU government bonds**
- ▶ **Option D2 – Return on Equity ('ROE') of institution or the EU banking system**

24. The net present value of variable remuneration depends not only on the expected inflation rate, but also on the opportunity costs of the remuneration not available today for another use or an alternative investment. For the opportunity costs a rate should be considered that measures the real yield without consideration of inflation, as inflation is already considered. However, as also mentioned above, market rates depend not only on inflation and credit risk, but also on the liquidity of the instrument and other aspects. If staff would receive non-deferred remuneration, they could invest it in equity instruments, bonds, property or other investments.

25. The choice of the discount rate should consider the aim to achieve harmonisation. The rate should be easy to apply and have an objective value. The latter is given for example for EU government bonds. When choosing a rate the length of deferral and retention periods should be taken into account, as rates are different for different maturities. A rate for government bonds with around 10 years' maturity seems to be appropriate to consider both the length of deferral periods which can be longer than five years and the inflation risk. The inflation risk is also relevant during retention periods and, therefore, the rate should at least correspond to the length of the deferral and retention period. It can be assumed that such periods in general do not exceed 10 years. Interest rates differ significantly between Member States for several reasons; hence an EU average for this value should be used to achieve harmonisation. Given that the rate is added to the factor for inflation, the interest rate for EU government bonds with a maturity of around 10 years seems to be appropriate to cover opportunity costs for other investments and the inflation risk. The rate is easily available. Using this rate is transparent and leads to a high level of harmonisation. The rate fluctuates over time, but is – when using an EU average – more stable than rates for single Member States.

26. The rate for opportunity costs could be based on the average return on equity of all institutions within the European Union or institutions' individual profitability. The latter would not lead to harmonisation and could also create conflicts of interest regarding accounting and valuation issues. The average ROE for the EU banking system as published by the European Central Bank shows very volatile values and, therefore, the discount rate would significantly differ over time. Linking the discount rate to the ROE could also lead to incentives to increase the ROE in the short term, which could contradict the long-term interests of the institution.

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27. Option D1 has been retained.

*Other options considered:*

28. It was suggested that staff turnover be considered in the calculation of the discount rate, as this would take into account the probability that a staff member would receive the variable remuneration after deferral. As the discount rate is applied to a single staff member, it is difficult to consider the general staff turnover within an institution and to apply this to individually awarded remuneration. Such figures would differ between institutions and Member States, which would not lead to harmonisation regarding the discount rate. The possibility that some staff members change positions should not lead to a discounting of the variable remuneration for the purpose of calculating the ratio. Long-term deferral should provide for long-term incentives for the individual.

29. The additional factor was not retained.

*Amounts of variable remuneration which can be discounted:*

- ▶ **Option E1 – Amounts that vest after a five-year deferral period should be eligible**
- ▶ **Option E2 – If remuneration is deferred for at least 5 years all amounts that are paid in instruments (up to a maximum of 25% of variable remuneration) should be eligible, including amounts vesting before the end of the deferral period.**

30. The CRD allows variable remuneration paid in instruments to be discounted if it is deferred for a period of at least five years. The discount rate should incentivise the use of longer deferral periods. Variable remuneration should not vest faster than on a pro-rata basis.

31. Applying the discount factors to amounts which vest only after a minimum period of five years would provide a strong incentive to defer large parts of the variable remuneration for five years or longer and, by doing so, to provide for a good risk alignment. However, this may not be practical as staff would receive larger parts of the variable remuneration at a very late stage, reducing the net present value of variable remuneration and the flexibility of staff to change work places. Both effects could lead to a situation where institutions do not use long deferral periods so as to avoid the negative effects. The discount rate may therefore not be applied at all.

32. Allowing the discounting of amounts which vest within a long deferral period would reflect the current remuneration practices in banks, which often use pro-rata vesting of variable remuneration. A sufficient risk alignment would still be achieved. The incentive to use long-term deferral would be increased, as the net present value of remuneration would not be reduced to the same extent as under option E1. The discount rate would provide sufficient incentives to defer variable remuneration for a longer time period, as the rate would consider the number of years it takes for the variable remuneration to vest.

33. Option E 2 was retained.

*Calibration of the discount rate:*

34. Some factors considered in the calculation of the discount rate are given externally (inflation, interest rate for Government Bonds), while other factors have been introduced to provide incentives to use longer deferral and retention periods. The calibration of the incentive factors took into account current inflation rates and market conditions and aims to provide for sufficient incentives to use longer-term deferred instruments and longer retention periods.

*Proportionality*

35. The discount rate can be applied to a maximum of 25% of variable remuneration awarded in instruments that are deferred for at least five years. Member States may set a lower maximum percentage. The discount rate is based on publicly available data. Therefore, smaller institutions should also be able to access the required information. The possibility of applying the discount rate, if introduced within the national legal framework, is up to the institution. In smaller institutions with lower staff numbers the calculation and the application of the discount rate seems to be possible without the implementation of IT systems or the allocation of additional resources.

5.1.3 Impact of the proposals

36. The implementation of this guideline is limited to the setting and application of the discount rate for variable remuneration. The discount rate itself is part of the CRD requirements. The impact of the CRD as such is not assessed. The marginal costs for applying the guidelines should be minimal. The costs of different options has not been analysed, as all options are based on data which are easily available and, therefore, costs for different options would be identical.

**Table 1 – Summary of the costs of applying the Guidelines for institutions**

Costs	One-off	On-going
<b>Changing the way remuneration policies are set, systems and controls.</b>	a. Cost of additional staff time to review and align remuneration policies in order to reflect the discount rate and implementation of the discount rate in HR systems to calculate the levels of variable remuneration. However, this is triggered by the CRD and costs to implement a system to calculate the effect of the discount rate should be minimal and occur only if the institution makes use of this possibility.	b. none
<b>Calculating and applying the discount rate</b>	c. none	d. Costs for the annual calculation of the discount rate and costs of applying it should be minimal. Cost for documentation.
<b>Remuneration Benchmarking Exercise</b>	e) minor costs for changing the existing IT systems for the processing of data to be disclosed and the reporting of remuneration figures to competent authorities	f. The scope of data which is collected for remuneration Benchmarking is extended by a few data fields containing readily available data, hence creating minor, if any, costs for the reporting and analysis

37. The introduction of a discount rate for variable remuneration may also have additional cost implications for national supervisory authorities, as they need to supervise the application of the discount rate if implemented in the national legislation and used by the institutions.

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However, this is not directly triggered by the guidelines, as this is already a CRD requirement. The application of the CRD, including the remuneration framework, is subject to supervisory review. The costs of the supervisory review are independent of the way in which the discount rate is calculated, but stem from the fact that compliance with the requirement regarding the ratio between variable and fixed remuneration needs to be supervised.

*Benefits of the proposal*

38. By establishing harmonised rules for a discount rate, the remuneration framework between Member States remains comparable and transparent regarding the application of the cap for variable remuneration.

Q 12: Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

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## 5.2 Overview of questions for consultation

Q1: Is the scope of variable remuneration which can be discounted sufficiently clear?

Q2: Is the suggested factor to consider inflation appropriate?

Q3: Is it appropriate to consider the rate for EU government bonds within the discount rate as a proxy for the opportunity costs of deferred remuneration and for the inflation risk?

Q4: Is the incentive factor for the use of long-term deferred variable remuneration appropriate?

Q5: Is an additional incentive factor for the use of retention periods for long-term deferred instruments appropriate?

Q6: Is the calculation of the discount rate sufficiently clear?

Q7: Is the application of the discount rate sufficiently clear?

Q8: What additional costs would be triggered by the documentation and transparency requirements?

Q9: Is the example 1 sufficiently clear and helpful to understand the application of the guidelines?

Q10: Is the example 2 sufficiently clear and helpful to understand the application of the guidelines?

Q11: Is the example 3 sufficiently clear and helpful to understand the application of the guidelines?

Q12: Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?