LATEST SHAKE-UP OF THE REMUNERATION PROVISIONS FOR BANKS AND INVESTMENT FIRMS PART 2: BANKS AND CREDIT INSTITUTIONS

12 March 2019 | Europe
Legal Briefings – By **Mark Ife and Paul Ellerman**

After over two years of debate, agreement has finally been reached on the proposed directive amending the Capital Requirements Directive (which is generally being titled **CRD5**), and the European Council has published its final text.

As detailed in our **previous briefing** (**Part 1**), however, the proposed new prudential regime for investment firms, will remove most investment firms from the scope of CRD5 and subject them to the specific remuneration rules in the new Investment Firms Directive (**IFD**) and Investment Firms Regulation (**IFR**). Consequently, the revised CRD5 is likely only to apply to banks and "bank-like" investment firms.

OVERVIEW

The key remuneration elements of CRD5 include:
• the bonus cap to apply to all banks and CRD investment firms irrespective of size
• deferral, payment in instruments, and malus and clawback to apply to all but the smallest banks and CRD investment firms
• the minimum deferral period to increase to four years
• the 'de minimis' provisions to be limited to employees earning bonuses of less than €50,000
• "gender neutral" remuneration policies to be required

The European Parliament will consider both the CRD5 provisions and the IFD in its plenary sessions between 15 and 19 April 2019, suggesting that the CRD5 package and the revised prudential regime for investment firms will be adopted at around the same time and with the same implementation period. For UK purposes, however, the form and timing of these reforms needs to be considered against the background of BREXIT, as discussed further below.

NEW REMUNERATION RULES FOR BANKS AND RECLASSIFIED CRD INVESTMENT FIRMS

CRD5 introduces a number of changes to the remuneration rules which apply to banks, and which will continue to apply to those systemically important investment firms reclassified as "credit institutions" under the IFD/IFR (together, **CRD firms**). Only those investment firms which are considered to be (a) systemically important (including those with assets exceeding €30bn at either firm or group level), and (b) who carry on the activities of dealing on own account or placing on a firm commitment basis/underwriting, will be re-categorised as "credit institutions" and will therefore continue to be subject to CRD5.

Whist the CRD5 changes are billed as amendments to exempt smaller CRD firms from certain of the more onerous remuneration requirements, the changes may (depending on BREXIT and the UK's approach to implementation) have the opposite effect in the UK, bringing more banks and systemic investment firms fully within the scope of the more onerous provisions.

THE PROPORTIONALITY PRINCIPLE – BONUS CAP AND DEFERRAL

Most UK CRD firms are currently not required to apply the bank bonus cap or, on a mandatory basis, the "pay-out process rules" (deferral, payment in instruments and malus/clawback) to those of their staff categorised as material risk takers (**MRTs**) as a result of the way in which the PRA and FCA have applied the "proportionality principle". This principle has allowed the PRA and FCA, through the application of their three proportionality levels, to require only the largest and most complex CRD firms (i.e. those dual-regulated CRD firms with total assets above £15bn) to apply the bonus cap and the pay-out process rules to their MRTs. The PRA and FCA have maintained this position despite some inconsistency with the EBA Guidelines on Sound Remuneration Policies published in 2015. Subject to BREXIT considerations, this flexibility may be more difficult to preserve at a UK level when it becomes incompatible with requirements that will in future have the status of mandatory EU legislation.

Under CRD5:

- the "bonus cap" (i.e. the 1:1 fixed remuneration to variable remuneration ratio, or 2:1 ratio with shareholder approval) will need to apply to MRTs of **all** CRD firms irrespective of size; and
- the deferral, instruments and malus/clawback requirements will apply to MRTs of all "large institutions" and of all other CRD firms with assets which, on average and on an individual basis, are in excess of €5bn over the prior four-year period. Local regulators will be able to vary the €5bn threshold for certain limited categories of CRD firm, and where the regulator considers it appropriate, but not to be higher than €15bn.

Consequently, for UK banks (and any full-scope investment firm which will remain a CRD firm) currently within Proportionality Level 3, significant changes will need to be made to the remuneration arrangements of MRTs in order apply the bonus cap and to change the form in which those employees receive their remuneration.

CHANGES TO THE *DE MINIMIS* PRINCIPLE

The UK regulators currently allow all CRD firms, irrespective of proportionality level, to apply a *de minimis* threshold to their MRTs to determine whether to apply the pay-out process rules. Consequently, in the UK, MRTs earning less than £500,000 in total, with variable remuneration being no more than 33% of the total, may be excluded from the application of deferral, instruments and malus/clawback.

CRD5 will change this threshold so that only MRTs with variable remuneration of less than €50,000, where that amount represents no more than one third of total remuneration, will be able to be excluded from the provisions. Save for a very limited number of employees, this means a significant increase in the number of employees whose remuneration will need to be deferred and paid in instruments rather than cash.

MINIMUM DEFERRAL PERIODS

Variable remuneration of MRTs currently needs to be deferred for a period of three to five years, with vesting no faster than pro rata each year. In the UK, the PRA "gold plated" these provisions to require a three year minimum period for all MRTs, but with a five year deferral for certain risk managers and a seven year deferral (with first vesting no earlier than year three) for senior managers under the Senior Managers and Certification Regime (**SMCR**).

Under CRD5, the minimum deferral period is to be increased to four years, meaning that most MRTs will have a longer period to wait before their variable remuneration is paid out. Coupled with the EBA guidance that, for payments in instruments where the vesting period is less than five years, a one year holding period on instruments should apply, this means that MRTs will have to wait at least five years for their variable remuneration (i.e. bonus) to be received in full. In practice, however, the additional CRD5 requirement for a minimum five year deferral for members of the management body and senior managers will actually bring the rest of Europe closer to the PRA requirements which currently apply in the UK to Level 1 and Level 2 CRD firms.

SHARE-LINKED INSTRUMENTS

CRD5 also amends the requirements for CRD firms to pay their MRTs in shares or share-linked instruments, making it clear that share-linked instruments (including "phantom awards") are available to be used by all CRD firms irrespective of whether they are listed or not. The interpretation of the EBA is that, currently, listed CRD firms are required to use shares and not share-linked instruments, although this interpretation is not shared by the PRA or FCA. Consequently, CRD firms in the UK have always been able to use share-linked instruments in place of actual shares, and the CRD5 amendments bring the rest of Europe into line with the UK interpretation.

APPLICATION ON A GROUP LEVEL

Where subsidiaries within a CRD consolidation group are not themselves CRD firms on a solo basis, they may nonetheless have staff who are categorised as MRTs on a group basis. CRD5 confirms that, if a subsidiary is subject to other remuneration regulations (for example, AIFMD, UCITS V or the new remuneration provisions of the IFD) then the sector-specific provisions will apply to their MRTs rather than the CRD5 provisions. This exemption also applies to equivalent non-EU firms not directly subject to the other European remuneration rules, but who would be if they were established within the EU.

This new exemption means that, in particular, investment firm subsidiaries (including asset managers, brokers, advisers, insurance intermediaries etc.) within banking groups will no longer be subject to the CRD5 remuneration rules, including the bonus cap, the increased deferral provisions and the conflicting provisions on instruments, thus levelling the playing-field with stand-alone investment firms that are not CRD firms.

However, CRD5 provides a limitation on this exemption, requiring the CRD5 remuneration provisions to continue to apply to certain individuals if they have a direct material impact on the risk profile of the banking group as a whole (including through delegation or outsourcing arrangements) – further detail on this will be needed through guidance from the EBA. CRD5 also permits local regulators to continue to require the CRD5 provisions to apply to entities which would otherwise have been able to take advantage of this exemption. This could mean that level playing field issues persist due to local gold-plating.

GENDER NEUTRAL REMUNERATION POLICIES

CRD5 includes a new requirement for CRD firms to ensure that their remuneration policies and practices are "gender neutral", meaning that their policies and practices should be "based on equal pay for women and men for equal work or work of equal value". Given that the principle of equal pay is already a requirement of European law, it is unclear what additional requirements will fall on CRD firms as a result of this provision, which has been left to the EBA to flesh out through its guidance. The EBA is also required, within two years of publishing its guidance, to issue a report on the application of this new rule by CRD firms (having collected data, including on the gender pay gap, from CRD firms as part of their annual reporting requirements).

IMPACT OF BREXIT ON CRD5

The impending BREXIT date means that it remains uncertain when and to what extent the CRD5 regime (and the parallel reforms to be brought forward to the Capital Requirements Regulation and Bank Recovery and Resolution Directive) will be implemented in the UK. After BREXIT the UK will become a "third country" and will no longer be formally obliged to implement EU law. Unless BREXIT is delayed or a transitional period is agreed during which the UK remains obliged to implement EU legislation that enters into force during that period, it is anticipated that the CRD5 reforms will enter into force after the BREXIT effective date and will accordingly have no direct legal effect in the UK. Further, as the CRD5 remuneration rules are likely only to apply to performance years from 1 January 2021, it is conceivable that UK banks and CRD investment firms may be saved from some of the more onerous provisions, depending on the UK's approach to the CRD5 reforms post-BREXIT.

CRD5 is, however, one of the pieces of "in-flight" EU legislation covered by the Financial Services (Implementation of Legislation) Bill currently before Parliament and anticipated to be implemented in the event of a 'no deal' exit from the EU. It is likely, therefore, to be adopted by the UK, either in whole or in the main, in order for the UK to be able to meet its Financial Stability Board and G20 commitments to maintain international standards and to support the Government’s commitment to ensure the UK continues to conform to the highest global standards of financial services regulation. There will also be certain benefits for the UK to (at least broadly) follow the CRD 5/CRR regime in order to secure equivalence-based concessions for prudential purposes (for example, in relation to preferential risk-weighting by EEA institutions of exposures to certain UK entities).

Even if a BREXIT deal is agreed, the implementation of CRD5 will, to some extent, depend on what form a transitional period takes, and also whether UK financial institutions will thereafter still be required to comply with equivalent provisions to those which apply to their European counterparts (and how closely the two regimes will need to be aligned in the longer-term).

The CRD5 provisions will apply to those European entities directly subject to the Capital Requirements Directive, including any UK branch and, on a consolidated basis, UK subsidiaries. Further, many European entities have received recent authorisations as part of their UK parent's BREXIT strategy, and any employees moving from the UK to Europe will need to be made aware that changes to their remuneration are coming.

NEXT STEPS FOR CRD5

The text of CRD5 will now need to be formally adopted by the European Parliament and, once published in the Official Journal, will need to be implemented into law by Member States within 18 months of publication. In the meantime, the EBA will need to produce revised technical standards and guidelines (in particular on the new provisions on proportionality and how the EBA expects "gender neutral" remuneration policies to be implemented).

At the UK level, the position remains unclear pending greater certainty on the nature and timing of BREXIT and the implementation of the related draft "onshoring" legislation for "in-flight" EU legislation.

UPDATES

We will continue to update you on the progression of both CRD5 and the IFD/IFR and how these provisions may be impacted by the BREXIT process. In the meantime, if you have any queries, please contact a member of the Remuneration and Incentives team.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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