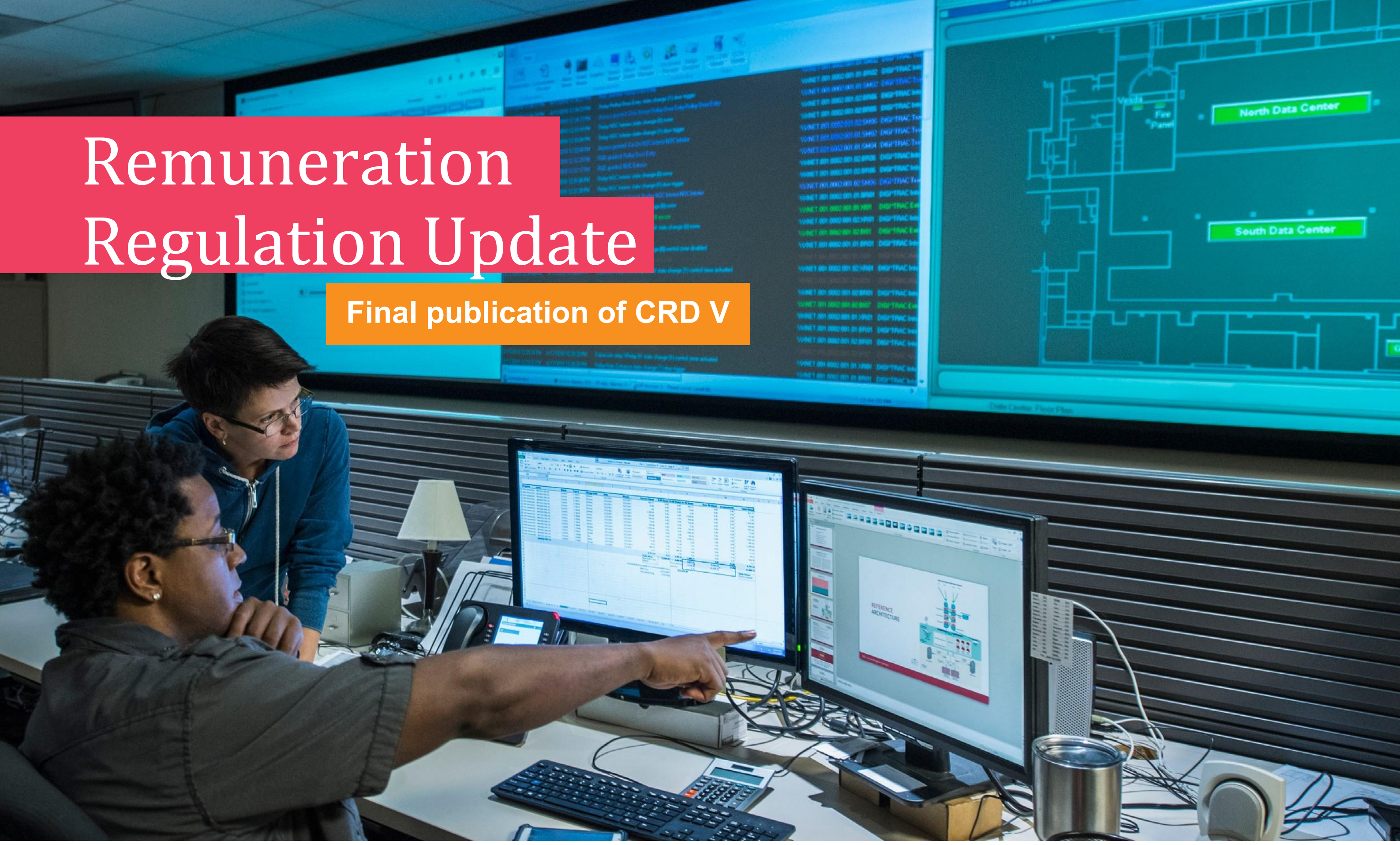
Remuneration Regulation Update

Final publication of CRD V



On 7 June 2019, the second iteration of the Capital Requirements Regulation ('CRR II') and the fifth iteration of the Capital Requirements Directive ('CRD V') were published in the EU Journal following the conclusion of the EU legislative process. The final rules contain a number of changes from a remuneration regulatory perspective.

At a glance

What is it?

- CRD V and CRR II are the latest iterations of the Capital Requirements Directive and Capital Requirements Regulation respectively, which both contain requirements for remuneration. The key changes from a pay perspective are changes to the application of proportionality. These are part of the Directive. There are limited changes in the CRR (which contains the disclosure requirements).
- Both final texts were published in the European Journal on Friday 7 June following adoption by the European Parliament.

Who is this relevant to?

- Credit institutions, and other institutions currently subject to CRD IV. This includes all banks and building societies and other financial services companies (including certain investment management firms, dependent upon permissions), operating in the EU.

Where can I find it?

- The official publication in the European Journal can be found here.

What is the timing?

- CRR II will apply from 28 June 2021.
- CRD V will apply from 28th December 2020. We understand that the remuneration requirements will come into effect for the first full performance period on or after this date (i.e. for firms with calendar financial years, it will come into effect from 1 January 2021 and impact bonuses paid in Q1 2022).

What should I do next?

- Carry out an impact assessment to determine to what extent the changes will impact your business.

Who can I contact?

Further information and contact details can be found at the end of this document.

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In detail

Introduction

On 7 June 2019, the European Parliament's Committee on Economic and Monetary Affairs published the final and official versions of CRR II and CRD V. EU national regulators now have until the 28th December 2020 to implement the requirements of CRD V through local law. The requirements are expected to come into effect for performance periods starting on or after 28th December 2020.

The final texts are largely unchanged from the latest version published as part of the EU legislative process.

Context

In December 2015 the European Banking Authority ('EBA') published its Opinion on the Application of Proportionality ('the Opinion'), stating that it did not think it was appropriate for some member states to disapply certain requirements on the basis of proportionality. In particular, the limit on the ratio of variable pay compared to fixed pay ('the bonus cap'), malus, and clawback were cited. The Opinion recommended that CRD IV should be amended to address this issue and ensure a more consistent application of the requirements across the EU. This, among other issues identified with the CRD IV regime, triggered the commencement of the process to amend CRR and CRD IV through the European legislative process, resulting in the final texts published last week.

Overview of requirements

The text is largely unchanged from the version agreed by the European Commission, Council and Parliament in January 2019. The key headlines from a remuneration perspective are:

Material Risk Taker (MRT) identification

- There will be a new EBA regulatory technical standard ('RTS') published on the criteria for identifying MRTs. This will include, at least, all members of the managing body and senior management, staff members with managerial responsibility over the institution's control functions or material business units, together with individuals entitled to significant remuneration in the previous year (equal to or greater than €500,000 and equal to or greater than the average remuneration awarded to the members of the institution's managing body and senior management) who perform their role within a material business unit. This draft regulatory technical standard must be submitted to the European Commission by 28 December 2019 and will define the terms in the Directive (e.g. material business unit).
- The wording in the Directive regarding the identification of MRTs is significantly more explicit than in CRD IV. The wording in the Directive is clear that individuals should only be identified under the quantitative criteria where they perform their role for a material business unit. This suggests that it will still be possible to exclude individuals earning over €500,000 where they don't create material risks for a material business unit. The use of 'and' in the definition of high earners indicates that individuals may have to satisfy the €500,000 threshold and exceed the average remuneration of senior management to be identified. This may also reduce the number of MRTs identified for some firms, however we will only know for certain once the RTS is published. Although the deadline for the RTS is 28 December 2019, typically there are a couple of iterations of the publication in advance of the deadline so we may get further clarity sooner.

Structures

- The requirement to limit variable pay to 100% of fixed pay (or 200% with shareholder approval) – the bonus cap – will apply to all CRD V MRTs of all firms in scope of the Directive.
- Malus and clawback will apply to all CRD V MRTs of all firms in scope of the Directive.
- Deferral periods will be extended from 3-5 years to 4-5 years. Currently, senior management are required to defer for 5 years and other MRTs for 3 years. The requirements for senior management will remain at 5 years, with other MRTs increasing to 4 years. The UK rules currently go further than the European rules, requiring 7 year deferral for Senior Managers and 5 year deferral for 'Risk Managers', This means it is likely that only the MRTs who are currently subject to 3 year deferral will need to increase their deferral by a year.
- The proportion of variable pay subject to deferral remains at 40%, or 60% for senior management and high earners (currently those earning over £500,000).
- Listed companies will now be allowed to use share linked instruments or equivalent non cash instruments to meet the requirement to pay 50% of upfront and deferred variable pay in instruments.

Firmwide proportionality

As above, the bonus cap, malus and clawback will apply to CRD V MRTs at all firms in scope.

Firms which are 'small and non complex' will continue to be able to apply proportionality for deferral and payment in instruments. The threshold for 'small and non complex' is currently €5bn balance sheet assets, however individual Member States can increase this to €15bn. We understand that the PRA intend to implement based on the maximum threshold of €15bn so current 'level 3' firms will not have to comply with the deferral and payment in instruments requirements.

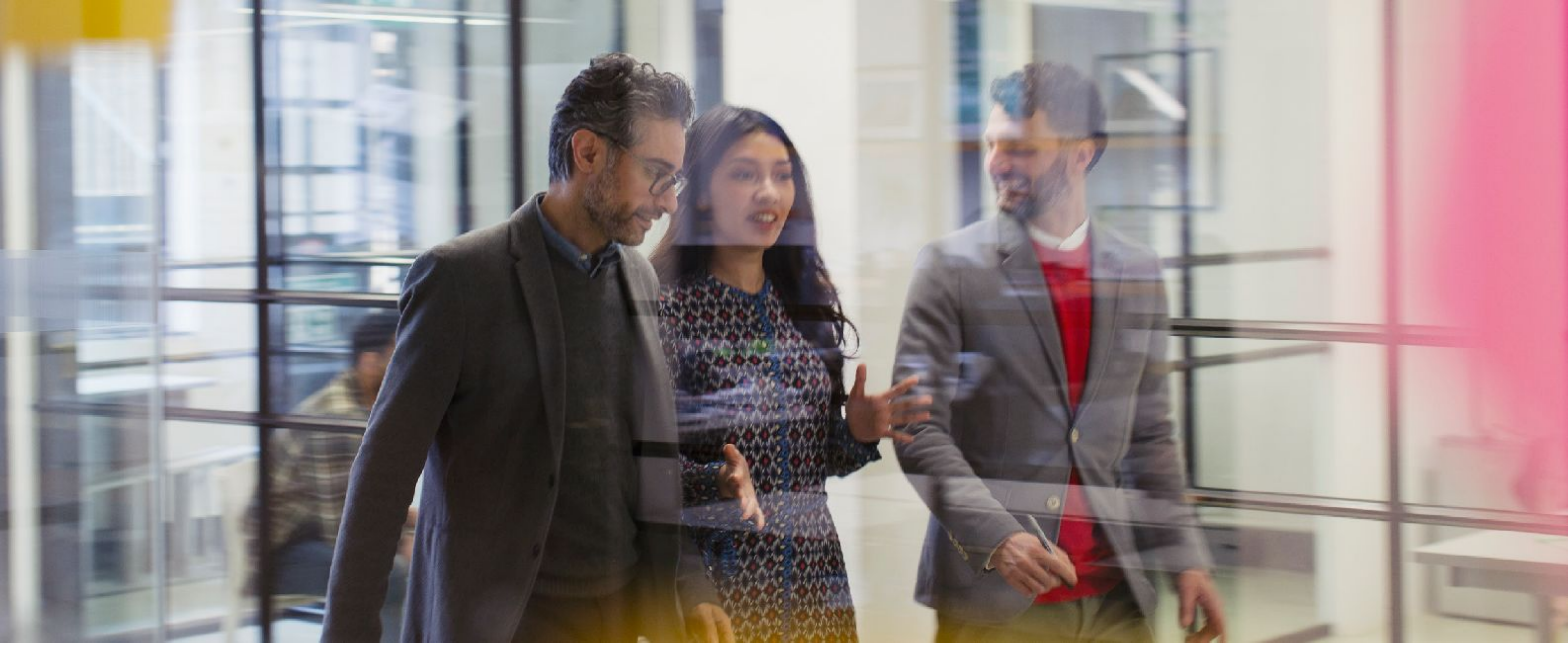
The definition of 'large' firms is set at €30bn balance sheet assets. This could bring more firms in scope of the PRA and FCA's annual review of remuneration policies and practices (currently restricted to 'level 1' firms with balance sheet assets in excess of €50bn). This could impact the level of scrutiny that current level 1 firms receive, as the regulators' resources will be more stretched, as well as significantly increasing the level of regulatory interaction and scrutiny for those firms that are currently 'level 2' but have balance sheet assets in excess of €30bn.

Individual proportionality

The current 'de minimis' concession that allows firms to disapply deferral and payment in instruments on the basis of proportionality at individual level will be reduced. The threshold will be individual variable pay of €50,000 (reduced from £500,000) and less than a third of total pay is variable. This will have a significant impact on firms where MRT pay is typically well below the current £500,000 threshold.

Disclosure

The disclosure requirements in Article 450 of the CRR II remain largely unchanged from the original CRR. Some of the requirements are more explicit and firms will be required to disclose where they have benefited from derogations such as the EBA discount factor (which enables firms to increase variable pay, within the cap, by 25% if the incentives meet certain requirements).



Long term interaction with other regulatory regimes, in particular IFD

We understand that, on a solo basis, the intention is that only ‘systemically significant’ investment firms will be subject to CRD V. These are likely to be a similar group of firms to the current list of PRA-designated investment firms. Otherwise the intention is that, long term, all investment firms will be subject to IFD not CRD V. See the section below for commentary on the potential short term interaction between the two Directives. There are some exceptions and institutions with balance sheet assets in excess of €15bn who deal on their own account, underwrite financial instruments and/or place financial instruments on a firm commitment basis would remain in scope of CRD V, for example. This means it is important for firms to consider the permissions they hold/business they undertake and the implications for remuneration (and indeed the wider requirements of the Directives).

Where an investment firm is part of a banking group, but is not subject to CRD V on a solo basis, we understand that the current intention is that only Group Material Risk Takers will be subject to the CRD V rules while any solo entity Material Risk Takers will be subject to IFD. It is not clear how this will work in practice for individuals identified under the quantitative criteria, however hopefully this will be clarified in the proposed EBA Regulatory Technical Standards for the identification of Material Risk Takers.

In terms of AIFMD and UCITS V, our understanding is that the interaction is likely to be the same as it currently is for CRD IV (i.e. firms must follow the most onerous rules applicable to a specific individual however specific sectoral requirements such as deferral in funds would override deferral in shares).

Implementation dates and short term interaction with IFD

Previously we understood that the intention was for IFD and CRD V to come into force at the same time, however IFD has now fallen behind in the European legislative process. When it comes into force, IFD will remove the majority of investment firms from the CRD regime. CRD V will come into force on 28 December 2020 – this means that the remuneration requirements will likely apply from the first performance period following that date i.e. 1 January 2021 for December year end firms, impacting bonuses paid in 2022.

IFD, however, has not yet been approved by the European Parliament. It is unlikely to make the agenda for the first session of the new Parliament in the first week of July however we expect that it will be approved and published in the European Journal in the month or so that follows (Q3 2019). There is currently an 18 month implementation period set out in the IFD text which would suggest an implementation date in March 2021 (similar to UCITS V in 2016). This would mean that the IFD remuneration requirements will come into force from the next full performance period after the implementation i.e. if the IFD is implemented in March 2021, it will apply from 1 April 2021 for March year end firms or 1 January 2022 for December year end firms.

The implications of the above are that it is possible that UK investment firms, who are currently subject to CRD IV (particularly December year end firms), may have to implement the bonus cap for the 2021 performance year, before IFD comes into force for the 2022 performance year. This is clearly an unintended consequence of the European legislative process and it remains to be seen how the FCA address the issue. They have indicated that they are aware of the issue and are currently exploring their options. We understand that it will likely be part of their consultation on the implementation of both regimes.

The UK’s departure from the EU could also impact its approach depending on the terms of any agreement that may be reached, and the requirements around equivalence with European legislation in return for single market access. Nonetheless, this will be an area of concern for current CRD IV investment firms who will need to plan for the worst case scenario of having to enforce the bonus cap until IFD comes into force.

Next steps

You should:

- Assess whether or not CRR II/CRD V will apply to your firm based on the regulatory permissions held.
- If CRR II/CRD V will apply determine if proportionality can be applied at firm or individual level.
- If CRD V will apply, conduct a gap analysis of the requirements against your current remuneration arrangements to assess the level of impact on your organisation.
- Consider the interaction of CRD V with IFD if your business contains MiFID firms.
- Consider whether CRD V may apply to your business in the short term as a result of the delay in the development of IFD.
- Review your MRT populations to ensure the correct population have currently been identified in light of the more stringent approach to proportionality.
- We will provide updates as and when the European Parliament approve IFD, the EBA publish the new RTS and the PRA and FCA begin to consult on their implementation of the requirements.

Indicative timeline

The timeline below sets out expected timings for the implementation of CRR II and CRD V. The dates below may be subject to change as the process develops.

June 2019

7 June 2019
Final CRR and CRD texts published in the EU Journal

27 June 2019
CRR and CRD texts come into force

c. Q3 2019
Expected approval of IFD and IFR by EU Parliament

c. Q3/Q4 2019
Final IFD and IFR texts published in EU Journal

20 days following publication in EU Journal
Texts come into force

c. Q4 2019
FCA and PRA (and other EU member state regulators) start consultation on implementation of both CRD V and IFD

Jan 2020

c. Q3/Q4 2020
FCA and PRA (and other EU member state regulators) finalise local implementation

c. Q3-Q4 2019 (Final deadline of 28 December 2020)
CRD V MRT Regulatory Technical Standard published

Performance periods starting on or after 28 December 2020
CRD V comes into effect

Jan 2021

Performance periods starting on or after c. March 2021
IFD comes into effect

28 June 2021
CRR comes into effect

Jan 2022

For further information, help or support…

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