Remuneration regulation update

EBA publish final draft Regulatory Technical Standard for identifying Material Risk Takers under CRD V

On 18 June 2020 the European Banking Authority ('EBA') published its final draft Regulatory Technical Standard ('RTS') on the identification of Material Risk Takers under the Capital Requirements Directive. This is the final iteration of the draft RTS first published in December 2019 and will replace the current RTS under CRD IV once CRD V comes into effect from 28 December 2020

At a glance

What is it?

- The EBA have published its final draft RTS on the identification of Material Risk Takers under CRD V following a 2 month consultation period which ran from December 2019. The RTS includes both quantitative and qualitative criteria to identify the individuals to whom the requirements of CRD V (including the bonus cap and deferral and payment in instruments, depending on the size and complexity of the firm) will apply to.

What are the key changes?

- The RTS now supplements a number of criteria for identification that are included in the CRD V text itself. Firms will need to apply both sets of criteria.
- The final text includes small changes to the draft criteria, limiting the requirement to identify heads of sub-functions and sub-divisions and certain categories of high earner to larger firms, as well as providing options for the calculation of remuneration for the purposes of applying the quantitative criteria.
- The criteria are broadly consistent with those set out in the current CRD IV RTS. There is, however, a degree of nuance in the qualitative criteria and some changes to the quantitative criteria that firms will need to consider. In addition, a number of terms in the Directive have been defined to ensure consistency in the application of the criteria. This introduces increased clarity for firms; however, it also reduces the scope for flexibility and interpretation.

Who is this relevant to?

- Credit institutions and other institutions who will be subject to CRD V. This includes all banks and building societies and a number of other financial services companies (including certain investment management firms, dependent upon permissions) operating in the EU.

Where can I find it?

- The final draft text from the EBA can be found here.

What is the timing?

- The RTS will come into force at the same time as CRD V (i.e. for performance periods starting on or after 28 December 2020).

What should I do next?

- Carry out an impact assessment to determine which staff would be captured under the new RTS.
- Carry out a gap analysis of the CRD V requirements against your current remuneration policy and work through any implementation changes.

Who can I contact?

- Contact details can be found on page 3 of this document.

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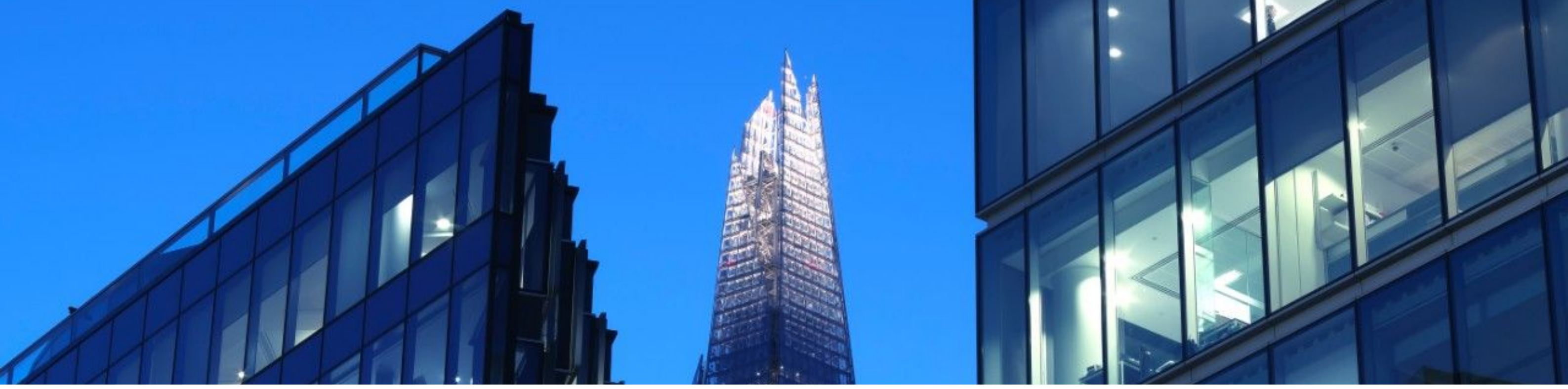


In detail

Introduction

On 18 June 2020 the European Banking Authority ('EBA') published its final draft Regulatory Technical Standard ('RTS') on the identification of Material Risk Takers under the Capital Requirements Directive. This will replace the current RTS under CRD IV once CRD V comes into effect from 28 December 2020

Context

The final texts for 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 European Journal in June 2019 and will come into effect for impacted firms' performance periods starting on or after 28 December 2020. As part of the new Directive the EBA were tasked with developing a new RTS for identifying MRTs. The final draft text has now been published and takes into account prevailing market practice, a review of the existing regime, and feedback from firms following the consultation period.

Key changes

Under CRD IV, the criteria for identifying MRTs were set out solely in the RTS; Under CRD V, a number of criteria have been included in the Directive itself, which will be supplemented with the proposed RTS. Firms will be required to comply with the criteria in the Directive and the RTS. Additionally, a number of terms in the Directive have been defined to ensure consistency of implementation among both member state regulators and impacted firms.

Many of the changes to the RTS reflect market practice and issues that firms have reported with compliance and interpretation of the current RTS.

A detailed analysis of the identification criteria against the current RTS is set out in the appendix and below we have set out an overview of the key changes.

Qualitative criteria

The revised qualitative criteria are broadly consistent with the current RTS; however, there are some changes and nuances for firms to consider. The criteria are also accompanied by definitions of 'managerial responsibility', 'material business units' and 'control functions'. Together, the revised criteria and definitions increase clarity for firms, but reduce the scope for interpretation and flexibility available to firms.

- The population historically captured by the 'senior management' criteria are now broadly captured by the criteria included in the Directive. These criteria, supplemented by the proposed definitions of 'senior management' and 'managerial responsibility', effectively capture:

  I. The Board;
  II. The Executive Committee ('ExCo')
  III. Individuals who head a Material Business Unit ('MBU') or control function and report to the Board or ExCo; and
  IV. For 'large' institutions, individuals who head a subordinated business unit or control function and report to someone identified in III above.

'Large' institutions are those who are the biggest or most systemically important firms in a particular country, those subject to ECB supervision, or those with balance sheet assets in excess of €30bn.

The groups identified are likely narrower than in the current RTS and may allow the removal of some direct reports of heads of control functions and MBUs, as well as heads of functions or divisions who do not report to any of the above individuals when compared to the current RTS.

- The RTS includes some additional functional heads alongside HR, legal, finance, etc, in particular the individuals responsible for financial crime risk, IT security and outsourcing. Whereas the current RTS links more directly to specific roles, the new criteria are more nuanced to help identify individuals responsible for the risks that the EBA are focussed on rather than specific job titles.
- The definition of a MBU has been expanded to include business units and activities that could create "material" prudential risk or generate "material" profits, revenues or franchise value for the institution. This is likely to capture some investment management and other non-banking operations in a banking group and could increase the number of high earners that may be considered MRTs. It is worth noting that the EBA has not defined 'material'.
- The individuals responsible for Compliance and Internal Audit within a MBU will now be captured in addition to Risk Management. This is likely to have little impact on many firms given these functions are typically centralised.
- Amendments have been made to the criteria concerning committee roles / membership. Only voting members of any committee specified in the criteria (other than committees responsible for managing risk categories other than credit and market risk) will be identified under the qualitative criteria.
- The RTS stresses that the criteria are not exhaustive and firms should carry out their own risk based analysis to ensure that all individuals who create material risks are captured. The RTS sets out a number of factors firms should consider as part of this process. It remains to be seen how member state regulators supervise the development and implementation of such a process; however, in the case of the PRA and FCA it is likely that firms will be expected to identify key additional populations already identified (such as traders) who don't meet the individual thresholds, and Senior Management Function holders.

Quantitative criteria

The quantitative criteria have been amended, primarily to attempt to reduce the administrative burden of the exclusion process on firms.

- The current €500,000 total remuneration threshold has been amended to €500,000 **and** the average of the management body and senior management. This includes NEDs and it is likely that this average will need to be calculated at solo, sub-consolidated and consolidated level.
- Individuals whose total remuneration exceeds €750,000, or in the top 0.3% of high earners will be identified regardless of the average earnings of the management body / senior management. The second measure is only applicable where the organisation has over 1,000 employees and is applied on a solo basis.
- The requirement to identify or exclude individuals earning more than the lowest paid MRT has been removed.
- Individuals identified under the quantitative criteria will be able to utilise an exclusion process which is similar to the process currently in place. The RTS suggests all exclusions will now require local regulator approval rather than just notification for certain categories.
- For individuals whose total remuneration is over €1m, local regulators will still be required to notify the EBA, and approve exclusion only in well justified, exceptional circumstances. The definition of 'exceptional' has been defined as 'entails a situation that is unusual and very infrequent or far beyond what is usual', which we understand is consistent with the approach taken by the EBA in the past under CRD IV.
- The RTS clarifies that remuneration should be calculated on a FTE basis and also now gives firms the option of basing the calculation on either remuneration awarded in the prior year, or remuneration awarded in respect of the prior year. Firms should set out their approach in their policy and be consistent year on year.

Impact of Brexit

The impact for UK firms will likely be influenced by Brexit. CRD V will come into force before the end of the transition period, and the PRA and FCA have committed to implementing it, the detail of implementation may be impacted by the UK's departure from the EU. For example, the PRA may not feel obligated to notify the EBA of exclusions of high earners.

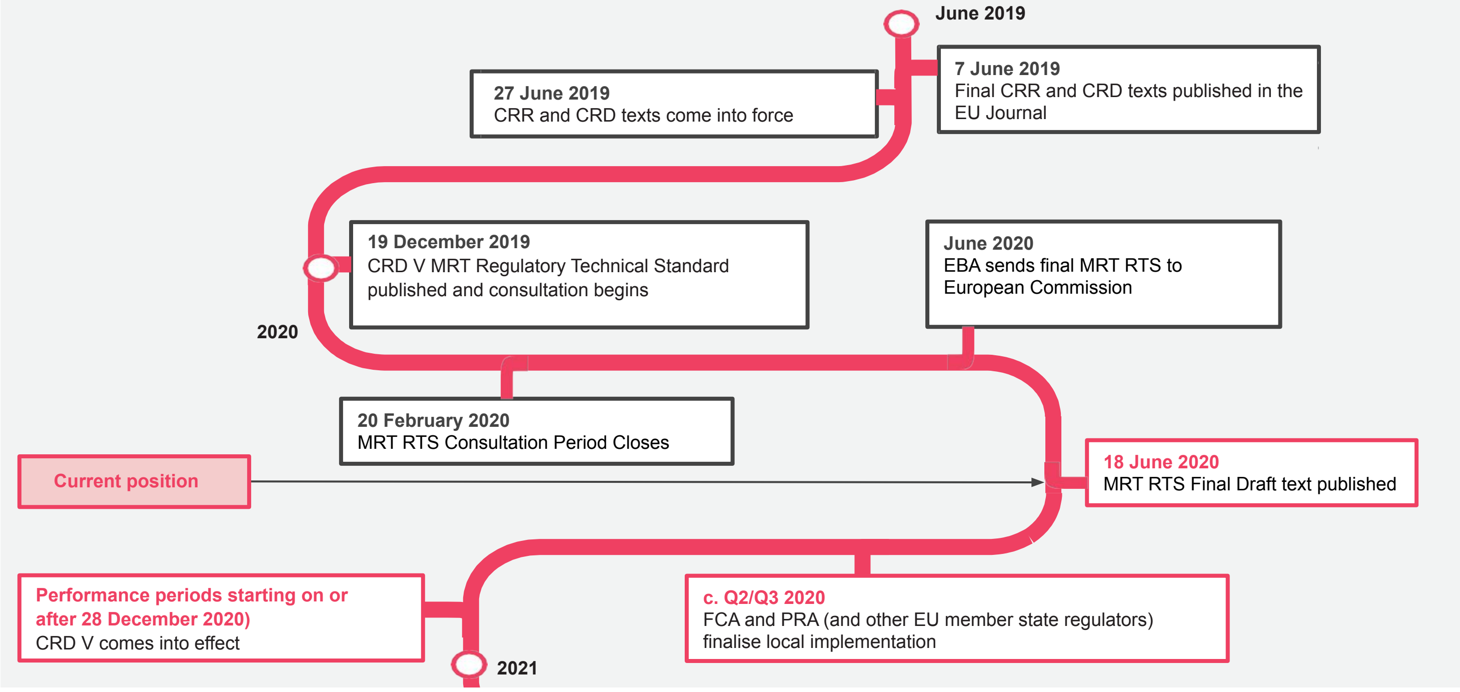
Next steps

The PRA and FCA (and other member state regulators) will now publish their own implementation ahead of 28 December 2020 when CRD V comes into effect. The PRA are expected to publish their consultation on implementation over the next couple of months.

Firms should update any draft impact assessment for the final RTS and continue implementation.

Indicative timeline

The timeline below sets out the final steps for the implementation of CRR II and CRD V completing the process which first began in June 2019.



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Appendix

Analysis of the proposed RTS and Directive against the current CRD IV RTS text

Current CRD IV	Commentary on CRD V and proposed RTS criteria
Qualitative criteria	
The staff member: 1) is a member of the management body in its management function;	This, together with (2) - (8), are covered in Directive (EU) 2019/878, Article 1 (26)(c): *“.... (a) at least all members of the management body and senior management; ...”*
2) is a member of the management body in its supervisory function;	The management body is defined as including both the management body in its management function and in its supervisory function.
3) is a member of the senior management;	Senior management is defined as those who exercise executive functions within an institution and who are responsible, and accountable, to the management body for the day-to-day management of the institution. This is typically the Executive Committee (‘ExCo’) and will also likely capture SMFs in the UK.
4) is responsible and accountable to the management body for the activities of the independent risk management function, compliance function or internal audit function;	Directive (EU) 2019/878, Article 1 (26)(c): *“... (b) staff members with managerial responsibility over the institution's control functions or material business units; ...”* Managerial responsibility means those who: a) head the function and reports to the Board, a member of the Board or a member of senior management, or b) head a subordinated function and report to someone identified under a), c) Heads of subordinated business units or functions where the firm is deemed “Large”
5) has overall responsibility for risk management within a business unit as defined in Article 142(1)(3) of Regulation (EU) No 575/2013 which has had internal capital distributed to it in accordance with Article 73 of Directive 2013/36/EU that represents at least 2% of the internal capital of the institution (a ‘material business unit’);	Now limited to those with managerial responsibility defined as above. *Material business unit* is extended to include: (i) core business units with activities that could create prudential risks at national level and (ii) core business lines that generate material profits, revenues or franchise value for the group. *Risk management* definition is extended to explicitly include compliance and internal audit (rather than just risk management.)
6) heads a material business unit;	Material business unit as defined above.
7) has managerial responsibility in one of the functions referred to in point (4) or in a material business unit and reports directly to a staff member identified pursuant to point (4) or (5);	Those who report to a Head of Control Function are covered where the firm is ‘large’ and they also head a subordinated Control Function. This may reduce the number of people identified where previously all direct reports of the heads of the Control Functions have been identified.
8) has managerial responsibility in a material business unit and reports directly to the staff member who heads that unit;	Those who report to a head of material business unit ure covered where the firm is ‘large’ and they also head a subordinated business unit. This may reduce the number of people identified where previously all direct reports of the heads of the material business units have been identified.
9) heads a function responsible for legal affairs, finance including taxation and budgeting, human resources, remuneration policy, information technology, or economic analysis;	‘Head of function’ has been replaced with ‘has managerial responsibility’. Categories have been added or amended, specifically: legal affairs, the soundness of accounting policies and procedures, finance, including taxation and budgeting, performing economic analysis, the prevention of money laundering and terrorist financing, human resources, the development or implementation of the remuneration policy, information technology, information security, and managing outsourcing arrangements of critical or important functions. The more nuanced descriptions may change who is identified, depending on how firms interpreted the original criteria.
10) is responsible for, or is a member of, a committee responsible for the management of a risk category provided for in Articles 79 to 87 of Directive 2013/36/EU other than credit risk and market risk;	‘Responsible for' is replaced by 'have managerial responsibility for'. This could restrict who is captured to ExCo+1, or ExCo+2 where the firm is ‘large’.

Appendix

Analysis of the proposed RTS and Directive against the current CRD IV RTS text

Current CRD IV	Commentary on CRD V and proposed RTS criteria
11) with regard to credit risk exposures of a nominal amount per transaction which represents 0.5% of the institution's Common Equity Tier 1 capital and is at least EUR 5 million, the staff member: (a) is responsible for initiating credit proposals, or structuring credit products, which can result in such credit risk exposures; or (b) has authority to take, approve or veto a decision on such credit risk exposures; or (c) is a member of a committee which has authority to take the decisions referred to in point (a) or (b);	The text provides clarification that the staff member is a voting member of a committee, rather than solely a member. (a) (responsibility for initiating or structuring credit proposals which can result in such credit risk exposures) has been removed.
12) in relation to an institution to which the derogation for small trading book business ..., the staff member: (a) has authority to take, approve or veto a decision on transactions on the trading book which in aggregate meet one of the following thresholds ...; or (b) is a member of a committee which has authority to take decisions set out in point (a);	As previous, the text provides clarification that the staff member is a voting member of a committee.
13) the staff member has managerial responsibility for a group of staff members who have individual authorities to commit the institution to transactions and either of the following conditions is met: (a) the sum of those authorities equals or exceeds a threshold set out in point 11(a), point 11(b) or point 12(a)(i); (b) where an internal model-based approach is approved for regulatory purposes those authorities amount to 5 % or more of the institution's internal value-at-risk limit for trading book exposures at a 99th percentile ...;	Managerial responsibility as defined above.
14) with regard to decisions to approve or veto the introduction of new products, the staff member: (a) has the authority to take such decisions; or (b) is a member of a committee which has authority to take such decisions;	As previous, there is clarification that the staff member is a voting member of a committee with the authority to take decisions rather than just a member.
15) the staff member has managerial responsibility for a staff member who meets one of the criteria set out in points (1) to (14).	Removed
Quantitative criteria	
1) (a) the staff member has been awarded total remuneration of EUR 500 000 or more in the preceding financial year;	This criteria is replaced by the Directive requirement of €500k and the average remuneration awarded to the members of the institution's management body and senior management. Anyone earning over €750k is included (subject to the exclusion process) regardless of the average remuneration of senior management.
2) (b) the staff member is within the 0.3 % of the number of staff, rounded up to the next integer, who have been awarded the highest total remuneration in the preceding financial year;	This only applies to firms with more than 1,000 staff and there is clarification that it applies on a solo level not consolidated.
3) (c) the staff member was in the preceding financial year awarded total remuneration that is equal to or greater than the lowest total remuneration awarded in that financial year to a member of senior management or meets any of the criteria in points (1), (3), (5), (6), (8), (11), (12), (13) or (14) of Article 3;	This has been removed
2. A criterion set out in paragraph 1 shall not be deemed to be met where the institution determines that the professional activities of the staff member do not have a material impact on the institution's risk profile because the staff member, or the category of staff to which the staff member belongs: (a) only carries out professional activities and has authorities in a business unit which is not a material business unit; or (b) has no material impact on the risk profile of a material business unit through the professional activities carried out.	This criterion remains the same.