Executive Reward Briefing

FIT Remuneration Consultants

CRD V published in draft

Background

The most recent iteration of the Capital Requirements Directive ('CRD IV') was adopted in 2013 and contains a number of requirements regarding the remuneration policies and practices of credit institutions and investment firms. In 2016 the European Commission published a report which assessed the efficacy of those requirements, including a number of recommendations.

On 14 February 2019 the European Council published a draft of the next iteration of the Capital Requirements Directive ('CRD V'), which builds upon the recommendations of the 2016 report. Subject to approval by the European Parliament and transposition by members states, CRD V is expected to take effect for performance periods starting in 2021 or possibly 2022.

CRD V remuneration-related changes

The key remuneration-related amendments in the draft directive are as follows:

- **Gender neutral remuneration policy**: The text of the new directive requires that institutions adopt remuneration policies and practices that are "gender neutral", i.e. men and women receive equal pay for work of equal value. The EBA will also develop and issue guidelines on what are considered to be gender neutral remuneration policies for institutions.
- **Identified staff**: The text of the directive now includes a definition of the categories of staff that are considered to have "a material impact on the institution's risk profile" (i.e. material risk takers). Previously this definition was set out only in the regulatory technical standards published by the EBA.

  This new definition includes amended quantitative criteria which state that a staff member will be considered a material risk taker if his/her remuneration is equal to or higher than €500,000 and the average remuneration awarded to the members of the institution's management body and senior management. This would potentially raise the quantitative threshold for identified staff as currently applied under CRD IV (although it would still remain subject to an assessment against the qualitative criteria).

  The new directive also mandates the EBA to produce updated regulatory technical standards setting out the criteria to define 'identified staff'. We anticipate that those standards will provide further detail to help institutions to identify material risk takers.
- **Deferral period**: The mandated deferral period has been adjusted to a period "not less than four to five years" (compared to the three to five year period currently applicable under CRD IV). Moreover, the new directive specifies that the deferral period should be not less than five years for the management body members and senior management of institutions that are "significant in terms of their size, internal organization and the nature, scope and complexity of their activities". This will not have a significant impact in the UK where the PRA already imposes longer periods. Deferral periods may be disapplied under the proportionality principle, outlined below.
- **Proportionality**: As expected, the draft directive permits institutions to disapply certain remuneration -related rules, where:
  - the institution has average assets of less than €5bn, assessed on a 4 year look-back (although member states will, subject to certain restrictions, have the ability to adjust this threshold up to a maximum of €15bn); or
  - a relevant staff member receives annual variable remuneration not exceeding €50,000 and this does not represent more than one third of the staff member's total annual remuneration (member states do not have the ability to increase this threshold although they may reduce it).

If either of the above cases apply, it will give institutions the ability to disapply the requirements to: (i) defer 40-60% of variable pay; (ii) pay at least 50% of variable remuneration in shares or equivalent instruments; and (iii) retain discretionary pension benefits.

- **Share-linked instruments**: The EBA has taken a view that CRD IV restricts the ability of some institutions (e.g. listed companies) to use different forms of instrument where it is required that at least 50% of variable remuneration will be paid in shares or other instruments. The 2016 Commission report noted that this presented "considerable administrative burdens and costs for listed institutions". The Council agreed and has therefore proposed that this restriction will be removed under CRD V. This will give institutions greater flexibility regarding which instruments they use (and in particular means that listed institutions will be able to use share-linked instruments if they wish).
- **Sector-specific rules**: The Council has acknowledged that a potential conflict can arise where a subsidiary is not an 'institution' on a solo basis but is still caught on a consolidated basis whilst at the same time it is also subject to sector-specific remuneration requirements under other EU legislation (e.g. AIFMD, Solvency II). The new directive acknowledges this issue and concludes that the requirements of CRD V "should not apply on a consolidated basis to such subsidiaries". This is a welcome relaxation because, as we have noted in previous briefings, it meant that some companies were caught by the more onerous provisions of CRD IV despite not being credit institutions or investment firms.

  However, the proposed relaxation of the rules is subject to a caveat where an individual working in the relevant subsidiary performs specific services (e.g. portfolio management, investment advice) or is considered to have a "direct material impact on the risk profile of the business of the institutions within the group".

Status quo

It is also worth noting that many of the provisions of the draft directive remain unchanged from CRD IV. In particular, the new directive makes it clearer that the maximum ratio of fixed to variable remuneration (the so-called 'bonus-cap') is not subject to proportionality, so should apply to all 'identified staff' in an institution regardless of its tiering status.

The other notable provisions that remain unchanged include the requirements to:

- apply malus and clawback provisions to all variable remuneration
- ensure remuneration of control function staff is independent of the business units they control
- pay guaranteed variable remuneration in exceptional circumstances only
- ensure that performance measures applicable to variable remuneration shall appropriately take account of risk

Implementation and Brexit

The draft Directive is expected to be put forward for approval by the European Parliament in April and then be published during summer 2019. Once the final directive is published, member states will have 18 months in which to transpose it into national legislation. This means that it is likely to be transposed by member states in late 2020 or early 2021 and take effect for performance periods starting in 2021 or possibly 2022.

The EBA will also be required to issue new/updated guidance to aid institutions in their preparations for CRD V, including guidelines relating to gender neutral remuneration policies, the application of proportionality, and criteria to define 'identified staff'. In particular, we expect the regulatory technical standards to be published towards the end of 2019 or early in 2020.

We understand that the PRA and FCA are also considering how they will implement the new requirements of CRD V. It will be interesting to see whether they will set out any early expectations regarding the use of derogations in the directive (e.g. increasing the proportionality threshold for smaller institutions to €15bn).

At the time of writing, the nature of the UK's proposed exit from the European Union remains far from certain. Parliament is currently considering legislation that would allow the UK government to implement and make changes to ‘in flight’ EU financial services legislation (such as CRD V). On the assumption that the UK will try to achieve some level of 'equivalence' with EU regulations (in order to maintain access for UK-based FS businesses), it is anticipated that the UK will adopt a regulatory approach similar to that set out under CRD V. However, it will be interesting to see how the UK approaches implementation of sensitive areas such as the bonus cap, given that historically this has been a topic of disagreement between the UK regulatory authorities and the EBA.

Investment Firm Directive

The European Council has also recently announced that it has reached internal agreement regarding a package of new measures that are intended to establish a new regulatory framework for investment firms. Currently, all investment firms are subject to the same regulatory requirements as banks (i.e. under Capital Requirements Regulation ('CRR') and CRD IV).

If this new framework is established, it will apply a differentiated regulatory requirements to investment firms, based on the "size, nature and complexity" of the firm. Larger firms are expected to continue to remain subject to the CRR/CRD regulatory regime. However, smaller firms will be able to apply "a new bespoke regime with dedicated prudential requirements".

Once the directive is approved, a five year transitional period is also expected to apply, in order to give firms enough time to adapt to the new regime.

The Council, Commission and the European Parliament will now begin trialogue negotiations on the proposals. We will provide a further update once the outcome of those negotiations become clearer.

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If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111.