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## European Commission report on CRD remuneration rules: proportionality revisited?

On 28 July 2016, the European Commission published [a report](#) on the implementation of the remuneration rules under the CRD III and CRD IV regimes, as mandated by the CRD IV Directive. **This is the first step towards possible amendment to the rules: there is no immediate impact on firms.**

In its report, the Commission indicates that it would support revisiting how certain aspects of the CRD remuneration rules relating to deferral and payment in instruments (the so-called "**pay-out process rules**") should apply to small and non-complex institutions in future legislative amendments. The report also provides helpful guidance on the application of the CRD IV remuneration rules in the group context and proposes greater flexibility for listed institutions to pay variable remuneration in share-linked instruments. However, the Commission has declined to change its approach in relation to the rules relating to the maximum ratio between fixed and variable remuneration (often termed the "**bonus cap**"), arguing that further experience of the implementation of those rules is required.

In terms of next steps, the Commission will need to bring forward appropriate legislative proposals. It anticipates that these will form part of its broader revision of the existing CRD IV regime, currently planned to start at the end of 2016. However, the Commission has also indicated that it will first need to carry out impact assessments to analyse the potential effects of the proposed changes in greater detail, so the timing is uncertain.

### BACKGROUND

In March 2015, the European Banking Authority ("**EBA**") published a consultation paper setting out proposed guidelines on remuneration under the CRD IV regime. At that time, the EBA indicated that, in its opinion, the concept of proportionality within the CRD IV Directive could not be used to "neutralise" or disapply certain remuneration rules.

In the text of the final version of the CRD IV remuneration guidelines published in December 2015, the EBA was non-committal on the question of proportionality, but also published a separate opinion on the topic addressed to the European institutions. The opinion suggested certain legislative amendments to apply the

rules in a more targeted manner, including proposed amendments to the CRD IV Directive to exclude certain small and non-complex institutions from the requirement to comply with the pay-out process rules.

We have previously published client briefings detailing these developments, which are available [here](#) and [here](#).

The CRD IV Directive requires the Commission to report to the European Parliament and Council on the implementation and effectiveness of the CRD IV remuneration rules, including, in particular, the impact of the rules relating to the bonus cap. The Commission has indicated that it will take into account the conclusions in the report when it undertakes its ongoing work on the potential revision of the existing CRD IV prudential regime. That work is itself taking place in the context of the wider ongoing review of the EU framework for financial services legislation launched in September 2015.

In the remainder of this briefing, we consider certain key aspects of the Commission's report and their implications for UK firms.

## PROPORTIONALITY AND THE PAY-OUT PROCESS RULES

The Commission notes that many EU Member States have put in place provisions which permit the pay-out process rules to be disapplied on the basis of an interpretation of the proportionality wording in the CRD IV Directive. While the Commission expressly re-states its view that such disapplication is not legally permitted under the current CRD IV legislation, it also notes that the existing rules may be disproportionate in certain circumstances. It is important to note that the Commission's comments on the application of proportionality in this context are limited to CRD IV; the Commission has not given any express indication that it disagrees with the European Securities and Markets Authority's alternative interpretation of the application of proportionality in the context of the UCITS and AIFMD regimes.

The report identifies that smaller and non-complex institutions may find compliance with the pay-out process rules to be excessively costly and that, in some cases, this might lead such institutions to cease paying variable remuneration altogether because the costs would outweigh the perceived benefits. In such cases, this could be harmful to the objective of aligning the remuneration of identified staff with the risk profile of the relevant firm.

*"Given that the current CRD text does not allow the rules on deferral and pay-out in instruments to be waived for small and non-complex institutions and for staff with non-material levels of variable remuneration, the Commission will consider proposing a legislative amendment allowing the use of some waivers..."*

*Any flexibility in the application of [these requirements] would need to be properly framed and delineated in order to prevent circumvention or an overly permissive interpretation of the rules and to ensure a level playing field across the EU..."*

- European Commission

As a result, the Commission suggests that the application of the pay-out process rules may not be effective for smaller, non-complex institutions or for staff who have levels of variable remuneration that are not considered to be material. The Commission has therefore indicated that it will consider introducing legislative amendments to the CRD IV Directive to allow disapplication of the pay-out process rules in such cases.

On its face, this would appear to be a positive development, but the Commission has also indicated that any such legislative amendments would need to contain clear criteria setting out the circumstances in which disapplication of the requirements would be permitted. Depending on how such criteria are phrased, this could lead to greater clarity but also a loss of flexibility, reducing the scope for firms to make individual judgements about whether the application of the pay-out process rules would be disproportionate in their particular circumstances. As a result, firms should monitor any proposals in this area carefully.

## **USE OF SHARE-LINKED INSTRUMENTS BY LISTED INSTITUTIONS**

The report notes that at present, listed institutions are only permitted to use shares (rather than share-linked instruments) to satisfy the requirement for payment in instruments. However, the Commission has concluded that share-linked instruments are as effective as shares in encouraging risk alignment, provided that such instruments closely track the value of the institution's shares and do not produce a leverage effect. This mirrors the conclusions previously expressed by the EBA in support of the use of share-linked instruments by listed institutions in its December 2015 opinion. As a result, the Commission will consider introducing a legislative amendment to permit listed institutions to use share-linked instruments for these purposes, which, if adopted, will lead to welcome flexibility for such firms.

## **APPLICATION OF REMUNERATION RULES ON A GROUP-WIDE BASIS**

The Commission has taken the opportunity to give some helpful confirmations about the application of the CRD IV remuneration rules to the staff of subsidiaries of CRD IV firms, which are consistent with interpretations that we have previously adopted. The CRD IV rules need only be applied to such staff where their role has a material impact at the group level.

## **WHAT ABOUT FIRMS THAT ARE NOT SUBJECT TO CRD IV?**

The report suggests that the Commission's proposed amendments will be taken forward as part of the broader ongoing work on the revision of the CRD IV regime. It is therefore likely that at present, such amendments would only apply to banks and other investment firms that are subject to CRD IV.

AIFMs and UCITS management companies would therefore be unaffected by the changes, although it remains to be seen whether the Commission might suggest amendments to the remuneration regimes for those firms at some point in the future. The Commission has indicated that it will examine the implications of the report's findings for the remuneration rules set out in other EU financial services legislation such as the UCITS Directive or AIFMD in due course. However, there is no suggestion that the Commission is seeking to produce a single harmonised cross-sectoral remuneration regime for all regulated firms at the present time.

Nonetheless, in the future this may be subject to the outcome of the broader review of the CRD IV prudential regime, as it is theoretically possible (although not currently anticipated) that the Commission could propose a unified prudential regime covering all such firms. If a unified prudential regime is adopted following that review, this may lead to the alignment of the applicable remuneration regimes as well.

## **HOW IS THIS AFFECTED BY BREXIT?**

UK firms may be questioning whether the Commission's report is still relevant in light of the vote by the UK electorate in favour of leaving the EU. In part, the answer to that question will depend upon the speed with which the Commission publishes any legislative proposals and how quickly they are subsequently adopted by the European Parliament and Council, if at all. Unless and until the UK leaves the EU, UK firms will continue to be bound by EU legislation which, in the case of CRD IV firms, means that they must continue to comply with the relevant remuneration requirements.

Whether the CRD IV remuneration regime continues to remain directly relevant following Brexit will depend upon the precise form that Brexit takes – for example, the CRD IV rules would continue to remain relevant if the UK adopts the EEA model.

In any case, the CRD IV regime will also be relevant following Brexit if the UK is treated as a non-EEA jurisdiction and certain UK firms therefore become non-EEA subsidiaries within EU prudential groups that are subject to CRD IV. This is because, as noted above, the CRD IV remuneration rules have a group-wide application.

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