TRAVERS SMITH

Financial Services and Markets

Remuneration requirements under CRD IV – consultation on a less generous proportionality framework

Today, 4 March 2015, the European Banking Authority (EBA) has published a consultation paper concerning proposed revised guidance on the pay regulation aspects of the Fourth Capital Requirements Directive (CRD IV).

The proposed guidelines have been eagerly anticipated because they will update the guidelines previously published by the Committee of European Banking Supervisors (CEBS – the forerunner to the EBA) about pay regulation under CRD III. In the absence of those guidelines several issues were unclear.

The consultation paper is available here and firms and trade associations have until **4 June 2015** to respond.

Which firms are affected?

The consultation will be highly relevant to:

- large banks and investment banks;
- asset managers which are subject to CRD IV – in the UK, these are known as "IFPRU firms" – a category which will include many debt fund managers in particular;
- UK Alternative Investment Fund Managers to the extent that they have a "top-up" permission under Article 6 of AIFMD to have custody of fund shares or units or hold (as opposed to control) client money.

Asset managers which are "BIPRU firms", "exempt-CAD firms" or AIFMs with either no top-up permissions, or top-up permissions to provide MiFID investment services other than custody or holding client money will not be affected.

What is proposed?

The guidelines cover a range of issues. Amongst them is the use by some larger banks of "role-based allowances", which are unpopular with some European authorities.

A key issue is the application of the concept of the "proportionality principle" to certain remuneration principles. The proposed EBA guidelines take a much narrower interpretation about the application of this principle than did the CEBS guidelines.

Narrowing of the proportionality principle

CRD IV provides that "*institutions [must] comply with the… principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities*".

The remuneration principles mainly relevant are those which, in relation to certain staff, require:

- a proportion of variable pay to be deferred over a number of years;
- a proportion of variable pay to be awarded in shares in the firm, or similar units, subject to vesting provisions;
- those elements of incentive to be subject to risk adjustment mechanisms, including malus (i.e. unvested items do not vest) and clawback based on conduct and performance; and
- a cap to be placed on the ratio of variable remuneration to fixed remuneration, at 1:1 or 2:1 if approved by shareholder vote.

The CEBS guidelines suggested that institutions could "neutralise" (or "disapply") certain of these remuneration principles where it was disproportionate to comply. It was assumed that the same approach would be taken to the bonus cap which was introduced under CRD IV but did not exist under CRD III. We understand that CEBS's position was based on the idea that the principles should be applied "*to the extent*" proportionate, which seems to suggest that it may not be proportionate to comply with them at all.

It was on this basis that the UK Prudential Regulation Authority and Financial Conduct Authority (FCA) were able to develop their three tiered proportionality framework under which, broadly, smaller banks and investment banks and almost all asset managers were able to avoid application of the relevant principles.

The draft guidelines reflect a different reading of CRD IV, which the EBA says is supported by the European Commission – namely, that these requirements have to be applied to all institutions. On this reading, the concept of proportionality can affect only the manner in which an institution complies with the principles: specific numerical criteria must be complied with in full but significant institutions may need to set stricter criteria. This is a very important change of interpretation.

What happens next?

We expect that firms and trade associations will wish to respond forcefully to the consultation.

The UK FCA has today made the following public statement:

"*CRD IV gives Member States flexibility to apply the rules in a proportionate way, including the rules on remuneration. This is an important part of the Directive and it helps to manage the impact on smaller firms. The FCA prudentially regulates approximately 1,000 firms under CRD IV and applies the proportionality principle to the smaller of these firms, given in particular its importance to our competition duty. These guidelines are not final at this stage. However, we strongly encourage firms to consider them, the likely impacts on their business, and respond to this consultation. It is open for three months after which the EBA will consider the feedback received and draft final guidelines for publication.*"

The EBA seems to be sympathetic about the impact on some smaller or less complex firms. It emphasises in its news report that it is seeking additional input from industry on the impact of the application of these principles to all institutions, particularly to small and non-complex institutions, "*and on the impediments for a full application as a starting point*". The EBA intends to recommend that the European Commission should put forward legislative amendments that would allow for a broader application of the proportionality principle, and is seeking input specifically on this issue. Such legislative changes could address how certain provisions "*could be 'neutralised' for certain institutions that do not extensively rely on variable remuneration and, if confirmed by further analysis, also for identified staff that receive only a low amount of variable remuneration*".

Any such legislative change would have a significant lead time, since changes would need to be approved by the European Council and European Parliament.

Travers Smith will be contributing actively to the debate.

If you would like to discuss these issues please contact any of the partners named below or your usual contact at Travers Smith.

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