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Briefing note

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CRD V proposals on the application of proportionality: what are the implications?

Proposed amendments to the current CRD IV remuneration principles may lead to more financial services firms being required to apply the bonus cap and more staff being subject to the remuneration codes.

Key issues

- Current position
- What?
- Implications in practice
- When?

Current position

In response to the financial crisis the EU has over recent years implemented extensive reforms to the financial services sector including the fourth Capital Requirements Directive (CRD IV). CRD IV imposes, amongst a variety of measures, requirements in relation to staff remuneration policies and practices aimed at curbing excessive risk taking and short termism. The CRD IV remuneration principles in relation to variable remuneration require: the deferral of payments, payment in instruments (shares), ex post risk adjustment and the imposition of a bonus cap; limiting the award of variable remuneration to 100% of fixed remuneration, or 200% with shareholder approval.

CRD IV also contains a proportionality principle that provides that when applying the Directive's remuneration principles firms should do so *"in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities"*. When the European Banking Authority published its Guidelines on sound remuneration policies under CRD IV its approach to the application of the proportionality principle was a departure from that of its predecessor CEBS and a surprise to many Member States; in particular its view that the bonus cap requirement could not be disapplied on the grounds of proportionality. It also became apparent that the proportionality principle was being interpreted in different ways across the EU resulting in uneven implementation of CRD IV's remuneration rules.

The CRD IV remuneration provisions are reflected in the FCA's dual regulated firms' remuneration code and the PRA remuneration code. Both regulators have provided general guidance on the application of the proportionality principle taking the view that [it will normally] [may] be appropriate for firms in proportionality level 3 to disapply the rules on deferral, payment in instruments, performance adjustment, and, contrary to the EBA Guidelines, the bonus cap.

In addition the regulators apply a de minimis concession to Code Staff whose total remuneration for the performance year is £500,000 or less if the variable remuneration component comprises not more than 33%. In such concession cases the rules on deferral, payment in instruments and guaranteed variable remuneration can be disapplied.

What?

The European Commission has published proposed amendments to the CRD IV remuneration principles to be incorporated into CRD V. Additional non remuneration related amendments are also proposed. In relation to remuneration, the proposed CRD V text:

- Clarifies that the rules in relation to deferral and payment in instruments will apply to **all** institutions and their identified staff except:
  - small and non complex firms whose assets' value is on average equal to or less than EUR 5billion; and
  - staff members whose annual variable remuneration does not exceed EUR 50,000 and does not represent more

than one fourth of the staff member's total annual remuneration.

- Permits Member State regulators to apply a stricter approach.
- Permits listed firms to use share linked instruments that track the value of shares to meet the payment in instruments requirement.
- Perhaps most significantly the effect of the CRDV text is the 'bonus cap' cannot be disapplied on proportionality grounds by any firm.

Implications in practice

Should these proposals be implemented it will require Member States to revisit their current proportionality regimes. In the UK it will mean that level 3 firms will no longer be automatically exempt from the remuneration rules on deferral, payment in instruments and the bonus cap as a bank or building society will come within Level 3 if its total assets do not exceed £15bn (significantly higher than the proposed EUR 5bn threshold). It could lead to further 'levels' being created or a requirement for level 3 firms to demonstrate to the regulators that they meet the exemption threshold.

In addition the population of Code Staff to whom the de minimis concession can be applied is also likely to shrink dramatically.

When?

The draft CRD V is currently subject to consideration and amendment by the European Parliament and Council. There is no specific time limit for this process however on average it takes around eight months. Second and third readings may also take place if agreement cannot be reached. How complex and controversial the non remuneration amendments are will be a significant factor in the speed of passage through the EU legislative process.

If agreement is ultimately reached the intention is that Member States will transpose it into national law within one year of its entry into force. Realistically CRD V is unlikely to have to be implemented in Member States before January 2019 (at the earliest).

The thorny question then arises of what will be the impact of Brexit? Depending on timing it may be that CRDV will have to be implemented prior to Brexit. Alternatively our regulators may take the view that regardless of when, and on what terms, Brexit occurs it is nevertheless appropriate to incorporate the revised remuneration principles into our domestic rules. Given our regulators' current approach to proportionality the latter approach does seem to be a little unlikely unless it is regarded as a small price to pay to be perceived as a regime maintaining adequate regulatory standards for the financial services sector?

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