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FINANCIAL SERVICES REMUNERATION UPDATE: WHERE ARE WE NOW?

– THOUGHT LEADERSHIP

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FINANCIAL SERVICES REMUNERATION UPDATE: WHERE ARE WE NOW?

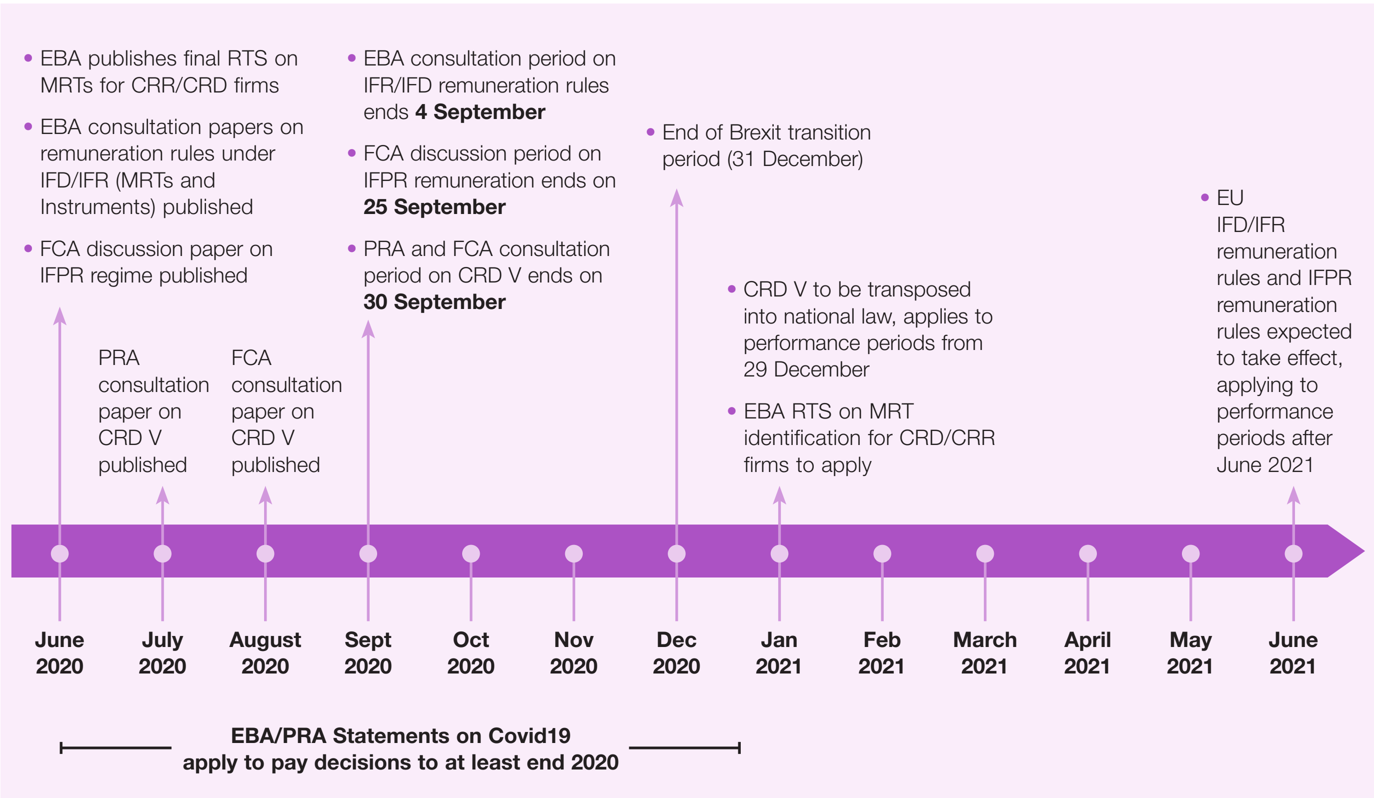
As the PRA and FCA launch their consultations on rule changes to reflect CRD V, pay and remuneration regulation continue to be areas of focus for financial services firms.

Given the impact of Covid-19, the wider economic climate, the end of the Brexit transition period bringing further regulatory change and investor, regulator and public scrutiny of pay being at an all-time high, pay and governance-related questions need particularly careful thought and planning now.

Whilst there will be much to do at implementation level and more individuals may be identified as Material Risk Takers, for larger banks and investment firms, the changes may not necessarily have a material impact on their well-established policies and practices.

For other investment and advisory firms, PE houses and portfolio managers, this signals a more significant shift and could result in a real change to how their staff are paid and require significant work to establish policies and practice that they have not previously had to consider.

Here's what to watch out for, ahead of what promises to be a busy end of 2020 and start to 2021 for the sector.



Short term – action needed now

CRD V – Transposition into UK law

Who does it affect?

Applies to UK banks, building societies and PRA-designated investment firms.

Why is it important?

CRD V introduces a number of key changes to remuneration regulation for firms covered by CRD and CRR, including a significant narrowing of the *de minimis* Material Risk Taker (MRT) carve out. This means that for some firms substantially more individuals will now be caught. The changes have been known for some time, however the PRA and FCA are now consulting on the transposition of the rules into UK law, by amending the Remuneration Part of the PRA's Rulebook and the FCA's Dual Regulated Remuneration Code (SYSC 19D).

Key points

- Change to the definition of MRT and method of identification (see below).
- *De minimis* MRT carve out (applied to payment in instruments, deferral and discretionary pension benefits) for individuals is to be limited to MRTs whose annual variable remuneration does not exceed EUR 50,000 and is not more than 1/3rd of total annual remuneration. This is considerably lower than the current threshold of EUR 500,000. For individuals who would be de *minimis* MRTs under the current carve out, different deferral and clawback provisions apply.
- *De minimis* firms carve out (applied to payment in instruments, deferral and discretionary pension benefits) for firms that do not qualify as 'large institutions' and have a balance sheet equal to or less than EUR 5 billion over a four-year period immediately preceding the current financial year. EUR 15 billion over the same period if certain other conditions are met. This also applies on a similar basis to branches of third-country firms operating in the UK.
- The bonus cap can no longer be disapplied on proportionality grounds, which will affect level 3 firms in the UK.
- Minimum vesting period for MRTs increased from 3 to 4 years (and for senior management, a minimum of 5/7 years remains).
- Scope for listed firms to use share-linked instruments (e.g. ADRs or phantom awards) to meet the payment in instruments requirement.
- No longer necessary to notify the PRA of any MRT exclusions where total remuneration is EUR 750,000 or less.
- No different treatment for part-year MRTs for 3 months or less.
- Separately, the UK Government has confirmed that it does not intend to legislate any further for gender-neutral remuneration policies or pay reporting requirements as required under CRD V, as it considers the current UK laws and regulations are fit for purpose.
- The UK Government has also confirmed that investment firms prudentially regulated by the FCA will be exempt from the scope of CRD V, given the planned introduction of the IFPR next year (see below on IFPR).

What stage are we at?

- Member States have until 31 December 2020 to transpose into national law and the UK has committed to do so by 28 December 2020.
- The PRA's consultation paper was published on 31 July 2020 and will remain open until 30 September and the FCA's consultation paper published on 3 August 2020 will also close on 30 September.
- The amended rules are to apply for performance periods from **1 January 2021**.

Financial Services: Reform and Changes to the FCA and PRA remuneration rules

The European Banking Authority (EBA) has re-jigged how investment firms are regulated, drawing a distinction between firms covered by the Capital Requirements Directive and Regulation (CRD and CRR) and those that are not.

The result is a new prudential regime that removes most investment firms from the scope of the CRD and CRR, and subjects them to new rules, including on remuneration, set out in the Investment Firms Directive and Regulation (IFD and IFR).

MRT Identification: EBA's revised RTS for CRD/CRR firms

Who does it affect?

Applies to investment firms considered systematically important, as designated by the relevant regulator.

Why is it important?

As required under CRD V, a number of technical changes are being proposed that will have a practical impact on a firm's MRT identification process. The framework of using qualitative and quantitative criteria for identification has however been largely retained.

Key points

- New definitions included for the terms 'managerial responsibility', 'control functions' and 'material business unit' bring increased clarity.
- Quantitative criteria are amended, for example, the total remuneration threshold for notification of exclusion purposes has been increased from EUR 500,000 to EUR 750,000 and changes are made to how the 0.3% of staff with the highest remuneration is calculated.
- The requirement to bring staff within scope by reference to their remuneration being equal to (or greater than) that of certain senior managers has been removed.

What stage are we at?

- Final draft RTS was published by the EBA on 18 June 2020 and submitted to the European Commission for approval.
- In its consultation paper on amendments to the PRA Rulebook, the PRA confirmed that it intends to update the PRA Rulebook to implement CRD V's revised approach to identifying MRTs and that the RTs will apply if adopted by the European Commission and are operative in EU law by 31 December 2020.

CRD V and MRT Identification: What do you need to do now?

The PRA and FCA consultations do not contain any material surprises to the changes anticipated under CRD V, Including on MRT Identification. They do, however, bring in new requirements for those who are currently *de minimis* MRTs who won't be under the new requirements. Some firms may well have commenced a review of their existing policies and practices. For those who have not, or who are still at the early stages of analysis, given that the timings for implementation will be tight and with an anticipated busy end-of-year period, firms will want to get ahead in planning. This will include:

- Reviewing processes, policies and remuneration structures, including whether share-linked instruments may be appropriate to be used for variable pay.
- A review of internal MRT identification processes and procedures will be needed to ensure that technical changes envisaged by the RTS are reflected in a firm's methodologies. Given that the new MRT identification requirements will apply from 1 January 2021, early preparation will be key to ensure the process is as pain-free as possible and to avoid individuals being caught purely because policies have not been updated in a timely way.
- Reviewing current MRT lists and the impact of the expanded definition and scope, including capturing new MRTs that were previously *de minimis*.
- Changes to the MRT exemptions process are also proposed and so a firm's regulatory exemptions procedures will also need to be reviewed.
- Consider how and when to communicate the extended deferral period to impacted MRTs (first applies to the performance year starting on or after 1 January 2021).
- For level 3 firms that currently disapply the bonus cap, planning will be needed to prepare for the impact of a bonus cap on MRT variable pay (including obtaining shareholder approval if the firm wants to increase the cap from 1:1 to 1:2).
- Firms that are materially impacted by the changes can reply to the consultation, but from prior experience however, the scope for any changes will likely be minimal.
- When finalised, the new rules will replace the existing RTS and are expected to apply to performance periods from 1 January 2021.

Short term – Impact of Covid-19

Impact of Covid-19 on pay: EBA & PRA Statements

Who does it affect?

EBA and PRA regulated banks and deposit-takers.

Why is it important?

The EBA and PRA issued statements in March 2020 setting out their expectations on any pay decisions and delivery in light of the Covid-19 pandemic. The ECB issued a further statement in July 2020 extending the prohibition on dividends and share buybacks to January 2021 for its supervised banks (and the PRA responded with its own statement).

Key points

- The EBA published 2 statements urging its regulated banks to stop any dividend distributions or share buybacks and encouraging banks to review their remuneration policies, practices and awards to reflect the current economic environment as well as set pay at a conservative level (with a larger proportion of variable pay to be deferred for a longer period and paid in instruments).
- The PRA also published a statement on large banks and deposit takers' approach to dividend payments, share buybacks and cash bonuses in response to Covid-19. It stated clearly that it expects banks not to pay any cash bonuses to senior staff, including MRTs until the end of the year.
- For listed companies in the UK, these statements should also be read in parallel with other investor guidelines on remuneration, like the IA's statement on Executive Remuneration in UK listed Companies: Shareholder Expectation during the Covid-19 Pandemic. Further detail can be found in our briefing here.

What stage are we at?

- Both PRA and EBA statements (and equivalent statements covering the insurance sector) took effect immediately, and should be considered by affected firms when making pay decisions.
- Further statements were issued by the ECB and PRA on 28 July 2020, under which the ECB extended the period of its prohibition on dividends, share buybacks and bonuses to January 2021. Previous statements by the PRA already applied the prohibitions to UK banks to 2020 year end.

Impact of Covid-19 on pay: What do you need to do now?

- Firms are working through challenging issues around pay, including pay cuts or freezes, reduced or forfeited bonuses paying variable pay solely in shares and how best to deal with performance-related pay. As matters progress throughout the year and the Covid-19 pandemic continues to evolve, further statements on pay will follow, both from regulators and investor bodies impacting pay-round decisions (as demonstrated by the ECB and PRA statements of 28 July 2020 and confirmation that the position will continue to be assessed and the implication that current restrictions may extend into 2021).
- Firms may want to start planning now, particularly those with a 31 December year-end, looking at how to conserve cash, for example by awarding a higher proportion of variable pay in shares or other alternative instruments. Ensuring that firms have enough flexibility in bonus and long term incentive plans to increase or decrease pay outs in the future will also be key; as well as being clear on powers and available discretions.

Medium to long-term implementation; planning recommended sooner

IFD/IFR: New regime for investment firms and EBA consultation on draft RTS

Who does it affect?

The IFD/IFR introduces a new categorisation regime for investment firms. Certain large investment firms, and those considered systematically important, will be subject to the CRD/CRR regime. All other EU investment firms will be subject to the new IFD/IFR remuneration regime (unless they are part of a CRD/CRR consolidated group or are categorised as 'small' or 'non-interconnected' and not otherwise part of an IFD consolidated group).

Why is it important?

The new IFD/IFR prudential regime applies to investment firms authorised in the EU. The UK will not be subject to it, however, a similar approach is being proposed by the UK's regulators (see IFPR below).

Key points

The new IFD and IFR remuneration rules are similar in breadth and scope to those under CRDV but with some key differences (these are underlined below). The new IFD/IFR rules include:

- Processes for the identification of MRTs.
- An appropriate ratio between fixed and variable pay must be set, although no bonus cap requirement.
- Deferral of at least 40% or 60% of variable pay for 3 to 5 years.
- Payment of at least half of variable remuneration in shares, share-linked instruments, instruments linked to a firm's capital or non-cash instruments linked to managed portfolios, and subject to holding periods. Consider appropriate instruments that might be available, depending on firm's legal structure (e.g. corporate vs partnership).
- Malus and clawback to apply.
- Discretionary pension benefits subject to a payment in shares requirement and holding periods.
- A gender-balanced RemCo (not defined).
- *De minimis* firm carve out (applied to requirements on RemCos, discretionary pension benefits, payment in shares or instruments and deferrals) where a firm's assets are equal to or less than a threshold of EUR100m measured over a 4 year period (can be raised to EUR300m at Member State level).
- *De minimis* MRT carve out (applied to the requirements on discretionary pension benefits, payment in shares or instruments and deferrals) for individuals whose annual variable remuneration does not exceed EUR 50,000 and is not more than 1/4 of total annual remuneration. This is a lower threshold than under current rules covering non-CRR investment firms and the list of what can be disapplied is also narrower (it does not, for example, cover guarantees or ex-post risk adjustment).

What stage are we at?

- The EBA published two consultation papers relevant to remuneration on 4 June 2020, inviting comments until 4 September 2020. This includes provisions on the identification of MRTs and the types of instruments that can be used for variable pay under the new IFD and IFR regime.
- The updated rules are expected to come into effect in June 2021.

FCA consults on its own new prudential regime for UK investment firms (IFPR)

Who does it affect?

The categorisation of firms under IFPR and application of the regime is intended to follow the same approach as the IFD/IFR (see above). Larger firms and those considered systematically important will subject to the CRD/CRR regime. All other UK investment firms will be subject to the IFPR rules (unless they are part of a CRR/CRD consolidated group or are categorised as 'small' or 'non-interconnected' and not part of an IFPR consolidated group).

Why is it important?

As there is no obligation on the FCA to implement the EU's IFD/IFR, the FCA is consulting on its own new prudential regime, designed with UK-authorised investment firms in mind.

Key points

- The FCA's discussion paper proposes that the FCA's IFPRU and BIPRU Remuneration Codes (SYSC 19A and 19C) are replaced with a new IFPR code.
- The remuneration rules in the IFPR discussion paper broadly track the provisions of the IFD/IFR, (see above).
- For smaller firms not currently subject to any FCA rules on remuneration and for firms currently able to disapply many of the requirements for proportionality reasons, the impact of the IFPR rules will be significant.
- As with the IFD/IFR, a lower threshold for *de minimis* MRTs is proposed than is currently the case. Similarly, the list of what can be disapplied (discretionary pension benefits, deferral and payment in shares/instruments) is also narrower (guarantees and ex-post risk adjustment are not expressly covered and therefore will no longer be subject to disapplication).

What stage are we at?

- The FCA discussion paper, published on 23 June 2020, invites comments until 25 September 2020.
- A consultation paper is expected later this year, with a formal consultation period on the new IFPR remuneration code to follow. It is anticipated that the new code will come into force in June 2021 and apply to performance periods starting after that date.
- The FCA will also consult on specific MRT identification rules for IFPR firms, based on the EBA's RTS.

IFD/IFR or IFPR: What do you need to do now?

- The level of planning and preparation needed will largely depend on the size and complexity of your firm and what level of regulation you are currently used to. For investment firms unfamiliar with remuneration regulation, the impact of the IFD/IFR or IFPR will be similar to that faced by banks following the last financial crisis. The initial impact of the new regime may even be greater, with its full impact being immediately felt rather than gradually evolving over time, as was the case under CRD/CRR. Investment firms will benefit from the well-trodden path taken by the banks and the lessons learned following the last financial crisis.
- Firms should consider looking ahead to their classification under IFD/IFR to determine whether the regime will apply. Where it does apply:-
  - Pay structures and policies will need to be thoroughly reviewed.
  - Firms will want to prepare for a larger MRT population, with new individuals within the organisation being impacted.
  - Impacted firms may wish to reply to the EBA consultation papers and/or FCA's discussion paper, as appropriate.

Further changes on the horizon – a watching brief

The UK Government also plans to carry out a review of Solvency II to ensure that it is properly tailored to take account of the structural features of the UK insurance sector.

The review will consider areas that have been the subject of long-standing discussion while the UK was a Member State, some of which may also form part of the EU's intended review.

A call for evidence is expected in the autumn of 2020 and this may of course include remuneration aspects.

Broader issues for firms on pay, remuneration, governance and Brexit

Firms will be faced with potentially tricky remuneration, governance and pay issues before the end of the year:

Governance and group structures – Many UK headquartered firms have reorganised their structures as part of Brexit planning, moving certain operations from the UK to an EU Member State.

If not already done so, firms will need to give careful thought to the impact of any internal reorganisation on remuneration governance and pay structures. Many of their European entities will have received regulatory authorisations as part of any reorganisation and so different remuneration regulatory requirements may well apply at the group, parent and subsidiary levels.

Careful analysis will be needed, including an analysis of applicable group consolidation rules, and any jurisdictional overlap. With the advent of new rules, codes and regimes, as set out above, this is likely to become more complex if and when the UK and EU rules diverge materially.

RemCo considerations – The EBA requires that a firm's significant subsidiaries (in terms of size and nature of activities) must have their own remuneration committee.

As above for governance and group structures, remuneration committees at parent and subsidiary levels will need clear direction and advice on how to navigate the impact of potentially different and diverging regulations on their populations.

CONTACTS

Andrew Patterson
Partner
T +44 20 7006 6160
E andrew.patterson
@cliffordchance.com

Sonia Gilbert
Partner
T +44 20 7006 2041
E sonia.gilbert
@cliffordchance.com

Catrin Wright
Head of Practice Development: Incentives
T +44 20 7006 2920
E catrin.wright
@cliffordchance.com

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