CLIFFORD CHANCE

# FINANCIAL SERVICES REMUNERATION UPDATE: WHERE ARE WE NOW?

**— THOUGHT LEADERSHIP**

UPDATE: MARCH 2021

# FINANCIAL SERVICES REMUNERATION UPDATE: WHERE ARE WE NOW?

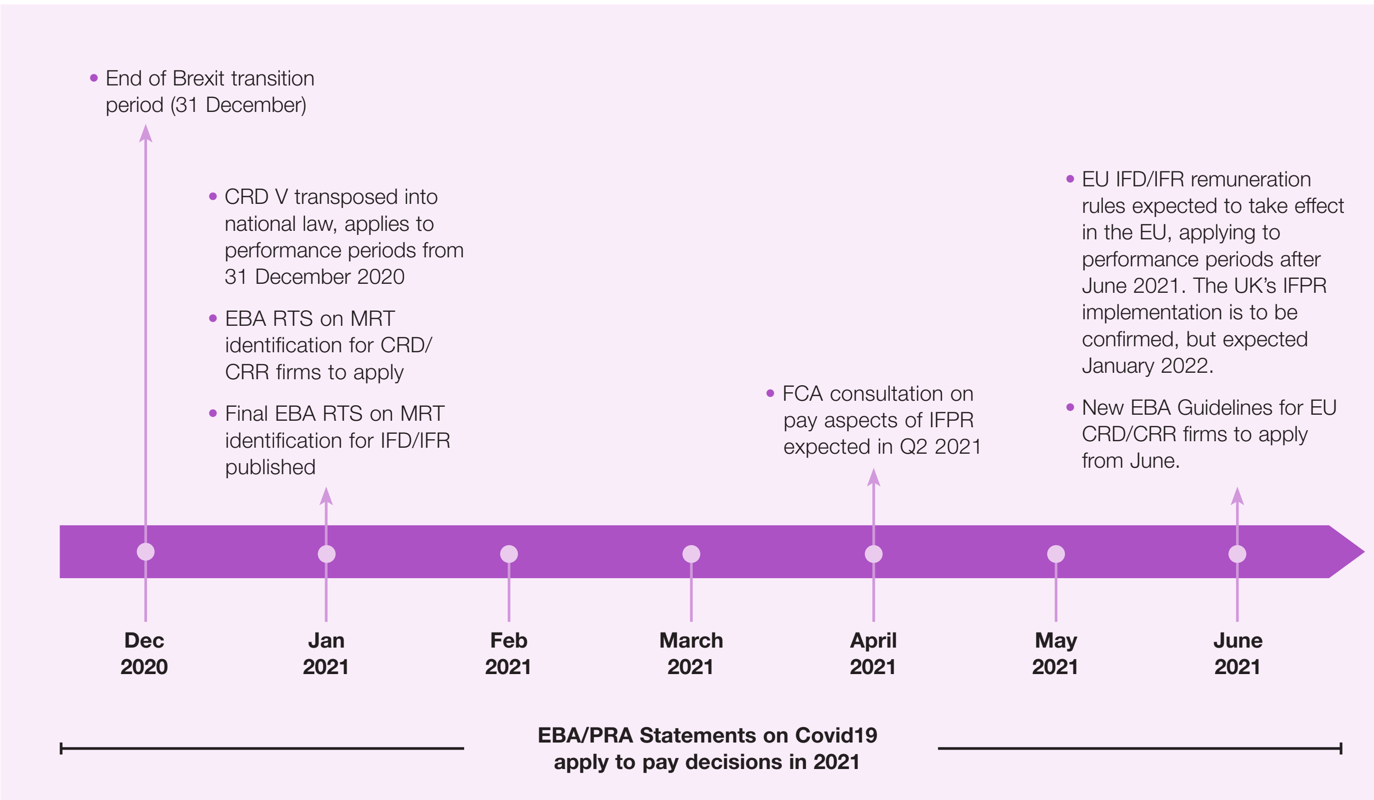
Since our last update in August 2020, the PRA and FCA have published their final rules on pay implementing CRDV.

The combined impact of these regulatory changes, the ongoing impact of Covid-19 and the end of the Brexit transition period, mean that remuneration continues to be an area of focus for firms, shareholders and wider stakeholders during this AGM season.

For larger firms and banks, although the changes introduced under CRDV may not necessarily have required a complete re-write of their established policies and practices, and the concepts are all familiar, there is still much to do at the planning and implementation level. Even though there were no particular surprises proposed by the final rules as implemented by the UK and EU Member States, there are a number of practical issues that require careful thought and preparation. For tier 3 firms and branches in particular this has meant a significant impact.

For other investment and advisory firms, PE houses and portfolio managers, the EU's new regime under IFD and IFR will take effect in June 2021 and the FCA's proposals for a new prudential regime for investment firms (IFPR) whilst still work in progress, will come into force in January 2022. That being said, early planning should still be considered, for what may be more of a fundamental change for these impacted firms.

Here's what to you need to think about.



## 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?

The Remuneration Part of the PRA's Rulebook and the FCA's Dual Regulated Remuneration Code (SYSC 19D) have been amended and the changes are now in force. No material changes were proposed to the final rules following consultation. As a reminder we've set out below the key CRDV changes. Updates to the position from our last briefing are underlined below.

#### 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 (GBP 44,000) and is not more than 1/3rd of total annual remuneration. This is considerably lower than the previous threshold of EUR 500,000. There are some areas of divergence between the PRA Remuneration Rules and the position under CRDV. For example, a new category of 'high earning' MRT has been created by the PRA, meaning that a different deferral and clawback period may be imposed on MRTs formerly categorised as de minimis under the previous carve out.
- *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 (GBP 4 billion) over a four-year period immediately preceding the current financial year or EUR 15 billion (GBP 13 billion) over the same period if certain other conditions are met (including conditions that apply where the firm is part of a group). This also applies on a similar basis to branches of third-country firms operating in the UK.
- 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 (for senior management, a minimum of 5/7 years remains), with up to 10 year clawback for FCA Senior Managers.
- 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.
- UK Government has confirmed that investment firms prudentially regulated by the FCA will be exempt from the scope of CRDV, given the planned introduction of the IFPR next year (see below on IFPR).
- Requirement for gender neutral remuneration policies and practices now included in the FCA and PRA rules, however the UK does not intend to legislate further on this point. For EU firms the EBA Guidelines are being updated (see below) including enhanced provisions in this area that will need to be considered.
- EU Headquartered firms with entities in the UK will not be required to apply any PRA Remuneration Rules (that are over and above the CRDV minimum requirements) until the first performance period starting on or after 1 April 2021.
- The EBA launched its consultation to revise its guidelines on sound renumeration policies in October 2020, which closed on 29 January 2021. The amendments broadly reflect changes taking into account CRDV. The revised guidelines also update the position on severance and retention payments in light of supervisory experience which will have a knock on effect on a firm's internal policies and procedures (for example, payments that are made on the settlement of a dispute, will now need to be for an 'actual labour dispute that could potentially lead to a court ruling' rather than a 'potential or actual' dispute).

### 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).

### What stage are we at?

- The amended FCA and PRA rules apply for most impacted firms for performance periods from **1 January 2021**.
- The amended EBA Guidelines are intended to apply to EU firms from June 2021.

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

### Who does it affect?

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

### Why is it important?

As required under CRDV, a number of technical changes have been made that have a practical impact on a firm's MRT identification process. The framework of using qualitative and quantitative criteria for identification has however been 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.
- The PRA has updated the PRA Rulebook to implement CRDV's revised approach to identifying MRTs. The final draft RTS applies to MRT identification for the 2021 performance year.

### CRDV and MRT Identification: What do you need to do now?

The PRA and FCA rules do not contain any material surprises and no material changes were made to the consultation drafts. Implementation steps 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 procedures to ensure that technical changes are reflected in a firm's methodologies. Changes to the *de minimis* threshold for MRTs under CRDV and the changes to the RTS will have knock-on impact for firms. The technical amendments to the definitions and categories of MRT in the RTS has the potential of narrowing a firm's list of MRTs, however the decrease in the MRT *de minimis* pay threshold potentially captures a new population of staff. The introduction of a 'high earning' category of MRT is also likely to have a practical impact (see further below). Firms will also want to give careful thought to how changes are communicated to affected employees, including the increase in minimum deferral period to 4 years.
- Changes to a firm's MRT exemptions process and procedures now need to be reviewed.
- For level 3 firms preparng 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) for the first time.
- There are some areas of divergence between the PRA Remuneration Rules and the position under CRDV, where the PRA goes over and above the requirements of the directive. Firms will need to consider the practical implications of this. For example with the introduction of a 'high earning' MRTs category, firms will need to consider whether they apply different periods of clawback to different categories of MRT.
- For EU Headquartered firms with entities in the UK, thought should be given to the PRA's transitional direction (following the Brexit transitional period) and what provisions can be disapplied in the short to medium term.

## 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 have updated their position on pay decisions and delivery in light of the Covid-19 pandemic since our August 2020 briefing. Material changes are underlined below.

#### Key points

- The EBA published various 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. The EBA issued another statement on 15 December 2020 urging banks to follow conservative distribution policies and use of capital. It also provided that variable remuneration for MRTs for the 2020 performance year should be deferred for a longer period and a larger proportion should be paid out in instruments. On 15 December 2020, the ECB also updated its guidance and called for banks to refrain or limit dividend payments until 30 September 2021 and repeated its expectations that banks exercise 'extreme moderation' on variable remuneration until that date, especially for its MRTs.
- The PRA updated its position on dividend payments and cash bonuses in December 2020.The PRA had previously said that it expected banks not to pay any dividends or cash bonuses to senior staff, including MRTs, until the end of 2020. The PRA has now relaxed this position, permitting distributions to shareholders within certain parameters or 'guardrails'. The payment of cash bonuses to senior staff, including MRTs, in 2021 is also permissible, provided that firms exercise a 'high degree of caution and prudence' in determining the size of any cash bonuses granted to senior staff given the uncertain outlook and the need for banks to deploy capital to support the wider economy.
- For listed companies in the UK, these statements should also be read alongside investor guidelines on remuneration, for example the recent statements and FAQs from the IA, ISS and Glass Lewis. Further detail can be found in our briefing here.

#### What stage are we at?

- PRA and EBA statements (and equivalent statements covering the insurance sector) should be considered by affected firms when making pay decisions.

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

- Firms continue to work 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 and the Covid-19 pandemic continues to evolve, further statements on pay will follow, both from regulators and investor bodies impacting decisions. The PRA's relaxation of its previous requirements for 2021 will be a welcome development for its regulated banks.
- Ensuring that firms have enough flexibility in bonus and long term incentive plans to increase or decrease pay outs in the future will continue to be key as the pandemic continues to evolve, as well as being clear on powers and available discretions.
- In terms of performance-related pay, proxy advisers have discouraged companies from adjusting performance conditions of "in flight" annual bonuses or LTIP awards. Care should also be taken when setting performance conditions for new awards, in particular, firms will need to be mindful of any risk of windfall gains. Disclosure on the determination of the performance conditions, grant value and the calculation of the number of shares to be granted will be particularly scrutinised.

## Medium to long-term implementation; planning recommended sooner

### IFD/IFR: New regime for investment firms

#### 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). The final rules have now been published by the EBA. We set out below a reminder of the key points.

#### Why is it important?

The 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 <u>underlined</u> 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 <u>no bonus cap requirement</u>.
- 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 <u>non-cash instruments linked to managed portfolios,</u> 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.
- *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 <u>are equal to or less than a threshold of EUR 100m measured over a 4 year period (can be raised to EUR 300m at Member State level</u>).
- *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 <u>1/4 of total annual remuneration</u>. This is a lower threshold than under former 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 has now published its final rules. This includes final 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 requirements are expected to come into effect on 26 June 2021 and apply to performance periods from 2022.

## 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 currently intended to follow the same approach as the IFD/IFR (see above) although this may change following consultation. Larger firms and those considered systematically important will be 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 proposed 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). However this may change and much will depend on the consultation documents as expected from the FCA.
- 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 closed for comments on 25 September 2020.
- A consultation paper on pay is expected in Q2 2021, with a formal consultation period on the new IFPR remuneration code to follow. The FCA has indicated that the new code will not come into force until January 2022.
- The FCA will also consult on specific MRT identification rules for IFPR firms.

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

- As flagged in our summer briefing, 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. Investment firms will benefit from the well-trodden path taken by the banks and the lessons learned following the last financial crisis. Much will depend on the position of the FCA in its consultation paper and on whether the IFPR will follow the principles of the IFD/IFR.
- Although the delay in bringing in IFPR until 2022 will mean more planning time, there is still much to think about now. For example, pay structures and policies will need to be thoroughly reviewed and firms will want to prepare for a larger MRT population, with new individuals within the organisation being impacted.

## Broader issues for firms: remuneration, governance and the end of the Brexit transition

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

Firms are now giving careful thought to the impact of internal reorganisations on remuneration governance and pay structures. Many of their EU based entities will have received regulatory authorisations as part of reorganisation and so different remuneration regulatory requirements may well apply at the group, parent and subsidiary levels.

Careful analysis will be needed, including looking at 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 as and when the UK and EU rules diverge materially from 2021 onwards.

**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 is the case for governance and group structure issues, 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. This is an issue for both UK and EU Headquartered firms with a presence in the UK.

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