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The IFD/IFR: Getting to grips with the new Remuneration Rules for Investment Firms

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The Investment Firms Directive ((EU) 2019/2034) and Investment Firms Regulation (EU) 2019/2033 (**IFD/IFR**) take effect from 26 June 2021 and will establish a new, tailored prudential regime for MiFID investment firms. In this briefing, we focus on the new remuneration regime under the IFD/IFR and how it will impact investment firms depending on their IFD/IFR categorisation. Many MiFID investment firms will already be subject to, and therefore familiar with, the remuneration rules under the Capital Requirements Directive (as implemented in Ireland by the European Union (Capital Requirements) Regulations 2014) (**CRD**)) which provide the foundation blocks for the IFD remuneration rules. However, the IFD remuneration requirements are likely to capture some investment firms not previously in scope of CRD remuneration rules. In addition, these new requirements alter, and have the potential to be more onerous than, the requirements currently applicable to the majority of CRD investment firms.

WHEN WILL THE NEW REMUNERATION REQUIREMENTS APPLY?

These rules will apply from 26 June 2021 and will impact on remuneration years commencing 1 January 2022. IFD, as a directive, will need to be transposed into Irish law. The Department of Finance (**DoF**) issued a consultation in May 2020 (closed in July 2020) seeking feedback on how Ireland should exercise available discretions, mostly in relation to the remuneration rules (without necessarily indicating a particular policy position).

WHO IS SUBJECT TO THE IFD/IFR AND ITS REMUNERATION RULES?

The IFD/IFR creates a prudential framework tailored to various 'classes' of investment firms that is intended to be more proportionate, risk-sensitive, and adapted to investment firms' business models and risk profiles, than the CRD regime. IFD's renumeration rules aply depending on the investment firm's classification with small and non-interconnected firms generally exempt (see below).

The first step on a firm's compliance journey will be to map out its anticipated categorisation with respect to the three potential classes or categories of firms:

CLASS OF FIRMS	CRITERIA		REMUNERATION RULES
CLASS 1 (AND CLASS 1 MINUS)	Firms (i) dealing on own account (including matched principal trading) or placing financial instruments on a firm commitment basis; and (ii) meeting solo/consolidated asset thresholds below		Status quo (i.e. CRD/CRR remuneration rules)
	Class 1 ≥ €30bn (require re-authorisation as a new form of credit institution)	Class 1 (minus) ≥ €15bn. There is also Central Bank discretion to classify a firm as Class 1 based on factors such as systemic risk, clearing member status, economic importance or cross-border significance.	
CLASS 2	Default category for firms exceeding any of the k-factor and other thresholds for Class 3 categorisation (see below)		IFD/IFR remuneration rules
CLASS 3	*Firm meeting all of the below criteria (see Article 12 IFR)*	*All figures on solo/group basis*	**Exempt from IFD/IFR remuneration rules** (Note: Class 3 firms could be in scope of IFD remuneration rules if part of a consolidated IFD/IFR investment firm group or otherwise subject to CRD remuneration rules if part of a CRD consolidated banking group)
	Safeguarding client assets and/or holding client money	No	
	Assets under discretionary management/ongoing advisory arrangements	Below €1.2bn	
	Client orders handled	Below €100m per day for cash trades/€1 bn (notional) per day for derivatives	
	For firms with trading books: Net position risk/clearing margin given/trading counterparty default/daily trading flow	Zero	
	Total annual gross revenue from investment services (averaged on previous 2 financial years)	Less than €30m	
	On and off-balance sheet assets	Less than €100m	

It is expected that most Central Bank of Ireland (**Central Bank**) authorised investment firms will fall outside the CRD/CRR framework and be subject to the bespoke prudential, internal governance and remuneration requirements under the IFD/IFR i.e. Class 2 firms, unless exempt due to Class 3 status. Class 2 firms which are currently CRD investment firms (within Article 4(1)(2) of CRR) will already be subject to CRD/CRR remuneration rules and will, therefore, have an exercise of adapting current frameworks. For non-CRD Class 2 firms, there will be a heavier lift to comply with the new remuneration framework including, as discussed below, a potential need to revise current variable remuneration arrangements in place with the pool of identified staff.

The remuneration rules will apply to Class 2 firms on an individual and consolidated basis, but Member States have the discretion for the remuneration regime to only apply on an individual basis for certain investment firms within group structures that carry low risk profiles. The Irish government has not yet indicated whether it will exercise this discretion in the transposing legislation.

KEY ELEMENTS OF THE IFD/IFR REMUNERATION FRAMEWORK

Although the IFD/IFR remuneration rules are based on, and therefore share much common ground with, the current CRD/CRR framework, there are some important differences. The IFD/IFR represents something of a mixed bag for firms as, on the one hand, some areas reflect a slight relaxation (e.g. no bonus cap) but, on the other hand, IFD significantly limits the proportionality grounds under CRD to disapply more onerous elements of the variable remuneration rules around pay-out process rules.

REMUNERATION POLICY

Class 2 firms must have a remuneration policy which, based on the principles it needs to address for identified staff, will largely resemble the current CRD requirements. An important piece of the jigsaw, and for the remuneration framework generally, will be the final EBA and ESMA guidelines on sound remuneration policies. These guidelines will build on common foundations in terms of the existing EBA Guidelines on Sound Remuneration Policies (EBA/GL/2015/22) issued under the CRD. However, a consultation on these guidelines has not yet issued. The EBA IFD/IFR Roadmap indicates that these may not be finalised until Q3 2021 (i.e. potentially after the application date of IFD/IFR).

REMUNERATION COMMITTEE

All Class 2 firms with balance sheet assets over €100 million (on average, over the preceding four years) are required to establish a remuneration committee. This committee will exercise competent and independent judgement and decision-making on remuneration policies and practices, the firm's incentivisation structures, and the identified staff assessment exercise and variable remuneration. Composition of the committee must comprise of non-executive members of the board and should be gender balanced. The committee may be established at group level rather than at the individual entity level. It seems that a potentially wider population of investment firms will be subject to a requirement to have a remuneration committee. Currently, such a committee is only required for the largest firms where they are CRD significant institutions or where they are "high impact" firms under the Central Bank's Corporate Governance Requirements for Investment Firms and Market Operators.

DISCLOSURES AND REPORTING

Firms will need to make public disclosures on aspects of their remuneration policy and practices regarding identified staff including aspects in relation to gender neutrality and the gender pay gap. The disclosure requirements are granular and comprehensive, although individual staff members are not to be named. There is some overlap with existing requirements regarding Pillar 3 disclosures by CRD investment firms. Disclosure items include:

- information on the most important design characteristics of the remuneration system including the level of variable remuneration and criteria for awarding variable remuneration, pay-out in instruments policy, deferral policy and vesting criteria;
- the ratios between fixed and variable remuneration;
- whether the firm benefits from a proportionality derogation (on deferral, pay-out process); and
- aggregated quantitative information on remuneration, broken down by identified staff categories with further detailed elements covering items such as the fixed to variable split, forms of variable remuneration, deferred amounts, amounts vested from previous performance periods, performance adjustments, guaranteed variable remuneration and number of beneficiaries and severance payments.

Similar to current CRD requirements, firms will need to report to the Central Bank on the number of natural persons earning more than €1 million including information on job responsibilities, business area and the elements of salary, bonus, long-term award and pension.

IDENTIFIED STAFF / RISK TAKERS

As with the current CRD regime, the remuneration policy and the rules on variable remuneration will apply to those categories of staff which have material risk taker status (such as senior management, material risk takers, controlled-function staff and higher earning staff). The EBA has consulted on a draft RTS to identify staff, having regard to qualitative and quantitative criteria, which have a material impact on the firm's risk profile or assets it manages (this consultation closed on 4 September 2020). These criteria broadly correspond with those under CRD (per the Identified Staff RTS - Delegated Regulation (EU) 604/2014 which are separately to be revised following an EBA consultation earlier this year as part of the CRDV package of reforms). However, it is evident from commentary and feedback to the consultation that the qualitative criteria may possibly capture a broader universe than is currently the case in CRD. The criteria as set out in the draft RTS are summarised below and may be subject to change:

Qualitative Criteria (if any are satisfied the staff member is deemed to have a material impact on the firm's risk profile or assets managed)	**Quantitative Criteria** (high earning staff are presumed to have a material risk impact but can be removed from the assessment if objectively determined not to have a material risk impact)
Member of the management body in its supervisory or management function (i.e. board members for Irish firms)	The staff member has been awarded total annual remuneration equal to/greater than €500k and equal to/greater than the average of the remuneration of members of the management body and senior management
Member of senior management	The staff member has been awarded total annual remuneration which is equal to or greater than €750k or more (decision to exclude subject to Central Bank approval)
Managerial responsibility of a business unit contributing more than [10%/20%] of the firm's own funds requirements	For firms with over 1,000 staff, the staff member is within the top 0.3% highest earners (decision to exclude subject to Central Bank approval)
Managerial responsibility of a controlled function or AML/CTF function	The staff member's total remuneration is equal to or greater than the lowest total remuneration for certain categories of identified staff
Managerial responsibility for a material risk to which the investment firm is exposed or is a voting member of a risk committee	Staff members earning total annual remuneration above €1m can only be excluded on Central Bank approval which will only be granted in exceptional circumstances
Managerial responsibility for processes/systems or outsourcing arrangements/providing IT or security relevant to portfolio management or ongoing advisory mandates/asset safeguarding/ order execution and trading activities.	
Staff member has authority to approve/veto new products (or is a voting member of a product committee)	

VARIABLE REMUNERATION

The IFD's requirements regarding variable remuneration for identified staff are very similar to those contained in CRD IV (save for some areas such as the bonus cap) and the key points are described below:

General	Variable remuneration should be linked to individual performance, that of their department and the firm. Both financial and non-financial criteria are to be considered for individual assessments and such assessments should be based on a multi-year period considering the business cycle and business risks of the firm. Variable remuneration should not affect the soundness of the firm's capital base.
Guaranteed Bonuses	As per CRD, guaranteed bonuses should only be paid for new staff in their first year.
Instruments	At least 50% of variable remuneration (deferred and non-deferred) must be paid in eligible instruments (shares or equivalent ownership interests/share-linked instruments or equivalent non-cash instruments/eligible capital instruments/for portfolio management/advisory firms, non-cash instruments reflecting the portfolios managed). (Derogation may be sought from the Central Bank for approval to use alternative arrangements meeting the same objectives if the firm does not issue any of the foregoing instruments). Firms should apply an appropriate retention policy to any such instruments. *(Subject to proportionality – see below)*
Deferral	At least 40% of the variable remuneration must be deferred over a 3- to 5-year period and vest no faster than on a pro rata basis. For a "particularly high amount" (not defined in IFD) of variable remuneration, at least 60% of the amount should be deferred. *(Subject to proportionality – see below)*
Bonus Cap	Firms will not be subject to a mandatory bonus cap. There is scope for more bespoke/flexible approaches for certain categories of staff as distinct from the 100/200% mandatory cap under CRD rules. Firms must set "appropriate" bonus caps and ensure that fixed remuneration represents a "sufficiently high proportion" of the total remuneration. *Note: the DoF consultation asked if Ireland should nonetheless introduce a bonus cap and feedback is awaited on the final policy outcome.*
Pension	If the employee leaves the investment firm before retirement, discretionary pension benefits should be held by the investment firm for five years in the form of instruments. (Subject to proportionality)
Malus/ clawback	Malus and clawback requirements apply for variable remuneration in similar fashion to CRD.
Termination	Early termination payments must be performance based and not reward failure.
Controlled Functions	Accordance with the achievement of the objectives linked to their functions, regardless of the performance of the business areas they control.

IFD PROPORTIONALITY

The payment in instruments, deferral and retention requirements noted above can be disapplied by a firm across its identified staff:

- where the firm's balance sheet assets are equal to or less than €100 million (unclear if this is on a solo or consolidated basis). (In CRD, the maximum firm asset size for application of the de minimis threshold is set at €5 billion); OR
- in the case of an identified staff member whose annual variable remuneration does not exceed €50,000 and does not represent more than 25% of the individual's total annual remuneration.

As noted by the DoF consultation, there is Member State discretion to increase (or decrease) the firm asset size threshold from €100 million to a maximum of €300 million. However, only a limited population of firms can take the benefit of that higher threshold:

- The firm must not be subject to (simplified or otherwise) recovery and resolution obligations under the Bank Recovery and Resolution Directive (i.e. 730K firms).
- The firm's balance sheet trading book business must not exceed €150 million.
- The firm's balance sheet derivatives business must not exceed €100 million.
- The firm must not be in the top three largest investment firms by assets in the State.

For those firms currently benefitting from a CRD proportionality waiver, it will be necessary to consider the impact of the IFD revisions above. For firms currently using that waiver, there may be a requirement to adjust, over a relatively short time horizon, to a more onerous pay-out process regime for variable remuneration awards to their identified staff.

NEXT STEPS

Time is ticking for firms to ready themselves for compliance with the IFD/IFR remuneration requirements. Firms should start planning for implementation sooner rather than later. Some preliminary action points that firms can progress now include:

- Identify the firm's IFD/IFR classification in order to understand what remuneration provisions apply and what steps need to be taken to prepare. Firms should take account of the potential impact of their IFD/IFR (or indeed CRD) group consolidation position. The main impact will be for Class 2 firms, which will be greater still for those Class 2 firms not currently subject to CRD remuneration rules.
- Review/map out the firm's remuneration policy.
- For firms relying on a CRD proportionality waiver for pay-out and deferral rules, assess whether the firm continue to qualify for that waiver based on the changed criteria.
- Consider how to demonstrate compliance with the requirements around payment in instruments and what types of instruments the firm can utilise for this purpose.
- Will the firm/group need to introduce a remuneration committee or adapt the composition and terms of reference of an existing one.
- Review the existing identified staff universe today and consider how will this change based on the draft RTS.
- Begin the gap analysis/impact assessment exercise to determine how employment contracts, staff bonus/compensation arrangements, internal policies etc will be affected. Given the sensitivities, it will be prudent to develop an communication and engagement strategy for impacted staff.

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