DILLON EUSTACE

Focus on the new IFR/IFD variable remuneration requirements in force from 26 June 2021

Karen Jennings reviews the new 'variable remuneration' regulation regime for investment firms in Ireland, under the Investment Firms Directive, which came into effect in June, identifying the Irish features that will govern pay and bonuses in the sector.

Introduction

On 26 June 2021, the new prudential regime for investment firms established under the Investment Firms Directive (EU) 2019/2034 (IFD) and the Investment Firms Regulation (EU) 2019/2033 (IFR) took effect. The objective of the new proposed framework is to provide for capital, liquidity, and other prudential requirements for investment firms in the European Union which reflect the business models of those firms and proportionately capture the risks posed and faced by them.

> **"Under the IFD, each Member State or their competent authority is afforded the discretion to place restrictions on the types and designs of these instruments or ban certain instruments as appropriate."**

Under the new proposed regulatory regime, certain systemically relevant investment firms which engage in "bank-like" activities and services will be reclassified as "credit institutions" (Class 1) and will be fully subject to the prudential requirements laid down in the Capital Requirements Regulation (EU) (575/2013) (CRR) and the Capital Requirements Directive 2013/36/EU (CRD IV). Other similar investment firms, but with smaller asset sheets (Class 1 minus) may be subject to the same prudential requirements as Class 1 firms. All other investment firms which are not considered systemic (Classes 2 and 3) will be subject to a new tailored regime with bespoke and lighter prudential requirements. The new regime introduces new prudential requirements primarily in the areas of remuneration, capital requirements, liquidity, reporting and disclosure requirements.

Karen Jennings

Variable remuneration requirements for Class 2 and Class 3 Firms

Class 2 and Class 3 investment firms are the most prevalent categories of firms established in Ireland. Class 3 firms are small, non-interconnected investment firms for whom a set of risk measures are below certain thresholds. Such Class 3 firms will remain subject to the existing MiFID II governance and remuneration requirements given their low-risk classification (save where the Class 3 firm is within a group subject to consolidated supervision under IFR/IFD or CRR/CRD IV).

The IFR and the IFD provide a comprehensive set of remuneration rules for Class 2 firms which encompass requirements in relation to variable remuneration, remuneration policies, and the establishment of remuneration committees. This article will focus on the requirements relating to the variable remuneration requirements applicable to Class 2 firms.

The variable remuneration requirements

Material Risk Takers

The variable remuneration requirements in the IFD will apply to Material Risk Takers (MRTs) identified by the relevant Class 2 firm. In January 2021, the European Banking Authority (EBA) published a final report on RTS on criteria for identifying such material risk takers. This details the qualitative and quantitative criteria that a firm must take into account when identifying MRTs[1].

Key differences from the CRD IV regime

The variable remuneration requirements contained in the IFD are broadly similar to those contained in the CRD IV. The key differences between the variable remuneration requirements contained in the IFD and those in the CRD IV are:

- MRTs include all staff members whose professional activities have a material impact on the investment firm's risk profile or (unlike CRD IV) assets under management.
- Unlike CRD IV there is no specific limit for the ratio between variable and fixed components of variable remuneration although firms are obliged to set appropriate ratios[2].
- The introduction of the exemption from the variable remuneration requirements concerning deferral and pay-out in instruments (as opposed to pay-out in cash) for small firms and staff with low levels of variable remuneration[3].

> **"The variable remuneration requirements in the IFD will apply to Material Risk Takers (MRTs) identified by the relevant Class 2 firm. In January 2021, the European Banking Authority (EBA) published a final report on RTS on criteria for identifying such material risk takers."**

Malus and clawback

Class 2 firms must also implement malus and clawback provisions[4] in accordance with the IFD covering all variable remuneration. These requirements are generally in line with CRD IV.

Pension benefits
The IFD requires that discretionary pension benefits are in line with the business strategy, objectives, values and long-term interests of the investment firm[5].

Guaranteed bonuses
Firms cannot issue guaranteed bonuses other than for new staff in their first year subject to the firm having a strong capital base[6].

Bonus cap
The IFD does not impose a fixed cap on the variable component of the total remuneration which can be paid to an MRT. However, in a development from CRD IV, such ratios must be set by the firm taking into account the business activities of the investment firm and associated risks, as well as the impact that different categories of staff (as MRTs) have on the risk profile of the investment firm[7].

Termination payments
These must not reward failure or misconduct[8].

Pay out
The IFD requires that at least 50% of an individual's remuneration be paid in shares or other non-cash instruments, as detailed in the IFD[9] and as further set out in the final report issued by the EBA on RTS on the use of instruments and possible alternative arrangements for risk takers' variable remuneration in January 2021[10]. Under the IFD, each Member State or their competent authority is afforded the discretion to place restrictions on the types and designs of these instruments or ban certain instruments as appropriate[11]. The Department of Finance in Ireland has recently indicated that Ireland will not be availing of this discretion[12].

"Class 2 and Class 3 investment firms are the most prevalent categories of firms established in Ireland. Class 3 firms are small, non-interconnected investment firms for whom a set of risk measures are below certain thresholds."

Deferral
The IFD also requires that at least 40% of variable remuneration, and 60% in the case of particularly high amounts (not defined in the IFD) should be deferred over a 3- to 5-year period[13].

Exemptions from pay out and deferral requirements
The IFD introduces an exemption from the variable remuneration requirements concerning deferral and pay-out in instruments for small firms, namely firms with average on and off-balance sheet assets of €100 million or less over the four years immediately before the given financial year[14]. Each Member State is given the discretion under the IFD to increase the threshold for this exemption to €300 million or less[15]. In accordance with this discretion, the Department of Finance in Ireland has recently indicated that the threshold will be increased in Ireland from €100 million to €300 million of on and off-balance sheet assets once certain criteria are met[16].
In addition, the IFD introduces an exemption from the variable remuneration requirements concerning deferral and pay-out in instruments for staff with low levels of variable remuneration[17]. For these purposes a lower-paid member of staff is an individual whose annual variable remuneration does not exceed €50,000 and does not represent more than a quarter of that individual's total remuneration. Each Member State is given the discretion under the IFD to limit the availability of this exemption to lower paid members of staff in certain circumstances outlined in the IFD. The Department of Finance in Ireland has recently indicated that Ireland will not be availing of this discretion[18].

Effective date
The IFR/IFD entered into force in December 2019 is applicable for all firms from 26 June 2021. Draft Irish implementing legislation transposing the IFD into Irish law is therefore anticipated very shortly.

Karen Jennings is a Senior Associate in Dillon Eustace's Financial Regulation group.

[1]Final Report (EBA/RTS/2021/02) published on 21/01/2021. [2]Article 30(2), IFD. [3]Article 32(4), IFD. [4]Article 32(1)(m), IFD. [5]Article 32(1)(n), IFD. [6]Article 32(1)(e), IFD. [7]Article 30(2), IFD. [8]Article 32(1)(f), IFD. [9]Article 32(1)(j), IFD. [10]Ibid. 1. [11]Article 32(3), IFD. [12]Department of Finance – "Investment Firms Directive (EU) 2019/2034 Public Consultation Feedback Statement on the Exercise of National Discretions" (May 2021). [13]Article 32(1)(l), IFD. [14]Article 32(5) and (6), IFD. [15]Article 32(6), IFD. [16]Ibid.12. [17]Article 32(4), IFD. [18]Ibid. 12.