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Financial Regulatory Update – January 2022

Supporting EU Investment Firms with the Investment Firms Directive and Investment Firms Regulation (IFD/IFR) from a Reward Perspective – What do you need to know?

Overview

The EU's Investment Firm Directive (IFD) and Investment Firm Regulation (IFR) establishes a new prudential framework for MiFID-authorised investment firms.

The IFD introduces a new set of tailored remuneration rules for investment firms. There are a number of specific requirements that impact the remuneration of individuals identified as Material Risk Takers ('MRTs) including rules on deferral, a requirement to pay a portion of variable remuneration in instruments and the application of malus and clawback. While the IFD remuneration requirements are broadly similar to the CRD IV provisions, the bonus cap requirement (which limited variable pay at two times fixed) has now been replaced by a requirement for firms themselves to set an appropriate ratio between fixed and variable remuneration for MRTs.

In addition to the specific requirements impacting the remuneration of MRTs, the IFD also includes a number of broader firm-wide provisions around remuneration policies, governance and disclosure (as detailed under the IFR) that need to be met. In particular, the IFD introduces specific remuneration rules for Class 2 investment firms such as the requirement to pay a portion of variable remuneration in instruments, deferral and establishing a remuneration committee.

The remuneration requirements have not changed materially from the previous CRD IV provisions. As was the case under CRD IV, a number of these requirements will now apply to individuals identified as MRT's; however, the types of staff considered as MRTs are somewhat different than was the case with CRD IV. Firms must ensure that their remuneration policies are: 1: Consistent with, and promote, sound and effective risk management. 2: Take into account the long-term effects of investment decisions and encourage responsible conduct and prudent risk taking.

Key Points

How are Investment Firms Classified for the Purposes of the new Remuneration Requirements?

Based on size, scale and activities, the new regime divides investment firms into three categories: Class 1; Class 2 and Class 3. **Only Class 2 firms are subject to the IFD remuneration requirements.**

Class 1 firms are systemically important investment firms subject to the CRD V/CRR capital and remuneration requirements.

Class 2 firms are non-systemic firms, that have less than €15 billion in consolidated assets or do not trade on their own account, perform underwriting services and do not meet any of the criteria necessary to be considered a Class 3 investment firm. These Class 2 firms fall under the IFD/IFR requirements, rather than the CRD V/CRR requirements.

Class 3 firms are small and non-interconnected firms subject to the MiFID II remuneration rules.

What are the Key Remuneration Requirements for MRT's?

Ratio between variable and fixed remuneration:
Regulatory requirements: While the IFD does not set a specific limit on the ratio of fixed to variable remuneration (i.e. the bonus cap as seen for the banks under CRD V), investment firms will be required to set an appropriate ratio for MRTs themselves and explain this in their remuneration policy.

Malus/Clawback
Regulatory requirements: 100% of variable remuneration should be subject to malus and clawback arrangements, including for situations in which individual conduct results in significant losses and the individual is no longer considered 'fit and proper'.

Deferral
Regulatory requirements: At least 40% of the variable remuneration (60% where variable is particularly high) shall be deferred over a three-to-five-year period.

Payment in instruments:
Regulatory requirements: At least 50% of variable remuneration must be paid in non-cash instruments. There is a great deal of flexibility in the types of instruments that may be used under IFD, including shares, funds, capital linked instruments and alternative arrangements.

Retention periods:
Regulatory requirements: Any payments made in instruments should be subject to an appropriate retention period post- vesting. The EBA Guidelines specify a minimum retention period of 1 year.

Firm wide remuneration requirements
In addition to the specific requirements impacting the remuneration of MRT's, the IFD also includes a number of broader firm-wide provisions around remuneration policies, governance and disclosure (as detailed under the IFR) that need to be met.

For example, there is a requirement for investment firms whose value of on and off-balance sheet assets exceed €100m to establish a Remuneration Committee. The IFD also requires a firm's remuneration policy and practice to be gender-neutral. This encompasses the principle of equal pay for male and female workers for equal work or work of equal value.

Proportionality - which Firms and Individuals can be Exempt from these Requirements?	Investment firm's Material Risk Takers may be exempt from some of the IFD pay rules. The requirements on deferral and payment in instruments may not apply in situations where: 1: An investment firm whose on and off-balance sheet assets have an average value of €100 million or less over the four-year period immediately preceding the given financial year.	2: An individual whose annual variable remuneration does not exceed €50,000 and does not account for more than a quarter of their total annual remuneration.
Latest Guidance from the Department of Finance and the Central Bank of Ireland.	On the 24th of May 2021, the Department of Finance published its Feedback Statement on the exercise of a small number of national discretions under the IFD. The Department of Finance has stated that the Central Bank of Ireland will be appointed as Ireland's single National Competent Authority. The Department of Finance also indicated that the only other national discretion it will exercise relates to the default threshold of on and off-balance sheet assets that must be met for firms to be exempt from the restrictions on variable remuneration.	The Minister for Finance will set the threshold at €300 million (rather than the default threshold of €100 million under the IFD). However, there is a discretion granted to the Central Bank to specify a lower threshold in particular circumstances. In October 2021, the Central Bank of Ireland set out how it will exercise the Member State remuneration related discretions granted to it by the Irish Minister of Finance. The Central Bank stated that this will be done on a "case-by-case" basis.
Regulatory Technical Standards (RTS)	In August 2021, the European Commission adopted regulatory technical standards (RTS), supplementing the remuneration provisions of the IFD. The first RTS relates to the criteria firms use to identify MRT's under the IFD. The RTS outline a series of prescriptive qualitative and quantitative criteria that firms will need to follow in order to identify MRT's. The second RTS specifies the classes of instruments that adequately reflect the credit quality of a firm that is subject to the IFD remuneration requirements as a going concern and, also, possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration.	To allow for any necessary changes to remuneration policies and the updating of required documentation, the implementation date for these standards is April 30, 2022. However, the application of these remuneration requirements applies to performance years starting after the 31 December 2021.
EBA Guidelines on Sound Remuneration Policies	The EBA updated its final Guidelines on sound remuneration policies under the IFD on November 22, 2021 which will be effected from April 30, 2022. A firm's remuneration policy should be applied in line with these Guidelines for the performance year starting after 31 December 2021. Some of the main changes and clarifications are: Firms can disapply the rules on deferral and payment in instruments for MRTs identified at an individual entity level, and at a consolidated level, if the entity's total assets fall below the applicable thresholds set in national law. The final Guidelines have removed the previous provision that, for investment firms that have more than €100 million of on and off-balance sheet assets, a five-year deferral period should apply for members of the management body.	The EBA advocated that members of the supervisory function of a company should only be compensated with fixed remuneration. The Guidelines have since been clarified to allow members of the management body, who fulfil multiple functions, to receive variable remuneration "in exceptional cases." Under the Remuneration committee, risk committee members are not expected to participate in all Remuneration Committee meetings but they should have the ability to do so when necessary. Investment firms should take particular care when implementing other measures to avoid conflicts of interest in remuneration decisions if the remuneration committee lacks a sufficient number of independent members.

Actions to take

How we can support you

Investment firms should familiarize themselves with the IFD/IFR remuneration requirements and their potential impact on their business to ensure compliance with the IFD/IFR regime. We recommend the following actions for which Deloitte can support:

- Work with you to redesign and update remuneration arrangements to align with the new requirements.
- Support in the drafting and updating of your remuneration policy, governance documentation and disclosure (e.g. remuneration policy, risk adjustment, remuneration committee terms of reference).
- Supporting in reviewing your approach and developing your list of MRT's under the IFD.
- Update plan rules to reflect any changes to variable remuneration structures.
- Support with communicating changes to employees and key stakeholders.
- Outline any tax changes from these requirements.

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