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New Prudential Regime for Investment Firms

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4. Remuneration

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Overview

The new EU prudential regime for investment firms largely continues the remuneration regime under the Capital Requirements Directive (**CRD IV**). In some respects, such as the replacement of the "bonus cap" with a requirement for firms to set appropriate ratios between fixed and variable pay, the remuneration requirements under the Investment Firm Directive (**IFD**) are less onerous than those in CRD IV. In other respects, such as the new, and significantly more restrictive proportionality framework, the IFD's requirements are more stringent than those in CRD IV. As with developments to the CRD IV remuneration rules under CRD V, IFD requires firms to adopt gender neutral remuneration policies.

The largest and most significant firms (**Class 1 firms**) will be subject to the CRD IV's remuneration requirements. Small and non-interconnected firms (**Class 3 firms**) are not subject to the IFD's remuneration requirements, whilst all other investment firms (**Class 2 firms**) must apply both high-level requirements relating to their remuneration policies, as well as more detailed and onerous requirements for variable remuneration. In certain cases, Class 2 firms can apply the IFD's proportionality framework to disapply some of the IFD's remuneration requirements.

Source materials

(a) IFD Recitals 22 to 26 and 41

(b) IFD Articles 25, 26(1)(d) and 30 to 35

(c) Financial Conduct Authority (**FCA**) Discussion Paper DP 20/2 dated June 2020 (**DP20/2**)

(d) HM Treasury, Policy Statement "Prudential Standards in the Financial Services Bill: June update"

Summary of obligations

Class 2 firms must put in place remuneration policies and practices that are consistent with and promote sound and effective risk management. These policies and practices must be gender neutral.

Class 2 firms must identify 'material risk takers' (**MRTs**) – though, in a development from CRD IV, this now includes staff that have an impact on the risk profile of the assets managed by a firm. In DP20/2, the FCA has interpreted this to include all aspects of the MiFID activities carried out by the firm – ie, beyond assets under management, this could include client assets and the firm's own assets. The EBA, in consultation with ESMA, is to develop draft regulatory technical standards to identify MRTs. These must take into account the EBA's existing CRD IV remuneration guidelines, as well as the remuneration provisions of the UCITS Directive, AIFMD and MiFID. These are due to be submitted to the Commission by 26 June 2021.

Class 2 firms must then apply specific requirements to the variable remuneration of their MRTs. EU parent undertakings are required to ensure the identification of MRTs and the application of the remuneration rules on a consolidated basis, including in third countries.

Variable remuneration requirements are, in most respects, the same as those under CRD IV. Firms must assess variable remuneration in the context of the performance of the relevant individual, business unit and the firm, addressing both financial and non-financial criteria over a multi-year period to account for the business cycle of the firm. Variable remuneration should not jeopardise the firm's capital base, must generally not be guaranteed, and must not reward failure or misconduct. The calculation of the bonus pool should take into account both capital and liquidity risks to the firm and the allocation of variable remuneration must account for all current and future risks.

At least 50% of variable remuneration must be paid in instruments, rather than cash, though the IFD enables a more flexible approach to be taken to the choice of instruments than is available under CRD IV. The EBA, in consultation with ESMA, is to develop draft regulatory technical standards to specify the eligibility of certain types of instruments for the purposes of paying variable remuneration. These are due to be submitted to the Commission by 26 June 2021.

The pay-out of variable remuneration is subject to a deferral requirement of three-to-five years, paid out pro-rata across the deferral period (unlike changes made to CRD IV by CRD V, the minimum deferral period has not been increased to four years). Instruments paid out must then be retained by the recipient, though, unlike CRD IV, a minimum retention period of one year is not specified.

Whilst CRD IV's "bonus cap" is abandoned, firms must set an "appropriate" ratio between fixed and variable remuneration. This is expected to vary between different types of staff. Malus and clawback provisions covering all variable remuneration remain applicable, though these now focus on failures in individuals' conduct.

Discretionary pension benefits must be set in line with the business strategy, objectives, values and long-term interests of the firm. Upon retirement, these must be paid out in instruments and made subject to a five-year retention period. Where an employee leaves the firm before retirement, these must be held by the firm, in the form of instruments, for five years.

Remuneration committees must be established and must be gender balanced, which firms operating with fewer staff may find difficult to achieve in practice. The remuneration committee may be established at group, rather than firm, level – this is not expressly tied to the consolidation group, and so should be capable of implementation at an entity in a third country (eg a group parent). Whilst the FCA has adopted this view, the approach to be taken by EU Member States and the EBA remains to be seen.

When does the obligation apply?

These obligations will apply from 26 June 2021 (or, in the UK, when implemented in UK law by way of the upcoming Financial Services Bill and regulatory rules, the timing of which is expected to broadly mirror that of the EU, but is yet to be confirmed). In practice, these requirements will take effect based on the timing of the start of each firm's remuneration year.

Are there any derogations?

IFD Recital 22 indicates that the requirements under MiFID II Articles 9(3)(c) and 24(1), which focus on the prevention of conflicts of interest, as well as requirements relating to corporate governance, are sufficient for Class 3 firms. IFD Article 25 accordingly exempts Class 3 firms from the IFD's remuneration requirements.

Class 2 firms can apply two forms of proportionality assessments in order to disapply requirements on deferral, retention and pay-out in instruments (the **pay-out process rules**), as it is considered that these are not appropriate for small and non-complex investment firms or for staff with low levels of variable remuneration. The FCA currently permits malus and clawback to be disapplied on proportionality grounds but this discretion is not available under the IFD.

The first of these proportionality assessments relates to individual staff. The pay-out process rules can be disapplied for individuals with low variable pay of up to EUR50,000, representing up to 25% of the individual's remuneration. Competent authorities are permitted only to reduce this threshold.

The second proportionality assessment enables firms to disapply the pay-out process rules at the firm and, if applicable, the consolidated level. This requires that the value of the investment firm's on and off-balance sheet assets is, on average over the preceding four-year period, equal to or less than EUR100m. Competent authorities may reduce this threshold. Competent authorities may also increase this threshold up to EUR300m where appropriate, taking into account a particular investment firm and the characteristics of its group, if the investment firm:

(a) is not one of the three largest investment firms in its Member State by value of total assets;

(b) is not subject to recovery and resolution planning obligations under the BRRD, or is only subject to simplified recovery and resolution planning obligations under BRRD Article 4;

(c) has on- and off-balance sheet trading-book business equal to or less than EUR150m; and

(d) has on- and off-balance sheet derivative business equal to or less than EUR100m.

The EBA is also due to develop guidelines on the application of these proportionality requirements.

Remuneration committees are required for all firms other than those with an average on and off balance sheet value of less than EUR100m over the preceding four-year period. As this threshold is set by reference to the proportionality threshold discussed above, it is expected that this can also be increased to EUR300m to ensure consistency – whilst the FCA has adopted this view, it remains to be seen whether this will also be adopted by EU Member States and the EBA. Irrespective of the ability to increase the threshold, this is a significant departure from the position under CRD IV, which requires only "significant" firms to establish a remuneration committee and with the meaning of "significant" still subject to the discretion of competent authorities.

Expected impact

The IFD's remuneration requirements are likely to have the greatest impact upon those Class 2 firms that cannot meet the reduced proportionality thresholds, as these firms will no longer be able to disapply the pay-out process rules. The inability for any Class 2 firms to disapply malus and clawback requirements may also require changes to remuneration terms. Additionally, the impact may be significant for CAD-exempt firms (ie adviser-arrangers), as these are not currently subject to any remuneration rules, though this may be avoided where they meet the thresholds either to be classified as Class 3 firms (in which case the IFD's remuneration requirements will not apply at all) or, for Class 2 firms, to disapply the pay-out process rules on the basis of proportionality.

The proportionality thresholds are a significant departure from the existing CRD IV rules, which allow Member States a broad discretion to disapply rules where appropriate. In the UK, under the current FCA rules, proportionality is applied at the individual level to employees whose overall compensation package is less than GBP500k, provided that no more than 33% of this is variable remuneration. The UK also applies asset thresholds only to full scope MiFID firms, and, at GBP15bn and GBP50bn, these thresholds are substantially higher than those under the IFD, which apply to all MiFID firms. Combined with the expanded scope of MRTs, this means that the more onerous provisions of the IFD's remuneration regime are likely to apply to a materially broader set of employees than under the CRD IV regime.

In the UK, aspects of the new remuneration regime that appeared potentially radical will likely be implemented in a less striking way. In particular, IFD requires remuneration policies to be "gender neutral" and remuneration committees "gender balanced". However, the FCA has indicated the former adds little to the position under the Equality Act 2010, whereas it views the latter principle as requiring "firms to promote a culture of inclusion and ensure appropriate representation rather than prescribing equal representation". How EU competent authorities apply these requirements remains to be seen, especially in light of the mandated EBA guidelines on gender neutral remuneration policies.

Finally, it is expected that many more Class 2 firms will be required to establish remuneration committees, though the ability to operate these at group level (and potentially outside the consolidation group) may reduce the significance of this impact.

To summarise, firms should:

- identify changes to the existing remuneration rules that apply to them
- assess the way the changes impact the firm's existing governance and remuneration arrangements

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