ABI Association of British Insurers

Guidelines on Sound Remuneration Policy under AIFMD

The ABI's Response to ESMA's Consultation Paper

<u>Introduction</u>

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.

- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.

- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.

- Promote the benefits of insurance to the government, regulators, policy makers and the public.

The ABI's registration number on the European Commission's Register of Interest Representatives is: **730137075-36.**

Executive Summary

As providers of, and investors in, a wide range of investment products, our members provide a unique market perspective. They share the goal of ESMA that remuneration policies and practices align interests, provide sound risk management and discourage excessive risk taking.

As companies that also run asset management businesses, our members are able to draw on their experience operating remuneration policies in practice and long-standing record of stewardship over investee companies.

Therefore, the ABI and its members have sound experience overseeing a wide-range of remuneration approaches - whether at investee companies, operating business lines or stewarding investment funds.

We share ESMA's goals but believe that careful consideration must be given to ensure that the right balance is struck between guidelines that reflect core principles and maintaining necessary operational flexibility. We believe the best way to achieve this is by adopting a broader, principles-based approach that ensures the measures can be adapted to fit the circumstances of the firm or funds and their wider group context.

There are a number of areas that we would highlight:

- **Danger of disjointed regulatory landscape for remuneration:** Many of our members which will be covered by AIFMD are in Groups that, by virtue of their activities being subject to MiFID, comply with the remuneration provisions under CRD III. Most, if not all, will also be in-scope of the UCITS regime and the forthcoming ESMA proposals on MiFID conduct risk.

  This could give rise to significant problems. Asset management firms predominantly operate a single business model, with remuneration schemes operating on a group basis, even though staff act for a range of clients of different group entities subject to different EU financial services directives. It is critical that there is a consistent approach for asset managers across all these guidelines.

- **Ensuring proportionality:** Our members do not generally undertake trading activities on a proprietary basis, or operate investment strategies associated with high portfolio turnover or highly complex instruments. The CEBS guidelines rightly acknowledge that asset managers present less systemic risk than credit institutions and therefore allow for the principles to be applied only where appropriate and proportionate to do so.

  We favour an approach that takes account of the risk profile of the AIFM and allows for greater flexibility over the implementation of the Guidelines. In our view, national regulators are best placed to assess proportionality, since they will already be closely monitoring the risk management approach in firms they supervise. They will also be better placed to take account of the extensive variation in legal forms and incorporation structures and, importantly, in corporate governance regimes and practices.

- **Instrument-based incentives:** Although there is theoretical benefit of incentive alignment, in practice this proposal may be undermined by severe operational difficulties. This primarily flows from the fact that <u>even those operating a single business</u>

model for clients will be subject to differing EU financial services directives. For instance, portfolio managers (PM) commonly provide services to different types of funds – AIFs, UCITS and other segregated accounts. This may result in:

- a potential "splintering" of remuneration schemes, as different segments of a PM's work will be subject to different remuneration regulation;
- personal conflicts of interest: as some PMs might have a bias towards those funds where they are paid in instruments, to the detriment of those where they are not, or a bias towards instruments with better growth characteristics over those with more prudent investment policies; or
- commercial conflicts of interest: in the light of the deferral and retention requirements, there could also be potential commercial conflicts between asset management businesses, if PMs remained substantially interested in the performance of competitor AIFs and AIFMs.

- **Deferral and retention of remuneration:** We are concerned that applying the full deferral and retention requirements to long-term share schemes (that already have three years or more performance testing) will be unduly onerous and lead to a re-weighting of variable awards more, if not exclusively, to annual bonuses. We believe this could represent a damaging shift towards shorter-term appraisal. Therefore, we believe that extended performance periods should be treated as part of, or at least contributing to, the deferral requirement.
- **Leavers:** We are concerned over a lack of guidance on the treatment of deferred shares or units for, in particular, good leavers (bad leavers will normally forfeit their unvested entitlement). It appears that AIFMs will not be permitted to accelerate vesting where a staff member leaves during the deferral and retention period. Hypothetically, a full vesting of all outstanding shares or units may not occur for 12 years beyond the leaving date. This may create tremendous complexity for AIFMs that will be subject to unwinding both commercial conflicts and remuneration valuations for candidates across potentially numerous AIFs and AIFMs. Furthermore, it may meet considerable resistance from employees if a substantial element of their wealth is tied up for long periods in an AIF with which they have no continuing connection. There is also uncertainty about how such requirements cut across contractual change of control provisions.

  We would suggest that an appropriate degree of risk adjusted alignment and ex-post performance adjustment could be achieved by specifying a full vesting of all outstanding deferred and retained shares within a defined period after the Fund manager leaves the AIFM.

In summary, we are concerned that the current proposals do not take account of the operational realities of the asset management industry. Applying different regulatory requirements across individual segments (and individuals) of the asset management industry, will result in complex and, in some cases, unworkable, remuneration schemes within firms.

We respond in greater detail below and would be happy to discuss any matter arising with ESMA.

ANNEX

Key Themes for Consultation

1. Risk of fragmented regulatory landscape

1.1 We welcome ESMA's efforts to ensure consistency with CEBS 2010 Guidelines on remuneration practice derived from the CRD. However, we would urge ESMA to take similar account of other legislative developments affecting remuneration within asset management groups. For example:

- The CRD is itself under review at Council level, with two sets of amendments concerning remuneration under consideration;
- The Commission has published UCITS 5 Level 1 remuneration controls as part of its recent Consumer Package; and
- ESMA has itself announced consultation on a new set of MiFID remuneration guidelines.

1.2 These four pieces of legislation are at different stages of development and each takes a different approach to remuneration regulation. For example, CRD, AIFMD and UCITS apply remuneration controls under a prudential regulation framework, while ESMA proposes remuneration controls under MiFID through an investor protection framework. We would emphasise the importance of consistency and co-ordination between different pieces of legislation.

1.3 With these different components still under development, we are concerned by the implementation date suggested in the consultation paper. For instance, there is a risk that AIFMD guidelines and UCITS 5 Level 1 would have to be revisited as a result of changes or amendments to CRD. Similarly, we are yet to have the opportunity to consider whether ESMA's proposed investor protection guidelines may be better suited to the control of agency entities such as AIF and UCITS management companies and MiFID portfolio managers than the currently proposed prudential controls, which are taken from banking / balance-sheet regulation.

1.4 Consistency is fundamental due to the issues that may arise as a result of implementing different guidelines across a single business. Asset management firms predominantly operate a single business model, with remuneration schemes operating on a group basis, even though staff act for a range of clients of different group entities subject to different EU financial services directives. This means a potential "splintering" of remuneration schemes, as different segments of a PM's work will be subject to different remuneration regulation. Furthermore, different requirements will come into force at different times, potentially requiring multiple changes to remuneration arrangements over many years.

1.5 This could cause significant operational difficulties: rather than fragmented remuneration policies subject to frequent change, it is important to ensure that firms can maintain one, consistent, firm-wide remuneration policy.

2. Proportionality

2.1 The principle of proportionality is welcomed. However, it could cause problems when applied differently under different pieces of legislation affecting the same financial services organisation.

2.2 When the concept of proportionality was introduced under the CRD, CEBS recognised in their guidelines the distinction between balance-sheet entity firms and non-balance-sheet ‘agency firms’. This helped draw a line between deposit-taking and investment banks on the one hand and asset managers on the other.

2.3 Asset managers invest on behalf of their clients - whether under segregated mandates (under MiFID) or through UCITS or AIFs (under UCITS 5 and AIFMD). They do not generally undertake trading activities on a proprietary basis, or operate strategies with high portfolio turnover. Therefore, the CEBS guidelines acknowledge asset managers generally present less systemic risk than credit institutions, and allow for disapplication of certain principles for asset managers.

2.4 In contrast, AIFMD and UCITS only apply proportionality *within* the narrow parameters of their individual scopes. So, whilst under CEBS guidelines agency entities are considered in the context of the financial services industry as a whole, including, in particular, relative to systemically important balance sheet entities, under AIFMD Guidelines, AIFM companies are considered <u>only</u> relative to other AIFM companies. Larger AIFMs are therefore bound to be caught – even if they are unimportant in the wider financial services context. The effect is that many AIFMs may face remuneration requirements equivalent to or, in some cases, tougher than, systemically important banks. We do not believe that this serves the rightful purpose of a proportionality principle.

2.5 More specifically, there is concern that none of the quantitative requirements expressed in the principles can be disapplied or dialled down; for example ESMA take the view that they ‘*are the minimum which will apply to any AIFMs and the flexibility only applies as regards the percentage to be deferred above that level’*.

2.6 We question whether this serves the purpose of the wording in paragraph 1 of Annex II of the Level 1 text, which states that ‘*AIFMs shall comply with the following principles in a way and to the extent that is appropriate’.*

2.7 We would favour <u>an approach that takes account of the risk profile of the AIFM and allows for greater flexibility over the stated percentages in Annex II</u>.

2.8 In addition, <u>national regulators are best placed to assess proportionality</u> since they will already be closely monitoring the risk management approach in firms they supervise. They will also be better placed to take account of the extensive variation in legal forms and incorporation structures and, importantly, corporate governance regimes and practices.

3. Delegated investment managers

3.1 While AIFMD does not apply to delegate or investment advisors, ESMA raises the prospect of extending its scope to the staff of such entities, even though the Level 1 text is clear that payments to delegates do not fall within the scope of remuneration rules. We believe that any such extension would be inappropriate:

- non-cash remuneration may not be appropriate in all instances for service providers: they may not be permitted to be a shareholder under their corporate constitution and, in any event, the risk of conflict increases. In the USA, payment in the form of shares would not be possible under the Volcker Rule. This leads to further concerns that EU AIFM will be restricted from delegating to some non EU countries and raises questions relating to protectionism;

- an extension could serve to widen significantly the scope of AIFMD and far exceed the current requirements in place for entities currently designated Tier 4 under the FSA Remuneration Code's proportionality principle. So that the contemplated increased scope is not disproportionate in markets that regularly operate designate and advisor models, one option could be to <u>disapply the AIFMD Remuneration Rules for staff of delegate entities where the Manager itself is a lower-tier designated entity.</u>

4. Identified Staff in scope

4.1 We do not agree that staff responsible for administration, marketing and human resources will generally be able to have a material impact on the risk profile of the AIF or AIFM. We therefore do not support the designation of these staff being automatically in scope. <u>It should be left to the firm to assess whether staff responsible for administration, marketing and human resources fall under the definition of impacting the risk profile. This approach would be consistent with the CEBS guidelines.</u>

5. Carried interest

5.1 The definition of 'remuneration' in paragraph 19 is not restricted to amounts paid to individuals but appears also to include carried interest payments paid by the AIF to the AIFM for professional services rendered by the AIFM's staff. Fees paid to the AIFM out of a fund are to pay for services provided by the AIFM as such and are not remuneration to one or more individuals as contemplated in the guidelines.

5.2 In many groups, a wide range of staff will provide services to a range of firms, clients and funds within the group, so the fees paid by the fund clearly cannot be attributed to particular individuals.

5.3 Furthermore, the AIFMD text does not provide the legal basis for performance or management fees payable by the AIF to the AIFM to be brought within the scope of the AIFMD Remuneration Rules.

6. Capital soundness

6.1 We agree that it is important that regulation should seek to ensure that AIFMs, as all Fund management businesses, should be sufficiently capitalised. In turn, the AIFM's financial situation should not be adversely affected by the overall pool of variable remuneration (and this principle should be applied in any case by the owners and/or Boards of Directors).

6.2 However, some members are concerned that the cumulative effect of the guidelines will result in them having, for competitive and operational reasons, to increase fixed components of remuneration. This could result in less flexibility through the business cycle and, in some cases, lead the business to have higher fixed costs at a time when it would normally seek to lower them. Some members are concerned that this constraint may make their business model less resilient during an economic downturn and result in a pro- rather than counter-cyclical outcome.

7. Fund units

7.1 In paragraphs 16s and following, the presumption is that individuals will achieve alignment through investment in the fund(s) for which they are responsible and that this is the only proper means of providing risk-adjusted variable remuneration.

7.2 This may not always be legally possible or practicable.

- There are many examples of situations under which it will not be practicable to award variable pay in fund units i.e. Open Ended Funds closed to investments, Unlisted Closed-Ended Funds or Listed Closed-Ended Funds for which there is no liquid market. In these situations there may be a heavy reliance on the use of cash-based equivalent instruments, which creates an uncapped cost to the manager in circumstances where hedging the liability is not possible;

- It is unclear that those who have placed their capital in a fund should necessarily wish to surrender an interest over the starting capital to the fund manager;

- There is also a concern over the potential market perception of a PM selling down his or her equity interest. Particularly in the context of PMs being paid across different funds, this could lead to a degree of second guessing and confusion where, for example, a PM is contemporaneously awarded units in one AIF and crystallises a large proportion of units in another AIF and even adversely affect the public perception of certain funds.

7.3 Equally, however, business models vary and it might be entirely reasonable for a fund manager to be rewarded, wholly or partially, with allocations of ownership instruments in the fund manager.

7.4 It is not practicable to legislate for all business models and so the structure of remuneration would be best overseen by a remuneration committee with sufficient discretion to exercise judgment, with appropriate disclosure to interested parties.

7.5 We have no strong view over whether pay-outs of dividends or interest prior to vesting should be prohibited but we urge clarification that this should not prohibit the rolling up of dividends or interest, either in cash or in ownership instruments, which then are payable or released upon vesting of the original award.

8. Remuneration Committees

8.1 The application of the proportionality principle to guidance on setting up remuneration committees (paragraphs 72-74) is unclear. Although a degree of flexibility is implied by reference to the three factors of proportionality, the suggested threshold of EUR 250 million assets under management would suggest a widespread application. We would advocate a comply-or-explain approach to this requirement, giving autonomy to competent national authorities.' Particular problems are:

8.1.1 Most asset management firms operate remuneration governance at Group level and therefore the addition of a Remuneration Committee at each subsidiary may be unnecessary and disproportionate. Those in-scope AIFMs will vary extensively both in legal form and incorporation and, importantly, corporate governance regimes and practices. A clear problem exists for those organisations adopting an owner-manager partnership, where the presence of outside non-executive directors will be less common.

8.1.2 Further clarity would also be welcomed on the composition of any remuneration committee:

- Under paragraphs 75-78 it is unclear what is meant by 'supervisory function'. Does this mean an individual in a management function but independent of the subsidiary, or does it mean independent of the AIFM and or Group entirely i.e. non-executive director?

- Paragraphs 75 and 76 require that a majority of the committee should qualify as independent and one of the independent members should Chair the Committee. No reference is made to what tests should govern the designation of independence or whether this requirement will be operated on a comply-or-explain basis. Here we believe <u>a localised approach should be adopted that takes account of the respective competent authorities' corporate governance regime</u>. This will provide better alignment with local market practices.

- There is a concern that paragraph 77 places an unnecessarily prescriptive burden on the composition of the committee in respect of required risk management and control competences. The primary objective of risk-adjusted design and implementation in remuneration systems would appear to be manifestly observed via the policies and guidelines as proposed. The primary responsibilities of the Committee are to attract, retain and motivate individuals to ensure the success of the enterprise. Those appointed to a board (in a non-executive function) are first and foremost done so based on their ability to oversee and challenge in the wider context of the business and the Board, and not for the exclusive purposes of one Committee. We support the emphasis on <u>access to internal and external advice and close contact with the risk function, and consider this sufficient for the Committee properly to take account of relevant risks.</u>

9. Deferral and retention of remuneration

9.1 Traditionally, variable remuneration has comprised a balance between short term (bonuses) and longer-term (share schemes) components. We are concerned that, while the proposed guidance is designed chiefly as a means to tackle short term performance rewards, it may in fact be detrimental to the use of longer term plans.

9.2 Subject to the proportionality principle, for a long-term share scheme that operates a three year performance (or accrual) period, the Identified Staff share award would be subject to five years of deferral under a malus environment and a further retention period that, under some circumstances, is recommended to be *longer* than the deferral period. This could translate into a total period of 13 years before share awards crystallised and is viewed as unduly onerous. In particular, we believe an additional deferral period – which in effect continues to apply performance criteria – is inappropriate for longer term schemes.

9.3 It could even create a perverse incentive on the part of the AIFM to increase the amount of potential remuneration subject to one year performance testing at a cost to longer-term performance rewards (3-5 years) that provide better risk-adjusted alignment. As a result of this re-weighting, variable pay may become increasingly front-loaded, with larger amounts than the case at present, subject to shortened, rather than longer, performance horizons. Given the sequential nature of share grants (i.e. on a rolling annual basis) it would appear there is already an innate deferral mechanism that achieves the desired goal of risk-adjusted alignment.

9.4 There is also a lack of guidance on the treatment of deferred and retained shares for leaving employees. It appears that AIFMs will not be permitted to accelerate vesting where an Identified Staff member leaves during the deferral and retention period. This would appear to be unnecessarily restrictive and perhaps even in conflict with the free movement of labour, since it would generally represent a conflict of interest for a fund manager to have a significant exposure to another fund management business or fund.

9.5 Employees are likely to consider such arrangements highly undesirable given that a large component of accumulated variable pay may subsequently be subject to the performance of another Fund manager, over the performance of which they will have no input or control. It may also create a commercial conflict of interest, given that a new fund manager of one AIFM may remain significantly interested in the performance of a competitor AIFM and / or AIF. As the risk-adjustment mechanisms have ceased to apply, there would appear to be no further need for former employees to remain aligned with the AIFM or AIF. It also follows that the AIFM will face a significant and on-going liability in the administrative burden associated with paying deferred remuneration to former employees.

9.6 There is also uncertainty about how such requirements might cut across contractual change of control provisions. While there may be a requirement to alter or renegotiate contracts to reflect the deferral and retention requirements for current employees, it is unclear how the share or unit pipeline for leavers no longer under an employee contract will be treated in respect of an M&A or restructuring event.

9.7 An appropriate degree of risk adjusted alignment and ex-post performance adjustment could be achieved by specifying a full vesting of deferred and retained shares within a defined period after the Fund manager leaves the AIFM. The period could be set by reference to the nature and risk capacity of the Fund under management.

10. Discretionary pension benefits

10.1 Both fixed and variable payments are referred to as part of a pension policy and appear to be positioned under a wider discretionary benefit umbrella. Given the suggestions under paragraphs 100-104, further clarity here is essential. For instance, it is not clear whether fixed components are considered discretionary or how variable components are defined. The considerable legal and operational variance across jurisdictions relating to pensions may add a material layer of complexity to the treatment of such definitions.

10.2 Owing to this uncertainty, there is concern over the requirements proposed in paragraphs 100-104. Pension benefits are part of the fixed component of remuneration, but under the current formulation they appear to be counter-intuitively positioned as ‘at-risk’ performance based variable remuneration. The result of this may be wholly inappropriate.

10.3 In particular, it is not clear under what circumstances it would ever be appropriate to limit an individual’s pension investment universe to one instrument only. Neither is it clear why the crystallisation of the benefits should be subject to an additional five year retention period following retirement. It is important that a person has access to his retirement savings at the point of retirement. Furthermore, the legal requirement to retain personal records under pension arrangements may in some cases be far shorter than the time-span to crystallisation envisaged for discretionary pension benefits.

10.4 The requirement for non-retiring, leaving employees to have their accumulated pension locked into the existing AIF for five years and still be subject to ex-post performance assessment may also create implementation difficulties. Aside from potential commercial conflicts of interest, it may also create a degree of uncertainty over who has contributed to any hypothetical “underperformance” and when. Another question is at what level “underperformance” triggers ex-post malus or claw-back and therefore a wider principle of materiality may need consideration to avoid a proliferation of employee disputes.