Investment Management Association
ima

8 November 2010

By email to CP42@c-ebs.org

Committee of European Banking Supervisors
Tower 42, Level 18
25 Old Broad Street
London EC2N 1HQ

Dear Sirs

IMA response to Consultation Paper on Guidelines on Remuneration Policies and Practices

The Investment Management Association (IMA) welcomes the opportunity to provide comments on the proposed guidelines on remuneration policies and practices.

The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes.

They are responsible for the management of £3.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

Our members all fall within the investment firm definition at Article 20(2) of Directive 2006/49/EC. Consequently, the limited scope of their activities when compared against other institutions within scope of the revised Capital Requirements Directive (hereafter the Directive) necessitates a proportionate application of the requirements. This ability is specifically recognised within the Directive. Having said that, we fully support the high level principle that remuneration policies should promote effective risk management. Asset management firms already implement remuneration policies which embrace risk management principles; the Directive requirements when applied in a proportionate manner will enhance these existing mechanisms and should enable the objectives of the Directive to be delivered.

We support the statement that it is primarily the responsibility of firms to assess its own characteristics and implement remuneration policies which appropriately align the risks faced. This recognises that one approach will not fit all firms within the

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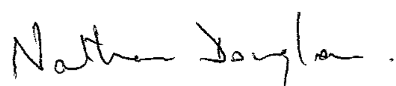
scope of the Directive; it is imperative that this is accepted by regulatory authorities when supervising against the Directive requirements. Our members, as asset management firms, are a fundamentally different proposition to some of the other firms within scope of the Directive: all asset management firms trade on an agency basis, with no risk to the balance sheet of the firm; the client assets are segregated from the assets of the firm and held by one or more independent custodians; there is a far greater certainty associated with the size of any variable remuneration pool compared to an entity which takes principal positions; and in an asset management firm, revenue and profits are based on realised value not on speculative positions. Consequently, the variance in the nature of the activities performed by an asset management firm when compared against others within scope necessitate that the Directive requirements are applied in a manner which appropriately reflects the risks within the remuneration structures in operation in an asset management firm.

On this basis, we broadly welcome the proposals within the guidance whereby firms can neutralise certain provisions within the Directive, and may then apply the remaining obligations in a proportionate manner, both at the level of the firm and for any staff which are identified as being subject to the specific requirements of the Directive. We also support the assertion that an holistic approach should be taken in view of the size and legal organisation of the firm, and the nature, scope and complexity of the firm's activities. No single factor should be a determinant (a small firm can be complex whereas a large firm can be simple), but it is the combination of all of these factors which should be considered by firms in their implementation of the Directive requirements.

We do however have significant reservations regarding the implementation timetable, and consider that implementation of the proposed guidelines by 1 January 2011 is overly aggressive and unrealistic. From the date of this letter, firms and supervisors have less than eight weeks in which to implement the requirements, even though the guidelines have yet to be finalised. We do not consider that this will result in appropriate implementation. Mandating firms to implement policies in such a short period may not result in the same level of effective risk management as could be achieved if firms were provided with a longer period within which to develop remuneration policies which adequately address the requirements. We note that the paper accepts that disclosures will develop over time in an evolutionary process. Given the very limited period before the Directive becomes effective, we would suggest that supervision of all aspects of the requirements – not just the disclosure – must accept that practices, policies and procedures will develop over time. We therefore request that a suitable transitional period within which compliance should be achieved is provided to firms.

We have included below comments on specific sections of the consultation paper, and would be willing to meet to discuss any of these matters in more detail.

Yours sincerely



Nathan Douglas
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IMA comments

Consultation on Guidelines on Remuneration Policies and Practices

1.1. Scope of the guidelines

The consultation states that 'It is primarily the responsibility of institutions to identify the members of staff whose professional activities have a material impact on the institution's risk profile'. We agree with this statement. Only firms themselves are able to ascertain which individuals within their employment can materially impact the firm's risk profile. Therefore we support the statement that firms can exclude individuals from the scope of the Directive where it can be 'demonstrated that they have no material impact on the institution's risk profile'. The categories of staff which firms should consider must not be implemented by supervisors as the default list of individuals which must be included within scope.

Furthermore, we support the assertion that those individuals whose remuneration is at similar levels to senior management should only be subject to the Directive requirements where they also have a material impact on the risk profile of the firm. This is consistent with the Directive text, and identifies that it is not the amount of remuneration that an individual receives but his impact on the risk of the firm which is the material determinant in who should be subject to the specific requirements.

We note the comment in the guidance that dividends that partners receive as owners of an institution are not covered by the guidance. We also agree with this statement. Partnerships are fundamentally different organisations from other company types, and it would be inappropriate to apply the requirements of the Directive to partners without appreciation of the nuances associated with the legal structure of a partnership and the bespoke nature of the payments made to partners. Thus, only remuneration paid by a partnership which cannot be considered as dividends should be subject to the Directive requirements.

1.2. Proportionality

We agree with the concept of neutralisation, and fully support the ability thereafter for firms to implement those remaining obligations in a proportionate manner, both at the level of the institution and at individual staff level. This should provide firms with an ability to implement the requirements appropriately having regard to their individual circumstances. The breadth of firm types within scope of the Directive necessitates that different implementation approaches should be available to firms based upon their activities and structure, especially where the firm in question will fall within the definition at Article 20(2) of Directive 2006/49/EC. The proposals within the guidance acknowledge this, and place the onus on firms to make an assessment of their characteristics when determining how the Directive requirements should be applied at firm and staff level. We commend CEBS for this approach, as it will allow firms to consider how their role and activities should influence the implementation of the remuneration policy.

Whilst we acknowledge that the determination of proportionality is to be made by each firm, in relation to an asset management firm, we believe that the following

characteristics support an approach that applies proportionality in its fullest expression, including as to neutralisation:

I. The defining characteristic of asset management is that it is an agency business. Asset managers do not bring their balance sheet into play in managing assets on behalf of clients; this contrasts with the risks that are carried on a balance sheet through proprietary trading. There are immediate consequences of this:

(a) First, the nature of the robust governance framework is fundamentally different from that of a credit institution since any particular investment activity does not directly impact the firm's own risk profile;

(b) Secondly, and in particular having regard to wider systemic concerns, the agency nature of this business model also means that the asset management firm is not in a creditor/debtor relationship with its clients in relation to the investment services. Systemic disruptions caused by runs on banks are historically well-documented; due to the agency nature of asset management and other aspects touched on below, the possibility of a "run" on an asset manager causing systemic instability is both hard to imagine and in any event remote; and

(c) Thirdly, building upon the points above, the asset manager is replaceable under the mandates at the election of the client. The business model therefore provides on the failure of an asset manager for a strong likelihood of continuity in the investment arrangements of any client; again rather than demanding a liquidation or other controlled wind down as with a credit institution.

II. The nature and extent of risks that an individual portfolio manager at an asset management firm may take with any particular client's assets are invariably addressed and constrained by agreed investment objectives and guidelines. These may detail asset allocations and benchmarks and may also prohibit or restrict certain investments or markets from being accessed; and in many cases these mandates will not have been set with the participation of the manager. Existing regulatory and contractual obligations already ensure that firms maintain systems and controls to prevent and detect non-compliance with the investment mandates. Taken with the custodial arrangements mentioned below, these provide a strong control over excessive risk-taking.

III. The nature of the asset management model is such that clients’ assets are commonly held under independent custodial arrangements. These give rise to at least two key considerations:

a. the failure of an asset manager does not place the clients’ assets at risk and therefore a fear of possible failure of an asset manager will not of itself transmit shocks through the financial system (in contrast to the fear of a bank failure); and

b. the custodian's duty to the underlying client operates as an independent control in relation to some legal and operational failures (which failures can be a source of risk at an asset manager).

IV. The reference point against which the size of the bonus pool for variable remuneration is assessed is a highly certain figure with asset managers; and much more so than experience shows has been the case with trading entities such as investment banks. Where the variable remuneration paid by an asset manager is based upon performance, then the type of performance that is measured reflects real value that has been captured for the clients. It is not, as in some business models, mere turnover or the totality of sales where the ultimate profitability is yet to be determined.

V. The key risks at asset managers often rest in the legal and operational areas of the business. These areas more than others can introduce significant uncontrolled impacts to the balance sheet of the asset manager. An example may be a derivative overlay for a client that has been put on the wrong way round. Nevertheless the impact that any particular remuneration structure can have upon the behaviour of key staff in these areas is much lower than it may be for those who are heads of proprietary trading activities at banks.

The assessment of how these characteristics apply to the asset management firm in question will assist that firm in determining how the detailed provisions of the guidance and the Directive can be applied in a proportionate manner.

Although we agree with the concept of neutralisation, we do not agree with the proposal in Annex 2 that the requirement relating to the kind of instrument in which variable remuneration is paid can be neutralised only where the institution is non-complex, not publicly traded and has no alternatives for equity-based variable remuneration available. The fact that an institution is publicly traded should not be a sole determinant in the assessment of how this requirement is applied proportionately. The consultation paper highlights the need for consideration of various factors holistically, and does not mandate that a single determinant should unduly influence the assessment of how to apply the requirements. We therefore fail to see justification for the proposal here, and would suggest that neutralisation of this requirement is available to non-complex institutions, as per the proposal in line (q) of Annex 2.

1.3. Group context

We consider that the purpose of group application should be to ensure that remuneration is not paid through companies so as to avoid the requirements of the Directive. In order to achieve this objective, we consider that firms should ensure group wide remuneration policies are in place which adhere to the general principle contained within the Directive of having remuneration policies which promote effective risk management. This would then be consistent with a proportionate application of the requirement as permitted by the Directive.

When applying the high level principle at group level, firms should have regard to the group in both a positive and negative context. The positive basis would necessitate that the nature, scale and complexity of the subsidiary or parent is considered when

determining how to apply the high level principle. The negative basis would necessitate that no structure could be employed so as to avoid this high level principle. To this extent, we generally agree with the comments in paragraph 28 of the consultation. However, group application should not result in specific obligations being imposed on subsidiaries or parent companies which are inconsistent with those in place in the local jurisdiction or that result in double standards being applied to individual firms.

Finally, where an individual is employed by an offshore entity but performs activities for a firm subject to the Directive and is subsequently remunerated for this activity, it should only be this aspect of the individual's remuneration which is aligned with the specific obligations within the Directive. Requiring firms and groups to operate remuneration policies which promote effective risk management will be sufficient to achieve the objectives of the Directive without imposing additional requirements on the pay structure of an individual which relates to activities outside the scope of the Directive.

2. Governance of remuneration

The governance of remuneration policies will be crucial to the successful delivery of effective risk management. The guidelines however need to reflect the scope of firm types which are subject to the requirements of the Directive. Not all firms within scope are required to have non-executive directors, and for some smaller or less complex firms, the management body and supervisory function could be one and the same. We therefore request that the guidance specifically recognises that the governance which is implemented by the firm should pay due regard to the legal structure of the firm, and should be applied in a proportionate manner having regard to the size and internal organisation of the firm and the nature, scale and complexity of the firm's activities.

2.3. Control functions

Control functions can provide a valid contribution to the design, oversight and review of the remuneration policy, but it is imperative that their independence is not compromised at any point in time, allowing them to effectively perform their role within the organisation. Involvement in the actual determination of individual awards may however jeopardise the independence of the control functions by providing these functions with a direct ability to influence the business decisions of those areas of which they are supposed to be independent. We therefore consider that, for most individual members of staff, the decision on actual remuneration should be the responsibility of senior management with appropriate input from Human Resources.

3.1. The basic principle of risk alignment

Having a remuneration policy aligned with prudent risk taking is a generalisation that is accepted by firms, with this concept already prevalent within asset management firms. The consultation paper identifies one example of how this can be achieved, but importantly accepts that alternative approaches exist for connecting risk management elements to a remuneration policy. We agree that other approaches

should be permitted to exist, thereby not mandating supervisors to impose rigid risk alignment mechanisms upon all firms.

Taking an asset management firm, variable remuneration may be based upon revenue rather than profit. Income received by an asset management firm reflects real value that has been added to the business, and no income is based upon speculative positions. It is therefore entirely appropriate for an asset management firm to pay variable remuneration based upon income rather than profits. We welcome the comment by CEBS that alternative approaches to risk alignment may exist and fully support a supervisory approach which implements this ability.

We would also highlight how remuneration affects capital levels for an investment firm referred to in Article 20(2) of Directive 2006/49/EC. For such firms, capital requirements are determined by reference to the fixed expenditure of the firm. Where a firm has to increase the fixed proportion of an individual's remuneration, this will directly result in an increase in the capital requirements imposed upon the firm. We accept that the payment of variable remuneration should not result in an undue deterioration of the capital position of the firm, but the guidance must reflect that imposing higher fixed remuneration requirements on Article 20(2) investment firms can similarly have the same impact. Therefore, the payment of remuneration – whether fixed or variable – should be made having regard to the capital position of the firm and all relevant stakeholders.

3.1.2. Discretionary pension benefits

In relation to discretionary pension benefits, we request that clarification is provided on the intended scope of benefits subject to the Directive. A pension will normally consist of either a defined benefit or a defined contribution, both of which should be considered similar to fixed remuneration by virtue of the contractual entitlement of the individual to the pension benefit. Consequently, neither type of pension should fall within the scope of the Directive and the guidance should explicitly exclude them. Discretionary pension benefits should therefore only comprise those elements other than any pension payable on either a defined benefit or a defined contribution basis. We understand from the public hearing on 29 October that this is the intention, but we would welcome additional guidance which provides the necessary clarity.

3.2.1. Guaranteed variable remuneration

We note the comment in paragraph 12 that 'A "retention bonus" … can only be allowed to the extent that risk alignment requirements are properly applied.' We agree with this. Firms must be able to offer retention bonuses to allow them to retain staff, provided the award is subject to suitable controls and governance.

If firms are unable to do so, individual employees could be encouraged to change employers on a regular basis and thereby benefit from any guaranteed variable remuneration which is payable within the first year of employment. Any such frequent movement of staff would likely generate instability for the firm and would be counter to the overriding obligation to promote effective risk management through remuneration structures. We therefore consider that firms must be able to offer retention bonuses where subject to suitable governance and controls, and

request that the guidance specifically recognises payment of this variable remuneration as permissible.

3.2.3. Personal hedging

We understand and agree with the rationale for the requirement for staff not to use personal hedging strategies or insurance to undermine the risk alignments embedded in the remuneration arrangements. We do not though consider that a firm can ensure that all staff comply with these requirements.

Although a firm will be able to take steps to mitigate the possibility of a member of staff using personal hedging strategies or insurance and can take action against any member of staff found to contravene this obligation, the firm will not be able to *ensure* that all staff comply with this requirement at all times. We therefore request that the guidance is amended to stipulate that firms should take reasonable steps to require staff to comply with the requirement not to use personal hedging strategies or insurance.

4.1. Fixed versus variable remuneration

We accept that firms should implement a remuneration policy which requires an appropriate balance between fixed and variable remuneration. We support the proposal within the guidance that the appropriate balance may vary across staff, according to market conditions and the specific context in which the firm operates. This flexibility should not therefore result in any expectation by supervisors that every firm, or even similar firms, should implement similar balances between fixed and variable remuneration.

4.2. Risk alignment of variable remuneration

We agree that variable remuneration should be risk adjusted. However, we request that the guidance reflects the nature of firms to whom the Directive is applied. Within an asset management firm, variable remuneration can be paid where it is based on realised value that has been delivered; there is no part of a variable remuneration bonus pool within these firms that has yet to crystallise, and no award is based on speculative positions. This provides certainty in the award process, and should not therefore necessitate that a performance adjustment is made in future to variable remuneration that has been paid on the basis of realised worth. The guidance should therefore identify that the risk adjustment should be proportionate to the nature, scale and complexity of the business activities of the firm.

5. Disclosure

We support the need for proportionality to be applied to the disclosure of remuneration policies and practices. We would request however that the factors which determine the disclosure should not be the size or complexity of the firm, but – and consistent with all other aspects of the Directive – the size and internal organisation of the firm, and the nature, scale and complexity of the firm’s activities.

Further, all these factors should be considered holistically rather than placing emphasis on any one item when the firm determines how the disclosure obligations should be complied with in accordance with the existing Pillar 3 framework.