Response to EBA consultation on the Draft Regulatory Technical Standards on the classes of instruments and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration

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About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the opportunity to engage with the EBA in relation to the Draft Regulatory Technical Standards (RTS) on classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration.

We have a general comment on the timing on the introduction of the remuneration requirements of the Investment Firms Directive (IFD). Section 2 of the RTS states: *"It is assumed that institutions will have to comply with the RTS with regard to the remuneration awarded for the performance year 2021."* Our view is that the IFD remuneration provisions should apply to a firm's first full performance year commencing on or after 26 June 2021. We believe any earlier application would result in most firms either subjecting their staff to new remuneration terms mid-way through a performance year, which brings material administrative complexity as well as employment law risks resulting from making potentially material changes to the remuneration structure of staff part-way through a performance year; or in order to limit the employment law risks needing to apply the IFD remuneration rules from the start of their 2021 performance year (before the IFD applies on 26 June 2021). The latter approach is particularly unworkable as it would involve firms making amendments to their remuneration policies and practices before all the details of the IFD remuneration provisions are finalised (by way of example, this RTS is not expected to be published in the OJEU until June/July 2021 at the earliest). We therefore believe it is appropriate for firms to be permitted to continue to operate their existing remuneration policies (based on whichever relevant regulatory regime the firm is currently subject) for the remainder of the performance year during which the introduction of the IFD falls, and to then implement a remuneration policy that is compliant with the remuneration requirements of the IFD from the start of the next performance year.

We are concerned that the approach that dividends or interest must not be paid on deferred remuneration in the form of instruments (recital 10), both for the purposes of this RTS but also in relation to the awarding of deferred remuneration in the form of instruments more generally, would create a potentially significant misalignment of interest with shareholders, investors or other

stakeholders. We have set out a preferable approach which we believe fully meets the policy purpose.

Additionally, it is our understanding that the EBA intends for the provisions in relation to "alternative instruments" under Article 6 to be flexible, to reflect the very broad range in the nature of investment firms, their legal structure and the types of instruments they are able to issue. However, we have noted that a number of the provisions of Article 6 are drafted relatively prescriptively, and seem to presuppose a relatively specific nature of the instrument. We therefore suggest that Article 6 is amended, to focus purposively on instruments that achieve the objective of alignment with relevant stakeholders, such as shareholders or clients, but with the more prescriptive requirements removed.

1. Background and context

The IA welcomes the development of a prudential regulation regime which reflects the requirements of firms outside the banking sector and is committed to working with regulators and the industry to support robust development, interpretation and application of the IFR requirements.

In order to support members with the introduction of the regime, the IA set up two working groups: one to review the overall requirements of IFR/IFD and another comprising senior remuneration specialists to look specifically at the remuneration provisions. Both working groups reflect the IA's membership in terms of a mix of firm size, business model, ownership structure and of existing regulatory regime (CRDIII v CRDIV) with most owning regulated entities across the EU-27 countries.

During 2019/20 the IA's working groups reviewed each of the Articles in the IFR/IFD Regulation and Directive in detail to assess the impact of the legislation, the requirements of the Level 2 text and potential proposals. The IA then used this analysis as the basis for engagement with the EBA (in November 2019) and with the FCA during late 2019 and early 2020.

The IA's remuneration group has considered this draft RTS in detail and, despite broad support for its contents, we have some outstanding concerns around the drafting which we have set out below.

2. Detailed comments and drafting suggestions

Our comments in relation to the specific questions in the consultation document are as follows:

Question 1: Are the provisions within Articles 1-5 sufficiently clear?

The RTS indicates that dividends or interest must not be paid on deferred remuneration in the form of instruments (recital 10). We are concerned that this approach, both for the purposes of this RTS but also in relation to the awarding of deferred remuneration in the form of instruments more generally, would create a potentially significant misalignment of interest with shareholders, investors or other stakeholders. Moreover, in our view there is a preferable approach, to which we refer below, which we believe fully meets the policy purpose.

The policy purpose in disallowing *receipt of* interest or dividends is to ensure that the full amount of variable remuneration represented by deferred instruments remains deferred for the duration of the applicable deferral period (and so as to avoid portions of that value represented by interest and dividends being distributed at an earlier date, thereby weakening the deferral and risk alignment intention of the IFD). However, this purpose would be fully met by an expectation that, whilst interest and dividends could accrue on deferred instruments, those amounts of interest or dividends should not be *distributed to* the individual staff member prior to the end of the deferral period

applicable to the deferred instruments (indeed, this approach, of allowing dividends to accrue but not be paid out until the end of the deferral period is a very common approach in, for example, listed company executive remuneration arrangements). This would achieve full alignment with shareholders, investors or other stakeholders as to the value of the deferred remuneration over time, whilst still ensuring the full value of the deferred instruments (including the full value of accrued but non-distributed dividends or interest) remain subject to deferral over the required periods. In particular, the value of the accrued dividends or interest could therefore remain subject to risk-adjustment through the operation of malus or clawback prior to the end of the deferral period.

In our view it is also not correct to say that staff members receive additional value by reason of dividends or interest accruing on deferred instruments. In our view this mischaracterises the nature of the interest or dividends that accrues, which does not accrue in the nature of remuneration, and further the value of the instrument as at the date the deferred remuneration is awarded will already have taken into account the nature of the instrument, including the impact on value of the right to (or the lack of a right to) receive dividends or interest. Consequently, the fact the dividends or interest would accrue on deferred instruments would be fully factored into the fair value of those instruments at the date the deferred remuneration is awarded.

We acknowledge that the EBA's Guidelines on the CRD IV remuneration requirements includes this prohibition. However, in our view, the rationale referred to above is equally applicable to the CRD V regime, and such that the preferable approach is for the EBA to amend its position in this regard under CRD V, rather than simply replicate that position in respect of the IFD.

Question 2: Is it appropriate to continue to require the same conditions for the use of AT1, Tier 2 and Other Instruments as under the current legislative framework?

No comments

Question 3: Are the provisions in article 6 appropriate and sufficiently clear?

Point (e) of Article 6

We welcome guidance on appropriate deferral periods to ensure consistency of application across the investment management industry as well as with UCITS and AIFMD requirements.

Article 6 states that the retention period shall be "at least six months". We agree that six months is an appropriate length and is proportionate from an administrative point of view.

However, it would be helpful to have some clarity on the scenarios when a longer period would be expected to be used and how long would be likely to be considered appropriate in these circumstances. We would favour an approach whereby firms could determine their own longer retention period based on their individual circumstances, risk horizon and the way in which their compensation is calculated. The guidance should recognise that for some firms, additional retention periods are disproportionate as they effectively apply the same approach twice.

Point (e) of Article 6

The text of point (f) of Article 6 refers to point (i), but this appears to be a mistake as there is no point (i) of Article 6.

Point (f) of Article 6

Please see our comment on the payment of interest (or dividends) on deferred instruments above.

Point (g) of Article 6

Our understanding, including from the EBA's public hearing, is that the EBA intends for the provisions in relation to "alternative instruments" under Article 6 to be flexible, to reflect the very broad range in the nature of investment firms, their legal structure and the types of instruments they are able to issue, and given that the need to use "alternative instruments" is likely to arise in relation to firms who have less common structures or circumstances (such that flexibility in structuring alternative instruments may be needed).

However, a number of the provisions of Article 6 are drafted relatively prescriptively, and seem to presuppose a relatively specific nature of the instrument (such as the requirements specifying how the instrument must be subject to deferral and retention, and also under point (g)(v) which – for instruments that track the credit quality of the institution – seems to provide a very specific structure for the instruments). We therefore suggest that Article 6 is amended, to focus purposively on instruments that achieve the objective of alignment with relevant stakeholders, such as shareholders or clients, but with the more prescriptive requirements removed. We also feel it is not necessary for Article 6 to reference the operation of deferral and retention, as this is a matter covered by the IFD itself, and these references within this RTS would seem to risk further restricting the degree of flexibility that is intended to be afforded by the concept of alternative instruments.

We do not feel there is any risk in terms of levels of compliance in this approach, given that the use of alternative instruments is in any event subject to approval of competent authorities under IFD Article 31(1)(k).

Question 4: Do respondents agree with the findings of the impact assessment?

No comments

3. Further information

We would like to thank the EBA for this opportunity to provide feedback on the draft RTS and hope our comments will positively contribute to the objective of an effective and proportionate prudential framework for investment firms.

If you would like to discuss anything in this response please contact kate.lemarechal@theia.org