CLIFFORD CHANCE

Briefing note 13 April 2016

PRA Guidance on Solvency II Remuneration Requirements

All insurance and re-insurance firms within the scope of the Solvency II Directive are bound by the remuneration requirements in the Solvency II Regulation (the "Regulation"). The remuneration requirements are set out in Article 275 of the Regulation and cover the requirement to have a remuneration policy that, among other matters, promotes sound and effective risk management. Article 275 sets out a number of broad principles, including as to the balance between fixed and variable remuneration, the measurement of performance and deferral of a substantial part of variable remuneration.

The PRA has published a draft supervisory statement (SS) clarifying its expectations of how Solvency II firms should comply with the requirements under the Regulation that relate to remuneration requirements on: (i) identifying Solvency II staff to whom the remuneration principles should be applied; (ii) deferral of variable remuneration; and (iii) performance measurement.

A link to the SS is attached at Solvency II: Remuneration Requirements - CP13/16

Which firms are required to comply with the supervisory statement?

As noted above, the Regulations apply to all in scope firms. However, the Regulation also provides for the application of the proportionality principle, so that the *'internal organisation of the insurance or reinsurance undertaking, and the nature, scale and complexity of the risks inherent in its business*' can be taken into account when designing the remuneration policy of a firm. In the SS, the PRA has indicated that in its view it is proportionate to require only PRA Category 1 and 2 firms to comply with the specific expectations set out in the SS. Thus, while the draft SS may be of most direct interest to Category 1 and 2 firms, other firms may should also consider the extent to which the provisions of the draft SS should shape their own remuneration policy in line with the requirements of the Regulation.

Application across a group

The PRA expects all entities within the Solvency II group to have a consistent, but not necessarily identical, remuneration policy. It is recognised that many insurance groups contain banking and asset management entities which are subject to other regulatory regimes such as the Capital Requirements Directive (CRD IV), Alternative Investment Fund Managers Directive (AIFMD) and Undertakings for Collective Investment in Transferable Securities Directive (UCITS V), and thus different remuneration requirements may need to be applied within the group.

The PRA expects non-EEA entities of UK Solvency II group firms, as well as UK branches of non-EEA insurers and reinsurers, to take account of the expectations set out in the SS.

Who are Solvency II staff?

The Regulation requires Solvency II firms to apply specific arrangements to 'the administrative, management or supervisory body, persons who effectively run the undertaking or have other key functions and other categories of staff whose professional activities have a material impact on the undertaking's risk profile'('Solvency II staff'). The PRA states in the draft SS that it expects the following to be identified as Solvency II staff:

- Board members;

- Executive Committee members;
- Senior Insurance Manager Function (SIMF) holders and Significant Influence Functions (SIF);
- Key Function (KF) Holders;
- Material risk takers (MRTs)

Broadly speaking individuals who fall within the first 4 bullet points above are likely to have been identified on the firm's governance map which was put in place for the January 2016 deadline. The bigger job for firms therefore may be in identifying other MRTs. The SS gives a degree of guidance in this regard, noting the need to identify those who are able to take material risks and those who are able to influence material risk taking.

The PRA expects firms to engage with their supervisors prior to finalising their approach for identifying MRTs. A record should be kept of the assessment made and the final list of staff identified for each performance year.

Deferral of variable remuneration

The Regulation requires firms to defer a ‘substantial portion of the variable remuneration component’ for a period of not less than three years.

The PRA's view is that the ‘variable remuneration component’ is the aggregate amount awarded in a given performance year from bonus plans, LTIPs and/or any other variable remuneration plans in which the individual participates.

Although the Regulation does not specify the amount to be deferred, the draft SS provides that a minimum of 40% of variable remuneration should be deferred for a minimum of 3 years.

Firms are also expected to apply 'malus' to unvested variable remuneration during the three year deferral period to take account of risk management failures and/or financial problems brought about by the activities of the individual or firm.

Firms are expected to apply the remuneration requirements to awards made to in scope staff in relation to service/performance from 2016 performance year onwards.

Performance measurement

The draft SS gives Solvency II firms flexibility on how they determine variable remuneration at aggregate and individual level but expects them to be able to demonstrate how they have taken into account short to long term risks and the cost of capital.

Termination payments

The draft SS provides that termination payments for Solvency II staff should be fair and proportionate relative to prior performance.

Can the PRA's deferral and performance measurement expectations be disapplied on the grounds of proportionality?

For UK banking and asset management entities (subject to CRD, AIFMD and UCITS V) the deferral requirements can be disapplied if an individual has total remuneration: (i) of no more than £500,000 and (ii) of which the variable element comprises no more than 33%. The draft SS states that the PRA will take into account this proportionality threshold when considering a firm's compliance with the Regulation's deferral and performance measurement requirements.

If Solvency II staff perform activities for the firm for only part of the performance period, the draft SS considers that the quantitative threshold can be adjusted relative to the months for which services were performed.

Although not expressly stated in the draft SS that PRA has previously indicated that for individuals who perform services for non insurance and Solvency II firms the firm may consider pro-rating the pay accordingly.

Disclosure

Firms will be expected to demonstrate how their policies, practices and procedures meet the Regulation's requirements and the PRA's expectations. Category 1 and 2 Solvency II firms can do so by submitting a remuneration policy statement (‘RPS’) a template for which has been produced by the PRA. Use of the RPS template is voluntary so firms may prefer to document how their remuneration policies comply with the Solvency II requirements in a different way.

Timetable and impact on 2016 remuneration

It appears that the PRA expect the SS to apply from January 2016. But the PRA's consultation closes on 2 June 2016 and therefore it is therefore unlikely that it will finalise its position until Q3 2016 at the earliest. Clearly any element of "retrospectivity" in the

SS may create issues for firms who have already designed their remuneration for 2016 along lines that did not anticipate the content of the SS and this is something that may well be raised in response to the Consultation.

Given the PRA's emphasis on the need for consistency across the financial services sector and the need to avoid a race to the bottom it is unlikely to change its stance that 40% of variable remuneration should be deferred, other aspects of the draft SS may change however.

It is the PRA's expectation, however, that firms with an accounting reference date of 31 December 2016 should submit their RPS by 30 September 2016. For firms with an accounting reference date later than 31 December 2016, the RPS should be submitted no later than 9 months after the end of the preceding financial year.

Practical steps

To the extent that they have not already started to do so Category 1 and 2 firms should:

- Identify which staff are Solvency II staff
- Consider whether there are groups of staff for whom any of the deferral and performance measurement requirements can be disapplied on proportionality grounds;
- Consider whether any the deferral requirements can be complied with for the 2016 performance year and whether this should be raised in response to the consultation;
- Review the metrics upon which variable remuneration awards are based;
- Consider whether a deferral period of longer than three years would be appropriate in some cases;
- Assess whether the language of variable remuneration schemes is sufficiently flexible to allow malus to be applied to unvested elements;
- Audit termination pay arrangements; and Consider how they will meet the RPS requirements.

Solvency II: Remuneration Requirements - CP13/16

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