PRA Supervisory Statement on Solvency II Remuneration Requirements

All insurance and reinsurance 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 address among other matters: the balance between fixed and variable remuneration, the measurement of performance and deferral of a substantial part of variable remuneration.

The PRA has now published its final supervisory statement (SS) clarifying its expectations of how Category 1 and 2 Solvency II firms should comply with the remuneration requirements of the Regulation. This Briefing note sets out the key provisions of the SS.

Key issues

- Which firms are required to comply with the supervisory statement?
- Application across a group
- Who are Solvency II staff?
- Deferral of variable remuneration
- Performance measurement
- Termination payments
- Can any of the PRA's expectations be disapplied on the grounds of proportionality?
- Disclosure
- Timetable and impact on 2016 remuneration
- Practical steps

Which firms are required to comply with the supervisory statement?

As noted above, the Regulation applies to all in scope firms; however, it 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. Applying this principle the SS sets out guidance for PRA Category 1 and 2 firms to comply with the Regulation's remuneration requirements. The PRA expects other firms to comply 'appropriately' with the Regulation but is clear, that however small, firms cannot simply disapply it. The provisions of the SS may therefore help them 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 acknowledges that non-EEA entities of UK Solvency II group firms may have to deviate from the group's remuneration policy because of conflicting local regulatory, legal, operational or taxation requirements. In such cases firms are expected to communicate to the PRA significant deviations from the group's remuneration policy with an explanation where there are material differences between: (i) the remuneration arrangements for Solvency II staff in non EEA entities; and (ii) the remuneration arrangements for other group Solvency II staff.

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 SS provides that the following are expected to be identified as Solvency II staff:

- Board members;
- Executive Committee members;
- Senior Insurance Management Function (SIMF) holders and Significant Influence Functions (SIF) holders;
- Key Function (KF) Holders; and
- 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 SS gives a degree of guidance in identifying other MRTs, noting the need to identify those who are able to take material risks and those who are able to influence material risk taking. The SS clarifies that firms can take into account the extent of management supervision when considering whether an individual operating within committee set limits should be an MRT.

Firms can 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. For these purposes the LTIP is valued at the grant date as the maximum potential value paid out if 100% of the performance conditions are met within the deferral period commencing on grant.

The Regulation does not specify the amount to be deferred; however the SS provides that the 'substantial portion' to be deferred for the three year period is very unlikely to be less than 40% of variable remuneration.

Firms are also expected to consider whether or not 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 and to be in a position to apply it where appropriate.

Performance measurement

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

Can any of the PRA's 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 currently 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 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 SS considers that the quantitative threshold can be adjusted relative to the months for which services were performed.

Although not expressly stated in the SS the 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

Firms are expected to apply the remuneration requirements to awards made to in scope staff in relation to service/performance from the 2016 performance year onwards. The PRA implicitly acknowledges that firms may have already designed their remuneration for 2016 along lines that did not anticipate the content of the final SS; accordingly the PRA Policy Statement 22/16 states that firms that are concerned that they may not be able to meet or exceed the SS requirements for the 2016 performance year should contact their PRA supervisory contact before submitting their RPS.

Firms with an accounting reference date of 31 December 2016 should submit their RPS by **31 October 2016**. For firms with an accounting reference date later than 31 December 2016, the RPS should be submitted no later than **10** 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 if not contact their relevant PRA supervisory contact;
- 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.

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Contacts

Imogen Clark
Partner
E: imogen.clark
@cliffordchance.com

David Sims
Senior Associate
E: david.sims
@cliffordchance.com

Katherine Coates
Partner
E: katherine.coates
@cliffordchance.com

Alex Erasmus
Partner
E: alex.erasmus
@cliffordchance.com

Hilary Evenett
Partner
E: hilary.evenett
@cliffordchance.com

Ashley Prebble
Partner
E: ashley.prebble
@cliffordchance.com

Narind Singh
Partner
E: narind.singh
@cliffordchance.com

Clare Swirski
Partner
E: clare.swirski
@cliffordchance.com

Amera Dooley
Senior
Associate/PSL
E: amera.dooley