FIT Remuneration Consultants

August 2016

Executive Reward Briefing

PRA's Final Solvency II Remuneration Guidance

The PRA has now published its final Supervisory Statement on Solvency II Remuneration Requirements. The PRA views this guidance as being applicable to impacted firms for the 2016 performance year: it is intended to assist firms in interpreting the core requirements of the EU's Solvency II Directive in relation to remuneration, with that directive being directly applicable to the UK since 1 January 2016.

In April 2016, the PRA published a consultation paper with a draft Supervisory Statement of guidance on how it expected firms to apply the Solvency II Directive's remuneration requirements (see our earlier briefing Solvency II Remuneration Requirements). The final Supervisory Statement ("SS") has updated or clarified the PRA's guidance in a number of important respects.

1. Deferral

- The PRA has confirmed that whilst a 3-year deferral period is the minimum expectation, pro-rata annual vesting of deferred amounts from the end of year 1 is possible.
- The PRA's expectation remains that at least 40% of total variable remuneration should be deferred. In addition, the PRA has made it even clearer that it regards the 40% level as applying to a combination of both annual bonus and LTIPs, with LTIPs for this purpose being valued using the maximum vesting potential and with the deferral period commencing on grant. (*Note that for share based-LTIPs, we would expect this valuation to involve the at grant face-value of shares, although the PRA's SS is not so specific*). The SS says that the PRA regards this approach of aggregating all variable remuneration for the purposes of the 40% deferral requirement as "proportionate".

2. Performance measurement

- The PRA has expanded its guidance on measures being risk-adjusted. While continuing to ask firms to "strongly consider" performance measures which are risk-adjusted, the final SS also specifically endorses performance measures which involve risk factors as part of the formulaic calculation process, citing the example of Economic Profit. The SS also continues to emphasise the appropriate application of discretion as a method of risk-adjustment, suggesting that a formal risk adjusted financial measure may not be required.

3. Control Functions staff

- The SS includes additional guidance that the PRA expects the variable remuneration arrangements for Solvency II Staff within Control Functions (internal audit, risk management, compliance, actuarial) to have performance criteria which do not measure the performance of the operational units or business areas subject to these individuals' control at all.
- In our experience, this is increasingly the case for annual bonuses. To date, we have seen little move from traditional performance based LTIP awards for this population to restricted stock which the reference "total variable" implies although, in our view, it would have been more helpful for the PRA to explicitly reference LTIPs given the current level of market uncertainty.

4. Disclosure to PRA

- The PRA has confirmed its expectation that PRA Category 1 and 2 firms should make a disclosure to the PRA on the basis of its Remuneration Policy Statement ("RPS") template.
- The PRA has, however, extended the timeframe for submission of the RPS for performance year 2016. Originally, the PRA were asking for this by 30 September 2016 but this has been extended to 31 October 2016. Information disclosed under the RPS will be treated confidentially.

5. Proportionality

- The SS makes clear that the SS is the PRA's expectation for PRA Category 1 and 2 firms.
- That said, the PRA is also clear that firms outside categories 1 and 2 are still expected to comply appropriately with the main requirements of Solvency II in relation to remuneration in a proportionate way: the PRA's view is that proportionality does not mean a complete disapplication of the Solvency II remuneration requirements for smaller firms, particularly in regards to identified "Solvency II Staff". Accordingly, smaller firms will still need to consider, albeit in a proportionate way, the following for its most senior people:
  - Balance between fixed and variable remuneration
  - Balanced scorecards between group and personal performance and financial and non-financial measures
  - Deferral of a substantial proportion of variable remuneration
  - Performance measures having capacity for adjustment for risk related features in some way
  - No personal hedging of remuneration arrangements
  - Termination payments not rewarding failure
  - "Control function" senior staff (internal audit, risk management, actuarial and compliance) not having variable pay linked to the performance of businesses which they oversee
- The SS also confirms that where a firm is considering the position of identified Solvency II Staff with total remuneration of £500,000 or less and for whom variable pay is no more than 33% of total remuneration, the PRA will accept that such individuals can be looked at as a distinct category in the context of proportionality. Although these individuals are not exempt from Solvency II remuneration requirements, the SS notes that these quantitative cut-offs do provide for certain exemptions under the CRD4, AIFMD and UCITs V remuneration codes.
- From our perspective, the final SS is thus potentially less helpful for this "*de minimis*" class of employee. Although the SS is technically correct in saying that there is no provision for a de minimis exemption in the Solvency II Directive, the direction of the PRA's statement is nonetheless towards leniency for those Solvency II staff meeting this quantitative test.

6. Non-EU entities in a group

- The PRA has confirmed that where non-EU entities in a group employ Solvency II Staff, the application of the overall group's Solvency II compliant remuneration policy can be varied for such individuals where this is necessary to meet local law requirements. Such cases should be disclosed to the PRA via the RPS.

Updated GC100 guidelines

On 15 August the GC100 group (comprising a number of leading investors and the General Counsel of larger quoted companies) published an updated version of its guidance on DRR reporting.

The most significant of the changes made is potentially a clear statement that each element of pay within the directors' remuneration policy should have a stated maximum amount for the (up to 3 year) period of the directors' remuneration policy approved by shareholders. This is particularly on-point at the present time as significant numbers of companies will be planning for renewals of their directors' remuneration policy at the 2017 AGM (the first 3-year approvals were given at 2014 AGMs after the current regime was introduced).

This statement by the GC100 is perhaps unsurprising:

- The underlying legislation was already clear that maxima were required for each pay element detailed in the policy (a position which this firm and leading law firms took).
- The report published by the Government in 2015 on initial compliance with the new reporting and approvals regime for quoted companies' directors' pay flagged the absence of clear maxima (particularly on salary) as a major issue of non-compliance.

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If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111.