Client Update
PRA Consults on Remuneration Rules

LONDON
James C. Scoville
jcscoville@debevoise.com

Benjamin Lyon
blyon@debevoise.com

Edite Ligere
eligere@debevoise.com

Christopher Garrett
cgarrett@debevoise.com

INTRODUCTION

On 7 April, the Prudential Regulation Authority launched a consultation into its draft guidance on Solvency II remuneration requirements for insurers, which have been in force since 1 January 2016. In particular, the PRA seeks to set out its expectations as to key requirements under Solvency II relating to deferral of variable pay and performance measurement.

The PRA is aiming to address concerns arising from a review of remuneration policies and practices of significant insurers in 2015 and ensure the correct and consistent implementation of remuneration requirements across Solvency II firms.

Under the PRA's current proposals, senior staff could see more than 40% of their variable pay deferred for at least three years, with claw-back possible if failures later come to light. This update considers these proposals in more detail.

BACKGROUND

A PRA review of the remuneration policies and practices of significant re/insurers in 2015 revealed a need for guidance in this area. The review uncovered concerns over a lack of clarity in the identification of risk takers, as well as inconsistency between firms as to the proportions of variable remuneration to which deferrals were applied.

The PRA's expectations of firms in implementing the new remuneration requirements are set out in its draft supervisory statement, "Solvency II: Remuneration requirements", in Consultation Paper CP13/16 (the "Draft Statement") relating to Commission Delegated Regulation (EU) 2015/35 (the "Regulation").

Absolute requirements are contained in the Regulation itself, which has been directly applicable to firms since 1 January. The Regulation requires firms to adopt a written remuneration policy that "promotes sound and effective risk management" and does not "encourage risk-taking that exceeds the risk tolerance limits of the undertaking".

The Draft Statement is relevant to all UK re/insurance firms and groups within the scope of Solvency II, including the Society of Lloyd's and Lloyd's managing agents.

The Regulation remuneration requirements that the PRA focuses on in its consultation are those relating to the identification of key staff, deferral and performance measurement.

The consultation closes on 2 June, though the PRA has highlighted that its proposals may be subject to change in any event, particularly depending on the outcome of the Bank of England and Financial Services Bill currently before Parliament.

IDENTIFICATION OF KEY STAFF

Under the Regulation, the written remuneration policy of re/insurance undertakings must 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" (the "Key Staff").

The Draft Statement explains the PRA's expectations as to which individuals should be identified as Key Staff and therefore subject to the specific arrangements, which include the deferral and performance measurement provisions set out below.

A firm's Key Staff will include:

- Board members;
- Executive committee members;
- Senior Insurance Manager Function holders with PRA supervisory pre-approval and Significant Influence Functions holders with FCA supervisory pre-approval;
- Key Function ("KF") holders reported to the PRA; and

- Material risk takers (“MRTs”).

In line with European Insurance and Occupational Pension Authority guidelines, the PRA’s expectation is that individuals will be considered to be KF holders if they “perform functions of specific importance” in view of the Solvency II entity’s business and organisation. This includes, but is not limited to, those with “significant levels of responsibility for risk management, compliance, actuarial and internal functions” at regulated entity level and across material business lines.

In relation to MRTs, the PRA’s expectation is that firms identify individuals able to take material risks and able to influence material risk taking. Thresholds will not be mandated, but firms will develop their own materiality thresholds based on their specific risk profile. For example, a quantitative risk threshold may be appropriate for the firm to identify those underwriters with significant underwriting limits relative to the firm’s overall risk tolerance. A firm’s process for identifying MRTs should be discussed with the PRA before being finalised.

On the basis of these proposals, the PRA’s proposed scope for individuals who should be identified as Key Staff and who are as a result subject to specific arrangements is reasonably wide.

DEFERRAL OF VARIABLE PAY

One of the specific arrangements applicable to Key Staff under the Regulation is to “defer a substantial portion of the variable remuneration component” of total remuneration for a period of not less than three years. The principle behind deferring variable payment is to allow firms to downwardly adjust unvested variable remuneration should failings in risk management or financial problems emerge over time. Deferral is therefore intended to incentivise prudent behaviour over short-termism and excessive risk taking.

The PRA’s expectation is that the concept of the variable remuneration component will be understood as the aggregate amount awarded over a year from bonus plans, long-term incentive plans and any other relevant variable payment plans. As to what constitutes a “substantial portion” of this, the minimum threshold proposed by the PRA is 40%. This is on the basis of language in the Capital Requirements Directive and current industry practice and is designed to have a proportionate impact on re/insurers.

The PRA emphasises in its Draft Statement that firms may not elect to reduce the three year-deferral period and should consider the “natural life cycle of [their] business and associated risks” when determining the appropriate period

for their firm. In any case, for the Regulation requirements to have the desired effect, firms should ensure they are able to claw back compensation during the minimum three-year deferral period.

The PRA's expectation in this area is likely to be the most widely discussed of its proposals, but given the exception set out below and the fact that the proportion of overall pay which is accounted for by variable pay is lower in the insurance sector than the banking and asset management industries, the impact of the deferral rules may not be as severe as headlines suggest.

PERFORMANCE MEASUREMENT

The Regulation also sets out requirements as to the calculation of variable remuneration to be awarded to Key Staff. Their performance should be assessed on the basis of:

- financial and non-financial criteria;
- the performance of the individual;
- the performance of the business unit; and
- the overall results of the group or undertaking.

Under the Draft Statement, the PRA intends to allow a degree of flexibility in relation to the Regulation requirement that Key Staff are subject to a "downwards adjustment" for exposure to risks, taking into account the firm's risk profile and the cost of capital. Firms must therefore be able to show how short- and long-term risks and the cost of capital have been taken into account when calculating variable pay for individuals and on aggregate. The proposed advice from the PRA is that risk-adjusted metrics be included in performance criteria.

When assessing the performance of an individual, the PRA's proposed expectation is that a balanced scorecard of financial and non-financial criteria will be used, in line with current banking industry practice. One non-financial factor included should be the extent to which the individual has managed risk effectively and complied with regulatory requirements.

In line with the Regulation requirement that termination payments should be designed not to "reward failure", the PRA expects that termination payments to Key Staff should be "fair and proportionate relative to prior performance".

PROPORTIONALITY AND SCOPE

The Regulation provides for a proportionate approach to be taken by re/insurers when implementing remuneration policies. Accordingly, the expectations in the PRA's Draft Statement are limited to Category 1 and 2 firms.[1] However, smaller firms are still expected to "give proper consideration" to the Regulation requirements when designing remuneration policies.

Additionally, and in line with remuneration requirements for banks and asset management entities, firms can disapply the deferral requirements in respect of Key Staff with a total remuneration of no more than £500,000, of which no more than 33% is variable remuneration.

M&A CONSIDERATIONS

For entities purchasing a UK re/insurer, the Draft Statement serves as a useful reminder that the target's compliance with the Regulation remuneration requirements should be checked as part of the due diligence exercise.

Further, following the PRA's group supervision rules, the remuneration policy should be applied consistently across all entities in a Solvency II group that contains a UK Solvency II re/insurer. While this does not mean that an identical remuneration policy must be in place across all entities in such a group, according to the Draft Statement there should be no "significant deviations between what applies to the Solvency II firms and other entities in the group".

Therefore, any non-EEA entity purchasing a UK Solvency II re/insurer would need to consider how the Solvency II group will implement remuneration policies to comply with the Regulation and the Draft Statement. Equally, any UK Solvency II re/insurer purchasing a non-EEA entity would need to consider how the target will implement compliant remuneration policies.

CONCLUSION

Re/insurance firms should already have implemented the remuneration requirements in the Regulation, but may wish to consider reviewing their remuneration policies to ensure they are in line with the PRA's proposed approach. Note, however, that the proposals are not finalised, and any

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[1] *i.e.* significant, or the most significant insurers, whose size, interconnectedness, complexity and business type give them the capacity to cause some or very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

supervisory statement eventually published may need to be adjusted depending on the passing of the Bank of England and Financial Services Bill.

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Please do not hesitate to contact us with any questions.