McLagan Alert

Regulatory Update: Solvency II – Remuneration Requirements

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This alert summarises the Supervisory Statement (SS) on Solvency II remuneration requirements, released today by the Prudential Regulation Authority (PRA), and what it means for insurance firms in the UK.

In a nutshell

- This SS is relevant to all UK insurance and reinsurance firms and groups within the scope of Solvency ('Solvency II firms'). It provides guidance for significant (PRA Category 1 and 2) Solvency II firms in complying with the requirements in Article 275. This limits direct applicability to about 80 large firms out of the 1340 insurers registered with the PRA in the UK.

  Category 1 : c. 25 firms
  Category 2 : c. 54 firms
  Category 3–5: c. 1,257 firms
  Note: These are approximate numbers.(Source: The Prudential Regulation Authority's approach to insurance supervision | June 2014)

- As the Senior Insurance Managers Regime (SIMR) applies to senior decision makers and those who manage the firm or who are responsible for key functions, it is important for these individuals to be identified as Solvency II staff. Identification should include SIMF, SIF and KFH identified at a group or entity level.

- Those with significant levels of responsibility in risk management, compliance, actuarial and internal audit functions (not just the heads at group level) should be identified as Solvency II staff. Firms should also go beyond and evaluate functions such as investment, IT or claims function.

- A minimum of 40% represents a 'substantial portion' of variable remuneration to be deferred for a minimum of 3 years. Variable remuneration is the aggregate of bonus and LTIPs. These principles will only be applicable to LTIP/Bonus that is granted/awarded in 2017 (for 2016 performance).

- PRA will expect firms to be able to apply malus where appropriate during the 3 year period. Whether reductions should be made to the unvested variable remuneration of Solvency II staff or other forms of performance adjustment applied should be considered on a case-by-case basis.

How you can respond

For direct consultation on further implications, please contact us.

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- Deferral can be dis-applied if an individual has total remuneration of no more than £500,000 and with variable remuneration awarded of no more than 33% of their total remuneration.

- Individual performance assessment for bonus or LTIP awards should be assessed based on a balanced scorecard approach with financial and non-financial criteria.

- Firms should provide for a downwards adjustment for exposure to current and future risks, taking into account the undertaking's risk profile and the cost of capital. Firms should strongly consider risk-adjusted metrics (eg. economic profits etc.)

What has changed?

The PRA has made minor modifications to its stance taken in the consultation paper released in April earlier this year.

International Entities

They accept that if staff identified in accordance with Article 275(1)(c) ('Solvency II staff') are employed by non-European Economic Area (EEA) entities. It may be necessary to deviate from the group remuneration policy for these employees.

Where the PRA is the group supervisor, the PRA expects non-EEA entities in the group to comply with the Solvency II Regulation. The PRA accepts however that, in groups with non-EEA entities, application of the 'specific arrangements' may require modifications to the remuneration policy to accommodate jurisdictional restrictions, which may mean the PRA's expectations are unable to be met.

Malus

The statement specifically refers to the importance of malus in incentive plans. However, it has allowed a degree of flexibility in the application of it. Whether reductions should be made to the unvested variable remuneration of Solvency II staff or other forms of performance adjustment applied is at the employer's discretion and should be considered on a case-by-case basis.

LTIP

The LTIP should be valued at the grant date as the maximum potential value that could be paid out if 100% of the performance conditions are met with the deferral period commencing on grant.

What are the key features?

This SS is relevant to all UK insurance and reinsurance firms and groups within the scope of Solvency ('Solvency II firms'). It provides guidance for significant (PRA Category 1 and 2) Solvency II firms in complying with the requirements in Article 275. It may also be used as a guide for smaller firms when reviewing their remuneration policies and practices against the Solvency II Regulation requirements.

Compliance with regulations

Application across UK headquartered Solvency II groups
The EIOPA Guidelines require that a consistent remuneration policy for the whole group should be implemented and that the 'policy should be applied to all relevant persons at group and individual entity level'. However, If staff identified in accordance with Article 275(1)(c) ('Solvency II staff') are employed by non-European Economic Area (EEA) entities. It may be necessary to deviate from the group remuneration policy for these employees.

Application to non-Solvency II entities

The PRA recognises that many insurance groups contain banking and asset management entities which are subject to other regulatory regimes such as the Capital Requirements Directive (CRD), 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. However there will still need to be a high degree of consistency across individual firm policies to enable the remuneration policy to be controlled at group level as required.

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Solvency II Staff

PRA expects the following individuals to be identified as being subject to Article 275(2) ('Solvency II staff') board members;

- Executive Committee members;
- Senior Insurance Management Function (SIMF) holders with PRA supervisory pre-approval and Significant Influence Functions (SIF) holders with Financial Conduct Authority (FCA) supervisory pre-approval;
- Key Function Holders (KFH) reported to the PRA; and
- Material risk takers (MRTs).

As the Senior Insurance Managers Regime (SIMR) applies to senior decision makers and those who manage the firm or who are responsible for key functions, it is important for these individuals to be identified as Solvency II staff. Identification should include SIMF, SIF and KFH identified at a regulated entity level as well as at the higher group level.

The PRA expects those with significant levels of responsibility for risk management, compliance, actuarial and internal audit functions (i.e. not only heads of function at group level) to be identified as Solvency II staff at regulated entity level. The PRA has been clear that key functions should not necessarily be restricted to these four areas with firms expected to consider whether there are any additional key functions such as the investment function, IT function or a claims management function.

PRA does not intend to mandate the specific arrangements and processes that firms should put in place. Rather it is the responsibility of firms to develop consistent materiality thresholds across their identification process. Based on the risk profile specific to the firm, to meet the PRA's expectations, firms should seek to identify staff members able to take material risks. Firms can engage with their supervisors prior to finalising their approach for identifying MRTs.

Deferral

Where remuneration contains a variable component, Article 275(2)(c) of the Solvency II Regulation requires firms to defer a ‘substantial portion of the variable remuneration component’ for a period of not less than three years for Solvency II staff.

The ‘variable remuneration component’ should be read as 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 should be valued at the grant date as the maximum potential value that could be paid out if 100% of the performance conditions are met with the deferral period commencing on grant.

The PRA states that a deferral threshold of 40% or more is likely to be proportionate. PRA will expect firms to consider whether or not to apply malus during the three year deferral period and to be able to apply it where appropriate. Whether reductions should be made to the unvested variable remuneration of Solvency II staff or other forms of performance adjustment applied (eg. reducing current year awards) should be considered on a case-by-case basis.

Performance Management

Performance should also be assessed based on financial and non-financial criteria. Incentive plans should incorporate non-financial criteria, particularly at the individual assessment level.

The PRA recognises that, given that the risks faced by Solvency II firms will vary subject to the business models and operational approaches to risk mitigation within the firm, it is appropriate to allow for a degree of flexibility. The PRA will expect firms to be able to demonstrate how they have taken into account the risks they face in the short to long term and the cost of capital when determining variable remuneration at aggregate and individual level. The PRA states that firms should strongly consider incorporating risk-adjusted metrics where risk is calculated as a measure of the return relative to the risk taken over a specified period (eg economic profit). A firm should also apply discretionary factors to the extent that it is appropriate.

A balanced approach comprising both financial and non-financial criteria should be adopted when assessing individual performance for either bonus or LTIP awards. Firms’ attention is drawn to the current practice in the banking sector whereby the weightings attached to profit measures (e.g. net income) or value creation measures (e.g. total shareholder return (TSR) or return on equity (RoE)) are restricted and should be employed only as part of a balanced, risk-adjusted performance scorecard.

Particular care should be taken to ensure that variable remuneration awarded to Solvency II staff identified within the risk management, compliance, internal audit and actuarial functions is not determined using criteria which measure the performance of the operational units or business areas subject to these individuals’ control.

Termination payments for Solvency II staff should be fair and proportionate relative to prior performance.

Proportionality

The PRA considers it appropriate to limit the application of the expectations as set out in this SS to significant firms only (Category 1 and 2 PRA-regulated firms). The PRA will still expect smaller firms (Category 3-5 PRA regulated firms) to comply appropriately with the Solvency II Regulation when setting their remuneration policies. The application of proportionality under Article 275(3) does not equate to smaller firms being able to dis-apply the Solvency II Regulation requirements.

PRA and FCA guidance provides for the prescriptive requirements on deferral to be dis-applied if an individual has total remuneration of no more than £500,000 and has been awarded variable remuneration of no more than 33% of their total remuneration.

Disclosure

To enable firms to demonstrate how their policies, practices and procedures are meeting the requirements in the Solvency II Regulation and the expectations in this SS, the PRA has designed a RPS template for PRA-regulated Category 1 and 2 Solvency II firms to use.

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