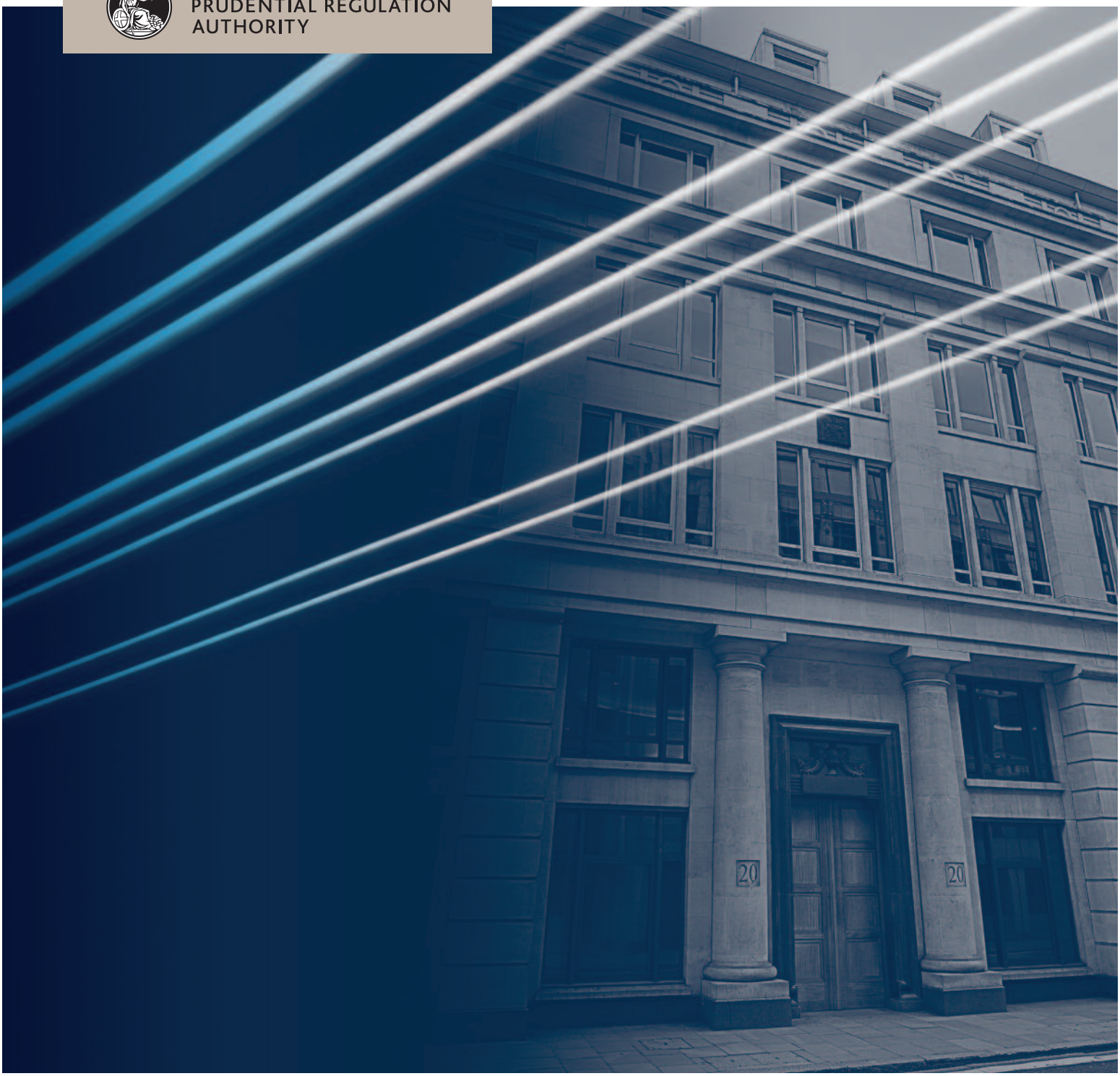
Supervisory Statement | SS2/13

PRA expectations regarding the application of malus to variable remuneration

October 2013

(Updated June 2015)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS2/13

PRA expectations regarding the application of malus to variable remuneration

October 2013

(Updated June 2015)

© Prudential Regulation Authority 2013

1 Introduction

1. This supervisory statement (SS) is aimed at all firms to whom the Prudential Regulation Authority's (PRA's) Remuneration Part of the PRA Rulebook applies. Its purpose is to clarify the PRA's expectations of the way in which firms should comply with the current requirements on *ex-post* risk adjustment (also referred to as performance adjustment) in Remuneration 15.20, in particular regarding the use of malus.

2. The purpose of regulation of remuneration generally is to foster the sound management of risk and to control the risk-taking behaviour of individuals. This clearly falls within the scope of and advances the safety and soundness of individual firms, which in turn avoids adverse effects on the stability of the UK financial system.

3. The effective and meaningful use of *ex-post* risk adjustment, including malus, is absolutely necessary to align remuneration policy with risk-taking. *Ex-post* risk adjustment allows firms to adjust previously awarded remuneration to take account of subsequent performance and potential risk outcomes thus enabling them to recoup variable pay in the event of a downturn in performance or a risk management failure.

4. The importance of *ex-post* risk adjustment has been underscored both in CRD IV, which requires up to 100% of the total variable remuneration to be subject to malus or clawback arrangements, and the Parliamentary Commission on Banking Standards' final report.

5. The terms malus and clawback are often used interchangeably but do in fact constitute distinct forms of *ex-post* risk adjustment. Malus is defined in the CEBS Guidelines on Remuneration Policies and Practices ('CEBS Guidelines') as 'an arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance'. Clawback is a contractual agreement 'whereby the staff member agrees to return ownership of an amount of remuneration to the institution under certain circumstances. This can be applied to both upfront and deferred variable remuneration'.

2 Expectations relating to the application of malus

6. In line with the PRA's Approach documents,[1] firms should comply with the Remuneration Part of the PRA Rulebook's provisions on *ex-post* risk adjustment in their spirit as well as to the letter.

Contracts and policies

7. Firms' remuneration policies and employment contracts should clarify that:

a. Variable remuneration awards are conditional, discretionary and contingent upon a sustainable and risk-adjusted performance, in excess of that required to fulfil the employee's job description as part of the terms of employment. They are therefore capable of forfeiture or reduction at the employer's discretion.

b. Variable remuneration awards should be paid or vest only if this is sustainable according to the financial situation of the firm and justified by the performance of the firm, the business unit and the individual concerned.

c. Variable remuneration awards should be reduced according to specific criteria set by the firm which should, as a minimum cover each of the scenarios outlined in Remuneration 15.23.

8. In accordance with the Record Keeping Part of the PRA Rulebook, SYSC 9 and Remuneration 6.5 firms should take adequate steps to identify and document all remuneration awards which are capable of reduction or forfeiture through malus and inform the relevant employees of the contingent nature of these portions of their remuneration.

Scope

9. The use of *ex-post* risk adjustment should not be limited to employees directly culpable of malfeasance. For example, in cases involving a material failure of risk management or misconduct, the PRA expects firms to consider applying *ex-post* risk adjustment to those employees who:

a. could have been reasonably expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly identify, assess, report, escalate or address it; or

b. by virtue of their role or seniority could be deemed indirectly responsible or accountable for the failure or misconduct, including senior staff in charge of setting the firm's culture and strategy.

10. Where a failure of risk management was collective or pervasive, firms should apply *ex-post* risk adjustment to individuals or groups of employees as appropriate, and consider reductions to in-year bonus pools firm-wide, at the relevant business units, and/or at an individual level.

11. Although firms can disapply the prescriptive requirements of the Remuneration Part of the PRA Rulebook on *ex-post* risk

(1) See www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx.

adjustment in respect of individuals who are not material risk-takers (MRTs) as defined in Remuneration 3.1 and those MRTs who are below the minimum threshold as set out in the supervisory statement on Proportionality, the PRA would generally expect all firms to have a firm-wide policy on *ex-post* risk adjustment (and group-wide policy, where appropriate).

Timing of the relevant failure or misbehaviour

12. Risk management failures and misconduct can take years to come to light. This should not prevent firms from applying *ex-post* risk adjustment to the extent that the relevant individuals have variable remuneration capable of reduction, even where this does not relate to performance in the year in which the misconduct or risk management failure occurred or came to light.

Procedure for considering malus cases

13. The PRA expects firms to develop and maintain an adequate procedure for deciding cases that could result in the use of *ex-post* risk adjustment either as part of, or alongside regular internal disciplinary proceedings. This procedure should:

a. Promote consistency, fairness and robustness in the application of *ex-post* risk adjustment.

b. Set out clear criteria on the kind of cases that may trigger the use of *ex-post* risk adjustment. These criteria should be indicative and non-exhaustive. Remuneration Committees should retain full discretion to introduce additional criteria where appropriate.

c. Indicate which roles, departments, functions and committees are responsible for reporting, escalating and deciding cases that may trigger the use of *ex-post* risk adjustment.

d. Ensure that control functions including Internal Audit, Compliance, Finance, Human Resources, Legal, Reward and Risk provide relevant information and contribute to discussions as required.

e. Set out a clear process for determining culpability, responsibility or accountability, including allowing individuals under investigation to make representations.

14. Firms should freeze the vesting of all deferred awards made to individuals undergoing internal or external investigation that could result in *ex-post* risk adjustment until such an investigation has concluded and the firm has made a decision and communicated it to the relevant employee(s).

Calculating reductions

15. All unvested deferred variable remuneration should, in principle, be capable of forfeiture or reduction through *ex-post* risk adjustment.

16. Malus should be applied robustly but fairly. Paragraphs 9, 10 and 12 above do not prevent firms from taking into account culpability or proximity to an incident when deciding the value of individual reductions.

17. When deciding the amounts to be adjusted, the PRA expects firms to take into account all relevant criteria, including:

a. The cost of fines and other regulatory actions (eg Section 166 reviews).
b. Direct and indirect financial losses attributable to the relevant failure.
c. Reputational damage.
d. The impact of the failure on the firm's relationships with its stakeholders including shareholders, customers, employees, creditors, the taxpayer, counterparties, and regulators.

18. Firms should ensure that the initial process for determining bonus pools is sufficiently transparent to enable them to quantify and articulate clearly the impact of any *ex-post* risk adjustments they might make prior to them being approved.

19. The methodology used to calculate *ex-post* risk adjustments and the value of the adjustments made at individual, business unit and firm levels should be clearly recorded so that it is possible to determine the value of each adjustment per incident and at the individual employee level.

20. Where *ex-post* risk adjustments are made to current or prior year awards before the full impact of the risk management failures or misconduct is known, subsequent consideration and where appropriate subsequent adjustments should be made to ensure the final value of the adjustment fully reflects the impact of the incident.