

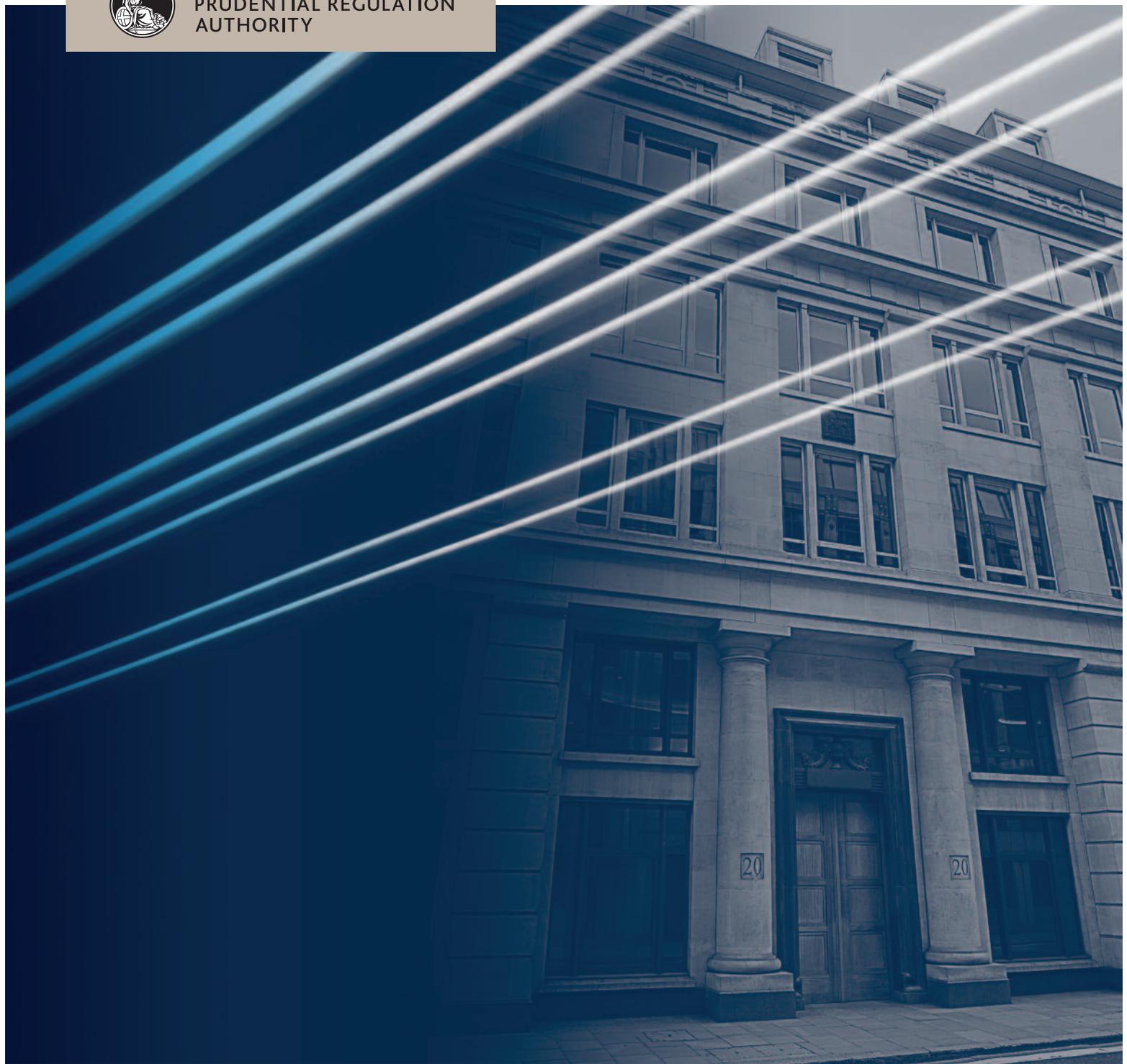
Supervisory Statement | SS27/15

Remuneration

June 2015



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



12 April 2017 - this document has been superseded, see
<http://www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss217.aspx>

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1 Introduction

1.1 This supervisory statement is relevant to all firms and designated investment firms regulated by the Prudential Regulation Authority (PRA) which fall within the scope of the Remuneration Part of the Rulebook ('the Remuneration Part').

1.2 This statement, together with the existing statements on Remuneration standards: the application of proportionality (LSS8/13)⁽¹⁾ and PRA expectations regarding the application of malus to variable remuneration (SS2/13)⁽²⁾ clarify PRA expectations on how firms should comply with the requirements of the Remuneration Part of the Rulebook, enabling firms to make judgements which advance the objectives of the PRA.

1.3 This statement is intended to be read together with the rules contained in the Remuneration Part. The Remuneration Part aims to ensure that firms adopt remuneration policies which are consistent with and promote sound risk management, eliminating incentives towards excessive risk-taking, and aligning employee incentives with the longer-term interests of the business whilst taking account of the timeframe over which financial risks crystallise.

1.4 This statement sets out the expectations of firms in relation to the:

- types of remuneration;
- material risk takers;
- proportionality;
- firm-wide application;
- governing body/remuneration committees;
- risk management and control functions;
- remuneration and capital;
- risk adjustment;
- personal investment strategies;
- remuneration structures; and
- breaches of the remuneration rules.

1.5 The Remuneration Part implements those provisions of the Capital Requirements Directive (CRD) which relate to remuneration. The Committee of European Banking Supervisors ('CEBS') published Guidelines on Remuneration Policies and Practices on 10 December 2010.⁽³⁾

2 Types of remuneration

2.1 The Remuneration Part covers all aspects of remuneration that could have a bearing on effective risk management including salaries, bonuses, long-term incentive plans, options, hiring bonuses, severance packages and pension arrangements. References to remuneration include remuneration paid, provided or awarded by any person to the extent that it is

paid, provided or awarded in connection with employment by a firm.

3 Material risk-takers

3.1 Chapter 3 of the Remuneration Part identifies the criteria for determining who is a material risk-taker.

3.2 In light of the process under Remuneration 3.2(1), where a third-country Capital Requirements Regulation (CRR) firm wishes to deem an employee who earns more than €750,000 not to be a material risk-taker, the firm should apply for a waiver of the Remuneration rules in respect of that person under s138A of the Financial Services and Markets Act 2000 (FSMA).

4 Proportionality

4.1 Chapter 5 of the Remuneration Part is aligned with the PRA's existing approach to proportionality. The PRA does not expect firms to apply the rules Remuneration 15.7–15.8 (guaranteed variable remuneration and buyouts); 15.15–15.16 (retained shares or other instruments); 15.17–15.19 (deferral); and 15.20–15.23 (performance adjustment) where, in relation to an individual, both the following conditions are satisfied:

- (a) Condition 1 is that the individual's variable remuneration is no more than 33% of their total remuneration; and
- (b) Condition 2 is that the individual's total remuneration is no more than £500,000.

4.2 In line with Remuneration 16.7, the voiding provisions under Remuneration 16.9–16.13 may also be disapplied by individuals satisfying the above conditions.

5 Firm-wide application

5.1 The PRA expects firms to apply at least the following rules on a firm-wide basis:

- remuneration policies;
- governance;
- risk adjustment;
- pension policy;
- personal investment strategies;
- payments related to early termination; and
- deferral.

(1) www.bankofengland.co.uk/pr/Pages/publications/ss/2015/lss813update.aspx.
(2) www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss213update.aspx.
(3) www.eba.europa.eu/documents/10180/106961/Guidelines.pdf.

6 Governing body and remuneration committee

6.1 Firms are expected to demonstrate that their decisions are consistent with an accurate assessment of their financial condition and future prospects. In particular, practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain should be evaluated carefully. The governing body or remuneration committee, or both, should work closely with the risk function in evaluating the incentives created by the remuneration policies of the firm.

6.2 The governing body and remuneration committee are responsible for ensuring that the remuneration policy of the firm complies with the rules on remuneration, and where relevant, should take into account guidance such as that issued by the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO).

6.3 In applying the remuneration rules, a firm should have regard to applicable good practice on remuneration and corporate governance, such as guidelines on executive contracts and severance produced by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). In considering the risks arising from its remuneration policies, a firm will also need to take into account its statutory duties in relation to equal pay and non-discrimination.

6.4 As with other aspects of a firm's systems and controls, in accordance with General Organisational Requirements 2.2 of the PRA Rulebook, remuneration policies, procedures and practices must be comprehensive and proportionate to the nature, scale and complexity of the firm's activities. The actions of a firm in order to comply with the Remuneration Part will therefore vary.

6.5 The periodic review of the implementation of the remuneration policy should assess compliance with the Remuneration Part.

6.6 The PRA may also ask remuneration committees to provide the PRA with evidence of the compliance of any remuneration policies against the rules under the Remuneration Part, together with plans for improvement where there is a shortfall.

6.7 The Remuneration Part is principally concerned with the risks created by the way remuneration arrangements are structured, not with the absolute quantum of remuneration, which is generally a matter for remuneration committees to determine.

7 Risk management and control functions

7.1 The PRA expects firms to ensure that the total remuneration package offered to employees in risk management and compliance functions is sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions.

7.2 The method of determining the remuneration of relevant persons involved in the compliance function should not compromise the objectivity of firms or be likely to do so.

7.3 The PRA expects firms to ensure that their risk management and compliance functions are involved in determining the remuneration policy for other business areas. This includes significant input into the setting of individual remuneration awards where those functions have concerns about the behaviour of the individuals concerned or the level of risk undertaken. A lack of involvement from the control function may be relied on as tending to establish contravention of Remuneration 8.1 requiring employees engaged in control functions to have appropriate authority.

7.4 Remuneration 8.1 is designed to avoid potential conflicts of interest which might arise if other business areas had undue influence over the remuneration of employees within control functions. Where such conflicts could arise they should be managed by having in place independent roles for control functions (including, notably, risk management and compliance) and human resources. The PRA considers it good practice to seek input from the human resources function when a firm is setting remuneration for other business areas.

7.5 The need to avoid undue influence is particularly important where employees from the control functions are embedded in other business areas. Remuneration 8.1 does not prevent the views of other business areas being sought as an appropriate part of the assessment process.

8 Remuneration and capital

8.1 The variable remuneration arrangements at a firm should be sufficiently flexible to allow it to direct necessary resources towards capital building.

8.2 The PRA also expects relevant firms to use the rules in assessing their exposure to risks arising from their remuneration policies, as part of the internal capital adequacy assessment process (ICAAP).

9 Risk adjustment

9.1 The governing body (or, where appropriate, the remuneration committee) should approve policies for incorporating risk-adjusted performance into calculating the

bonus pool and individual awards, including the triggers under which adjustments would take place. The PRA may ask firms to provide a copy of their policies and expects firms to make adequate records of material decisions to operate the adjustments.

Risk adjustment frameworks

9.2 The PRA expects firms to adopt a risk adjustment framework that provides a clear and verifiable mechanism for measuring performance, and which leads to quantifiable risk adjustments being made in a clear and transparent manner. Firms will be expected to justify how they have adjusted remuneration decisions to account for risk.

9.3 The PRA expects firms to choose the most appropriate risk adjustment technique according to its circumstances. Firms are expected to provide a quantitative reference or starting point that explicitly includes risk-adjusted metrics, before the application of more discretionary factors. The full range of future risks should be covered and firms should be able to provide the PRA with details of all adjustments made, whether through application of formulae or the exercise of discretion. Where discretion has been applied, the firm should be able to provide a clear explanation and quantification of such adjustments.

Accounting for profit for remuneration purposes

9.4 In order to ensure that incentives are better aligned with the long-term sustainable financial performance of the firm, the PRA expects variable awards to reflect the long-term *ex-ante* risks associated with employee activities and to reduce the sensitivity of financial performance measures to short-term profit.

9.5 Profits for the purpose of determining the initial size of the pre-risk adjusted bonus pool should be calculated by adjusting any profit figure taken from a fair valuation accounting model with the incremental movement in the prudent valuation adjustment (PVA) figure at the end-Q4 prudent valuation return in current year and previous year. All UK dual-regulated firms (including UK subsidiaries of international firms) excluding branches, are required to file quarterly prudent valuation returns with the PRA.

9.6 For UK subsidiaries of international firms that do not have a specific UK bonus pool and where the bonus pool is determined and allocated by the parent company, the PRA, as part of the annual supervisory remuneration review, will require the firm to evidence that the incremental change in the PVA for the UK subsidiary has been applied to the UK-regulated entity's profits that feed into the global bonus pool.

9.7 The PRA expects prudent valuation adjustments to be determined using the Simplified Approach or Core Approach

proposed by the European Banking Authority (EBA) in its final draft regulatory technical standards (RTS) on prudent valuation under Article 105(14) of Regulation (EU) No 575/2013 (CRR).⁽¹⁾

9.8 As branches of overseas firms are not required to submit prudent valuation returns, they will be out of scope of this new requirement. However, the PRA will expect those firms to apply an appropriate adjustment to profit based on comparable principles to the extent it is achievable in the jurisdiction in which the global pool is determined.

Use of metrics

9.9 Aligning variable remuneration awards to sustainable financial performance requires firms to make appropriate *ex-ante* adjustments to take account of the potential for future unexpected losses. Performance measures commonly used such as earnings per share (EPS), total shareholder return (TSR) and return on equity (RoE) are not suitably adjusted for long-term risk factors, and may incentivise highly-leveraged activities. The PRA expects these earnings-based metrics to form part of the risk adjustment process only if it can be demonstrated that they are used as part of a balanced scorecard which gives credible weight to non-profit based measures.

10 Personal investment strategies

10.1 The circumstances in which the PRA expects a personal hedging strategy to be used include, and are not limited to, entering into an arrangement with a third party under which the third party will make payments, directly or indirectly, to a person that are linked to or commensurate with the amounts by which the person's remuneration is subject to reductions.

11 Remuneration structures

Assessment of performance

11.1 The PRA expects that the non-financial criteria in Remuneration 15.4(2) should include the extent of the employee's adherence to effective risk management, and compliance with the regulatory system and relevant overseas regulatory requirements.

Specific award structures: guaranteed variable remuneration, buyouts and retention awards

11.2 The PRA considers guaranteed variable remuneration to be subject to the general rules for variable remuneration awarded by the firm including deferral, malus and clawback. Guaranteed variable awards should not be expected as the norm and should be limited to rare, infrequent occurrences. All guaranteed variable remuneration awarded should also be

(1) www.eba.europa.eu/regulation-and-policy/market-risk/draft-regulatory-technical-standards-on-prudent-valuation.

documented and included in a firm's annual remuneration policy statement. Notification of guaranteed variable remuneration is not required except when a retention award is offered to a material risk-taker. In such cases, the PRA will consider whether the retention award is appropriate.

11.3 The PRA expects firms to structure buyouts so that they vest no faster than the awards that they replace.

11.4 Retention awards shall form part of variable remuneration for the purpose of Remuneration 15.10 (Ratio between fixed and variable components of total remuneration).

Procedure to increase the permitted ratio of fixed to variable remuneration

11.5 All percentage thresholds referred to in Remuneration 15.11(5) should be calculated by reference to the shares or other ownership rights in the firm. This, in turn, should be taken to mean the voting rights capable of being cast on the relevant resolution, and which attach to the shares or ownership rights.

11.6 The 75% threshold, which applies when fewer than 50% of shares are represented in the vote and the 66% threshold, which applies when at least 50% of shares are represented, are percentages of the share or ownership voting rights represented, and not of the firm's whole issued share capital or ownership rights.

11.7 The concept of shares or ownership rights being 'represented' is not clearly defined for these purposes in EU or UK law and may depend on the legal nature of the firm in question.

- (i) To be clear what proportion of the share/ownership rights is 'represented' as required by Art. 94(1)(g)(ii) CRD, the PRA expects a poll vote to take place at the relevant shareholder meeting, even if the outcome of such a vote may appear obvious from a show of hands and/or any proxies received.
- (ii) The PRA has not ascribed a specific meaning to the word 'represented'. The PRA expects firms to consider what will constitute being represented for the purpose of this vote, within the range of meanings that the word 'represented' could reasonably carry.
- (iii) The PRA expects firms to make clear to shareholders how each voting decision (voting for or against, sending a

proxy, abstaining, attending but not voting etc) will be treated for the purpose of being represented.

- (iv) It is prudent to proceed on the basis that the meaning of being 'represented' is the same for the threshold test (ie the 50% test) as for the majority test (ie the 66% or 75% test), even if other interpretations are possible.

11.8 In line with Remuneration 15.11(4), staff who are directly concerned by the higher maximum levels of variable remuneration are not permitted to exercise any voting rights they may have. Accordingly, their voting rights should be disregarded when calculating the percentages.

Retained shares or other instruments

11.9 The PRA regards six months as the minimum retention period compatible with Remuneration 15.15(2).

Deferral

11.10 The PRA expects firms to have a firm-wide policy (and group-wide policy, where appropriate) on deferral. The proportion deferred should generally rise with the ratio of variable remuneration to fixed remuneration and with the quantum of variable remuneration awarded. In line with the specific requirements of Remuneration 15.18, the PRA further expects that where any employee's variable remuneration component is £500,000 or more, at least 60% should be deferred. However, firms should also consider whether this deferral ratio should be applied in cases of variable remuneration below £500,000.

12 Breach of the remuneration rules

Recovery of payments made or property transferred pursuant to a void contravening provision

12.1 Remuneration 16.14(2) applies in the context of a secondment. Where a group member seconded an individual to a firm and continues to be responsible for the individual's remuneration in respect of services provided to the firm, the PRA expects the firm to take reasonable steps to ensure that the group member recovers from the secondee any remuneration paid in pursuance of a contravening provision.

Notification to the PRA

12.2 In line with the Fundamental Rules, the PRA expects any breach of a rule referred to in Remuneration 16.1 to be notified to the PRA. Such a notification should include information on the steps which a firm or other person has taken or intends to take to recover payments or property in accordance with Remuneration 16.14.