BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

David Rule
Executive Director, Insurance Supervision

12 July 2019

Dear Chair of the Remuneration Committee

Remuneration requirements – PRA findings and expectations

This letter provides clarification on the PRA's expectations of firms and Remuneration Committee ('RemCo') Chairs in their implementation of the Solvency II Delegated Regulation ('Solvency II') remuneration requirements. We consider remuneration an important factor that defines incentives within the firms that we regulate. Firms' remuneration policies and practices drive underwriting decisions, individuals' behaviour, and organisational culture. This letter follows our analysis of implementation by firms to date, and highlights areas where firms have fed back that they would like further guidance.

Insurers within the scope of the Solvency II regime must comply with requirements when setting remuneration policies and processes. In 2016, we published Supervisory Statement (SS) 10/16 'Solvency II: Remuneration Requirements'[1] setting out our expectations of how firms should comply with Article 275. We have also asked PRA Category 1 and 2 firms[2] to complete, on a voluntary basis, Remuneration Policy Statement (RPS) templates detailing remuneration policies, practices and procedures.[3] In autumn 2018, we hosted roundtable meetings with a number of RemCo Chairs. This engagement has enhanced our understanding of how firms are implementing the Solvency II requirements in practice, and provided valuable feedback on the main remuneration challenges and concerns they face.

Our analysis has concluded that there is a wide range of interpretations of the Solvency II remuneration requirements and that, while firms' implementation of the rules has improved over time, inconsistencies in their approaches to implementation remain apparent. This is in line with the feedback received in our meetings with RemCo Chairs which suggested an appetite for further clarification from the PRA to help to address these inconsistencies.

Material Risk Takers (MRTs)
Appropriate and clear identification of MRT populations in insurance firms is a key consideration in our remuneration analysis. MRT identification captures the individuals who have a material impact on a firm's risk profile and are subject to specific remuneration requirements. Our analysis has found that firms' approaches towards determining Solvency II Staff [4] vary widely. Some firms use a range of quantitative and qualitative criteria to capture a wide population of individuals who might affect risk outcomes. Others have adopted a narrow interpretation of the term and have not identified MRTs beyond the highest levels of management. These variations even exist between firms that operate in similar parts of the insurance market.

We recognise that the business models of the firms we regulate vary significantly from one another, and we do not seek to impose a uniform approach towards MRT identification. However, the variation suggests that some firms are not fully capturing and/or reporting the appropriate set of individuals who have a material impact on the undertaking's risk profile. For example, in the RPS submission exercise the number of MRTs identified by firms in 'Operational Systems and Controls' appears disproportionately high compared to what we would expect to see (as detailed in the annex). Similarly, there are some areas, particularly in first line roles such as 'Head of Material Business Unit', 'Investment Management', and

[1] July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency-2-remuneration-requirements-ss.
[2] PRA 'Categories' of firms are explained in the 'PRA's approach to insurance supervision' available at https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.
[3] Available in the 'Remuneration' section of our 'Strengthening accountability' page at https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/strengthening-accountability.
[4] As defined in Article 275(1) (c) of the Solvency II Delegated Regulation.

‘Underwriting and Pricing’ where we might have expected to see a higher proportion of MRTs due to the material impact these roles tend to have on a firm’s risk profile.

RemCo Chairs have also requested greater clarity on how firms should be identifying MRTs. As we continue to review the information provided by firms on how they are identifying MRTs, we will consider whether and how we can provide further clarification to improve firms’ understanding of this area.

Variable remuneration

Balanced and appropriate variable remuneration structures provide transparency on how individuals at a firm are incentivised to take decisions and manage risk. Poorly designed variable remuneration structures can pose a prudential risk if they encourage excessive risk taking and poor decision making and do not capture the correct population of staff. We have observed examples of where MRTs’ remuneration packages have not taken adequate account of long-term performance. Variable remuneration remains a key area of interest for the PRA.

As set out in Article 275.2(b) of Solvency II, we expect firms to demonstrate compliance with the requirement that total variable remuneration is based on a combination of the performance of the individual, business unit, and overall firm, or the group to which the firm belongs. Our analysis has found that few firms were able to do this and many did not include business unit performance as part of their assessment. We wish to reiterate that firms need to comply with Solvency II in this regard and we will consider whether and how further clarity can be given on this matter in any future work.

Similarly, SS10/16 sets out that firms should use a balanced approach when assessing individual performance for bonus or Long Term Incentive Plan (LTIP) awards. This approach should include a combination of financial metrics such as revenue, risk, capital and return metrics, as well as non-financial measures. However, we have found that there is a strong reliance on financial returns metrics for measuring performance against LTIPs, such as total shareholder returns and return on equity. These metrics, especially if adopted in isolation, have been linked to excessive risk taking. We will continue to assess the extent to which firms have adopted a balanced approach to LTIP awards and whether due consideration of non-financial metrics has been given. In line with Solvency II and SS10/16, firms should also ensure that, where relevant, they include metrics accounting for the long-tail nature of their insurance undertakings and consider Solvency II capital generation when allocating variable remuneration.

Some RemCo Chairs expressed the view that, while they recognised the need for a balance between financial and non-financial metrics, they came under pressure from shareholders/proxy advisers and other stakeholders on this issue. This included pressure to focus primarily on financial metrics, sometimes on the grounds that it could be difficult to measure non-financial performance. However, Article 275.2(d) of Solvency II stipulates that financial and non-financial criteria shall be taken into account when assessing an individual’s performance. Regulated firms must therefore ensure that such dynamics do not impede their ability to adhere to Solvency II requirements.

Variable remuneration of control functions

Article 275.2(h) of Solvency II states that variable remuneration for control functions staff should be independent of the performance of those functions they oversee and hold to account. Some RemCo Chairs have fed back that insurers faced challenges in adhering to this requirement when structuring the remuneration of control function staff. Firms are reminded that Solvency II provides no discretion here. We will consider whether and how further guidance can be issued in this area.

Ex-post risk adjustment

Risk adjustment is an important tool in allowing firms to hold individuals accountable for poor risk decisions and can help set the tone for the desired behaviours of MRTs. Paragraph 4.4 of SS10/16 outlines our expectation that firms’ remuneration arrangements should be able to permit a reduction in the value of variable remuneration where appropriate. This might be used, for example, where decisions have had a material negative impact on the firm’s performance. Firms should be able to provide us with evidence of how risk adjustment has been considered or used in practice in their RPS submissions, where relevant, and close and continuous engagement with supervisors. This information allows us to assess whether a firm’s remuneration structure is credible, applicable, and responsive to the risks to which it is exposed.

Analysis from the voluntary RPS submissions from Category 1 and 2 insurers has shown that a majority of firms can evidence the use of risk adjustments when setting bonus pools. Similarly, most firms detailed how malus and clawback could be applied, although evidence of these tools being used was far more limited. Our expectations on the application of malus are set out in paragraph 4.4 of SS10/16. We will, where relevant, continue to ask firms to demonstrate how these tools are being used to take account of material risk failings.

Firms should also be able to explain how risk and control functions have input into the setting of remuneration and, in some cases, how this input has led to adjustments in individuals' pay. Most firms reported in their RPS submissions that they consult risk, compliance and actuarial functions in setting and adjusting variable remuneration. However, we observed that some firms have gone further than others in enabling the risk function to provide meaningful input into remuneration decisions. Firms may find it useful, where contribution from the risk function is limited, to consider the ways in which risk can contribute to remuneration decisions in a more meaningful manner, taking account of both current and future risks to which the firm is exposed.

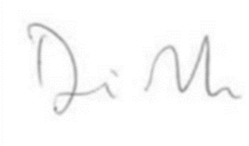
Role of the RemCo
Finally, our analysis identified differences across firms over the design, roles, and responsibilities of RemCos. Some committees focus largely on senior management remuneration, while others take a more granular, firm-wide approach. Article 271.1(c) of Solvency II requires that the remuneration policy applies to the firm as a whole, and while it is for the board to consider the responsibilities of its committees, specific consideration should be given to the areas that the RemCo does and does not cover. Where items are not considered to be the responsibility of the RemCo, the board should be comfortable that appropriate governance and consideration is given to these issues in other forums.

Future work
The PRA will continue to focus on remuneration in our ongoing prudential supervision of firms. We will seek to address any inconsistencies in the interpretation of the Solvency II requirements, and share any findings that may help to improve firms' understanding. We will consider whether it is appropriate for us to provide more clarification or guidance for firms.

Collection of Remuneration Policy Statements
The 2017 and 2018 RPS exercises have been important tools in furthering our understanding of the approach taken by firms and identifying areas where we could provide further information. We are therefore repeating this voluntary exercise and in May 2019, we wrote to the regulatory contacts of those firms within scope. We will give due consideration to whether there is an ongoing need for the collection of this data in future years.

We intend that this letter, alongside our future engagement, will provide you with greater clarity on how you should be applying Solvency II remuneration requirements.

Yours sincerely



Annex – MRT allocations (2017)

This table shows the:

i) average number of MRTs which have been allocated to each business function from a sample of firms across various insurance sectors; and
ii) percentage of the overall MRT population, from a sample of firms, allocated to each business function.

Retail	**Function**	Operational Systems and Controls	Management Body	Finance	Risk and Compliance	Head of Material Business Unit	Actuarial	Audit	IT
	Average in Sample	3.3	2.6	1.8	1.5	1.2	1	0.6	0.5
	% of Sample	26%	21%	15%	12%	9%	5%	5%	4%

Life	**Function**	Operational Systems and Controls	Other	Risk & Compliance	Finance	Management Body	Investment Management	Head of Material Business Unit	Actuarial	Committee	IT
	Average in Sample	5.8	3.3	2.1	2	1.8	1.5	1.4	1.3	0.9	0.9
	% of Sample	26%	15%	9%	9%	8%	7%	6%	5%	4%	4%

Groups	**Function**	Operational Systems and Controls	Finance	Risk & Compliance	Management Body	Investment Management	Actuarial	Other	Committee	IT	Audit
	Average in Sample	8	6.8	6.4	5.4	3.6	3.4	3.4	2.8	1.6	1
	% of Sample	16%	14%	13%	11%	7%	7%	7%	6%	3%	2%

London Market	**Function**	Head of Material Business Unit	Operational Systems and Controls	Other	Committee	Underwriting and Pricing of Policies	Finance	Risk & Compliance	Management Body	Claims	Multiple
	Average in Sample	6.9	5.4	4.5	3.4	3.3	2.6	2.5	2.3	1.5	1.5
	% of Sample	18%	14%	12%	9%	8%	7%	6%	6%	4%	4%

Commercial Corporates	**Function**	Underwriting and Pricing of Policies	Head of Material Business Unit	Other	Finance	Operational Systems and Controls	Claims	Risk & Compliance	Management Body	Investment Management	Reinsurance
	Average in Sample	8.8	8.2	2	1.7	1.5	1	0.8	0.88	0.7	0.7
	% of Sample	32%	30%	7%	6%	5%	4%	3%	3%	2%	2%

Source: PRA analysis of RPS Identified Staff Templates submitted by 37 PRA Category 1 and 2 firms on a voluntary basis for their 2017 performance year.