Supervisory Statement| SS10/16

Solvency II: Remuneration requirements

February 2023

(updating July 2018)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Contents

Introduction

1.1 This supervisory statement (SS) is relevant to all UK insurance and reinsurance firms and groups within the scope of Solvency ('Solvency II firms'). The Prudential Regulation Authority (PRA) expects firms to read this statement alongside all relevant European legislation.

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1.2 This SS provides guidance for significant[1] (PRA Category 1 and 2) Solvency II firms in complying with the requirements in Article 275 of the Commission Delegated Regulation (EU) 2015/35 ('the Solvency II Regulation'). It may also be used as a guide for smaller firms when reviewing their remuneration policies and practices against the Solvency II Regulation requirements. This statement does not set absolute requirements as these are contained in the directly applicable Solvency II Regulation which came into force on 1 January 2016. Category 1 and 2 firms unable to meet or exceed the PRA's expectations (as set out in this SS) should inform their PRA supervisory contact.

Compliance with the Regulation

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2.1 The PRA expects all Solvency II firms to comply with the remuneration requirements of Article 275 of the Solvency II Regulation and with the European Insurance and Occupational Pensions Authority (EIOPA) 'Guidelines on system of governance' finalised on 14 September 2015[2].

Application across UK headquartered Solvency II groups

2.2 Group Supervision 17.1(2) of the PRA Rulebook (transposing Article 246 of Directive 2009/138/EC2 ('Solvency II Directive')) requires Solvency II firms to ensure that risk management and internal control systems and reporting procedures are implemented consistently in all entities included in the scope of group supervision. The EIOPA Guidelines[3] confirm 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'.

2.3 All entities within the scope of a Solvency II group should have a consistent remuneration policy that is in line with the group's risk management and internal control system to ensure those systems (including remuneration policy governance) can be controlled effectively at group level. Material risks at group level should also be reflected appropriately in the design of remuneration arrangements across all group entities.

2.4 It does not follow that the same remuneration policy with identical variable remuneration structures and pay practices should apply to every group entity. If staff identified in accordance with Article 275(1)(c) ('Solvency II staff') are employed by non-European Economic Area (EEA) entities located in jurisdictions with conflicting local regulatory, legal, operational or taxation requirements it may be necessary to deviate from the group remuneration policy for these employees. Firms should communicate to the PRA any significant deviations from the group's remuneration policy either in the Remuneration Policy Statement (RPS) reporting template for PRA Category 1 and 2 firms or via an alternative format if preferred. Firms should include an explanation where there are material differences between: (i) the remuneration arrangements for Solvency II staff identified in non-EEA entities; and (ii) the remuneration arrangements for other group Solvency II staff.

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1 The 'PRA's approach to insurance supervision' March 2016 explains that Category 1 and 2 firms are deemed significant within the PRA's supervisory framework model; www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
2 https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-system-of-governance.
3 Guideline 9 (para 139) Guidelines on system of governance, EIOPA-BoS-14/253 EN.

2.5 The EIOPA Guidelines[1] are clear that 'the holding company should ensure all undertakings that belong to the group comply with the [Solvency II] remuneration requirements'. Therefore, 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' (contained in Article 275(2)) to Solvency II staff may require modifications to the remuneration policy to accommodate jurisdictional restrictions, which may mean the PRA's expectations are unable to be met.

Application to non-Solvency II entities

2.6 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.

Solvency II staff

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3.1 Article 275(1)(c) and (2) of the Solvency II Regulation requires Solvency II firms to 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'.

3.2 In order to satisfy the scope of this Solvency II staff identification requirement, the PRA expects the following individuals to be identified as being subject to Article 275(2) ('Solvency II staff'):

- board members;
- Executive Committee members;
- Senior Management Function (SMF) holders with PRA or FCA 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).

3.3 As the Senior Managers Regime (SMR) 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 SMF, SIF and KFH identified at a regulated entity level as well as at the higher group level.

3.4 The EIOPA Guidelines[2] consider risk management, compliance, the actuarial and the internal audit function to be key functions. This is supported in the definition of 'key function' contained in the PRA Rulebook Glossary. Individuals are considered to be holders of key functions if they are responsible for functions of specific importance for the Solvency II entity in view of its business and organisation. Consequently, the PRA expects those with significant levels of responsibility for risk management, compliance, actuarial and internal audit functions (ie not only heads of function at group level) to be identified as Solvency II staff at regulated entity level. The same applies across material business lines given the wholly different businesses of many subsidiaries and branches within group structures. The PRA has been clear

1 Guideline 9 (para 140 b) Guidelines on system of governance, EIOPA-BoS-14/253 EN.
2 Para 1.4, Guidelines on system of governance, EIOPA-BoS-14/253 EN.

that key functions should not necessarily be restricted to these four areas[1] with firms expected to consider whether there are any additional key functions of specific importance to the sound and prudent management of their business, such as the investment function, IT function or a claims management function.

3.5 As part of the supervisory review process and consistent with Article 275(1)(c), the PRA expects firms to be able to demonstrate that employees carrying out activities which have a material impact on the risk profile of the firm have been appropriately identified as MRTs. The 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. For example, one approach may be setting a quantitative risk threshold (monetary or other metrics) to identify underwriters with significant underwriting limits relative to the firm's overall risk tolerance, or investment managers able to commit to significant credit risk exposures and market risk transactions above a certain material threshold.

3.6 Based on the risk profile specific to the firm, to meet the PRA's expectations, firms should seek to:

(i) Identify staff members able to take material risks.

Key factors to consider

- The firm should take into account the types and severities of risks to which it is exposed as well as its aggregated risk appetite when assessing whether the activities of the individual could have a material impact on the risk profile of the firm.

- Staff members operating within the constraints of committee-set limits on their authority should not systematically be excluded from identification. The risk taking authority and level of decision-making responsibility attached to the role should still be properly assessed for materiality. For example, if having taken into account the extent of management supervision prior to an underwriter being able to commit the firm, there is still the potential for their decisions to significantly increase the risk of harm to the firm in reasonably foreseeable adverse scenarios, they should be identified.

(ii) Identify staff members able to influence material risk taking.

Key factors to consider

- Senior staff members working within key functions (not necessarily the key function holder)[2] with significant levels of responsibility for monitoring adherence to the risk appetite and framework should be identified, particularly if they have overall responsibility for their function within a material division or business line.

1 See PRA Rulebook Glossary definition of 'key function' and Supervisory Statement 35/15 'Strengthening individual accountability in insurance', August 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss3515.aspx, and letter from Sam Woods to PRA-regulated insurance firms, 25 August 2015; www.bankofengland.co.uk/pra/Documents/supervision/strengtheningacc/simr0815.pdf.

2 'Key function holder' is defined in the PRA Rulebook Glossary as 'any person who is responsible for discharging a key function'.

- Voting members of committees responsible for the oversight of risk-taking activities (eg setting risk appetite limits) across the firm, or group, or material business lines should be identified.

3.7 Senior staff members should be categorised as Solvency II staff and subject to the specific remuneration arrangements set out in Article 275(2) of the Solvency II Regulation where they perform activities on behalf of a Solvency II firm, that have a material impact on the risk profile of either: (i) that firm and/or another a Solvency II entity within the group; or (ii) the group as a whole.

3.8 Firms can engage with their supervisors prior to finalising their approach for identifying MRTs. The PRA expects all Solvency II firms to keep a record of the assessment criteria applied and the final list of staff identified as Solvency II staff for each performance year.

Deferral

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4.1 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. There is no flexibility in the Solvency II Regulation for Solvency II firms to elect a shorter period than this specified minimum three year period, with firms required to ensure that the period (be it three years or longer) is 'correctly aligned with the nature of the business, its risks, and the activities of the employees in question'. The natural life cycle of the business and associated risks should be considered when setting the length of the deferral period. Variable remuneration payable under these deferral arrangements must vest no faster than pro-rata from year one. There may also be the potential for multi–period schemes to operate within the same deferred bonus plan or Long Term Incentive Plan (LTIP). The actual arrangements put in place to comply with this requirement will remain, however, a discretionary matter for the firm.

4.2 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.

4.3 The PRA believes that a 'substantial portion' of variable remuneration, which must be deferred for a minimum of three years, is very unlikely to be less than 40%. Based on current industry practice, the PRA is of the view that a deferral threshold of 40% or more is likely to be proportionate, particularly given this would not be applied independently to distinct variable remuneration awards but to the total amount.

4.4 Deferral of variable remuneration allows firms to apply downwards adjustments by the application of malus[1] prior to the award vesting, to take account of specific risk management failures. In order to comply with Article 275, the PRA will expect firms to consider whether or not to apply malus during the three year deferral period required by the Solvency II Regulation 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

1 Malus is defined for CRD firms in the EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU as 'an arrangement that permits the institution to reduce the value of all or part of deferred variable remuneration based on ex post risk adjustments before it has vested'.

applied (eg reducing current year awards) is at the employer's discretion and should be considered on a case-by-case basis.

Performance Measurement

5.1 Article 275(2)(b) requires that, where variable remuneration is performance related, the aggregated 'total amount of variable remuneration' is to be based on a 'combination of the assessment of the performance of the individual and of the business unit concerned and of the overall result of the undertaking or the group to which the undertakings belongs'. Performance
5 should also be assessed based on financial and non-financial criteria (Article 275(2)(d)). To encourage positive behaviours or actions, incentive plans should incorporate non-financial criteria, particularly at the individual assessment level. These criteria should include the extent of the employee's adherence to effective risk management and compliance with the relevant regulatory requirements relating to the activities of the employee in question.

5.2 Article 275(2)(e) requires performance measurement as a basis for variable remuneration for Solvency II staff to 'include a downwards adjustment for exposure to current and future risks, taking into account the undertaking's risk profile and the cost of capital'. 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. To reflect this requirement, 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.

5.3 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 should be drawn to the current practice in the banking sector whereby the weightings attached to profit measures (eg net income) or value creation measures (eg 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.

5.4 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 (Article 275 (2)(h)).

6 5.5 Article 275(2)(f) stipulates that 'termination payments shall be related to performance achieved over the whole period of activity and be designed in a way that does not reward failure'. Termination payments for Solvency II staff should be fair and proportionate relative to prior performance.

Proportionality

6.1 Article 275(3) of the Solvency II Regulation provides for the application of the proportionality principle with the 'internal organisation of the insurance or reinsurance undertaking, and the nature, scale and complexity of the risks inherent in its business' to be taken into account when designing the remuneration policy.

6.2 The PRA takes the view that for smaller insurers (the majority of which operate in one locality or niche market) to seek to meet the expectations set out in this SS would have a disproportionate cost impact on these firms. Conversely, larger firms with complex risk profiles should seek to meet (or exceed) the PRA's expectations as set out in this SS in complying with the regulatory requirements. The PRA therefore 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).[1]

6.3 The PRA will still expect smaller firms (Category 3-4 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 disapply the Solvency II Regulation requirements. These firms should be exercising appropriate judgement to ensure that the specific arrangements for Solvency II staff contained in Article 275(2) are applied proportionality and modified where required to reflect the size and nature of their businesses.

6.4 The PRA will take a proportionate approach in assessing firms' compliance with Article 275(2). The PRA will also seek, so far as possible, to limit the potential for outcomes that are disproportionately different across sectors. In this context, firms may be aware that, in respect of UK banking and asset management entities (subject to CRD, AIFMD and UCITS V), current PRA and FCA guidance[2] provides for the prescriptive requirements on deferral to be disapplied 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. While Article 275(2) does not provide for the disapplication of its provisions in these circumstances, the PRA will take this indicator of proportionality into account when assessing the specific arrangements that firms have put in place for Solvency II staff in order to comply with Article 275(2). For Solvency II staff performing activities for the firm for only part of the performance period, the quantitative threshold can be adjusted relative to the months for which services were performed.

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Disclosure to PRA

7.1 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. The RPS and Solvency II staff table is available on the Bank of England's website[3] for Category 1 and 2 firms to download and submit. The template meets the PRA's expectation of the level of detail which should be included when asked to demonstrate compliance with the Solvency II Regulation. However, use of this template is voluntary as the PRA recognises that some firms may prefer to document how their remuneration policies comply with the Solvency II requirements in a different way. All information received in this regard will be treated as confidential. Any questions on the reporting template should be referred to the firm's usual supervisory contact.

1 The 'PRA's approach to insurance supervision' March 2016 explains that Category 1 and 2 firms are deemed significant within the PRA's supervisory framework model; www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
2 Rule 16.7, Remuneration Part of the PRA Rulebook, AIFMD Remuneration Code (SYSC 19B.1.13A G) and UCITS V Remuneration Code (SYSC 19E.2.17 G).
3 www.bankofengland.co.uk/pra/Pages/supervision/activities/remuneration.aspx.

Annex

Updates

February 2023

- This SS has been updated to remove a reference to category 5. This category was removed by the PRA when it updated its approach to categorising the 'potential impact' of firms.

July 2018

- This SS has been updated to reflect changes in terminology as a result of the publication of PS15/18 'Strengthening individual accountability in insurance: extension of the SM&CR to insurers'.[1]

1 www.bankofengland.co.uk/prudential-regulation/publication/2018/strengthening-individual-accountability-in-insurance-extension-of-the-smcr-to-insurers.