INSURANCE - UNITED KINGDOM

UK implementation of Solvency II remuneration requirements

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AUTHORS

Marisa Orr

Martin Membery

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Solvency II remuneration requirements

The EU Solvency II Directive (2009/138/EC) prescribes remuneration requirements – set out in Article 275 of European Commission Delegated Regulation 2015/35 – which will apply from January 1 2016. These pertain to the governance structure and risk management of (re)insurance businesses. They include requirements for the establishment and maintenance of remuneration policies and procedures to avoid conflicts of interest and promote sound and effective risk management, so as not to encourage excessive risk taking.

Article 275(1) sets out the following overarching governance requirements:

- A (re)insurer's remuneration policy and practices must:
  - align with its business and risk management strategy, and the long-term interests and performance of the undertaking as a whole; and
  - aim to avoid conflicts of interest.
- The remuneration policy must apply to all employees and contain specific arrangements relating to:
  - members of the (re)insurer's administrative, management or supervisory body; and
  - persons who either effectively run the firm or could potentially have a material impact on its risk profile.
    (For the purposes of this update, the persons to whom these specific arrangements apply are referred to as 'material risk takers'. They would likely include the executive board, senior sales executives and heads of support and control functions such as risk, compliance, actuarial and internal audit.)
- There should be clear, transparent and effective governance of the remuneration policy.
- Where appropriate, given the size and internal organisation of the (re)insurer, an independent remuneration committee must be established to oversee the design and implementation of the remuneration policy.
- The remuneration policy must be disclosed to each employee.

Article 275(2) sets out the following specific requirements for material risk takers:

- The fixed and variable components of remuneration should be balanced so that the fixed element represents a sufficiently high portion of the total remuneration.
- Performance-related variable remuneration should be based on a combination of individual performance (including both financial and non-financial metrics), business unit performance and overall performance of the (re)insurer or the group to which it belongs.
- A substantial portion of the variable remuneration should be deferred for a period of at least three years, depending on the nature of the business, its risks and the activities of the relevant employees.
- The measurement of performance must include a downwards adjustment or exposure to

current and future risks.
- Termination payments must relate to performance over the whole period of activity and must not reward failure.
- Material risk takers must not use personal hedging strategies or remuneration and liability-related insurance which would undermine the risk alignment effects embedded in their remuneration arrangement.
- The variable remuneration of employees engaged in control functions (ie, risk, compliance, internal audit and actuarial) must be independent from the performance of the operational units and areas that are submitted to their control.

UK regulatory guidance

Neither of the UK insurance regulators – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority –has to date issued detailed guidance on the Article 275 requirements. However, the PRA has been conducting a comprehensive survey on current remuneration practices in the insurance industry in the context of developing its supervisory framework for 2016, and there seems to be a strong likelihood that the UK regulators will ultimately issue guidance on how they will supervise compliance with Article 275 of the delegated regulation.

Possible areas for future regulatory guidance, particularly with respect to the remuneration of material risk takers, include the following:

- Striking the right balance between fixed and variable remuneration – Article 275 neither stipulates bonus caps for material risk takers nor indicates when the fixed element of a material risk taker's remuneration would be considered a 'sufficiently high' portion of the total remuneration.
- Deferral of variable remuneration – Article 275 does not specify what would constitute deferral of a 'substantial portion' of the material risk taker's variable remuneration.
- Clawback – Article 275 does not expressly require (re)insurers to adopt a clawback policy ('clawback' being a form of *ex-post* risk adjustment, whereby past awards of variable remuneration may be adjusted to reflect subsequent information about the underlying risks, including emerging evidence of poor risk management). However, arguably the central tenet of Article 275 – that firms should establish, implement and maintain a remuneration policy and practices that are consistent with and promote effective risk management – means that a (re)insurer should at least consider adopting a clawback policy if to do so would allow it to manage the risks it faces more effectively.

While not necessarily indicative of the approach that the UK regulators will take to supervision of remuneration practices in the insurance industry, (re)insurers might in the interim have regard to how some of these questions have been addressed in the banking and investment services industry. The applicable remuneration requirements - set out in the EU Capital Requirements Directive (2013/36/EU) (CRD IV) and implemented in the United Kingdom via the Senior Management Arrangements, Systems and Controls Handbook (SYSC) - are notably more prescriptive than the delegated regulation's Article 275 requirements which will apply to (re)insurers. For example, CRD IV requires that:

- caps on fixed to variable remuneration of 1:1 or 1:2 (with shareholder approval) apply;(1)
- at least 40% (and in some cases 60%) of variable remuneration be deferred;(2) and
- all variable remuneration be subject to clawback.(3)

CRD IV also contains various rules on the form of any variable remuneration. CRD IV's new prudential requirements sit in a context of financial stability concerns arising from the banking crisis, but nonetheless provide a benchmark against which (re)insurers can assess their own remuneration policies and practices.

Practical steps

For those UK (re)insurers still reviewing the potential impact of Solvency II's remuneration requirements, the key items to be addressed will likely include the following:

- Gap analysis – a gap analysis of existing remuneration policy against the forthcoming requirements under Article 275 of the delegated regulation should identify any changes required to ensure that the policy is Solvency II compliant.
- Internal processes – consideration should be given to the time needed to approve and roll out any changes required to the remuneration policy and the scope, if any, for accelerating that process if necessary in order to meet the January 1 2016 Solvency II implementation date.
- Employee communications – careful consideration should be given to how best to communicate internally (especially to material risk takers) any changes to the remuneration policy.
- Other legal issues – other legal issues (eg, employment law and tax law issues) may arise with respect to any amendments to the remuneration policy and employment contracts.
- Regulatory guidance – future guidance issued by the UK regulators on how they will supervise compliance with Article 275 of the delegated regulation should be monitored, as well as any further information published at the European level.

For further information on this topic please contact Marisa Orr or Martin Membery at Sidley Austin LLP by telephone (+44 20 7360 3600) or email (morr@sidley.com or mmembery@sidley.com). The Sidley Austin LLP website can be accessed at www.sidley.com.

Endnotes

(1) CRD IV, Article 94(1)(g)(i)-(ii); SYSC 19D.3.48R-19D.3.49R.

(2) CRD IV, Article 94(1)(m); SYSC 19D.3.59R.

(3) CRD IV, Article 94(1)(n); SYSC 19D.3.61R.

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