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INDIVIDUAL NAME & ADDRESS

14 September 2016

Dear [RemCo Chair / UK NED with remuneration responsibility]

The 2016/17 Remuneration Round

I am writing to you ahead of the 2016/17 remuneration round to provide further information on relevant regulatory developments, and to inform you of the approach we intend to take to this year's annual review. This letter also shares the FCA's findings and observations from the 2015/16 remuneration round (in Annex 1).

We are sending this letter to all firms in proportionality level 1[1] subject to annual review by the FCA and it should be considered in the context of the firm-specific feedback you have previously received, which remains valid. I would like to take this opportunity to thank you and your colleagues again for your co-operation during the last remuneration round, which was welcomed.

Culture and Governance Priority

In the 2016/17 Business Plan, the FCA has identified culture and governance as one of our key priorities. We define culture as the mindsets, values and behaviours that are typical for a firm. Experience has demonstrated that culture has a significant impact on the risk of poor conduct outcomes.

Indeed, a particular organisation's culture can either act as a driver or a mitigant of conduct risk. Experience has also demonstrated that remuneration is a key tool that can reinforce or embed a firm's desired culture. Conversely, any disconnect between perceived reward outcomes and the culture will negate other factors such as the "tone from the top" and statements of firm values.

We will continue to use the annual remuneration round to ensure that remuneration policies and practices promote the link between risk and individual reward, discourage excessive risk-taking and short-termism, and encourage sound and effective risk management. This in turn reinforces stated firm values and supports delivery of a strong and appropriate conduct culture.

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[1] General Guidance on Proportionality: The Dual-regulated firms Remuneration Code (SYSC 19D) - http://www.fca.org.uk/your-fca/documents/finalised-guidance/remuneration-code-dual-regulated. Proportionality level one covers all UK banks, building societies and investment firms with relevant total assets exceeding £50billion.

Enhanced accountability

We previously reminded firms of the need to assign the prescribed responsibility for remuneration to a Non-Executive Director (NED) in scope of the Senior Managers Regime (SMR) and of the corresponding Senior Manager Function (SMF12 - Chair of the Remuneration Committee function) relevant for firms with a UK RemCo. The responsibility for remuneration must be allocated to an appropriate individual irrespective of branch or subsidiary status of the UK business of a non-UK firm.

The relevant individual must be sufficiently empowered and accountable for overseeing the development and implementation of the firm's remuneration policies and practices in accordance with SYSC 19D (dual-regulated firms Remuneration Code). We do not expect this to be a significant step-change for firms that have already implemented robust remuneration governance arrangements.

As part of reinforcing individual accountability, especially at senior management levels within firms, it will also be important for you to ensure that the outcomes of individual performance assessments are consistent with positive conduct in areas where Senior Managers have a prescribed responsibility. Where conduct falls below expectations, firms should make appropriate adjustments to individual senior managers' variable remuneration to reflect their accountability for these areas and to reinforce appropriate standards of conduct.

FCA approach to the 2016/17 Remuneration Round

In the last remuneration round, our forward looking approach focused on firms' work on aligning incentives with positive behaviours and a strong and appropriate conduct culture, irrespective of whether risks have crystallised. This year, we aim to build on the progress made in 2015/16 and will continue to focus our annual review on the potential risk that firms may be incentivising behaviours that are not in the interests of consumers, market integrity or fair competition.

In the 2016/17 remuneration round we intend to focus on:

- **Material Risk Takers (MRTs)** – identification of roles that have a material impact on the firm's risk profile, particularly those involving material conduct risk.
- **Bonus pools and individual performance assessment** – the balance and relative importance of risk and performance measures used to determine levels of variable remuneration (both those based on past year and future performance) and how these transparently demonstrate how performance has been risk-adjusted in a way that supports positive behaviours that embed a strong conduct culture.
- **Ex-post risk adjustment** – breadth and robustness of action taken to prevent rewards for conduct failure and discourage excessive risk taking or misconduct.
- **Policy changes** – compliance with latest requirements and progress against feedback, in particular how firms have implemented SMR and the extent to which the RemCo Chair/NED role has been empowered to take appropriate action.

Ex-post risk adjustment (performance adjustment)

Whilst our findings from the 2015/16 remuneration round set out below show progress by firms on ex-post risk adjustment, particularly around the strength of the consideration process and breadth of application, challenges remain with respect to the transparency of individual in-year and collective adjustments.

We also note there were no multi-firm cases observed of the magnitude of failings in relation to foreign exchange that previously came to light ahead of the 2014/15 remuneration round. It is therefore important that firms remain vigilant and continue to ensure appropriate consideration is given to all relevant individuals and events and, where appropriate, make robust adjustments.

Full expectations are set out in our general guidance on the application of ex-post risk adjustment to variable remuneration.[2]

Review process

We will co-ordinate our annual review work with that of the PRA and work closely with you and your colleagues over the course of the remuneration round. The PRA has updated the Remuneration Policy Statement (RPS) questionnaire and tables in consultation with the FCA. These are available on the PRA's website and are to be submitted to **both** the PRA and FCA.

In addition to this information, please submit alongside your RPS:

- two examples of completed performance assessments carried out for SMF holders in respect of the 2015 performance year, and
- the terms of any reward scheme tied to future performance (e.g. executive Long-Term Incentive Plans (LTIP)).

In order to facilitate the timely completion of our review, the RPS should be submitted no later than eight months after the end of the firm's preceding financial year, with supplementary data submitted in line with the review timetable set out in the RPS.

In particular, it is imperative that the list of relevant events you expect to be considered for ex-post risk adjustment as part of this remuneration round is submitted alongside the RPS.

Draft information on expected adjustments should then follow in RPS Annex 1 and RPS Table 7 three months ahead of sign-off, followed by final information as soon as practicable and no later than two weeks ahead of the date on which you have requested our non-objection. This will reduce the risk of delays in receiving our non-objection prior to you communicating and distributing your awards.

If you wish to discuss the contents of this letter further, please contact me or [SUPERVISOR NAME] on your Supervision Team.

Yours sincerely

Director of Supervision – [Retail and Authorisations Division]
[Investment, Wholesale and Specialists]

cc. Head of HR, CRO, Head of Compliance

[2] https://www.fca.org.uk/your-fca/documents/finalised-guidance/remuneration-code-application-ex-post-risk-adjustment

Annex 1 – Outcomes of the 2015/16 Remuneration Round

The FCA reviewed the remuneration policies and practices of the 17 fixed portfolio firms in proportionality level 1, comprising the major deposit takers and investment firms operating in the UK against the requirements of the dual-regulated firms Remuneration Code (the Code) and directly applicable European regulation. This review was carried out jointly with the PRA.

The 2015 annual review marked a shift in the FCA's focus from the application of ex-post risk adjustment by firms to one also aimed at evaluating how the remuneration policies and practices of firms support and drive positive behaviours and sound conduct culture.

The FCA's review focused on answering five key questions:

- **Material Risk Takers** – Are individuals who pose material risk to the firm, particularly conduct risk, being identified as MRTs?
- **Bonus pools** – Are firms taking sufficient account of non-financial risks (including conduct risks) when setting their bonus pools?
- **Balanced scorecards and LTIPs** – Are firms including non-financial metrics that are capable of driving the right behaviours and a good conduct culture?
- **Ex-post risk adjustment** – Are firms appropriately adjusting awards for crystallised risks in line with FCA rules and general guidance on the application of ex-post risk adjustment?
- **Policy changes** – Are firms complying with latest requirements and addressing prior year feedback?

This document sets out our key findings in each area and shares practices observed during the review to support industry progress in these areas.

All information provided in this report has been prepared with reference to the information submitted to the FCA for the 2015/16 annual review and does not take account of wider disclosures or subsequent changes in approach subsequently made by firms.

Material Risk Takers

During the annual review, a number of firms were reminded of the need to consider all types of risk involved in an employee's professional activities when identifying material risk takers, and not just those that are prudentially focused.

The FCA's review focused on wider categories of role that may have a material impact on the firm's risk profile, particularly those that may pose material conduct risk. The FCA also considered any individuals identified on the basis of the risks posed to a solo-regulated firm within the group.

Almost all of the firms reviewed by the FCA were able to provide examples of MRTs identified on a broader basis than under the mandatory criteria that are in place for identifying staff who are material risk takers including many with roles or responsibilities linked to delivering good outcomes for customers.

During the review, the most common such types of role identified were:

- **Additional heads of risk and support functions:** Individuals heading conduct risk, reputational risk, strategy, operational risk and financial crime functions.

- **Earnings thresholds –** Individuals earning over €500k, €750k or €1m where firms decided not to seek any exclusions.
- **Seniority –** Individuals captured above a certain job grade, or where responsible for business units, divisions or lines of business not otherwise identified as material business units.
- **Additional traders** – Those that fall below the mandatory CET1 and VAR thresholds.

Other examples included portfolio managers, senior sales staff, research analysts, client advisors, individuals responsible for customer experience or product control, senior lawyers and in cases where material crystallised risk events had been observed.

Bonus Pools

When measuring performance for the purpose of setting a firm's bonus pool, the Code requires firms to include adjustments for all types of current and future risks[3].

Whilst all firms made reference to both financial and non-financial factors when setting the bonus pool, a wide variety of risk-adjustment techniques and measures were observed in the 2015 remuneration round, with limited consistency of practice across the population. The extent to which aggregate conduct risk was taken into account, which can be more difficult to measure, varied considerably.

Those operating more sophisticated risk-adjustment methodologies utilised measures to assess the relative level of conduct risk being run to achieve a given level of performance, including for emerging issues. Considerations included building and maintaining customer relationships, reputation, achievements in line with strategy and values, and effectiveness of the risk and control environment. This allowed firms to reflect the way in which risk-adjusted performance was achieved when setting their pool, even in a year where this did not result in an increase in short-term financial performance.

Some firms relied more heavily on discretion, individual performance assessments or more tangential factors to assess conduct factors such as operational risk and adherence to risk appetite. This made it difficult for these firms to demonstrate how they had adequately adjusted their bonus pool for the impact of this risk type in order to meet FCA requirements.

In a small number of cases where the range of measures were more narrowly focused, late-stage changes in methodology or use of a high degree of discretion were observed in order to put forward a proposed pool that the firm considered to adequately reflect its broader performance, creating challenges for consistency and comparability.

Many firms still operate a fully discretionary approach. While this provides full flexibility, it often made it more difficult for firms to demonstrate to the FCA that sufficient weight had been given to relevant considerations, or that robust and independent oversight had been applied. In contrast, firms that utilised a formulaic framework with discretion applied thereafter were much more able to evidence how they had ensured a consistent and risk-adjusted outcome, even where key staff overseeing the process had changed. SYSC19D.3.24G sets out the FCA's view of good practice in this area.

[3] SYSC 19D.3.23R

Transparency

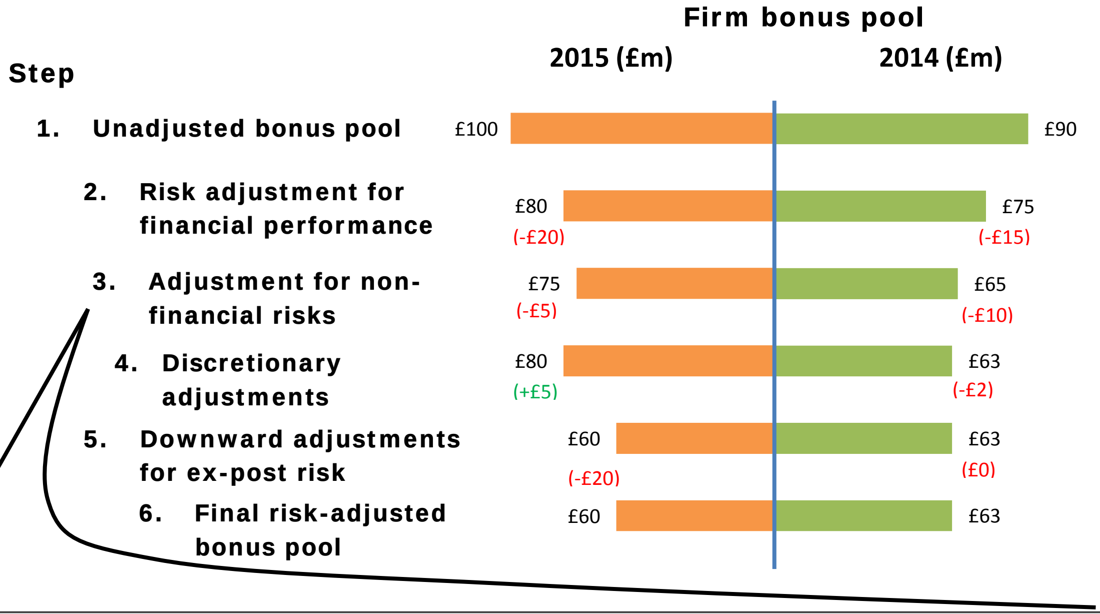
While the FCA does not prescribe the process firms should follow when risk-adjusting their bonus pools, firms are required to have a clear and verifiable mechanism for measuring performance. Thereafter firms are required to apply risk-adjustments in a clear and transparent manner[4].

Where sufficiently clear and transparent, these enabled firms to show how the relative weight and importance of major risk and performance considerations had led to the final risk-adjusted bonus pool. However, a significant number were still unable to demonstrate a clear and verifiable mechanism to provide assurance that the necessary transparency was in place to facilitate a consistent approach, subject to robust challenge from the firm's Remuneration Committee.

An approach successfully used by a number of firms to demonstrate to the FCA that their firm has an appropriate mechanism for measuring risk-adjusted performance is a 'waterfall' diagram.

When supported by appropriate further explanation, a waterfall diagram can be used as a presentational tool to illustrate simply on a step by step basis how adjustments for the firm's main risk and performance considerations have led to the final risk-adjusted bonus pool. A stylised example is set out below.

Remuneration waterfall diagram



Adjustment for non-financial risks
Measure (e.g. customer complaints, reputation etc.), outcome (improvement/worsening), impact on pool (+/-£m)
...

In this example, the final risk-adjusted bonus pool reduced by £3m from 2014 to 2015. It is possible to see from the waterfall diagram that this resulted from downward adjustments for increased financial risk and ex-post risk adjustment in 2015 that more than offset the larger unadjusted pool in 2015 (from increased profitability), upward discretionary adjustment and reduction in non-financial risks from 2014 to 2015.

[4] SYSC 19D.3.25R

Balanced scorecards and LTIPs

Balanced scorecards

Ahead of the last remuneration round, we wrote to firms requesting examples of individual performance assessments carried out for senior Code staff. This was to assess the extent to which the assessment included measures capable of driving and rewarding positive behaviours and conduct culture. As part of these discussions, we also looked at approaches adopted more widely across firms.

Our review of the measures used yielded broadly positive results. In all cases, firms used a range of financial and non-financial measures, including many directly relevant to conduct. Commonly observed measures included those linked to values, ethics, culture, strategy, customer outcomes, adherence to risk and compliance limits, and people.

Weaknesses were most commonly observed around the process for ensuring that the agreed targets and measures then led to consistent risk-adjusted outcomes. In a number of cases, it was unclear how control function input affected the outcome of the performance assessment or the view of the line manager.

FCA guidance on individual performance assessment set out in SYSC19D.3.41G is also clear that poor performance assessed by non-financial metrics, such as poor risk management or other behaviours contrary to firm values, can pose significant risks for a firm and should, as appropriate, override metrics of financial performance.

The sophistication of firms' systems and processes to track and monitor outcomes for consistency varied. In one example, a firm had implemented a system that clearly tracked reward outcomes relative to performance ratings and risk/compliance breaches across comparable job roles to ensure that those who had breached such limits or had received a lower performance rating consistently received lower levels of variable remuneration. This helped to ensure that reward outcomes were more closely aligned with stated firm priorities and to provide a positive example to other employees.

Long-term incentive plans

The majority of firms reviewed operate executive reward schemes where the value of variable remuneration due to vest is tied to an assessment of future performance based on achieving certain target measures (commonly referred to as an LTIP).

This practice was most common among firms headquartered in the UK. While the specific measures used and the balance between financial and non-financial criteria varied between these firms, on average, 65% of measures were linked to financial performance.

Typical financial measures were those linked to profitability, capital utilisation and shareholder return. Non-financial measures often looked at a similar range of measures to those used to assess past year performance. Further information on how market practice has evolved up until 2015 is set out in the Q4 2015 Edition of the Bank's Quarterly Bulletin, "Bonus regulation: aligning reward with risk in the banking sector".[5]

The FCA previously issued guidance in SYSC19D.3.30G that measures such as earnings per share (EPS), total shareholder return (TSR) and return on equity (RoE) are not suitably

[5] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q401.pdf?utm_source=emails&utm_medium=email&utm_campaign=QB15Q4

adjusted for longer-term risk factors and have a tendency to incentivise highly leveraged activities. However, these are not prohibited and continue to be used as a component of many scorecards alongside other financial and non-financial measures.

Our primary concern in the annual review was to ensure that the value of future awards was not too heavily tied solely to risk-adjusted financial performance (particularly where that performance was measured narrowly) without also taking conduct considerations into account. This was to avoid the risk of inappropriate incentives for senior executives to focus on achieving a certain target, irrespective of how this was achieved, or its potential impact on customers and the long-term interests of the firm.

For non-UK headquartered firms, LTIPs were operated at global group level and tended to be linked to a narrower range of financial measures such as EPS, TSR and ROE used in their home market. In some cases, a small number of UK Code staff continued to be included in these global plans. However, FCA requirements on performance assessment apply to the variable remuneration of all those subject to the Code, including the guidance referred to above. In order to be deemed compliant, the variable remuneration of UK Code staff must meet all relevant requirements of the Code irrespective of the geographical location of the plan. Further specific information on the treatment of awards linked to future performance is set out in the EBA guidelines[6] which apply from 1 January 2017.

Ex-post risk adjustment

Significant improvements in industry practice were observed in this area following the 2014 remuneration round and subsequent publication of FCA "General Guidance on the application of ex-post risk adjustment" in 2015.[7]

Whilst there were no multi-firm events of a similar magnitude to the failings in relation to foreign exchange that came to light ahead of the 2014 remuneration round, improvement was evident in the breadth of investigations. Where material events occurred, firms were generally able to demonstrate that a wider range of individuals were being considered on the basis of how failures or poor performance within their role and responsibilities may have contributed to the crystallisation of risk. Increased consideration of individuals was observed throughout the management chain and within the second and third lines of defence.

However, we continued to observe weaknesses at a significant minority of firms around the transparency of individual and collective adjustments when applied to current year awards rather than through malus and clawback. The FCA's general guidance articulates our expectation that it should be possible to separately identify the value of each adjustment distinct from other considerations. This is important to facilitate communication of the value and reasons for adjustments to staff in order to impact behaviour.

Policy changes

All firms were aware of and engaged in preparations to implement latest developments arising from the EBA guidelines and changes to the dual-regulated firms Remuneration Code due to come into effect.

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[6] http://www.eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies/-/regulatory-activity/consultation-paper

[7] https://www.fca.org.uk/your-fca/documents/finalised-guidance/remuneration-code-application-ex-post-risk-adjustment