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Chair, Remuneration Committee

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Dear

Remuneration at firms

In our Approach to Supervision document, we describe our focus on the key drivers of behaviour that can lead to harm, including the purpose of a firm, its leadership, its approach to rewarding and managing people, and the effectiveness of its governance arrangements.

A key aspect of reward is our ongoing assessment of remuneration policies and practices. The purpose of this letter is to let you know how we plan to assess these for firms in proportionality level 1 (level 1 firms)[1] throughout 2018/19 and what this means for you as SMF12. We also set out some thoughts on diversity and inclusion and key remuneration elements of our ongoing work on culture in financial services.

Our approach for 2018/19

<u>Link between accountability and remuneration</u>

The Senior Managers and Certification regime (SM&CR) is at the heart of our culture and governance work. The SM&CR is designed to ensure that leaders have clarity and accountability; and foster the right behaviours amongst staff. In your role as SMF12 you are accountable and responsible for the design and implementation of your firm's remuneration policies and practices, ensuring that these drive the right behaviour.

Given remuneration is such an important influence on behaviour, our supervisors will engage with you during the 2018/19 remuneration round to discuss how you have satisfied yourself that your firm's remuneration policy reinforces the firm's values, ethics and culture and promotes the right behaviour; amongst other things this will include assessing how any issues fed back as part of the previous remuneration round have been addressed. Further information on our findings from the 2017/18 remuneration round is set out in Annex 1.

Ex-post risk adjustments

We have continued to review firms' approaches to the application of ex-post risk adjustment. We still observe that firms do adjust awards, but that the size of an adjustment may not

[1] Level 1 firms include e.g. Deposit takers and investment firms with total assets exceeding £50bn as indicated in our General Guidance on Proportionality for SYSC 19D.

always match the seriousness of the incident or misconduct. As indicated in SYSC 19D and our General guidance on the application of ex-post risk adjustment to variable remuneration, where conduct for any employee falls below the standards expected, firms must make appropriate adjustments to variable remuneration. You should be satisfied that the level of adjustments are appropriate and be able to provide justifications for adjustments.

Non-objection letters

As in previous years, FCA supervisors will continue to engage with you throughout the year to ensure that the design and implementation of your firm's remuneration policies and practices drive the right behaviour. If these policies or practices could give rise to harm, or where non-compliance with the Remuneration Code is identified, supervisors will use the most appropriate tools to remedy the issue including but not limited to SM&CR. The FCA will no longer provide a 'non-objection' to your firm communicating and distributing variable remuneration awards but we will continue to write to you following the remuneration round, highlighting positive areas of engagement and any issues to be addressed. We will continue to coordinate our remuneration work with the Prudential Regulation Authority (PRA), taking into account the approach the PRA takes to engagement with firms going forward.

Diversity and inclusion

Cultures that promote diversity and inclusion will have wider benefits for an organisation; they are more likely to encourage speaking up, better decision-making and good conduct outcomes, with consequent reduction of harm to consumers and markets.

In April 2018, firms were required to publish gender pay gap information. Our supervisors will engage with you on the results of your gender pay gap analysis and plans for addressing inequalities and any other potential drivers of poor culture arising from that analysis.

Transforming Culture in Financial Services

In March 2018, the FCA published a Discussion Paper (DP) on 'Transforming Culture in Financial Services'[2] which was a collection of essays intended to encourage discussion, strengthen current consensus and speed up the pace of change for cultural transformation in financial services. The DP was followed by a conference held on 19 March 2018.

Following the conference, we published an event summary[3] identifying four key thematic lines of enquiry, one of which is on remuneration and incentives. The papers and discussions about incentives raised important questions about the efficacy and role of financial rewards. We will consider more holistically how remuneration drives and supports the cultures of firms, and what non-financial incentives can be used to motivate healthy and high-performance behaviour. Over the next year, we will continue to engage with the financial services community and convene thought leaders to explore these, and related, themes and questions. Your views on these issues are valuable and welcome.

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[2] https://www.fca.org.uk/publications/discussion-papers/dp18-2-transforming-culture-financial-services

[3] https://www.fca.org.uk/publication/documents/fca-transforming-culture-conference-event-summary.pdf

Your sincerely,

Executive Director of Supervision – [Retail and Authorisations Division]

[Investment, Wholesale and Specialists Division]

cc. [Head of HR, CRO, Compliance]

Annex 1 – Findings and observations from supervision of remuneration during 2017/18

In 2017/18, the FCA changed its approach to remuneration reviews, meaning that our supervisors engage with firms to assess and discuss remuneration issues as they arise throughout the year.

Through our on-going supervision of the level 1 firms (deposit takers and investment firms with total assets exceeding £50bn), where we identify harm or potential harm we engage with firms' senior management to address the drivers of behaviour which are likely to cause harm.

During the 2017/18 remuneration round, the FCA, jointly with the PRA, reviewed the remuneration policies and practices of 18 level 1 firms, against the requirements of the dual-regulated firms Remuneration Code (the Code) and applicable European regulation. Overall, we found that firms continue to embed conduct and culture within their remuneration policies and adjust awards to reflect material poor performance and misconduct.

The 2017/18 remuneration round focused on the following areas:

- **Identification of Material Risk Takers** (ensuring roles are identified as having a material impact on the firm's risk profile, particularly those involving material conduct risk);
- **Bonus pools** (adjustments made for non-financial risks);
- **Individual performance assessment** (ensuring sufficient focus not only on 'what' was achieved but also to 'how' it was achieved);
- **Ex-post risk adjustment** (breadth and robustness of action taken to prevent rewards for conduct failure and discourage excessive risk taking or misconduct); and
- **any changes to firms remuneration policies** (including changes due to the implementation of the EBA Guidelines on Sound Remuneration Policies (The EBA Guidelines) which were effective from 1 January 2017).

This document sets out our key findings in each area of review 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 2017/18 remuneration round and does not take account of wider disclosures or subsequent changes in approach subsequently made by firms.

Material Risk Takers

As in previous years, we focused on wider categories of roles that may have a material impact on a firm's risk profile and the identification of staff on the basis of the risks posed to a solo-regulated firm within the Group (MRTs).

In the 2017/18 round, most firms identified additional roles that expose their firm to a material level of harm beyond the qualitative and quantitative criteria set out in Commission Delegated Regulation 604/2014 on identification of MRTs (RTS).[4] We observed that firms have developed their own internal identification criteria or frameworks which seek to identify additional MRTs

[4]https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.167.01.0030.01.ENG

especially from a conduct and reputational risk perspective e.g. members of Conduct Risk Committees. These internal frameworks capture additional MRTs who would not have been identified under the mandatory qualitative or quantitative criteria set out in the RTS. We encourage firms to maintain a focus on individuals whose roles can give rise to risk including those of a prudential, operational, conduct and reputational nature.

Bonus pools

We also focused on the transparency of bonus pool setting and ensuring that adjustments are made for non-financial risks. Firms are required to base bonus pools principally on profits, including adjustments for all types of current and future risks, and to apply risk adjustments in a clear and transparent manner. Firms may apply discretionary factors but should be able to quantify and explain how discretion has been applied. We consider it good practice for firms to consider non-financial risks such as reputation, conduct and client outcomes when setting their bonus pools. As in previous years, we observed that all firms have a framework in place for setting their bonus pools.

Where bonus pools are not set in the UK, often we continued to find it more difficult to secure sufficiently granular information to inform our review. Our supervisors will continue to engage with you to ensure that bonus pools reflect risk-adjusted performance in a way that supports positive behaviours and embeds an appropriate culture.

Individual performance assessment

Firms are required to take into account financial as well as non-financial criteria when assessing individual performance. We found that some firms assess performance by focusing on the 'what' and the 'how' thereby incorporating non-financial performance. Some firms measure this through 360° feedback.

In some firms, however, it remains unclear how an individual's performance assessment translates into the amount of variable remuneration they receive, with only a discretionary link between appraisal and realised compensation. Firms are required to explain their performance assessment process to relevant employees.

Ex-post risk adjustment

During our review, we found that all firms have established frameworks in place for applying ex-post risk adjustment. Some firms have a threshold in place to determine the level of adjustments both at bonus pool and individual level. However, where the amount of adjustment is discretionary, in some cases, we found that it is difficult for firms to explain how the amount of the adjustment has been considered reasonable. We observed that the size of an adjustment may not always match the seriousness of the incident or misconduct.

The timing and application of ex-post risk adjustment remains a challenge for some firms. We noted that in some cases, firms showed over-reliance on the outcomes of enforcement investigations to inform their own decisions on the application of ex-post risk adjustment. As set out in our letter to Remuneration Committee Chairs dated 31 August 2017[5] and in our

[5] https://www.fca.org.uk/publication/correspondence/2017-letter-to-remco-chairs-on-the-application-of-ex-post-risk-adjustment.pdf

General guidance on the application of ex-post risk adjustment to variable remuneration, our expectations are that: (i) firms should start to consider ex-post risk adjustment once relevant events have been identified and impose reductions as soon as reasonably possible; and (ii) where ex-post risk adjustments are made to current or prior year awards before the full impact of the relevant event is known, subsequent consideration and, where appropriate, subsequent adjustments should be made to ensure the final value of the adjustment fully reflects the impact of the incident.

Changes to firms remuneration policies including policy changes due to the EBA Guidelines

Throughout the year, we reviewed changes to firms remuneration policies including changes due to the implementation of the EBA Guidelines. One of the main policy changes arising from the EBA Guidelines was the prohibition on the payment on dividends on deferred shares (instruments). In response, a number of firms set out an approach to 'fair value' the instruments as a non-dividend paying share does not reflect the market price. We reviewed firm's approaches in the context of the EBA Guidelines and observed firms using a formulaic calculation designed to reflect a discount to the ordinary share which results in a higher number of shares awarded to the individual.