

31 August 2017

Chair, Remuneration Committee

Dear,

The 2017/18 Remuneration Round

I am writing to you to share the FCA's findings and observations from the 2016/17 Remuneration Round (in Annex 1), and to inform you of the FCA's approach to the supervision of remuneration for 2017/18.

Remuneration, as a key driver of behaviour, continues to form part of the FCA's Culture and Governance priority, with the remuneration of senior and risk taking staff remaining an important area of focus for the FCA.

In the 2016/17 Remuneration Round, we observed improvements in the remuneration policies and practices of your firm. We also found that most of your peers had made progress in embedding conduct in their remuneration policies and practices, continuing the positive improvement observed over the previous two years.

Our Approach

This year, your firm's supervisory team will engage with you throughout the year to be satisfied that the FCA is in a position to issue a non-objection to the paying out of your firm's awards. This means that your supervisory team will assess and discuss with you the remuneration impact of issues as they arise throughout the year.

We will also assess how issues identified in your firm's remuneration arrangements communicated in the 2016/17 feedback letter have been addressed. Your supervisory team will monitor how conduct is embedded in your firm's remuneration policies and practices in a manner proportionate to concerns they may have. Potential areas of focus may include identification of Material Risk Takers (MRTs), conduct risk in bonus pools, individual performance assessment and ex-post risk adjustment. This information, together with our knowledge of your firm, will be used to form our judgements. In summary, this will allow a more flexible and proportionate approach which in turn maximises public value.

The PRA is not changing its approach to the remuneration review of your firm and that of your peers. We have liaised with the PRA on our approach and we will continue to co-ordinate our supervisory work. You will receive a joint letter from the FCA and the PRA setting out our decision in respect of non-objection. The letter will correspondingly highlight areas of joint FCA/PRA interest.

Additionally, we will continue to approve the application for exclusion of Material Risk Takers relating to staff in FCA solo-regulated firms where the FCA is the relevant National Competent Authority.

Enhanced accountability

I wish to take this opportunity to re-emphasise the need for the individuals responsible for remuneration to 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). This will continue to form part of ongoing conversations with your firm's supervisor.

The content of this letter 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.

If you wish to discuss the contents of this letter further, please contact me or a supervisor on your Supervision Team.

Yours sincerely,

Jonathan Davidson
Executive Director of Supervision – Retail and Authorisations Division

cc. Head of HR, CRO, Head of Compliance, Reward & Performance Director

Annex – Findings from the 2016/17 annual remuneration round

The FCA reviewed the remuneration policies and practices of 17 firms, 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 applicable European regulation. This review was carried out jointly with the PRA.

The 2016 annual review continued the shift in the FCA's focus from the application of ex-post risk adjustment by firms to evaluating how the remuneration policies and practices of firms also support and drive positive behaviours and sound conduct culture.

The FCA's review focused on the following areas:

- **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.

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 2016/17 annual review and does not take account of wider firm disclosures or subsequent changes in approach.

Material Risk Takers

The FCA's review 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).

We observed that all firms subject to the annual remuneration round are now addressing the EBA Guidelines on sound remuneration policies¹ (EBA Guidelines) requirement to treat Commission Delegated Regulation 604/2014 (MRT RTS) as a minimum standard for identification of individuals. Whilst additional roles identified were shared in this letter last year, there was an upward trend in the number of further additional roles identified as posing a material risk, based on a wider assessment of other types of risk, including for conduct risk.

¹ <http://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b>

Further examples of identified roles from those shared last year include sales traders, heads of desk, senior advisors, individuals previously identified under the quantitative criteria now identified under the qualitative, and heads of geographical or strategically important functions or business areas not otherwise deemed material.

Most firms used internal identification criteria to set thresholds at which other types of role should be identified in support of consistent application. While criteria linked to a certain job grade or earnings level remained popular, we noted the increased sophistication and granularity of criteria used this year. This was particularly evident at the larger and more complex firms where greater focus was given to more tailored risk-based approaches linked to the responsibilities of the role. As an example, some firm designed internal criteria which identified staff as MRTs who could have a material impact on the firm's reputational risk profile and a material impact as to the firm's customer service objectives.

As well as additional roles being identified as MRTs, in 2016, we also received an increase in the number of applications to exclude individuals from the MRT list for FCA solo-regulated firms. These were reviewed on a consistent basis with consideration to the merits of each case. Where firms could demonstrate that they had considered all risks associated with the role (including operational, reputational, client and conduct risk) and explained why these risks were not material, applications for exclusion from identification as MRT were approved. Sufficiently granular detail was key to enable the FCA to carry out an independent role-based risk assessment prior to arriving at and communicating a decision.

A small number of firms only considered the risks posed by staff to the consolidated group and not also explicitly to the solo-regulated entity on the basis of the significance of their responsibilities within that firm. Para 102 of the EBA Guidelines which apply from 1 January 2017 makes clear that all firms must now apply the MRT identification process with respect to the solo firm and consolidated group. Additional guidance on how to identify MRTs and apply FCA requirements within groups was published in PS17/10 in May 2017.

Transparency of bonus pool setting process

While the FCA does not prescribe a formulaic approach to setting bonus pools, firms are required² to have a clear and verifiable mechanism for measuring performance with risk adjustment applied thereafter in a clear and transparent manner. This should be sufficient to enable a firm to provide the FCA with details of all adjustments that the firm has made whether through application of formulae or the exercise of discretion.

We observed a greater degree of transparency this year, with most firms able to articulate their pool setting process through a waterfall diagram (as set out in last year's remuneration round letter) or other step by step process to quantify each of the main risk and performance considerations used to derive the final risk-adjusted pool from a non-risk adjusted starting point.

Firms were most easily able to demonstrate the suitability of their approach where each stage was supported by a clear narrative to explain the drivers for each adjustment. Firms with transparent approaches were also clearly able to distinguish market considerations e.g. for

² SYSC 19D.3.39 R; SYSC 19D.3.40 G and SYSC 19D.3.42 R

franchise protection or to meet commitments to shareholders from broader discretion used for residual risks not already accounted for.

In these cases, we engaged with firms to understand how market considerations were consistent with and justified by the firm's strategy and long-term performance. We also looked at the interaction with ex-post risk adjustment to ensure any in-year collective adjustments were not any less impactful.

In all cases where it was provided, greater transparency aided the completion of the FCA's review in a timely manner. Where bonus pools were not set in the UK, it was often more difficult to secure sufficiently granular information to inform our review. In such cases, further discussions and information requests were required. This was necessary to understand how operation of a group-wide approach also met UK requirements and gave consideration to the risk and performance of the EMEA group when determining the size and allocation of the pool.

Consideration of conduct risk in bonus pools

All firms have bonus pool setting methodologies in place that allow them to take account of conduct risk once crystallised e.g. to recognise compliance breaches or higher magnitude failures and misconduct where in-year collective adjustment is appropriate to take account of the impact of fines, losses and redress.

Firms are also required to adjust bonus pools for all current and future risks³. In a number of cases, we observed that risk adjustment in respect of conduct risk was not distinguished from operational risk or was limited to consideration of crystallised risks. In all such cases, feedback on the need for further development in order to meet regulatory expectations was given.

The most common approach used by firms to demonstrate consideration of conduct risk when making an ex-ante risk adjustment is by introducing conduct dashboards or scorecards incorporating appropriate MI from each business area to measure and assess divisional performance against defined, desired conduct outcomes at firm level or external measures of performance.

We have already shared examples of good practice in PS10/17. These include measures relating to:

- Building and maintaining positive customer relationships;
- Reputation;
- Achieving in line with firm strategy and values;
- Effectiveness and operation of the risk and control environment

The specific approaches varied by firm but included criteria such as incidence of complaints, customer satisfaction or advocacy rates, successful implementation of process improvements, frequency of more minor compliance or policy breaches and aggregation culture and values ratings from individual or divisional scorecards. This kind of approach allowed firms to identify trends in conduct risk and inform year-on-year discretionary adjustments at group and divisional level beyond operational risk. This made apparent to firms what the relative levels of conduct risk were to achieve their given level of performance, including for emerging issues.

³ SYSC 19D.3.23

Firms that did not adequately capture non-financial and conduct factors relied more heavily on the exercise of discretion in setting their awards. This approach made it more difficult to demonstrate the empirical factors underlying awards and therefore harder to justify to RemCo or staff why awards had been set either higher or lower than expected, particularly in comparison with a firm's year on year financial performance.

Individual performance assessments

We requested two examples of individual performance assessments carried out for current SMF holders to supplement the RPS and discussions with firms.

All firms provided examples that showed a range of financial and non-financial performance criteria. Non-financial criteria included those linked to positive treatment and outcomes for customers and clients, collaboration, culture leadership, integrity, championing values, managing risk and compliance performance/remediation and developing systems and controls.

Where a scorecard approach was taken and weightings applied, non-financial considerations generally made up 40-50% of the overall assessment. Other firms used discretionary approaches with no specific weightings.

A small number of firms applied a generic set of objectives that did not match onto the individual's specific role and responsibilities. This resulted in inconsistencies between the objective framework and the assessment narrative which made it difficult to see which objectives were important to the final grade and reward outcome. This was particularly problematic for control function staff where firms must ensure employees engaged in control functions are remunerated independently of the performance of the business areas they control.

Where the impact of behaviour on ratings and remuneration was entirely discretionary, it was much more difficult for firms to demonstrate that non-financial considerations had a meaningful impact on the outcome.

We observed a number of approaches including: mandating control function feedback, using 360 feedback including peer analysis of the resulting scores, negative control function feedback triggering an action for line managers, or consolidating a range of indicators of good and bad conduct for consideration for remuneration adjustments by a central committee.

Examples of such indicators included: tracking low level compliance incidents, failure to complete mandatory training or feedback, involvement in firm initiatives to drive a positive conduct culture, feedback showing particularly exemplary behaviours, or involvement in disciplinary proceedings. This also enabled firms to evidence and communicate the rationale behind rating and compensation decisions. The FCA views this as key to driving desired behaviours in future in line with the business strategy, objectives, values and long-term interests of a firm.

Another area of further development observed this year was more widespread use of 'what' and 'how' performance ratings to reflect any conduct issues that had occurred over the performance year. A number of firms have introduced systems or processes that track conduct indicators throughout the year for consideration at year end. This allowed firms to look for

patterns or trends in an individual's behaviour as well as enabling the production of MI to ensure consistency and appropriateness of outcomes against different conduct and performance 'filters'.

Future performance conditions

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 a Long Term Incentive Plan or LTIP).

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

UK firms primarily addressed our requirements using balanced scorecards of financial and non-financial measures. The specific measures used varied between firms and non-financial measures generally accounted for around a third of the award. Common measures linked to non-financial performance and conduct included customer metrics, the effectiveness of the risk and control environment and implementation of regulatory Risk Mitigation Plans.

The FCA previously raised concerns in the 2015 remuneration round over the inclusion of UK executives in non-UK group LTIPs that did not include non-financial performance measures. FCA guidance on remuneration in CRDIV firms (PS17/10) published in May 2017 now makes clear that the requirement in SYSC19D.3.39R(1)(b) for financial and non-financial criteria to be taken into account applies wherever performance is performance-related including within any assessment of future performance. Those firms concerned have now removed UK staff from the group plan or introduced a conduct assessment.

We also held preliminary discussions with firms and other stakeholders on upcoming changes to the terms of their LTIPs made in order to accommodate the EBA Guidelines. A common area of interest was the FCA interpretation of Para 125 of the EBA Guidelines. Firms were interested in how to carry out an assessment of past performance for staff who have been at their current employer for less than a year, where a firm does not wish to rely on future performance conditions in determining the award of an LTIP, as provided for in Para 125 of the EBA Guidelines. We recognise the high degree of complexity in this area and the correspondingly wide range of scenarios that may exist, including assessments linked to part-year performance or taking into consideration evidence of strong performance at a previous employer. The FCA remains open to engaging further with firms on their proposed approaches where such complexities exist.

Ex-post risk adjustment

Progress from previous years has generally been maintained and further incremental improvements made. In almost all cases, firms were able to evidence a wide scope of investigation, demonstrating consideration of individuals with roles and responsibilities in areas that contributed to or failed to prevent the crystallisation of risk beyond those bearing direct

culpability for gross misconduct. This enabled those firms to adjust the final value of the variable remuneration received to reflect risk and performance outcomes once known, including within all three lines of defence and up the management chain to Senior Managers, based on their accountability.

We also observed greater transparency and clearer communication of how events had explicitly impacted individual reward decisions to make clear the link between their involvement or responsibility and their variable remuneration, helping to reinforce and drive future positive conduct behaviours.

While the majority of firms are generally operating robust ex post adjustment processes, we observed in a number of cases that responsibility for systems and processes had not been clearly allocated. Consequently, when a firm experienced material crystallised risks as a result of a failure of systems or processes, some firms found it difficult to identify and adjust the awards of appropriate individuals.

Firms that operated robust governance arrangements when designing and implementing new systems and thereafter allocated clear responsibility for their operation and maintenance were better equipped to determine to whom adjustments for such failures should be applied.

We have observed an increase in the number of firms experiencing challenges in the interaction between the timing and application of ex-post risk adjustment and FCA enforcement action. We have previously given guidance⁴ that awards should be frozen for those under investigation and adjustments made 'as soon as reasonably possible'. Subsequent adjustments can then be made once the full impact of the relevant event is known.

A number of firms showed signs of over-reliance on the outcomes of Enforcement investigations to inform their own decisions on the application of ex-post risk adjustment. Whilst FCA guidance⁵ is clear that firms should make reference to regulatory action and fines when deciding whether there has been a relevant event and the amounts to be adjusted, this is only one of the criteria in Para 3.8, which itself is a non-exhaustive list.

Other criteria listed which should also be considered include impacts on customers, stakeholders, reputation and financial impacts. A decision by the FCA not to take action against individuals or the firm as a whole only satisfies one of these criteria and firms must still ensure that variable remuneration is only awarded or allowed to vest where justified by performance.

Policy changes

A new area of focus for 2016/17 was to assess how the introduction of Senior Managers Regime (SMR) had changed approaches to remuneration, and in particular how the remuneration responsibility holder has been sufficiently empowered to deliver their prescribed responsibility in accordance with the Dual-regulated firms Remuneration Code at SYSC 19D.

⁴ Para 4.1-4.2 General guidance on ex-post risk adjustment, <https://www.fca.org.uk/publication/finalised-guidance/guidance-on-ex-post-risk-adjustment-variable-remuneration.pdf>

⁵ Above at No.5

As expected, the new regime was not a significant step-change for those firms with a pre-established UK RemCo and RemCo Chair (SMF12). We also observed a significant increase over the last year in the number of local RemCos established in the UK for non-EU headquartered firms. A number of firms in this position allocated SMF responsibility to a non-executive director who also held a non-executive role on the group Board or group RemCo. Those firms highlighted the benefits of facilitating early sight of group remuneration issues relevant to the UK and the increased capacity to make recommendations and input into group decisions.

Where Committees are newly established, discussions necessarily focused on the functioning of the new governance arrangements, compliance of firm policies and RemCo expectations. For these firms, we recognise it will take time to fully embed the new governance arrangements. Having been through their first remuneration round, this will facilitate future discussion on how they have ensured effective implementation in practice.

We also looked at previously submitted Statements of Responsibilities (SoRs) related to the prescribed responsibility for remuneration. In addition to setting out the prescribed responsibility, these allow for the firm to expand on the SMF holder's responsibilities.

Firms took a range of approaches here. As similarly observed in our feedback statement, FS16/6 'Senior Managers and Certification Regime: Feedback for all UK banks, investment firms and building societies'⁶, firms submitted SoRs with additional information that was either not relevant to the individual's responsibilities or which focused on how the individual discharged their responsibilities, rather than what they were actually responsible for. We would therefore like to reiterate Handbook requirements⁷ that where a firm expands on the SMF12 role or the prescribed responsibility, including additional details of responsibilities and information, firms should remain clear and concise so as not to dilute, qualify or caveat the responsibility. Where describing the responsibilities of the SMF12, firms should describe the responsibilities of the individual only (and not the Remuneration Committee). Additionally, firms should not reference text that is external to the SoR, unless the text is submitted as supplementary information to the SoR itself.

⁶ www.fca.org.uk/publications/feedback-statements/senior-managers-and-certification-regime-supervisory-review

⁷ SUP 10C.11