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Removal of the bankers' bonus cap: impact and next steps

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The PRA and the FCA have published a joint policy statement in response to their consultation proposals on removing the bonus cap requirements to strengthen the effectiveness of the banking remuneration regime. In this Briefing, we summarise the key points arising from the final proposals, their likely impact and next steps for firms.

Background

On 19 December 2022, the PRA and FCA published their consultation paper on the cap on the remuneration ratio (the **bonus cap**) for banks, building societies and PRA-designated investment firms, including third-country branches that are subject to the Remuneration Part of the PRA Rulebook and FCA SYSC 19D: Dual-regulated firms Remuneration Code (together, **banks**). On 24 October 2023, the PRA and the FCA published a joint policy statement setting out their final proposals in response to the feedback received on that consultation paper. The proposals do not affect FCA solo-regulated investment firms (e.g. asset managers) that are subject to other Remuneration Codes. However, it will be of interest to firms that are members of a group to which the Dual-regulated firms Remuneration Code applies on a consolidated basis.

Summary of proposals

In a nutshell, the PRA and FCA propose to implement the updates to their rules with only limited changes to the approach initially considered in the consultation paper. The core point is that the bonus cap is being removed, and the most significant change made to the consultation proposals is that this will occur with full effect from 31 October 2023 – banks will not need to wait until their next performance year.

As expected, deleting the bonus cap from the rules puts more focus on the requirement for banks to set an "appropriate ratio" between the fixed and variable components of total remuneration (the **remuneration ratio**). Accordingly, the approach of the PRA and FCA is to reimagine the bonus cap for banks in a way that echoes the position for MIFIDPRU investment firms. The PRA and FCA have provided guidance on how to determine an "appropriate remuneration ratio" which is based on the corresponding provisions and guidance in the FCA's MIFIDPRU Remuneration Code (SYSC 19G).

As proposed, banks will no longer be required to limit variable remuneration for material risk takers (**MRTs**) to 100% (or, with shareholder consent, 200%) of fixed remuneration. Instead, in addition to the retained requirement to set an "appropriate remuneration ratio", banks must continue to ensure that:

— fixed and variable components of total remuneration are appropriately balanced; and

— the level of the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to remuneration no variable remuneration component

As such, the new rules would permit banks to: (i) set their own remuneration ratios for MRTs that fit their business model; and (ii) flex these remuneration ratios to reflect MRTs' roles and "potential for excessive risk taking". In practice, this shifts the balance of the obligation to set an appropriate overall mix of remuneration from the PRA and FCA and onto banks.

Timing

As noted above, the changes will apply with effect from 31 October 2023. As a result of this difference to the proposals in the consultation paper, the transitional provisions that were included in the consultation paper are no longer required and will not be made into rules. This revised approach gives firms full flexibility to determine for themselves when and how to move beyond the bonus cap (though shareholders may well have a say).

Commentary

In the main, the changes to the PRA's and FCA's rules are relatively light, leaving the Dual-regulated firms Remuneration Code substantively intact. Indeed, the PRA and FCA put significant emphasis in the consultation paper on the ongoing importance of the role of deferral, payment in instruments, and risk adjustment (including malus and clawback), which aim both to disincentivise excessive risk taking and to ensure accountability. The PRA and FCA do not suggest in the policy statement that their approach on this has changed; they do, however, hint that a wider review of the remuneration regime, aimed at streamlining the rules and making them more effective and proportionate, might follow. Proposals to better align the remuneration rules with the Senior Managers and Certification Regime (the **SMCR**) could also be pursued as part of the separate review of SMCR.

As such, the main changes proposed will merely remove references to the bonus cap, the procedure for raising the bonus cap from 1:1 to 2:1, and the (related) provisions on the discounting of instruments. Accordingly, the bonus cap would no longer apply to variable remuneration, including guaranteed variable remuneration, buy-outs and retention awards.

Draft revisions to the PRA's SS2/17 delete guidance that relates to the calculation of the remuneration ratio. However, the PRA has not proceeded with all of the changes initially proposed to its Remuneration Supervisory Statement SS2/17 (e.g. paragraph 5.33) – it has instead deleted provisions that related exclusively to the bonus cap but retained those relating to other areas (e.g. guaranteed variable remuneration) which contain reference to the "fixed to variable ratio".

These references should in future be read as references to the remuneration ratio adopted by firms rather than to the bonus cap. This confirms that guaranteed variable remuneration will count towards the variable component of the fixed to variable ratio and will continue to be subject to other variable remuneration restrictions.

Finally, despite the intended shift away from the historic EU regime, the EBA's Guidelines on sound remuneration policies under the EU CRD and EU CRR (EBA/GL/2015/22) remain applicable under the regulators' approach to EU non-legislative materials (available here for the PRA and here for the FCA).
Helpfully, the PRA and FCA have included an express statement in the policy statement directing firms to ignore those aspects of the EBA Guidelines that relate to the bonus cap.

Impact and purpose

The main bugbear of the PRA and FCA expressed in the consultation paper was the growth in the proportion of the fixed component of total remuneration (including via the use of role-based fixed allowances), which reduces banks' ability to adjust costs to absorb losses in a downturn. The PRA and FCA consider that these changes should help remove such unintended consequences of the bonus cap.
The impact is that UK-based banks will have more freedom to remuneration MRTs in a manner that suits them, and that MRTs may have both more upside and downside remuneration risk in the future.

Other objectives behind the changes include: (i) enabling banks to restructure remuneration faster and giving them further flexibility over their cost base to deal with downturns; (ii) contributing to a better alignment of risk and reward, thereby promoting the right behaviours and effective risk management; (iii) improving the competitiveness of banks, relative to other financial services firms not previously caught by the bonus cap; and (iv) facilitating UK competitiveness in global financial markets.

The consultation paper expressly acknowledged that the regulators expect the impact of this change to be gradual. This point is not developed in the policy statement, presumably because firms will now have a discretion whether to implement the change and, if so, when.

Next steps

In the short term, banks proposing to remove the regulatory cap have some risk analysis and preparatory work to do in order to address the impact for their organisation.

Key areas to consider include:

Shareholder strategy:
Existing bonus cap approvals (to increase the bonus cap from 100% to 200%) should be reviewed to determine if further shareholder approval is needed to remove the current cap, when that could be obtained and the case to be put to shareholders. If the market moves in favour of removing the cap, then shareholders are unlikely to withhold approval, but the delay in waiting for the next AGM could put these banks at a disadvantage to their peers in the meantime.

Determining the "appropriate ratio":
There will be considerations around the "appropriate remuneration ratio" to be introduced in place of the cap, and whether firms should adopt different ratios for different roles. The question of what appropriate internal caps look like is one with which MIFIDPRU investment firms have had to grapple over the last two years and which, for some, has not been straightforward to answer. Banks face a competitive risk if they take a stricter approach than their peers.

Contractual variation and strategy:
If the cap is to be removed, role-based allowance and salary structures will likely need to be revisited. Firms should consider carefully whether and, if so, how these can be amended. Even if there is an express right to remove fixed allowances, there could be a risk of contractual and constructive dismissal claims (based on an alleged breach of implied duties) in exercising this unilaterally. The cleanest approach to withdrawing fixed allowances will likely involve seeking consent from MRTs. Such a process, however, would not be straightforward, and is an issue that may provoke very different reactions from different MRTs (for example, some may be attracted to the greater upside of variable remuneration while others may object to a greater proportion of their remuneration being "at risk"). Banks may wish to conduct an initial impact assessment on the financial effects of any compensation changes on their MRTs to help anticipate resistance to such changes. Many banks may choose either to adopt a 'wait-and-see' approach or seek to recalibrate compensation strategies more slowly as new MRTs are promoted or hired into roles.

Discrimination and gender remuneration gap risks:
The liberalisation of the variable remuneration regime and award of bigger bonuses if the cap is removed could also fuel discrimination and equal remuneration claims, exacerbate the gender remuneration gap and taint gender remuneration gap reporting results, unless firms take mitigating steps. The PRA and FCA acknowledge that gender remuneration gaps in bonuses are typically larger than in fixed remuneration, and that this Wis a particular issue in the banking sector (as well as potentially remuneration gaps for other protected characteristics). Banks will need to review bonus award processes to eliminate any discriminatory aspects and ensure that these will stand up to scrutiny. At the same time, they will need to embrace the PRA and FCA's new regulatory framework on DE&I (which is the subject of a separate consultation) to help tackle the elimination of remuneration discrimination.

Stakeholder relations:
Given that remuneration (and, perhaps particularly, banker remuneration) remains a hot topic and generates headlines, banks will need to carefully manage their stakeholder relations – with investors, regulators, their workforce and the public – in relation to any planned change.

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