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Remuneration Update – Reimagining the ratio between fixed and variable bank pay

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The PRA and FCA have published a joint consultation paper on their proposals to remove current bonus cap requirements, with the aim of strengthening the effectiveness of the banking remuneration regime. In this Briefing, we summarise the key points arising from the 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 which are subject to the Remuneration Part of the PRA Rulebook and FCA SYSC 19D: Dual-regulated firms Remuneration Code (together, **banks**). The consultation paper does not affect FCA solo-regulated investment firms (eg asset managers) which are subject to other Remuneration Codes. However, it will be of interest to such firms which are members of a group to which the Dual-Regulated firms Remuneration Code applies on a consolidated basis.

The consultation paper is perhaps one of the few legacies of the ill-fated fiscal statement of 23 September 2022 delivered by the then Chancellor of the Exchequer Kwasi Kwarteng. In that statement, Mr Kwarteng announced that the Government intended to scrap the cap on bankers' bonuses, with the aim of attracting more banks and bankers to the UK. In the consultation paper, we now have sight of what this proposal might look like in practice.

Summary of proposals

In a nutshell, the PRA and FCA propose to delete the externally-imposed bonus cap from the rules, but put 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, their approach is to reimagine the bonus cap for banks in a way that echoes the position for MIFIDPRU investment firms.

As envisaged, banks would no longer be required to limit variable pay for material risk takers (**MRT**s) to 100% (or, with shareholder consent, 200%) of fixed pay. 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 pay 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 pay from the regulators and onto banks.

Timing

Banks have until 31 March 2023 to respond to the consultation paper. The proposed changes would come into force the next calendar day after the publication of the final policy – anticipated for Q2 2023 – and would apply to firms' performance year starting after that (likely, for most firms, to be their performance year starting in 2024). Transitional provisions are proposed for remuneration awarded in relation to a performance year starting before the implementation date of the final policy being consulted on. In that situation, such remuneration would still be subject to the current requirements on the bonus cap.

Commentary

In the main, the changes proposed look to be relatively light, leaving the remuneration codes substantively intact. Indeed, the regulators 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). These rules aim both to disincentivise excessive risk-taking and to ensure accountability. The consultation paper references further proposals to improve the alignment of and interlinkages between the remuneration regime and the Senior Managers and Certification Regime (the **SMCR**). These could be included in part of Jeremy Hunt's "Edinburgh Reforms" which will review and, potentially, make changes to the 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 ratio between fixed and variable remuneration. While all of this guidance supports the bonus cap, some of it also supports the remuneration ratio. It remains to be seen, following the consultation, whether aspects of this guidance will instead be retained, potentially alongside a statement confirming that the retained provisions now apply exclusively in the context of the remuneration ratio and are not intended to re-establish the bonus cap.

Further, there is a proposal to delete paragraph 5.33 of the PRA's SS2/17 which (as well as addressing the bonus cap and the remuneration ratio) speaks to guaranteed remuneration being subject to the general rules for variable remuneration. However, since there is no corresponding proposed deletion of the FCA's SYSC 19D.3.46G, these general rules applying to guaranteed variable pay are expected to remain under the reimagined regime.

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). It is to be hoped that the regulators will include an express statement in their final policy statement directing firms to ignore those aspects of the EBA Guidelines that relate to the bonus cap. In the absence of such a statement, the

expectation is that these EBA Guidelines should be read in line with the context of the developments to the UK regulatory regime.

Impact and purpose

The consultation paper expressly acknowledges that the regulators expect the impact of this change to be gradual. However, over time, they consider that the proposed changes should help remove unintended consequences that have arisen as a result of the bonus cap, and some interesting data is given about such unintended consequences. However, the main bugbear that they take aim at is 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. Greater scrutiny of new fixed remuneration arrangements, and of role-based allowances in particular, can be expected as a result.

The PRA and FCA hope that this change will improve: (i) the competitiveness of banks, relative to other financial services firms not previously caught by the 2:1 bonus cap; and (ii) UK competitiveness in global financial markets. They also consider that the changes should increase senior management accountability because senior managers would be more greatly personally impacted by the outcomes they achieve with an increased amount and proportion of "at risk" compensation. Lastly, and in keeping with wider themes of deregulation from the current Government, the amendments reduce the burden on the regulators of monitoring compliance with a fixed ratio, instead transferring compliance with new, internally set, ratios to senior management and remuneration committee chairs.

Next steps

Banks impacted by the removal of a rigid regulatory cap will need to start looking at the terms of their existing bonus cap approvals (where relevant) in order to understand what any unpicking of an internal adoption of the regulatory fixed cap would look like for their organisation. Equally important will be questions regarding the level of the internal cap to be introduced pursuant to the continuing requirement to implement an "appropriate" remuneration ratio. The conundrum of what appropriate internal caps might look like is one with which MIFIDPRU firms have had to grapple this year – and it wasn't always easy to reach a landing. As referenced in our earlier blog – **Big Bang 2.0 sees bankers' bonuses under review**, banks are also likely to want to revisit their role-based allowance structures, particularly for new MRT hires going forward. If there is an appetite to unravel existing role-based allowance structures, this will need to be carefully considered with employment law support in order to understand whether and how it could be done.

In the longer term, it is clear that UK-based banks will have more freedom to pay MRTs in a manner that suits them, and MRTs may have both more upside and downside pay risk in the future.

Contacts

Kate Pumfrey
Counsel
Tel +20 3088 1329
kate.pumfrey@allenovery.com

Jack Prettejohn
Senior Associate
Tel +20 3088 1276
jack.prettejohn@allenovery.com

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