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Financial Services - UK PRA and FCA consult on removing the bonus cap.

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The UK's Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have launched a joint consultation on the removal of the bonus cap requirements that apply to UK banks, building societies, PRA-designated investment firms and third-country branches that are subject to the Remuneration Part of the PRA Rulebook and the FCA's SYSC 19D Dual-regulated firms Remuneration Code. The deadline for consultation responses is **31 March 2023.**

Background

Currently, UK banks, building societies, PRA-designated investment firms and third-country branches that are dual-regulated by the PRA and the FCA under the Remuneration Part of the PRA Rulebook and the FCA's SYSC 19D Dual-regulated firms Remuneration Code, respectively, are subject to limits on the ratio between the fixed and variable components of total remuneration that can be paid to certain staff members. With limited exception, variable remuneration is limited to 100% of fixed remuneration or 200% of fixed remuneration where qualified shareholder approval is obtained. This is known as the 'bonus cap'.

The bonus cap derived from the EU's Capital Requirements Directive IV that was published in 2014 and transposed in the UK in line with the UK's legal obligations as an EU member state at the time. The then UK Chancellor, George Osborne, unsuccessfully challenged the imposition of this requirement at the time, with the bonus cap being criticised for hindering the UK's ability to compete for talent with other key financial centres, such as New York and Singapore.

The bonus cap has also been criticised for its role in driving up fixed remuneration, which is not 'at risk' or subject to deferral, payment in instruments, malus or clawback, thereby reducing a firm's ability to adjust costs to absorb losses in a downturn. This is due to the fact that firms, to remain competitive on total remuneration, would need to pay higher fixed remuneration to permit higher variable remuneration to be awarded. The Bank of England explored this practice in a study that was published yesterday.

In September 2022, as part of the 'mini-budget' delivered by the then UK Chancellor, Kwasi Kwarteng, the government announced that it would remove the bonus cap to help the City of London to remain competitive with other key financial centres and to help boost productivity. Although most of the other aspects of the mini-budget have since been dropped, the decision to remove the bonus cap remained. The PRA and FCA have a statutory duty to consult when changing rules and that is the reason for the present joint consultation.

Key points

The key points raised in the consultation paper are as follows:

- The initial rationale for the bonus cap was that it would limit risk-taking by capping the maximum bonus that a Material Risk Taker could receive. It is possible that removing the bonus cap could lead to higher total remuneration for some employees, which could, in turn, incentivise excessive risk-taking, although the PRA does not consider that the proposals create material risks in this regard. There is no apparent evidence that the bonus cap has had any positive impacts on limiting risk-taking and there are other remuneration and accountability rules in place to mitigate excessive risk-taking behaviours.
- The proposed removal of the bonus cap aims to: (a) strengthen the effectiveness of the remuneration regime by increasing the proportion of compensation 'at risk' that can be subject to incentive setting tools, including deferral, payments in instruments, malus and clawback; and (b) remove unintended consequences of the bonus cap, namely the growth in the proportion of the fixed component of total remuneration.

- The proposed changes will remove limits on the ratio between fixed and variable remuneration and related provisions on shareholder approval and discount rates from the Remuneration, Disclosure (CRR) and Disclosure (CRR) - Pillar 3 Templates and Instructions Parts of the PRA Rulebook, the PRA's SS2/17 'Remuneration' Supervisory Statement and the FCA's SYSC 19D Dual-regulated firms Remuneration Code.

- The proposed changes would not remove the requirement that a firm must set an appropriate ratio between the fixed and variable components of total remuneration and ensure that: (a) fixed and variable components of total remuneration are appropriately balanced; and (b) 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.

- Many of the adverse impacts of the bonus cap, namely the relative growth of fixed remuneration, have already occurred but the removal of the bonus cap would allow firms to restructure their pay over time by giving firms greater flexibility over remuneration structure design, allowing firms to rebalance towards the variable component.

- The regulators considered alternatives to removing the bonus cap, including setting a higher limit, retaining the bonus cap only for certain people and/or having alternate mechanisms for setting the limits. The regulators determined, however, that a regulatory limit on the ratio between fixed and variable components of total remuneration is undesirable from the perspective of meeting their statutory objectives and removing it will help to enhance their objectives.

- The proposed changes would come into force the next calendar day after the publication of the final policy, which is anticipated for Q2 2023, and would apply to a firm's performance year starting after that. For most firms, that is likely to be the performance year starting in 2024. There would be a transitional provision for remuneration awarded for a performance year starting before the implementation date of the final policy with such remuneration still being subject to the current requirements.

- The PRA considers that there may be scope to improve the alignment of, and interlinkages between, certain other remuneration requirements (i.e. other than the bonus cap) and the Senior Managers and Certification Regime to further support senior management accountability for risk-taking and the effectiveness of risk adjustment tools. The PRA indicates that they "will consider these issues further in due course".

Next steps

The proposed changes are subject to consultation and so the final policy changes may differ to those set out in the consultation paper. The consultation closes on **31 March 2023**. Comments or enquiries should be sent to CP15_22@bankofengland.co.uk or to: Governance Remuneration and Controls Policy Team, PPD, Prudential Regulation Authority, 20 Moorgate, London EC2R 6DA.

Tapestry comment

The proposed removal of the bonus cap will be welcomed by many firms. Many firms that we have spoken to consider the bonus cap to have had no positive impact on limiting risk-taking and have noted that it instead raises fixed costs, increases the cost and time burden of compliance and hinders the firm's competitiveness with other UK businesses and overseas competitors.

It is important to note that the removal of the bonus cap will generate a range of practical challenges that firms should start to consider as soon as possible. The following are a few indicative examples:

- The removal of the bonus cap will, in most cases, have no automatic impact on existing contractual arrangements. This means that any contractual terms that govern salary and role-based allowances will need to be considered. If a firm wishes to reduce either of these elements, there will be: (a) a contractual question – i.e. how can we lawfully reduce these elements, particularly as these should be permanent and non-recoverable remuneration components; and (b) a communication question – i.e. how can we communicate to / convince staff members with regard to the reduction of their fixed remuneration without this causing legal or retention issues. It will, therefore, likely be difficult to quickly restructure remuneration for existing employees. We have, on a few occasions, seen the terms of some role-based allowances that refer to the allowances only being payable when the staff member is subject to the bonus cap and so those terms would also need to be considered, where relevant.

- The removal of the bonus cap may not allow a firm to immediately restructure the remuneration that it offers to new hires. For example: (a) in a market where a relatively high component of fixed remuneration is paid, it may be difficult to convince a well-informed new hire to accept lower (guaranteed) fixed remuneration initially, particularly if they are moving from a comparable role which currently pays high fixed remuneration; and (b) firms will need to carefully consider anti-discrimination and equal pay laws and policies to ensure that the firm does not inadvertently breach these laws and policies through the offer of a different (less beneficial) remuneration structure to someone with a protected characteristic compared to a suitable comparator.

- Firms that are part of EU CRD-regulated groups will need to continue to apply any applicable bonus cap that would apply to UK-based staff members as a consequence of the applicable EU rules, if any.

Firms will also need to update any applicable documentation and policies which may refer to the bonus cap, such as the firm's remuneration policy, directors' remuneration policy (if applicable) and any Material Risk Taker letter or other communications. We would be happy to help with identifying and then making these updates, if helpful.

Firms should carefully consider the proposals and respond to the consultation paper with any comments or concerns that they may have. In particular, the regulators encourage firms that believe they may be disproportionately disadvantaged by the proposed timing of the final policy to respond on this point.

Matthew can be contacted directly should you wish to discuss these changes or if you require any additional information - matthew.hunter@tapestrycompliance.com