PAUL HASTINGS

Stay Current

October 2023

Follow @Paul_Hastings

The U.K. Abolishes the Bonus Cap for Banks

By Arun Srivastava, Nina Moffatt, Konstantin Burkov, Bhavesh Panchal & David Wormley

Introduction

The PRA and FCA have announced that the U.K. will be removing the bonus cap for individuals working in U.K. banks.

The U.K.'s remuneration rules for the banking and financial services sector were introduced in the wake of the 2008 Financial Crisis. The original remuneration rules were intended to create a better alignment of interest between regulated banks and in scope employees. The rules were not intended to limit total remuneration paid to employees and had the effect of encouraging firms to increase fixed pay at the expense of bonuses. The increase in fixed costs has made it more difficult for firms to respond flexibly to changing economic circumstances. The 2008 Financial Crisis, on the other hand, had highlighted risks to institutions from short-term risk taking by individuals with a view to inflating bonus payments.

The existing U.K. rules were introduced through EU level legislation and in particular the EU's Capital Requirements Directive. Post-Brexit, the U.K. has the ability to act independently and the removal of the bonus cap is an expression of the U.K.'s ability to set its own standards. The U.K. is clearly seeking to strike a new balance between establishing a competitive environment for the banking sector and ensuring that the U.K. remains well regulated. While the bonus cap is going, other remuneration rules, such as requirements around deferral and payment in non-cash instruments, remain in place.

The PRA and the FCA's position is set out jointly in Policy Statement 9/23 (*Remuneration: Ratio between fixed and variable components of total remuneration ('bonus cap')*).

Policy Motivations

In explaining the changes to the U.K.'s rules, the U.K. Regulators say that a bonus cap is not routinely imposed in other leading international financial centres outside the EU. Therefore, when compared with the rest of the world outside the EU, the U.K. is at a disadvantage. The Regulators note in this connection that the bonus cap has limited labour mobility.

Another issue of concern that the Regulators identified is the fact that the bonus cap reduced firms' flexibility in structuring remuneration. The imposition of the bonus cap increased firms' commitments to fixed remuneration. The proportion of remuneration paid to staff as fixed remuneration has increased, thereby reducing the flexibility available to firms to adjust overall remuneration through reduction of bonuses or variable remuneration. The Regulators note that the removal of the bonus cap means that firms will have flexibility to restructure pay faster and subject a greater proportion of pay to incentive setting tools. The Regulators believe that this will contribute to a better alignment of incentives and financial rewards with principles of effective risk management, good conduct and the long-term interests of regulated firms.

The removal of the bonus cap should be viewed in light of the broader thrust by the U.K. Government to deregulate the financial services sector, which includes the revocation and replacement of some EU-derived rules which have been retained post-Brexit.

Regulated Firms in Scope of the Changes

The change to the remuneration rules applies to banks, building societies and PRA Designated Investment Firms.

The rule changes are not relevant to credit unions, insurers and FCA solo regulated firms. One exception to this are solo regulated firms that are part of a group which includes a bank, where the remuneration rules apply on a consolidated basis.

Rule Changes

The current bonus cap limits remuneration of certain bank staff to 100% of their fixed remuneration. This ratio can be extended to 200% with shareholder approval.

The Regulators have agreed to remove this cap, which is the ratio between fixed and variable remuneration. Therefore, Rule 15.9(3) of the Remuneration Part of the PRA Rulebook, which sets out the limit on the maximum ratio between fixed and variable pay, is being deleted. Certain other changes to regulatory rules are being made, including deleting certain parts of the SYSC rules in the FCA Handbook.

The changes to the rules do not entirely remove the concept of a bonus cap. Firms will still need to set an appropriate ratio between the fixed and variable components of total remuneration and ensure that fixed and variable components of total remuneration are appropriately balanced. Moreover, the requirement that the level of the fixed component should be sufficiently high to allow firms the flexibility to pay no variable component will also continue to apply.

Guidance in SYSC 19D.3.48G sets out the criteria that firms will need to have regard to a number of relevant factors such as the firm's business activities, and associated prudential and this includes risks and the role of the individual in the firm. This guidance is based on guidance for firms subject to the FCA's MIFIDPRU Remuneration Code.

Other Remuneration Rules

The Regulators remind firms that other remuneration-related rules continue to apply to banks.

These include rules on deferral of variable remuneration, the payment of variable remuneration in shares or other non-cash instruments, requirements on risk adjustment and clawback and the requirement that total variable remuneration must not limit the firm's ability to strengthen its capital base.

Timing

The requirements are effective from 31 October 2023. The changes will apply to a firm's performance year which is ongoing on that date, and to future performance years. The Regulators would not ask firms to re-submit their remuneration policy statements for the ongoing year if they have already done so before the date of the publication of final policy.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

Nina Moffatt
44.020.3023.5248
ninamoffatt@paulhastings.com

Bhavesh Panchal
44.020.3321.5148
bhaveshpanchal@paulhastings.com

Arun Srivastava
44.020.3023.5230
arunsrivastava@paulhastings.com

David Wormley
44.020.3321.1032
davidwormley@paulhastings.com

Konstantin Burkov
44.020.3321.1009
konstantinburkov@paulhastings.com

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2023 Paul Hastings LLP.