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Financial services briefing

More regulatory tinkering with bonus rules

Key messages:

- Remuneration Code staff will need to wait longer until they can receive the full amount of their deferred bonus.
- The period that firms can clawback bonuses is being extended – with proposals of up to ten years after the award if the person is under investigation.
- The regulators have 'buy-outs' on their radar – firms should look out for proposals to curb this practice.
- Bonus pools may be smaller – regulators want a prudential valuation adjustment applied.

The Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**) have published a joint consultation paper (the Consultation) titled PRA CP15/14 / FCA CP 14/14 on strengthening the alignment of risk and reward: new remuneration rules. The Consultation proposes changes to the Remuneration Code (the Code) and is in response to the Parliamentary Commission on Banking Standards' report last year identifying certain weaknesses in the operation of the Code and the regulators' concern that the existing Code does not go far enough to curb short-termism in the award of bonuses.

The Consultation closes on 31 October 2014. The PRA and FCA will then respond and publish their respective final rules which will come into force for awards made for performance periods starting on or after 1 January 2015.

Scope

There are five aspects of the Consultation that should be of interest to firms: deferral periods for variable remuneration, clawback, rules relating to bailed out banks, the practice of buy-outs and the correct accounting techniques to be used for calculating bonus pools.

The proposed rules on deferral and clawback will apply to banks, building societies, and dual regulated investment firms that fall within proportionality levels 1 and 2 (being those firms with total assets exceeding £15 billion to which all of the Code's provisions apply). Certain overseas firms will also be caught in respect of their activities carried on from the UK.

The proposals are summarised in more detail below.

Deferral

Currently, either 40 per cent of bonus awards made to material risk takers (**MRTs**) or 60 per cent for directors and other high earners must be deferred for at least three to five years with awards vesting no faster than on a pro rata basis.

The Consultation proposes longer deferral periods than currently in place in order to tie in with the typical period over which major business risks tend to play out. There is some discussion of what that period should be, ranging from five years right up to twenty years. The Consultation also recognises that the value of a bonus to the recipient is discounted by reference to the length of time before it can be paid out. One study quoted by the Consultation suggests that individuals discount at a rate of about 30 per cent per annum.

Taking both those factors into account, the proposal which the PRA and the FCA have settled on is as follows:

Senior managers

A "senior manager" is a new concept which covers those who take decisions in relation to a firm's regulated activities that could have a risk of serious consequences for the firm in the UK. Senior managers would have bonuses:

- deferred for at least seven years;
- with the first vesting being not earlier than the third anniversary of the award; and

- vesting no faster than between years three and seven.

All other MRTs

- All other MRTs would have bonuses:
- deferred for at least five years;
- with the first vesting being no earlier than the first anniversary of the award; and
- vesting no faster than pro rata.

The PRA and FCA also have a power under their existing arrangements to direct firms to defer a substantial part of variable remuneration for longer, up to 10 years, where necessary for effective long-term risk management.

Clawback

The publication of the Consultation coincides with the publication of the PRA's policy statement setting out its final rules on clawback following its consultation on the issue in March this year.

There is some good news for firms in that the grounds on which clawback is to be applied are narrower than previously proposed and the PRA has changed its mind on the retrospective application of clawback.

Grounds for clawback

Firms should use reasonable efforts to clawback amounts from an individual if:

- there is reasonable evidence of employee misbehaviour or material error; or
- the firm or business unit suffers a material failure of risk management.

Previously it was proposed that the grounds for clawback should be the same as those for malus (malus being the ability of a firm to reduce a person's variable remuneration prior to it vesting) i.e. clawback should also apply if the firm or business unit suffers a material downturn in its financial performance. However, the PRA has now concluded that clawback should only apply if there is some element of an individual's culpability involved.

The final rules also allow firms to take a proportionate approach. Firms will need to form an internal policy on how they will apply clawback which the regulator should be informed about.

Clawback period

Clawback will apply for 7 years from the date of the award rather than 6 years from the date of vesting as originally proposed.

However, in the Consultation the PRA and FCA are considering lengthening the period for clawback for senior managers for a further three years (so there are ten years in total that malus and clawback can apply to variable remuneration). This extension will apply where:

- a firm has commenced its own internal inquiry into a potential material failure which could lead to the application of clawback; or
- a firm has been notified by a regulatory authority, including an overseas authority, of its own investigation which could lead to clawback.

Each firm will have discretion to determine whether either of these scenarios has arisen before taking the decision to extend the period of clawback. It is proposed that the period of extension will lapse if the internal or regulatory investigation is concluded and the person has not been found to be responsible.

If these rules are introduced, employment contracts should be amended, where necessary, to ensure that the possibility of such an extension is provided for. It would also be a good idea for firms to make it clear in any award letter that malus and clawback can apply and in what circumstances they may do so.

Commencement date

The clawback rules apply to awards made on or after 1 January 2015. The original proposal for firms to amend employment contracts to apply clawback to awards made prior to 1 January 2015 which vest after that date has been dropped. This is particularly welcome as it would have raised tricky contractual issues.

Bailed out banks

Following the public bail out of some of the UK's largest banks, the PRA and FCA recognise that there is concern that some senior management were able to walk away with their large incentive packages intact. There are existing rules in the Code that allow firms to restrict or stop payment of bonuses (including discretionary pension payments) but the regulators want to make it explicit in the rules that there is a presumption against payment or vesting of any discretionary payments to senior management of a failing firm.

Buy outs

One of the consequences of the rules on remuneration is the growing practice of 'buy-outs'. Put simply, where a member of staff who is subject to the Code leaves a firm to join a competitor, often the previous firm will cancel the unvested bonus award, while the new firm will compensate the employee for his or her forfeited award (subject to Code rules that require the buy out to align the employee with the long term interests of the new firm).

The issue for the regulators here is that this practice defeats the purpose of the Remuneration Code in that it effectively wipes the slate clean for the employee. It is also a tricky practice for the regulator to legislate against. Banning buy outs will simply make the UK an undesirable place for financiers to work and, in a global marketplace such as international finance, that just will not do.

The issue is clearly vexing the regulators. Neither the FCA nor PRA proposes a preferred solution but they do provide four possible approaches to rectifying the problem. These are:

- Banning buy-outs – not a workable option given that it is likely to make the UK uncompetitive and to drive up levels of fixed pay.
- Maintaining unvested awards – this would require firms who are subject to the Code to continue to honour unvested awards even if an employee joined a competitor. Malus would continue to apply to those awards. However, this could create the potential for a conflict of interest where the employee retains an interest in the performance of a former employer.
- Applying malus to bought-out awards – this proposal involves the regulator having the ability to apply malus to deferred remuneration where the former employer would have had grounds to do so, or the buy out being held in trust on behalf of the former employer (and subject to malus). The difficulty with this is that it substitutes the regulator for the former employer in deciding on the application of malus when it should be a contractual matter between employer and employee.
- Reliance on clawback – the last possibility is to make no change to the existing rules, but to rely on the clawback provisions (described above) which apply to vested variable remuneration, both deferred and non-deferred. This could achieve the desired result if a previous firm is required to clawback amounts from an ex-employee if it turns out that they misbehaved or made a material error / failure in risk management. The amount bought out by the new firm, however, would be safe from clawback in relation to misdemeanours at the employee's old firm and this may be unacceptable to the regulators.

Rules on buy outs will be difficult for the regulators to get right. There will almost certainly be a divergence of interests between the old firm and the new firm so the regulators are interested in hearing industry views on the practice.

Risk adjustment

The rules surrounding remuneration rely on firms to apply appropriate risk adjustment techniques to ensure that the firm's performance accurately captures the risks in the firms' businesses. Common practice is for firms to use as a benchmark financial performance which is based on the firms' profits or revenues.

In the Consultation the regulators set out their concerns that the fair value accounting model leads to overstating profits which in turn leads to higher remuneration packages and payments of bonuses. The PRA has proposed a new rule requiring firms to calculate profits for the purposes of determining their bonus pool by using the existing prudential valuation regime, which requires banks to make a prudential valuation adjustment from their fair value accounting figure. Firms already have to report to the PRA using this method so the new rule would not create extra work but it is likely to reduce the amount available for the bonus pool.

The PRA also proposes prohibiting reliance on previously used performance metrics, such as return on equity, earnings per share and total shareholder return, in the calculation of variable remuneration unless as part of a balanced and risk adjusted scorecard.

Non-executive directors

The Consultation proposes an explicit rule prohibiting non-executive directors of firms receiving variable remuneration, such as bonuses. It is already general market practice not to reward non-executive directors in this way, but the regulators want it to be codified.

Sales-based incentives

The regulators have also put down a marker that sales based incentives are on their radar and they

intend to revisit financial incentive schemes as they implement MiFID II. This is one to watch as it could have wide ranging implications.

Conclusion and action points

Affected firms will need to revisit their firms' remuneration policies, as well as conducting another exercise to determine which individuals fall within the scope of the Remuneration Code as senior managers or MRTs. Depending on the existing wording, employment contracts should be reviewed to ensure that the new clawback rules are covered. Compliance departments and regulatory reporting will also need to be involved as the regulators want to know what changes have been made. Finally, internal finance departments will need to look at the proposals for the accounting calculation of bonus pools and what this will mean for them.

These further tweaks to the Code rules give an indication that the regulators have not quite found the right balance in how to curb the bonus culture without jeopardising the incentivisation of employees and UK competitiveness. Certainly, we would wager that this is not the last we will hear on it.

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