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FCA and PRA final rules on remuneration in financial services firms

To jog your memory, in July 2014 the PRA and FCA (the Regulators) published a joint consultation paper on 'Strengthening the alignment of risk and reward: new remuneration rules (PRA CP15/14/ FCA CP14/14)'. Our briefing on this is available here. The consultation paper contained key proposals to amend the rules relating to deferral and claw back as well as the rules on remuneration of non-executive directors and bonus provisions for bailed-out banks. Now, almost a year after the consultation was originally published, the Regulators have produced a policy statement (PRA PS12/15/ FCA PS15/16) which sets out their final approach to these issues.

It is no surprise that there has been considerable delay in the production of these final rules considering the on-going debate both at national and European level on the issue of bankers' pay. In Autumn last year we had the withdrawal of the UK's challenge to the European bankers' bonus cap in the European Court of Justice. Earlier this year we also had the EBA's consultation on guidelines for sound remuneration policies which proposes to remove the principle of proportionality for remuneration rules in European member states.

It is worth noting in that context that, to accompany the policy statement, the Regulators have republished their respective guidance and supervisory statements on the principle of proportionality. What is striking is that there is no mention whatever of the political disagreement between the UK and the EBA on the subject - still less any substantive amendment to the existing UK approach. In effect, the UK regulators seem to be confirming their legal and policy position in advance of the EU debate later this year and next.

The policy statement sets out the Regulators' final position on the remuneration rules. Unsurprisingly, there is very little difference between what was proposed last July and the final rules. The main change relates to the position on deferral where the original proposals have been relaxed a little in their application to more junior staff.

The new rules on clawback and deferral will apply to variable remuneration awarded for performance periods beginning on or after 1 January 2016. The rest of the requirements will apply from 1 July 2015.

A summary of the main points is set out below:

Deferral lengths

Currently, at least 40 per cent of bonus awards for material risk takers (MRTs) or 60 per cent in the case of directors or high earners, must be deferred for at least three to five years with awards vesting no faster than on a pro-rata basis. In their original consultation, the Regulators proposed to replace this with two extended periods of deferral:

- a deferral period for Senior Managers, as defined under the new Senior Managers' Regime (SMR), of no less than seven years, with vesting no faster than on a pro rata basis from the third anniversary of the award; and
- a deferral period for all other MRTs of five years with pro-rata vesting from the first anniversary of the award.

These periods exceed the minimum requirements under the Capital Requirements Directive but the Regulators take the view that the longer deferral periods for certain categories of staff are justified by the need to improve the alignment of risk and reward. They are aware of the argument that staff may discount the value of awards subject to extended deferral and that this could lead to higher levels of fixed pay but say that this argument needs to be balanced against the need to extend risk horizons; any further increase in fixed pay would not be welcomed.

Deferral scope

Respondents to the July consultation said that the Regulators' proposals on the scope of deferral proposals failed to take into account the breadth of the MRT population which had increased this year due to the application of the EBA's regulatory technical standards (RTS) on the identification of MRTs. The

Regulators agreed that it would be disproportionate to apply five-year deferral to all MRTs below Senior Manager level as originally proposed (particularly those in junior roles with limited authority to commit the firm to risk) although the PRA maintains that the five-year deferral is appropriate for MRTs with senior, managerial or supervisory roles. In summary the deferral requirements for awards of variable remuneration will apply as set out in the tables below:

PRA requirements		
Category	**Role**	**Deferral period**
Senior managers (as defined under the SMR)		No less than seven years with no vesting prior to the third anniversary and vesting no faster than on a pro-rata basis thereafter
Risk Managers (excluding those covered by the SMR)	Members of the management body Risk managers and direct reports, except those identified solely due to committee membership Heads of material business units and their direct reports Heads of functions Managers of risk-taking MRTs	No less than five years with vesting no faster than pro-rata from year one
All other MRTs	Individual exposing firm to credit risk Individual exposing firm to trading book/market risk Individual exposing firm to trading book/market risk MRTs identified solely under quantitative criteria if subject to managerial oversight	

FCA requirements	
Category	**Deferral period**
Senior managers (as defined under the SMR) – a new definition will be introduced to cover this	No less than seven years with no vesting prior to the third anniversary and vesting no faster than on a pro-rata basis thereafter
All other MRTs	No less than three to five years with vesting no faster than pro-rata from year one

This means that the PRA and FCA will have different rules on deferral. The PRA differentiates between 'risk managers' and other MRTs (see table above) using the EBA RTS, whereas the FCA will maintain the CRD IV minimum deferral period (of three to five years) for all MRTs below Senior Manager. The FCA has made this decision to ensure consistency for these staff at FCA solo-regulated firms and also because the category of "risk manager" is based on the EBA RTS criteria which are largely prudentially-based i.e. tailored to the identification of staff who present greater prudential rather than conduct risk.

Dual-regulated firms will be required to comply with PRA minimum requirements (which will consequently make them compliant with FCA requirements).

Clawback

The FCA will follow the PRA by introducing a rule to require a minimum clawback period for all MRTs of seven years from the date of the award.

The Regulators additionally proposed that the seven-year clawback period should be extendable by three years for MRTs who perform a 'PRA senior management function' (the FCA will adopt a new definition of this term later this year) where there are outstanding internal or regulatory investigations at the end of the normal seven-year clawback period. Despite much opposition to this proposal, the Regulators have decided to press ahead and implement this rule.

Bailed-out banks

The Regulators have already implemented a rule, in line with EU requirements, that no firm in receipt of exceptional government intervention should pay bonuses to the management body unless justified. The Regulators' position remains unchanged since the consultation: it will be made explicit that the presumption against payment or vesting in a bailed-out bank extends to all discretionary payments, including payment for loss of office or discretionary pension benefits. The Regulators make clear that this change will apply from the commencement of the rules and will not apply to firms who have previously been subject to government intervention.

Buy-outs

Clearly the position on buy-outs remains undecided. In the consultation paper, the Regulators suggested four possible approaches to the issue of buy outs: ban them; require firms to maintain unvested awards in the event that an employee leaves; require buy-out awards to be held in a form that permits them to be subject to malus by the previous employer; or rely on the clawback provisions.

Respondents ruled out the first and second approaches. The Regulators have said that they intend to explore option three and to consider whether detailed proposals on this should be published. In the meantime, they will seek to ensure that clawback arrangements at firms are robust.

Risk adjustment and performance metrics

The PRA proposed that firms should calculate profit for the purposes of awarding remuneration on the basis of prudent valuation principles in order to exclude unrealised profits from thinly traded or illiquid markets from being counted as profit for the purposes of remuneration calculations. The policy statement provides detail on how this would work for groups.

For UK-incorporated regulated firms (including UK subsidiaries of overseas firms), the final rule will require them to calculate profit for the purpose of determining the initial size of their pre-risk adjusted bonus pool by adjusting their fair value accounting profit with the year-on-year change in the prudent valuation adjustment (PVA) figure. For firms that do not set a UK bonus pool and where the bonus pool is set by the parent company, the PRA will require the firm to provide evidence that the incremental change in the PVA for the UK subsidiary has been applied to the profits of the UK regulated entity that feed into the global bonus pool. As branches of overseas firms are not required to submit prudent valuation returns, they will be out of scope of this new requirement but the PRA will expect those firms to apply an appropriate adjustment to profit based on comparable principles to the extent that it is achievable.

The PRA also proposed an explicit rule against over-reliance by firms on a narrow set of metrics based on short-term revenue or profit (such as RoE, EPS and

TSR) to determine remuneration. Respondents suggested that industry practice already ensures that there is a balanced, risk adjusted score card used to determine remuneration. The PRA is therefore introducing the proposed rule that simple revenue or profit-based measures may not be relied upon to determine bonuses at aggregate or individual level except as part of a balanced and risk-adjusted scorecard.

Remuneration of NEDS

The Regulators are introducing a ban on paying bonuses to NEDs. They consider – and respondents suggested – that this will not make much difference in practice.

Impact

The changes on deferral and clawback mean that these rules are probably the most stringent in the world right now. Whether they have the effect of driving up fixed salaries and whether there are problems with enforceability remain to be seen.

All sights will now be set, however, on where the EBA will go with its proposals to scrap the principle of proportionality. We will keep you informed.

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