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MORE RISK, MORE REWARD: FINANCIAL REGULATORS PUBLISH CONSULTATION PAPER ON BANK REMUNERATION REFORM

1. INTRODUCTION

Following the global financial crisis, the UK implemented a highly structured regulatory regime for bank remuneration in line with the EU's approach under the Capital Requirement Directives. In some respects, this regime went further than the rules in other EU member states in seeking to disincentivise risky behaviour and increase personal responsibility.

In recent years, however, these rules have increasingly been criticised as excessively complex and a barrier to attracting global talent to London. Liberalisation has long been discussed, but the first major change took place in Autumn 2023 with the removal of the cap on variable remuneration (the so-called "bonus cap"), allowing banks to set their own ratio of variable to fixed remuneration. Since then, calls for reform have continued; in Chancellor of the Exchequer Rachel Reeves' first Mansion House Speech, she added her voice to these calls, stating that post-crisis regulation "had resulted in a system which sought to eliminate risk taking [which] has gone too far" and noting in particular that "post-crisis pay structures made the UK an international outlier on deferral arrangements". Bonus deferral periods in the UK were longer than those in other major financial centres.

On 26 November 2024, the PRA (along with the FCA, with whom it is jointly responsible for regulating bank remuneration) issued Consultation Paper 16/24, in which it sets out substantial proposed changes to the bank remuneration regime and invites stakeholders to provide feedback by 13 March 2025. In this briefing, we set out an overview of the PRA's key proposals and suggest what banks should be doing now to prepare for these changes.

2. KEY PROPOSALS

Structural simplification

One change which is likely to be welcomed by banks and advisors alike is the consolidation of rules which are currently duplicated in the FCA Handbook and the PRA Rulebook. The regulators are proposing to delete all duplicative provisions in the FCA Handbook, and to cross-refer to the PRA Rulebook as much as possible. This means firms will generally only need to consider one set of rules when considering their remuneration position.

Faster vesting

At present, the variable remuneration of decision-makers in a bank is subject to strict rules on the rate at which it vests, effectively imposing a long delay before those individuals can access the entirety of their variable pay. The regulatory minimum period for the most senior material risk takers is seven years – significantly longer than most other jurisdictions, and a regular focus of industry criticism. Conscious of their relatively new secondary growth and competitiveness objective (and following analysis suggesting that 70% of risk events are discovered within four years of the incident that gave rise to them), the regulators are proposing to cut the vesting period to five years for senior management function-holders approved by the PRA, and four years in all other cases. Where previously the portion subject to a deferred vesting schedule rose from 40% to 60% where variable remuneration was above £500,000, this threshold has now been raised to £660,000 (adjusting for inflation).

The Consultation also proposes to allow vesting to start immediately, rather than the "clock" only starting three years from the point at which the award is made – this will both simplify the process of managing incentives for firms

and allow affected staff to receive their bonuses much sooner. The rules requiring proportions of incentive awards to be made other than in cash are not being amended – but the retention expectations for non-cash awards (which often saw firms imposing a year-long "holding" period on shares awarded as part of bonuses) are also being removed, again enabling realisation of non-cash awards much quicker.

Identifying material risk takers

The remuneration rules for banks primarily attach to "material risk takers" – the staff whose activities are deemed by the regulators to have a potentially material impact on a bank's risk profile. Banks have to undertake identification processes on an ongoing basis, relying upon both quantitative and qualitative criteria. Whilst the qualitative criteria are fairly clear, the quantitative criteria are a somewhat blunt tool and can result in unfair or anomalous outcomes. The regulators are proposing to replace these quantitative criteria with a single expectation that where an employee's total remuneration places them within the 0.3% of highest earners within a firm but they are not captured as a material risk taker by the qualitative criteria, banks will need to consider their impact on the risk profile of the bank and make a reasoned assessment of whether the employee is a material risk taker. Practice will no doubt develop as to what this assessment should involve and who should perform it.

Increased accountability for senior managers

Since the introduction of the senior managers and certification regime for banks in 2016, the most senior executives at banks have become increasingly personally accountable for breaches of law and regulation. This Consultation continues this trend – although (as noted above) those executives will face fewer obstacles to prompt vesting of their remuneration, there will continue to be fairly strict expectations as to how that remuneration should be affected if problems arise in areas of the business for which executives are responsible.

The Consultation includes proposals requiring banks to have policies on how they could adjust remuneration for material risk takers where those individuals should reasonably be held responsible for risk events, or for failings which might have led to those risk events. Additionally, for senior management function-holders banks will need to determine variable remuneration at least partly by reference to how those individuals are discharging the duties set out in their Statements of Responsibility. Significantly, the Consultation proposes that performance adjustments should be considered even if an incident breaching the risk appetite framework of a firm does not result in a loss to the firm. We expect downwards adjustments to remuneration to be an increasingly frequent event following internal or external investigations that establish that senior individuals have not, for example, taken all reasonable steps to prevent a failing.

3. NEXT STEPS FOR BANKS

Although the consultation closes in March 2025 — and will undoubtedly be subject to much debate and industry scrutiny — there is clear political backing for many of these changes. Banks should start to consider how their share plans will need to be amended to reflect any decision to take advantage of the additional flexibility being offered, including whether any shareholder consents might be required. The same is true for listed banks whose shareholder-approved directors' remuneration policies are up for renewal in 2025. Appropriate employee consents to malus and clawback adjustments should be included in all relevant bonus and share plan documentation.

The additional expectations for banks regarding before-the-fact and post-fact adjustments to variable remuneration include requirements for information regarding risk incidents to be shared with remuneration and risk committees. Banks should ensure that the flows of management information up to those committees are in line with regulatory expectations and that the committees consider the import of risk incidents fairly and, where appropriate, with the benefit of legal advice.

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