Scrapping the UK banker bonus cap — what next for financial services pay?

Financial services firms regulated in the UK by both the Financial Conduct Authority ("**FCA**") and Prudential Regulation Authority ("**PRA"**) have long caused confusion, particularly in international financial services groups, with their complex regulatory pay structures and infamous bonus cap.

In welcome news, the regulators have announced the scrapping of the bonus cap with effect from 31 October 2023, enabling dual-regulated firms to change remuneration structures for Material Risk Takers ("**MRTs**"). We explore in this article some of the challenges and practical considerations that are likely to crop up in that process.

A recap on the cap

The bonus cap was first introduced in 2014 through EU legislation and limited the variable remuneration of MRTs to 100% of their fixed remuneration (or 200% where there was shareholder approval). An MRT is a staff member whose professional activities have a material impact on the firm's risk profile or the assets the firm manages. By way of a simple example, under the bonus cap rules, a bank CEO who receives fixed salary and allowances totalling £300,000 could only receive up to this amount in bonuses and long-term incentives (or £600,000 if the shareholders had approved a 200% bonus cap threshold).

The rationale for introducing the bonus cap was to discourage excessive risk-taking based on short-term forecasting by MRTs by setting a ceiling on the financial gains an MRT could make. The introduction of the bonus cap came hand in hand with strict rules on deferrals, malus and clawback, also introduced with the same intent.

What were the problems with the bonus cap?

The UK government, FCA and PRA opposed the cap at the time it was introduced. They had the following concerns:

- Financial services firms would be pressured to increase base salaries and allowances — components of remuneration that are fixed and not linked to longer-term performance — to enable greater variable bonus payouts. This is precisely what played out in the market. The increase in fixed pay was in many ways counterintuitive to the aims of the bonus cap: such pay cannot be reduced or clawed back if an

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MRT is found to have engaged in past misconduct, and it is not subject to deferral, so it does not necessarily incentivise a longer-term focus towards risk.
- Having such a large component of remuneration that is fixed would decrease firms' ability to absorb losses by adjusting costs in an economic downturn (and consequently reduce the competitive potential of the UK financial services sector on a global scale).

There have also been significant practical hurdles to operating the bonus cap. UK firms have faced challenges recruiting international talent from jurisdictions like Asia and the US where there are much more flexible pay structures. Implementing what would otherwise be simple secondment programmes has proved problematic as potential secondees have squirmed at the idea of being subject to a bonus cap.

The regulators' policy statement of October 2023

In December 2022, the FCA and PRA issued a joint consultation paper proposing to scrap the bonus cap.

By way of a policy statement published on 24 October 2023, the regulators implemented the proposal with some minor amendments based on responses they received. The long-awaited outcome is that, from 31 October 2023, banks, building societies and PRA-designated investment firms are no longer required to limit an MRT's variable remuneration by reference to their fixed remuneration.

Firms may choose to apply the changes to their current or future performance years, may adopt the change in future performance years or not at all. Firms now have a duty to set 'appropriately balanced' remuneration (more on this below). Importantly, the usual rules on deferrals of variable remuneration continue to apply.

The changes are not relevant to credit unions, insurers and FCA solo-regulated firms (though the latter may have interest in the changes to the extent such firms are members of a group subject to the dual-regulated firm rules).

What happens next? The future of banking remuneration

Flexible pay structures

The changes in theory give firms more flexibility with pay structures, but this is not as easy as it sounds. Many existing pay structures are contractual and will require employees' agreement to change them. Financial services firms will need to think carefully about how they manage this. An MRT may agree to reduce their base salary if tempted by the prospect of a remuneration package with a high fixed-to-variable ratio; however, this will depend on the MRT having comfort that the firm is actually going to deliver on increased bonus expectations (a challenging sell in a market of reduced bonus pools and economic uncertainty). Firms who can manage this change would have the obvious benefit of reducing the capital costs that historical high base salaries have created.

Employee messaging

If MRTs are given an election to reduce their salaries to participate in a higher-reward bonus scheme, firms will need to be prepared that not all employees will agree to this change, potentially creating a two-tiered workforce where members of the same team are remunerated differently. This is a situation firms will want to avoid. Employee messaging, and encouragement to agree to changes, will be key. Even then, firms may see a trend of employees not being quick to adopt the changes, particularly where those employees wish to manage personal financial circumstances (such as mortgage restructuring) before changing their remuneration structure. While MRTs are typically high earners, there are still individual discrepancies with approaches to personal finances — employees with a lower threshold for personal financial risk (e.g. mortgagors or those with young families) may prefer to stay on high fixed salaries (at least in the short term) while employees who are more risk-tolerant may be willing to give up high salaries in exchange for greater bonus potential. These are never simple differences to manage, and firms will want to be careful that pay practices do not develop that could be indirectly discriminatory to certain groups.

Firms who choose to do away with the bonus cap internally will need to decide on a new ratio between fixed and variable pay. Such a ratio will need to be 'appropriately balanced' taking into account the regulators' new guidance around this. The guidance is aligned with the rules that MIFIDPRU firms are subject to and says that, when setting an appropriate ratio, a firm should consider all relevant factors including the firm's business activities and associated risks and the MRT's role in the firm. Firms will need to update their remuneration policies and, on a cultural level, they may need to consider how the bonus cap removal may impact on organisational risk-taking behaviours.

Diversity and inclusion

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A key consideration in reviewing remuneration policies will be diversity and inclusion. During consultation, there was evidence before the regulators that gender pay gaps (and potentially pay gaps based on other protected characteristics) are larger in bonuses than in fixed pay. The discretionary nature of bonuses leaves them exposed to unconscious bias, so it will be vital for firms to monitor these gaps and ensure the new ratio is not used in a way that perpetuates, or exacerbates, any biases. We note the SYSC 19D (the FCA's remuneration code for dual-regulated firms) reminds firms that the Equality Act 2020 applies to all aspects of pay, including variable remuneration, and that remuneration policies will need to comply with this legislation.

Comment

Although there will be challenges bedding down any new reward structures, the scrapping of the cap will be welcome news to HR and Reward teams in the financial services sector by allowing greater flexibility with remuneration arrangements.

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