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Remuneration Codes

For banks, building societies and designated investment firms

Inside

Introduction

Since the 2007/08 financial crisis, the financial services industry has been the focus of wide-ranging reform as a result of both UK government and European initiatives. For banks, building societies and designated investment firms the latest reforms, implementing the fifth set of amendments to the EU Capital Requirements Directive (CRD V), took effect for performance periods beginning after 28 December 2020.

These reforms build on the requirements of the third and fourth sets of amendments to the Capital Requirement Directive (CRD III and CRD IV), which aimed to align remuneration principles in banks, building societies and investment firms across the EU. CRD III placed restrictions affecting the structure and timing of bonus payments, while CRD IV went a step further by imposing restrictions on the quantum of variable pay under the so-called "bonus cap". CRD V ensures these rules apply to all firms apart from those which are small and non-complex.

This Inbrief provides an overview of the Remuneration Codes issued by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – we refer to these collectively as "the UK Regulators".

What are the Remuneration Codes?

The Financial Services Authority (FSA) issued the first Remuneration Code in August 2009 as part of its regulatory response to the banking crisis. It applied with effect from 1 January 2010 to the UK's largest banks, building societies and broker dealers (approximately 26 firms in total), and required those firms to ensure that their remuneration policies, practices and procedures were consistent with, and promoted, effective risk management.

With effect from 1 January 2011, this Code was substantially revised and the number of firms within its scope significantly extended, to take account of the requirements of CRD III. It was revised again with effect from 1 January 2014 in the light of CRD IV. Several other remuneration codes were also issued, detailing the remuneration requirements for firms in different financial services sectors.

As already mentioned, this Inbrief focuses on the PRA's Remuneration Code, which regulates the position of firms covered by the Capital Requirements Regulation (CRR) from a prudential perspective, and the FCA's Remuneration Code which regulates the position of CRR firms from a conduct perspective. Both the Codes were amended to take account of CRD V.

The requirements of the Codes are supplemented by a variety of guidance, supervisory statements and opinions. This supplementary guidance is not only from the UK Regulators (in particular see the PRA's Supervisory Statement 2/17 effective from 23 July 2021) but also the European Banking Authority (EBA) (in particular, its guidelines on sound remuneration policies, the latest version of which was issued on 2 July 2021 (2021 Guidelines). The 2021 Guidelines will apply from 31 December 2021 and will replace the earlier version of the guidelines on sound remuneration policies issued in 2015 (2015 Guidelines). Post Brexit, the 2021 Guidelines do not specifically apply to the UK, but it is anticipated that the UK Regulators will update their guidance to take account of the 2021 Guidelines later this year. In the interim, firms are expected to comply with the 2015 Guidelines. (In this Inbrief, we refer to the 2015 Guidelines and the 2021 Guidelines collectively as the Guidelines.)

Which firms are caught by the Codes?

The Codes apply to CRR firms (banks, building societies and PRA designated investment firms. These include firms outside the European Economic Area (EEA) that carry on activities from a UK establishment and which would be a CRR firm if they were based in the UK. Firms in a group containing one or more CRR firms are also subject to the Codes.

The general principle of the Codes is that firms must ensure that their remuneration policies and practices are consistent with and promote sound and effective risk management. In addition, firms must ensure that their remuneration policies and practices are gender neutral – that is, based on equal pay for women and men for work of equal value.

The Codes are applied proportionately according to the firm's size and internal organisation and the nature, scale and complexity of its activities. The 2021 Guidelines suggest that these criteria should be considered from both a quantitative and qualitative perspective.

The UK Regulators categorise CRR firms into three proportionality levels depending on their total assets, with different minimum requirements for each level. Traditionally, the UK Regulators have allowed firms in the lowest proportionality level (i.e. those firms that pose the least systemic risk) to disapply certain requirements of the Codes. However, in accordance with CRD V, all CRR firms – other than the smallest and least complex firms - must now apply the remuneration requirements in full (including the bonus cap). This means that the UK Regulators' proportionality levels are now relevant only in relation to: remuneration disclosure; regulatory reporting; and expectations regarding remuneration committees.

Affected firms which operate a website must explain on it how they comply with the Codes.

Which individuals are subject to the Codes?

The Codes apply to all staff, including employees, secondees from non-UK group companies who are working in the UK, and consultants. Certain requirements under the Codes must be applied on a firm-wide basis (e.g. ensuring termination payments are not a reward for failure or misconduct), while others are applied only to "material risk takers".

An individual is a material risk taker if their professional activities have a material impact on the firm's risk profile, including:

- All members of the management body and senior management.
- Staff members with managerial responsibility over the firm's control functions or material business units.
- Staff members who are: (i) entitled to significant total remuneration in the preceding performance year i.e. their total remuneration in the preceding performance year was at least £440,000 and at least equal to the average remuneration awarded to members of the firm's management body and senior management; and (ii) whose professional activity is within a material business unit and is of a kind which has a significant impact on the relevant business unit's risk profile.
- Staff members whose activities are deemed to have a material impact on the firm's risk profile under the qualitative and quantitative criteria set out in the EBA's Regulatory Technical Standards published in June 2020 (RTS).

The qualitative criteria include staff members who have managerial responsibility for: legal affairs; accounting policies and procedures; economic analysis; human resources; information technology and security; and prevention of money laundering and terrorist financing.

The quantitative criteria apply to staff members who were awarded in or for the preceding financial year total remuneration of at least €750,000 or, in the case of firms with over 1,000 staff, a staff member whose earnings are within the 0.3% of the highest earners. There is a facility for firms to demonstrate that a particular individual who is only caught under the quantitative criteria is not a material risk-taker. The firm will require prior approval from the UK Regulators if it wishes to do so, however, and for those earning more than €1 million approval will only be given in exceptional circumstances.

More stringent requirements may be applied depending on whether the individual is:

- A "Senior Manager" performing a designated senior management function. Senior Managers are, in broad terms, the most high-level and influential individuals in the business.
- "Higher paid". A material risk taker is higher paid for a performance year if:
  - their total remuneration for that performance year exceeds £500,000; and
  - their variable pay for that performance year exceeds 33% of their total remuneration.

Remuneration structure

The main principles of the Codes relating to different remuneration structures are set out below.

Ratio of fixed pay to variable pay

This means that each firm must set appropriate ratios between fixed pay and variable pay to ensure that fixed pay is a sufficiently high proportion of total remuneration to allow for the possibility of paying no variable pay.

"Variable pay" is defined as remuneration which reflects "a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment". This includes not only discretionary and guaranteed bonuses, but also long-term cash and equity incentive plans.

"Fixed pay" is defined as remuneration which "primarily reflect[s] relevant professional experience and organisational responsibility as set out in an employee's job description as part of the terms of employment." This includes salary and benefits.

The Guidelines indicate how to determine whether pay is fixed or variable.

Under the CRD, variable pay in respect of services and performance of material risk-takers should generally not exceed 100% of fixed pay. Firms can increase the cap to 200% of fixed pay if at least 66% of the firm's shareholders agree (or at least 75% of shareholders if less than 50% of the total shares or ownership rights are represented).

The Codes set out the procedure that firms should follow to obtain a shareholder resolution to increase the cap on variable pay. In the UK Regulators' view, the 75%, 66% and 50% percentages refer to the share or ownership voting rights represented, rather than to the firm's whole issued share capital, ownership rights or the number of individual shareholders or owners.

The UK Regulators expect firms to seek a resolution of the shareholders or owners of the ultimate EEA parent. For UK-headquartered banking groups or subsidiaries of EEAheadquartered groups, this requires a resolution of the shareholders of the ultimate EEA parent. In the case of UK subsidiaries of non-EEA firms, the PRA and FCA currently accept a resolution of the immediate non-EEA parent company. Branches of non-EEA firms require a vote by the shareholders of the non-EEA firm.

There are special rules set out in the Guidelines dealing with when variable pay (including long-term incentive plans and allowances) should be considered for the purposes of the bonus cap and how it should be valued. In addition, up to 25% of variable pay will benefit from a discount if it is paid in equity or debt instruments which are deferred for at least five years. The calculation of the discount rate should consider the following three factors:

- the normal average inflation rate
- the average interest rate of EU Government Bonds
- an incentive factor linked to the length of the deferral period. The incentive factor for a five-year deferral period is 10%, increasing by 4% for each additional year of deferral.

Discretionary variable pay

The amount of the discretionary variable pay pool should be based on profit, adjusted for current and future risks, and firms should consider the cost and quantity of the capital and liquidity required. When determining the size of their annual bonus pools, firms should deduct a prudential valuation adjustment figure from fair value accounting profit. The UK Regulators make it clear that Earnings Per Share and Total Shareholder Return (two common performance measures) are not properly adjusted for longer-term risk, and firms should take this into account when developing risk-adjustment methods.

Firms must ensure that performance-related bonuses are assessed in a multi-year framework considering the performance of the individual, the relevant business unit, and the overall results of the firm. The performance-assessment process must be clearly explained to the relevant individuals.

In assessing an individual's performance, both financial and non-financial metrics (such as compliance with effective risk-management policies and regulatory requirements) should be considered.

Firms should have a firm wide deferral policy and the proportion of variable pay which is deferred should generally rise with the ratio of fixed pay to variable pay and with the quantum of variable pay awarded.

At least 40% of variable pay awarded to material risk takers should be deferred over a period of at least four years but increasing to at least seven years depending on the seniority and remuneration of the individual and whether the individual works in a significant firm. A firm is significant if it is significant in terms of its size, internal organisation and scope and complexity of its activities. In setting the length of the deferral period account should be taken of the business cycle, the nature of the business, its risks, and the activities of the individual in question in determining the length of deferral.

Where the variable pay is of a particularly high amount or is paid to an executive director of a firm that is significant in its size, internal organisation and the nature, scope and complexity of its activities, at least 60% must be deferred. The UK Regulators indicate that generally £500,000 is a particularly high amount, but in appropriate circumstances the threshold may be lower.

As mentioned above, the length of the deferral period depends on the role, responsibilities and remuneration of the material risk taker and whether the firm is significant.

For higher paid material risk takers, irrespective of whether they are working in a significant firm, the minimum deferral period for:

- Senior Managers is seven years with no vesting until three years after award and vesting no faster than on a pro rata basis thereafter;
- Material risk takers who are not Senior Managers but who are members of the management body or senior management; or who have managerial responsibility over the firm's control functions or material business units; or who are identified as a material risk taker in accordance with certain criteria set out in the RTS, is five years with vesting no faster than on a pro rata basis;
- Any other material risk taker, is four years with vesting no faster than on a pro rata basis.

For material risk takers who are not higher paid but whose annual variable pay for the relevant performance year is either more than £44,000 or more than one third of the individual total's remuneration for that performance year and who are working in a significant firm, the minimum deferral period for:

- Senior Managers or members of the management body or senior management, is five years with vesting no faster than on a pro rata basis;
- Any other material risk taker, is four years with vesting no faster than on a pro rata basis.

For material risk takers who are not higher paid but whose annual variable pay for the relevant performance year is either more than £44,000 or more than one third of the individual total's remuneration for that performance year and who are not working in a significant firm, the minimum deferral period is 4 years.

There is no requirement to impose deferral in a performance year on any material risk takers whose annual variable pay for that performance year is no more than £44,000 and no more than one third of the individual total's remuneration for that performance year, irrespective of whether they are working in a significant firm.

The 2021 Guidelines specify a minimum deferral period of four to five years (an increase on the three year minimum deferral period specified in the 2015 Guidelines).

Generally, at least 50% of both the upfront and deferred components of variable pay of material risk takers should be paid on a net-of-tax basis in the form of shares, equivalent ownership interests, or share-linked instruments or equivalent non-cash instruments. This is subject to a derogation (explained below, under "Approach to proportionality and derogations").

It is not necessary to ensure that the upfront and deferred components of variable pay have the same split of cash and instruments. Both the UK Regulators and the EBA have indicated that the deferred portion of variable pay should contain a higher proportion of instruments. In other words, more than 50% of the deferred portion of variable pay should be in instruments.

Any shares, ownership instruments or other non -cash instruments should also be subject to a retention policy, generally of twelve months, to ensure that the incentives are aligned with the longer-term interests of the firm. If the individual's variable pay is subject to a deferral period of five years, a six-month retention period may be acceptable unless the individual is a Senior Manager.

Guaranteed variable pay

Firms must not award or pay guaranteed variable pay, or provide it as an incentive, to any member of staff unless:

- It is exceptional;
- it occurs in the context of hiring new staff;
- the firm has a strong and sound capital base; and
- it is limited to the first year of service.

To demonstrate that guaranteed variable pay is exceptional, the firm must consider whether it is exceptional both on commercial grounds and prudential grounds. Firms should also consider the number of staff to whom they offer guarantees: it is difficult to demonstrate that a bonus is exceptional where a high number of new hires are awarded a guarantee. For PRA-regulated firms, guaranteed bonuses should not be the "norm" but rather should be "rare and infrequent".

Under the Codes, all guaranteed variable pay should be subject to deferral and performance adjustment. Account should also be taken of it for the purposes of the bonus cap.

Buy-out awards

A buy-out award is one that buys out rights which will be reduced or forfeited on the staff member leaving their former firm. This is treated as guaranteed remuneration. Unlike a guaranteed bonus, the UK Regulators do not require buy-out bouses to be exceptional. This is different from the position taken by the EBA in its Guidelines.

The buy-out award should not be more generous (either in terms of amount or vesting) than the awards that the staff member will forfeit. The UK Regulators apply this requirement strictly: an award of a lower amount but with a shorter vesting schedule will be in breach. The buy-out award should also align with the long-term interests of the employer and be subject to appropriate retention, deferral and performance-adjustment provisions.

Firms must ensure that buy-outs for individuals who were material risk takers in their previous firms are subject to terms which give the new firm a contractual right to reduce the buy-out if it receives a reduction notice from the former firm. The new firm must reduce the buy-out by the amount specified in the reduction notice.

The previous firm will only be able to issue a reduction notice if it has determined, acting fairly and reasonably, that the individual has committed misconduct or made a material error or there have been risk-management failings. The new firm is expected to act solely as the executor of the previous firm's decision, without any exercise of discretion. In practice, however, the new firm should at least check that the staff member is aware of the reduction notice.

Retention awards

Retention awards are not guaranteed variable pay but should nonetheless not be common practice and should be limited to rare and infrequent occurrences. A retention bonus may be appropriate in the case of restructuring; change of control; finalisation of a specific project or a winding down.

In accordance with the 2015 Guidelines, retention awards should be subject to the requirements relating to deferral, payment in instruments and performance adjustment. In addition, such awards form part of variable pay for the purposes of the bonus cap. Retention awards should not be granted to compensate for the lack of performance-related pay due to insufficient performance or the firm's financial situation.

Where a firm intends to grant retention awards to material risk takers, it must notify the appropriate UK Regulator and explain why the award is justified. The 2021 Guidelines require firms to document for each staff member the reason why it was necessary to award a retention bonus, the conditions applicable to the bonus, the retention period and the date or event after which the firm will determine whether the conditions have been satisfied. The conditions applied to the retention bonus should be linked to the retention objective and therefore should be different from the conditions applied to other variable remuneration.

In addition, under the 2021 Guidelines, when deciding whether a retention bonus should be awarded, firms should consider:

- the concerns that lead to the risk that the staff member may choose to leave;
- the reasons why the retention of the staff member is crucial for the firm;
- the consequences for the firm if the staff member leaves; and
- whether the amount awarded is necessary and proportionate to retain the staff member.

Non-executive directors and variable pay

Firms are prohibited from awarding or paying variable pay to non-executive directors in respect of activity carried out in their roles as non-executives.

Performance adjustment

Performance adjustment refers to the downward adjustment of variable pay. This may be in accordance with:

- a **malus** arrangement (under which unvested, deferred variable remuneration is reduced) or
- a **clawback** arrangement (under which the staff member is required to repay amounts he has received).

Firms which under the principle of proportionality are not required to defer variable pay (see below) will not be able to apply a malus arrangement. Such firms are still required to apply a clawback arrangement.

Where financial performance is subdued or negative, firms must ensure that variable pay is "considerably contracted", including reducing pay-outs of amounts previously earned.

Firms must ensure that any variable pay awarded to material risk takers (including both the non-deferred and deferred element) is only paid or vested if it is sustainable according to the financial situation of the firm and justified on the basis of the performance of the firm, business unit and individual. In addition, variable pay should be subject to performance adjustment where the staff member participated in, or was responsible for, conduct which resulted in significant losses to the firm and/or failed to meet appropriate standards of fitness and propriety. The Guidelines list additional circumstances in which performance adjustment should be considered, including the imposition of regulatory sanctions on the firm and any significant increases in the firm's or business unit's economic or regulatory capital base.

The PRA has indicated that performance adjustment should not be limited to the staff directly culpable for misfeasance. It should also apply to:

- staff who could reasonably have been expected to be aware of the failure or misconduct at the time but failed to take adequate steps to promptly address it; and
- staff who, by virtue of their role or seniority, could be deemed indirectly responsible or accountable for the failure or misconduct.

Under the Codes, firms are required to apply malus to deferred variable pay (including any element to be paid in non-cash instruments in the event of poor performance) to higher-paid material risk takers when:

- there is reasonable evidence of the staff member's misbehaviour or material error;
- the firm and/or relevant business unit suffers a material downturn in its financial performance; and/or
- the firm and/or relevant business unit suffers a material failure of risk management.

Clawback should be applied to higher-paid material risk takers where either :

- there is reasonable evidence of the material risk taker's misbehaviour or material error; and/or
- the firm or relevant business unit suffers a material failure of risk management. The firm must take account of all relevant factors, including the proximity of the staff member to the failure of the risk management in question and their level of responsibility.

The period for which clawback arrangements should apply depends on the role, responsibilities and remuneration of the material risk taker and whether the firm is significant.

For material risk takers who are higher paid the minimum clawback period for both deferred and non-deferred variable pay is seven years, irrespective of whether the individual works in a significant firm. If the individual is a Senior Manager firms are required to extend the clawback period from seven to ten years if, at the end of the seven year period, there is an outstanding internal or external investigation which may otherwise have resulted in the application of clawback but for the expiration of that period.

For material risk takers who are not higher paid and who are working in significant firm, either as a Senior Manager or as a member of the management body or senior management the minimum clawback period for deferred variable pay is six years. For non-deferred variable pay it is one year .

In all other cases the minimum clawback period for material risk takers for deferred variable pay is five years and for non-deferred variable pay is one year.

Note that as explained above if the annual variable pay of a material risk taker for a particular performance year is no more than £44,000 and no more than one third of the individual total's remuneration for that performance year, there is no requirement to defer a proportion of that individual's variable pay for that performance year

There are several legal and practical difficulties with implementing performance-adjustment mechanisms, particularly for existing awards, so firms should seek advice on such arrangements.

Pension policy

A firm's pension policy must be in line with its business strategy, objectives, values and long-term interests. Pension contributions which are discretionary (i.e. in the nature of a bonus) should be held for five years in the form of shares/equivalent ownership interests.

Termination payments

Payments on termination of employment should not reward failure or misconduct but should reflect the performance achieved over time.

Severance pay should not be awarded where either of the following applies:

- a staff member voluntarily resigns to take up a position in a different legal entity (unless required by national law).
- there is an obvious failure which allows the employer to summarily dismiss the staff member.

In addition, where a firm does award severance pay, it must be able to demonstrate the reasons for the settlement, the appropriateness of the amount of the payment and the criteria used to determine that amount. When determining the amount of a severance payment, the firm should consider performance achieved over time and assess (where relevant) the severity of any firm or individual failure.

Termination payments are variable pay. However, there is currently no need to take certain termination payments into account for the purposes of the bonus cap and the pay-out process rules (i.e. the application of deferral pay-out in instruments and performance adjustment). These include:

- termination payments that are mandatory under national labour law or following a decision of a court.
- termination payments that are subject to a contractual non-competition clause and paid out in future periods up to the amount of the fixed pay which would have been paid for the non-competition period, if staff were still employed.
- termination payments where the firm has demonstrated the reasons and the appropriateness of the amount of the severance payment where either
  - the firm and the staff member agree on a settlement in the case of a potential or actual employment law dispute to avoid litigation; or
  - in broad terms, the staff member is being made redundant.

Under the 2021 Guidelines, the types of termination payments which can be disregarded for the purposes of the bonus cap and the payout process rules are more restricted in particular firms will need to be able to demonstrate the reasons for and the appropriateness of any amount paid in return for a non-competition clause and a settlement payment in the case of an employment dispute will only be disregarded if there is an actual labour dispute which could otherwise realistically lead to court action.

The EBA has also confirmed that discretionary pension benefits are not severance payments even if the staff member retires.

It is best practice not to accelerate the vesting of any outstanding bonus payments or long-term incentive awards.

Hedging strategies

Material risk takers should undertake that they will not engage in personal-investment strategies that undermine risk strategies, such as hedging or remuneration-related insurance strategies. The Guidelines suggest that firms should implement arrangements to ensure material risk takers are complying with this provision, including by conducting spot checks.

Approach to proportionality

The effect of the proportionality principle is that not all firms have to give effect to the remuneration requirements in the same way and to the same extent. Proportionality operates both ways: some firms will need to apply more sophisticated policies or practices in fulfilling the requirements while others will be able to meet the requirements in a simpler or less burdensome way.

As stated above, all CRR firms should comply with the CRD V requirements in full unless one of the limited derogations set out below apply. Even where one of the derogations is applicable, it only applies to the rules requiring firms to defer variable pay and pay variable pay in non-cash instruments. The two derogations are for:

- "Small and non-complex" firms, which are not a subsidiary of a significant firm and whose asset value over the four-year period immediately preceding the relevant financial year is on average equal to or less than EUR 15 billion.
- Staff members whose total annual variable pay for the relevant performance year is £44,000 or below and not more than one third of the individual's total annual remuneration for that year.

Breaches of the Codes

Under the Financial Services Act 2010, the UK Regulators have power to:

- prohibit a firm from remunerating its staff in a specified way
- make rules to render a contractual term void if it contravenes such a prohibition.

Under the Codes, contractual terms for material risk takers who do not satisfy the De Minimis Concession (see below) are void in certain circumstances if they breach the rules on guaranteed variable pay, buy-out awards, deferral of discretionary variable pay or clawback of variable pay. Such terms will be void if the material risk taker works for a firm that has relevant total assets exceeding £50 billion or is a credit institution or PRA-designated investment firm which forms part of a group that has relevant total assets exceeding £50 billion. Relevant total assets are the arithmetic mean of the firm's total assets as set out in its balance sheet on the last three accounting reference dates.

An individual will satisfy the De Minimis Concession for a performance year if:

- total remuneration for that performance year is not more than £500,000; and
- variable pay for that performance year is not more than 33% of the individual's total remuneration.

Where a payment or other property is paid or transferred to an individual in pursuance of a void term, the firm is obliged to take reasonable steps to recover it from the individual. The firm is restricted from paying further variable pay to that individual in respect of the same performance year, unless it has a legal opinion stating that the award complies with the Codes.

Any payment made in breach of this restriction is also void and should be recovered.

The Codes contain wide anti-avoidance provisions, requiring all firms to ensure that variable pay is not paid through vehicles or using methods that facilitate avoidance of the Codes. One example of a device that is viewed as a breach of the Codes is the practice of effectively awarding staff an immediate bonus by giving them non-recourse loans pledged against share/share equivalent awards which are still subject to retention or deferral.

Sanctions which are available to the UK Regulators for breach of the Codes include: private warnings (which may include restricting how a firm structures its variable pay in the future); fines; public censure; and ultimately, variation or cancellation of a firm's authorisation.

How can we help?

We have a specialist team of employment and reward lawyers able to review and advise on your remuneration plans, policies and practices and contracts for individual staff members. We can ensure they are compliant with the Codes and advise where necessary on how they should be amended.

For further information on this subject please contact:

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