Bonus regulation: aligning reward with risk in the banking sector

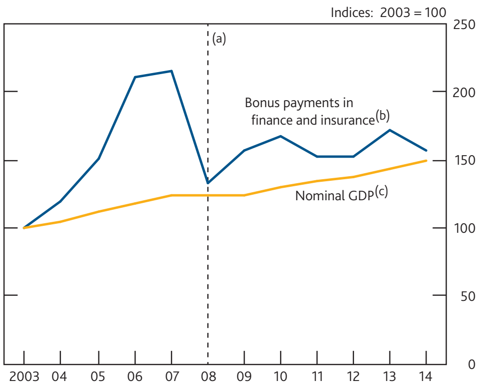
By Marilena Angeli and Shahzad Gitay from the Bank's Cross-Sectoral Policy Division.[1]

- Remuneration policies in the banking sector incentivised excessive risk-taking, thereby contributing to the financial crisis. Since the crisis, remuneration rules have come into force to better align employees' incentives with the long-term health of banks and the financial system.
- This article explains the key components of the Prudential Regulation Authority's remuneration rules for banks and considers the direction of the global policy agenda.

Overview

In the years leading up to the financial crisis, bonus payments more than doubled in the finance and insurance industry — significantly outpacing growth in overall spending in the economy (shown by nominal GDP in the **summary chart**). There is broad consensus that banks' remuneration policies were a contributing factor to the financial crisis. This included rewarding high short-term profits with generous variable remuneration awards (like bonuses) by encouraging excessive risk-taking that did not consider the long-term risks created for banks and, ultimately, wider society. The global regulatory response sought to align incentives with risks taken. In the United Kingdom, the Bank of England's Prudential Regulation Authority has implemented rules to achieve this with a view to improving the safety and soundness of individual firms and the resilience of the financial system.

Summary chart Timeline of UK bonus payments



Sources: ONS and Bank calculations.

(a) From 2007–08 there was a large drop in the value of the FTSE 100 UK banks.
(b) See footnote (b) on **Chart 1**.
(c) GDP at current prices on a financial-year basis.

Requiring the size of awards to employees to be determined by a balanced suite of metrics, and requiring awards to be paid at least 50% in non-cash instruments which tie the size of the award to the longer-term performance of the firm, should help to align incentives from the outset. Deferring awards means they can be adjusted to reflect longer-term risk horizons. From 2016, deferral periods of up to seven years from the date of payment will apply. Through reduction of unvested awards ('malus') and reclaiming vested awards ('clawback'), *ex-post* adjustments can be made up to ten years from the initial date of award. Finally, variable remuneration payments must not limit firms' abilities to strengthen their capital bases.

Looking ahead, remuneration remains on the agenda for regulators around the world. As Governor Carney said in November 2014, 'Senior manager accountability and new compensation structures will help rebuild trust in financial institutions'. One consequence of the regulation of remuneration, particularly the introduction in the European Union of the bonus cap, has been an increase in fixed remuneration as a proportion of total remuneration. As with excessive variable remuneration without appropriate incentives, this can also impact negatively on resilience within the financial system. Higher fixed pay limits the proportion of total remuneration that can be used to absorb losses in a downturn and that which is aligned to long-term risks. The global regulatory focus is on the need to ensure a sufficient portion of remuneration remains 'at risk' of being reduced or eliminated and on the role of incentives in reducing misconduct.

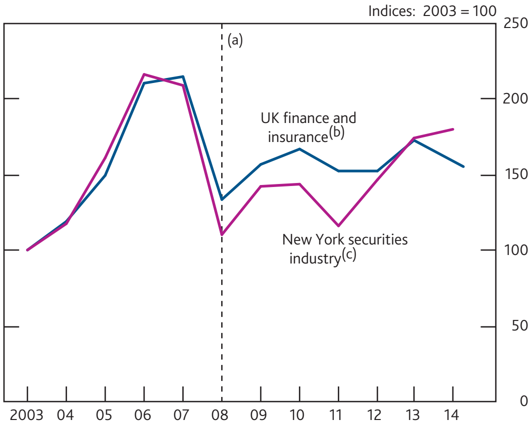
Click here for a short video that discusses some of the key topics from this article.

(1) The authors would like to thank Christopher Gynn for his help in producing this article.

Introduction

In the years leading up to the financial crisis, the quantities of variable remuneration paid out within the UK financial sector increased substantially with a similar trend seen elsewhere, for example in the United States (**Chart 1**). There is broad consensus that, particularly in banks, remuneration policies were one of the contributing factors to the financial crisis. Lord Turner, former Chair of the Financial Services Authority (FSA), has highlighted the role that inappropriate incentive structures played in encouraging imprudent behaviour. The Treasury Select Committee's report on the banking crisis argued that, in too many cases, 'the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks'. The report criticised the bonus-driven remuneration structures prevalent in the City of London and other financial centres that led to 'reckless and excessive risk-taking'.

Chart 1 Bonus payments across the UK finance and insurance industry and bonus pools in the New York securities industry



Sources: Office of the State Comptroller (OSC), ONS and Bank calculations.

(a) From 2007–08 there was a large drop in the value of the FTSE 100 UK banks. See the House of Commons Treasury Committee (2009).
(b) Finance and insurance industry as defined by the ONS. Bonus payments paid during the financial year, figures derived from the ONS Labour Market Statistics release. The base year is the 2003/04 financial year.
(c) Data derived from the OSC estimations of bonus pools in the New York securities industry. The base year is set for year-end 2003.

The perceived role of remuneration in incentivising excessive risk-taking and undermining sound and effective risk management brought remuneration onto international regulatory agendas. This article explains the broad types of remuneration that are currently used by firms, and some of the 'incentive effects' to which they give rise. It explains the international and domestic remuneration rules that have been brought into force since the crisis with the objective of better aligning the incentives of individuals with the risks taken. Finally, the article describes how global regulators are working to ensure the effective implementation of these reforms and strengthen them further going forwards. Click here for a short **video** that discusses some of the key topics from this article.(1)

What is variable remuneration?

Employees' remuneration packages can be broken down into two parts. **Fixed remuneration** is the contracted, fixed in advance amount, which is paid to an employee for their work as a reflection of their professional experience and the responsibilities associated with their role. **Variable remuneration** includes any remuneration awarded in addition to the fixed element, which varies according to some measure of performance (the main example being bonuses).

The primary purpose of variable remuneration is, therefore, to incentivise performance, but there are other reasons why firms award variable remuneration. Having a substantial proportion of remuneration that can be varied provides greater flexibility in the management of banks' costs. Variable pay may also be awarded due to the expectations of individuals working in the banking sector — particularly those working in investment banking. Deferred variable remuneration, where payment of the award is delayed for a set time period, may also play a role in staff retention. Furthermore, variable remuneration can help to address the 'agency problem' by enabling a better alignment between the interests of risk-takers within firms and their shareholders, and between the interests of shareholders and wider society. The box on page 324 explains this in more detail.

Variable remuneration can consist of a combination of bonuses and long-term incentive plans (LTIPs). Bonuses are usually delivered at the end of the firm's reporting year and, by reflecting the performance over the year, are used to incentivise the delivery of targets and/or assess employees' performance against a range of financial and non-financial metrics. They are therefore based on prior performance over a relatively short period. LTIPs, by contrast, seek to align the interests of the employee with the long-term interests of a firm, and performance is determined with reference to forward-looking metrics assessed over a multi-year framework. These metrics effectively act as a 'scalar' to the initial award value: if defined targets are not met, then the initial value of the award will be adjusted downwards. Exceeding or meeting targets would result in the full value of the initial award remaining. The size of any adjustment will depend on the outturn of performance compared to the target.

For the finance and insurance industry, variable remuneration reached a peak of 34% of total remuneration in 2006 (**Chart 2**). Despite falling back following the onset of the financial crisis, it has continued to be a sizable proportion, on average comprising one quarter of total remuneration between 2007 and 2013, before falling to 20% of total

(1) https://youtu.be/k29LK7jGRUM.

The 'agency problem'

This box introduces the agency problem. It then explains the theory behind the use of certain forms of variable remuneration — such as payment via non-cash instruments like shares or debt — which can serve as a solution to this problem. The following section of the article discusses the actual changes that have occurred since the crisis in the form that variable remuneration typically takes.

What is the agency problem?

The origin of the 'agency problem' (sometimes known as the 'principal-agent problem') lies in the separation of ownership and management of the firm. Executive directors (agents) act on behalf of shareholders (principals) in making decisions and carrying out activities for the firm.

The theory assumes a conflict of interest between a firm's shareholders and the executive directors. Executive directors acting as the agents are hired to make decisions that will maximise shareholder wealth. However, as agents, they may be tempted to maximise their own wealth. By taking more (or greater) risks than the shareholders would, they stand to receive immediate gains (such as high bonuses) but will not be liable for any costs or losses the firm and shareholders may subsequently incur.

Shareholders may therefore wish to monitor executive directors' actions to ensure they accord with their own risk appetite. In reality, however, constant monitoring is costly and impractical.

Variable remuneration as a way of aligning employee and shareholder incentives

A solution would be to use variable remuneration to attempt to better align the executive directors' risk appetites to those of the shareholders. For instance, variable remuneration awarded as shares transfers a proportion of the bank's ownership onto the executive directors. This could increase long-term performance considerations in executive directors' decision-making, better aligning the time horizons which they consider with the time horizons over which risks may manifest themselves.

Shareholders' incentives and financial stability

There are instances, however, when shareholders' incentives may not lead to the strengthening of financial stability. Some shareholders may have a very high appetite for risk. In such cases, aligning employee incentives with those of shareholders could lead to risk-taking levels beyond those which the Prudential Regulation Authority considers prudent. Hence, a secondary agency problem arises from the divergence of incentives between shareholders and the wider society, reflected by financial stability. Payment in debt instruments might provide an alternative way to link variable remuneration to the long-term health of the firm, and, hence, financial stability. The European Banking Authority has issued a regulatory technical standard which provides for the payment in convertible debt instruments which reflect the credit quality of an institution as a 'going concern' — that is, where a firm is viewed to be operational and profitable for the foreseeable future, and meets their regulatory requirements.

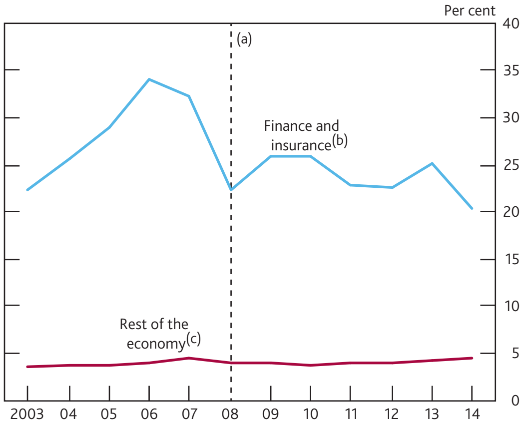
In a debt-based award, the future gains are fixed when the award is made, with adjustments only possible in the form of reduction — in contrast to an equity award which has the potential of unlimited upside gain should the price of the equity increase. Debt instruments could, for example, be structured to automatically absorb losses when a firm's capital level falls below a certain threshold. The awards could be converted to equity to help ensure that the capital returned to above the breached threshold. It is, therefore, sometimes argued that payment in debt instruments better aligns the incentives of bank employees with those of wider stakeholders, in particular the firm's creditors. However, to date, there has been very limited use of such instruments. This reflects the fact that institutions find them costly to develop and implement, they are not popular with shareholders (because of their large coupon payments, for example), their lack of transparency and certainty, and the fact that eliminating upside gains can make them unpopular with recipients.

remuneration in 2014. For most companies in the economy, by contrast, pay largely comprises of fixed remuneration and only a relatively small proportion of total pay — less than 5% — is variable.

Regulating remuneration

This section begins by explaining how the regulation of remuneration can support resilience in the banking sector and financial stability. It looks at how remuneration has featured in the international and UK regulatory agenda following the crisis. It then focuses on the main components of the rules that have been introduced in the UK financial sector since the crisis, which include: rules relating to the form that variable remuneration takes (for instance, cash versus non-cash awards); the use of broader performance metrics; longer deferral periods between when an award is made and when it is paid out; and the conditions under which an award can be scaled back by 'malus' or 'clawback'. The infographic on page 331 summarises the main changes in the remuneration rules since the onset of the financial crisis.

Chart 2 Bonus payments as a percentage of total remuneration in the United Kingdom



(a) From 2007–08 there was a large drop in the value of the FTSE 100 UK banks.
(b) Finance and insurance industry as defined by the ONS.
(c) Rest of the economy as defined by the ONS.

How can regulators ensure that remuneration supports financial stability?

Following the financial crisis there was considerable public frustration about remuneration in the banking sector. As discussed at the recent Open Forum event held by the Bank, in order for the markets to maintain their 'social licence', they need to operate in a fair and accountable way, working with the interests of society in mind.[1] In regulating remuneration, the Prudential Regulation Authority (PRA) helps to maintain this social licence: the aim is to better align risk and reward by encouraging good risk management and discouraging excessive risk-taking, including via the deferral of a proportion of variable pay. As such, it is intended to contribute to a better level of resilience within banks and therefore support financial stability.

A lot of the public's frustration centred on the overall level of bankers' bonuses and pay. The PRA is interested in the total level of pay awarded, in as far as it seeks to ensure that it is consistent with retaining an appropriate level of capital within the bank in question. Effective competition within the banking sector and the labour market will determine total levels of pay.

In its 'Principles and standards for sound compensation practices', issued in 2009, the Financial Stability Board (FSB) stated that variable remuneration schemes should be designed to work in concert with overall risk management. The metrics that determine variable remuneration awards should provide signals of the firm's risk appetite which, in turn, should translate into a given level of risk-taking by employees. These metrics should be structured so as to align employee incentives with the long-term interests of the business while taking account of the time frame over which financial risks crystallise.

Variable remuneration also contributes to the flexibility of banks' staff cost bases. In times of stress, costs can be reduced to help maintain the financial health of the firm. Variable remuneration can thus act as a form of loss-absorbing capacity for the financial system. The FSB has also said that a substantial proportion of remuneration should be variable and paid on the basis of individual, business unit and firm performance.

The UK remuneration rules

The FSB Principles & Standards (FSB P&S) were implemented in the United Kingdom through remuneration rules introduced by the FSA in 2009 which took effect from 1 January 2010.[2] These standards have subsequently been extended through the European Union (EU) Capital Requirements Directive (CRD). **Figure 1** provides a timeline of the key remuneration regulatory developments for the banking sector in the United Kingdom.

The UK remuneration rules, which implement these international requirements, are set and supervised by the Bank of England's PRA and the Financial Conduct Authority (FCA).[3] In June 2013, the report of the Parliamentary Commission on Banking Standards (PCBS) included recommendations to the regulators for strengthening the remuneration rules.[4] The PRA and FCA consulted jointly on new rules which were published in June 2015.[5] In particular these put in place tougher requirements for deferral and clawback (which are explained in more detail on pages 328–30).[6]

Whose pay is regulated?

The remuneration rules apply to banks[7] on a firm-wide level and to the variable remuneration of all employees who can have an impact on a firm's risk profile, known as material risk-takers (MRTs). Firms must identify their populations of MRTs using the criteria in the regulatory technical standard published in 2014 by the European Banking Authority (EBA) to ensure consistency of identification across EU jurisdictions. The box on page 327 outlines the identification criteria for MRTs and their link to the new deferral rules and Senior Managers Regime. The application of this standard has led to approximately a threefold increase in the number of

(1) See *Open Forum: building real markets for the good of the people*, June 2015; www.bankofengland.co.uk/markets/Documents/openforum.pdf.
(2) See Financial Stability Forum (2009) and Financial Stability Board (2009).
(3) The PRA is part of the Bank of England and responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms. The FCA is an independent body and responsible for the conduct regulation in the UK financial services industry and the prudential regulation of firms not covered by the PRA.
(4) See Parliamentary Commission on Banking Standards (2013).
(5) See Bank of England and Financial Conduct Authority (2015).
(6) The PRA and FCA work together in implementing the regulation of remuneration rules in the United Kingdom for firms regulated by both authorities and for consistency in the wider industry. The FCA's solo initiatives on remuneration are beyond the scope of this article and further information is available at www.the-fca.org.uk/remuneration.
(7) Banks in this article are defined as the PRA-regulated banks and building societies, and PRA-designated investment firms.

Figure 1 Timeline of remuneration rules

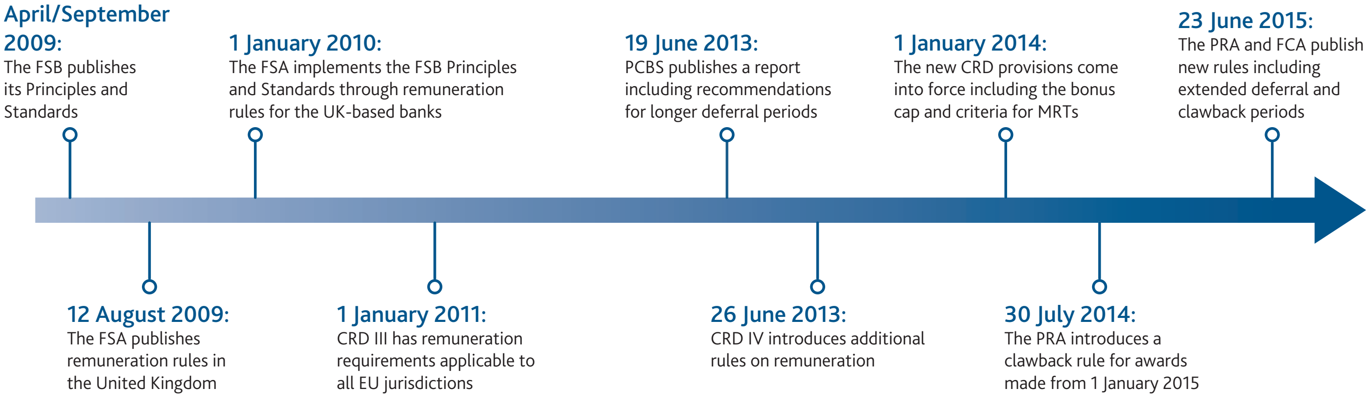
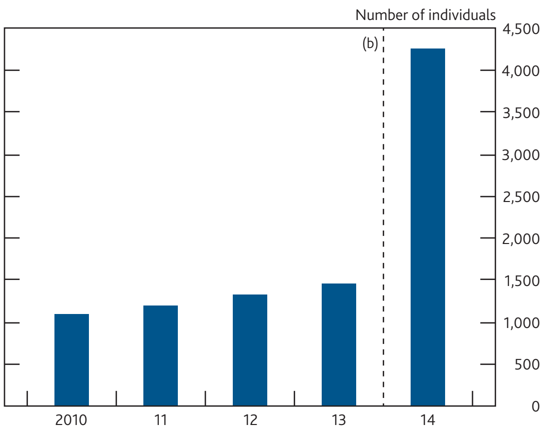


Chart 3 Population of material risk-takers in the major UK banks(a)



Sources: Annual accounts and Pillar 3 remuneration disclosures.

(a) Defined as the top five UK-headquartered banks by market capitalisation.
(b) Introduction of the EBA's regulatory technical standard on the identification of material risk-takers.

individuals in the major UK banks subject to the remuneration rules[1] (**Chart 3**).

Composition of variable remuneration: cash and non-cash

The crisis prompted regulators to consider whether non-cash awards could be used as an effective way to align risk-taking incentives. Prior to the crisis banks were able to award their bonuses as cash awards at the end of the year. Since 2010, at least 50% of variable remuneration awards are required to be delivered in non-cash instruments such as shares or debt, which create incentives aligned with long-term value creation and the time horizons of risk.

The EBA has developed a regulatory technical standard on the classes of instruments that would qualify. In practice, institutions have predominantly paid the non-cash portion of variable remuneration in shares or share-linked instruments. As discussed in the box on page 324, there has been an increasing focus on the case for payment in debt rather than equity.

Incentives and performance metrics

The performance measures on which variable remuneration awards are determined should be risk-adjusted and designed to encourage sustainable business practices. A balanced suite of metrics lessens the likelihood of individual short-termism, and also allows consideration of the bank as a whole rather than just bottom-line profit figures. These metrics can include, but are not be limited to:

- **Risk-adjusted return metrics** where risk is calculated as a measure of the return relative to the risk taken over a specific period. Some measures used include economic profit and return on risk-weighted assets.[2]
- **Prudential metrics** which reflect the financial strength of the firm, such as a healthy balance sheet or capital levels as a share of risk-weighted assets.
- **Strategic metrics** which focus on the forward-looking direction of the firm on a financial (such as market growth or cost savings) and non-financial basis (such as investment in human resources).
- **Conduct metrics** which reflect behaviours that have the interests of customers in mind. Measures can include customer outcomes and compliance with regulation.

Since the introduction of the rules, the PRA has sought to discourage firms from determining remuneration using a narrow set of metrics based on non risk adjusted return metrics.[3] The PCBS concluded that before and during the financial crisis, banks had over-relied on return metrics that were not adjusted for the risks taken, in particular return on equity, when setting remuneration. This encouraged individuals to focus on short-term, leveraged growth rather than more sustainable business models. In 2015 the PRA

(1) Top five UK-headquartered banks by market capitalisation.
(2) Economic profit is similar to accounting profit but also has the opportunity costs deducted from revenues earned. Risk-weighted assets are a bank's assets or off balance sheet exposures, weighted according to risk.
(3) A measure of direct financial gain from the business undertaken.

European Banking Authority Regulatory Technical Standard and its link to the new deferral rules and the Senior Managers Regime

The Regulatory Technical Standard (RTS) sets out criteria for the identification of categories of staff who have a material impact on an institution's risk profile.

Firms are required to identify the material risk-takers in their institution on an annual basis. To ensure harmonisation across the European Union, there are two types of criteria that must be used by firms for identification:

- Qualitative criteria ('Article 3' in the RTS) which identify staff by job roles and specific responsibilities; and

- Quantitative criteria ('Article 4' in the RTS) which are based on total remuneration in absolute terms (staff earning more than €500,000) and in relative terms (0.3% of staff with the highest remuneration).

If a firm determines that individuals captured under the quantitative criteria do not have a material impact on its risk profile, there are processes for their exclusion from the application of the RTS. **Table 1** sets out requirements for exclusion under the quantitative criteria.

Table 1 Exclusion criteria

Criterion	Regulatory oversight requirement
Total remuneration €500,000–€750,000	Notification to the PRA and FCA
Total remuneration > €750,000	Prior approval of exclusion from PRA and FCA
Total remuneration > €1,000,000	PRA to inform EBA before approval

Source: European Banking Authority (EBA).

In June 2015, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) introduced new rules that increase the period of deferral for many material risk-takers (MRTs). The new rules distinguish between the levels of responsibility MRTs may have on the firm's risk profile. The PRA's Senior Managers Regime (SMR) requires senior individuals responsible for the executive management or oversight of those areas of a firm which the PRA deems relevant to its safety and soundness objective to be held individually accountable.

As a result the new deferral rules split the MRT population into three categories, using the SMR and RTS frameworks. Senior managers will be subject to seven-year deferral, risk managers to five-year deferral and all other MRTs to three to five-year deferral. The rules draw a distinction between risk managers and all other MRTs using the qualitative criteria of the European Banking Authority RTS (**Table 2**). Any individual solely caught by the quantitative criteria also falls into the other MRTs category.

Table 2 New deferral requirements

MRT population	Minimum deferral period
Senior managers All individuals as defined by the SMR. This includes the chief executive, chief finance officer and heads of key business areas.	Seven years
Risk managers All individuals in risk managing roles; derived from the RTS. This includes members of the management body, heads of other material business units and managers of MRTs.	Five years
All other MRTs All MRTs not captured by the categories above. Examples include individuals exposing the firm to trading/market risk and individuals approving the introduction of new products.	Minimum CRD provision of three to five years

Source: Prudential Regulation Authority.

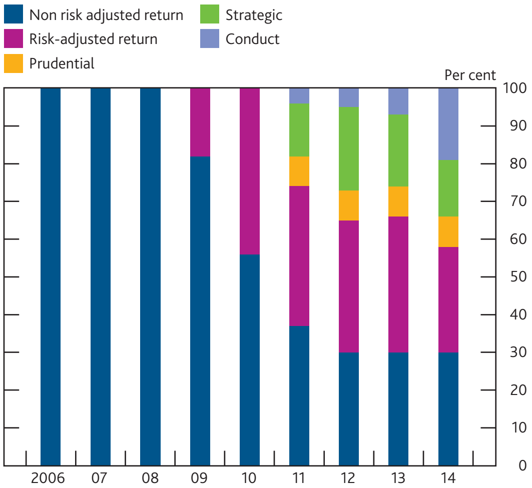
brought in a new rule explicitly to require banks to use metrics based on return or revenue only as part of a balanced, risk-adjusted scorecard when determining variable remuneration. This formalised the approach required under the remuneration rules introduced after the crisis.

The performance metrics of executive directors are a useful measure in assessing how incentives have changed over time. Executive directors are responsible for setting strategy (subject to approval by their Boards) and their impact upon the UK banking sector has been highlighted by the Senior Managers Regime (SMR), which introduces personal accountability to their actions. Therefore it is insightful to consider the personal incentives of executive directors, since these will underpin their actions and filter down through the incentives of staff working beneath them.

Chart 4 demonstrates that before and during the crisis, performance metrics were based purely on non risk adjusted return measures. Since 2009, the introduction of risk-adjusted return and non return based metrics has led to a reduction of the extent non risk adjusted return based metrics determine awards, from 100% to 30% for the average executive director.(1) This shift away from non risk adjusted return metrics, such as return on equity and total shareholder return, to a more balanced set of performance metrics, reflects the change towards a new framework for setting senior manager incentives which are more in line with the long-term health of the firm.

(1) The chart analyses metrics in LTIP awards as they feature significantly in total variable remuneration for executive directors (approximately 70% in 2014).

Chart 4 Average weighting of metrics used to determine executive directors' long-term incentive plans in the major UK banks



Sources: Annual accounts, annual remuneration reports and Bank calculations.

Deferral

Deferral of variable remuneration awards (both cash and non-cash) is a key element of the way in which the rules seek to ensure that longer-term risk horizons are reflected. By deferring the payment (or 'vesting') of part of an award, there is an opportunity to reassess the nature, scale and outcomes of the risks taken in order to assess the performance for which variable remuneration has been awarded. This is referred to as *ex-post* risk adjustment or 'malus' (explained further below).

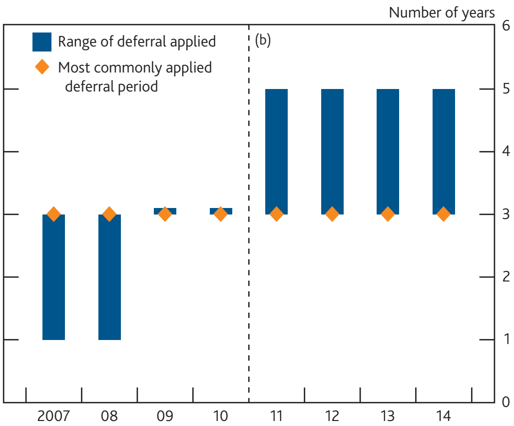
The current rules which came into force in 2011 stipulate minimum deferral rates that banks with assets of over £15 billion must apply in relation to variable remuneration for their MRT staff. These are:

- At least 40% of the total variable remuneration award for the year to be deferred or 60% for senior executives or if total variable remuneration is £500,000 or higher.
- A minimum deferral period of three to five years.
- The payout or vesting of the deferred awards may not be faster than in equal tranches. This is known as 'pro-rata vesting'.

It should also be noted that these minimum deferral periods are required under the CRD. The PRA has encouraged banks operating in the United Kingdom to apply higher deferral rates to match their risk profiles. From 2016, more senior risk-takers will be subject to a minimum of five to seven years' deferral, with no vesting until year three for the most senior managers (see below).

The CRD provisions have increased the deferral periods banks apply to executive directors (**Chart 5**). Before the crisis, deferral periods ranged from one to three years for executive directors. The remuneration rules shifted the range of deferral periods upwards. Although the rules provided for a minimum of three to five years for deferral, most banks opted to use a three-year deferral period (as shown by the orange diamonds).

Chart 5 Deferral applied to executive directors in the major UK banks(a)



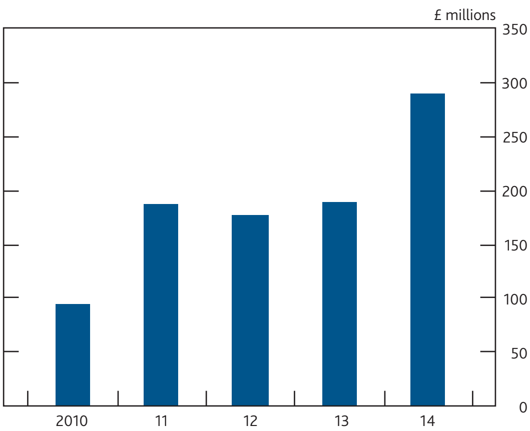
Sources: Annual accounts, annual remuneration reports and Bank calculations.

(a) Based on banks' deferral policies for the annual bonus and LTIP schemes.
(b) CRD deferral rules introduced.

Ex-post risk adjustment: malus

Malus is the reduction or cancellation of unvested or unpaid awards. Under the rules, firms must be able to make such reductions, where justified, to take account of risks that have subsequently crystallised, instances of individual misconduct that have been uncovered, failures in the management of risk or oversight of that part of the business, or a subsequent material downturn in the performance of the firm.[1] Malus has been used increasingly by banks in relation to risk management failings that have come to light since 2010 (**Chart 6**).

Chart 6 Total malus adjustments applied across the material risk-takers population within the major UK banks(a)



Sources: Pillar 3 remuneration disclosures and Bank calculations.

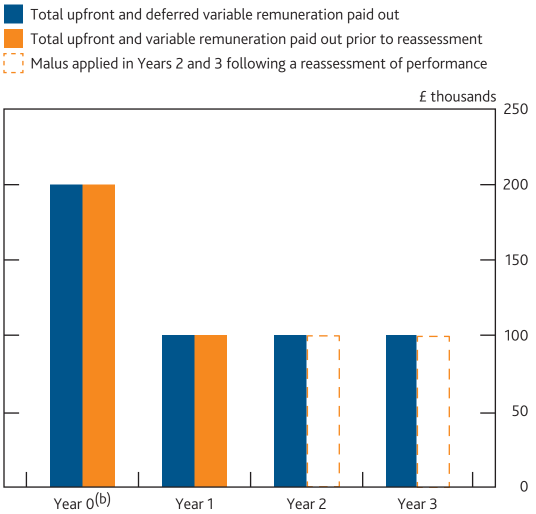
(a) Excluding figures for individuals who resigned or had their contracts terminated.

(1) See Bank of England (2013).

Figure 2 provides an illustrative example of a three-year deferral period with and without the application of malus. In this example an individual working in a bank is awarded £500,000 of variable remuneration at the end of the year. Half of this will be paid in cash and half paid in shares of the bank. The maximum amount of the individual's variable pay that can be received upfront at the end of the year is £200,000, 40% of the initial value. The remaining £300,000 (60% of the initial value) will be paid out over the next three years in three equal amounts of £100,000. It is these deferred amounts that will be subject to reassessment until they are paid out.

Should no adjustments occur at the end of Year 3, the individual would have received the entire £500,000 award, as indicated by the blue bars. However, should there be evidence of misconduct, a risk management failing or material downturn in the firm's performance in Year 2, say, then the remaining awards are potentially subject to reassessment and the application of malus to all or part of them. Subject to the severity, the firm could apply up to 100% malus on the remaining awards of Years 2 and 3, and the individual would only have received £300,000 of his or her initial award at the end of Year 3, as indicated by the orange bars.

Figure 2 Comparison of a minimum three-year deferral period with and without malus applied[(a)]



Source: Bank calculations.

(a) Based on current remuneration rules.
(b) Year 0 represents the year in which the initial award of £500,000 is made and represents the undeferred amount of 40% (with 60% deferred).

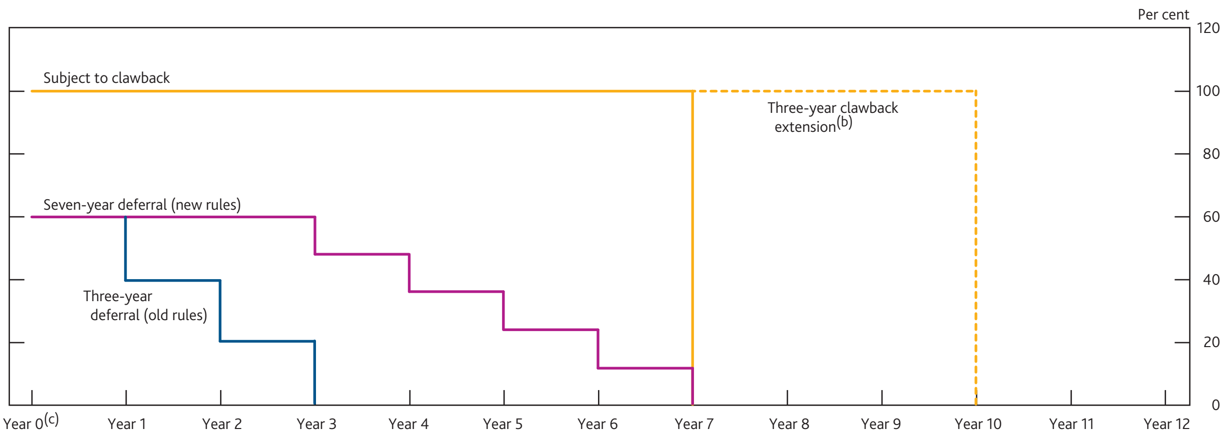
Rationale for longer deferral requirements

The new extended deferral rules coming into force at the start of 2016 reflect the conclusions of the PRA and FCA and the PCBS that strengthening of the existing rules was desirable. **Figure 3** shows how the deferred amounts change under the current and new remuneration rules from three years to seven years. The figure also refers to 'clawback' which is explained further on.

The PCBS took the view that short deferral periods were insufficient to take account of the timescales over which material business issues can come to light and concluded there should be a presumption that all staff to whom the new rules apply should be subject to greater and longer deferral than had been customary. Furthermore, the PCBS suggested that the regulators should have a power to require that a substantial part of remuneration be deferred for up to ten years where necessary for effective long-term risk management.

Longer deferral periods better align the risk horizons of key individuals with the longer-term safety and soundness of the firms for which they work. This is particularly important for senior executives who help to determine or are responsible for implementing the overall business strategy of a firm and are ultimately responsible for risk management. For these employees, the risk horizon should reflect the timescales over which the risks associated with those strategic decisions are

Figure 3 Illustration of deferral and clawback for senior managers under the old and incoming remuneration rules[(a)]



Source: PRA.

(a) Illustration based on 60% of the award being deferred.
(b) Line includes representation of extension of clawback by a further three years where there is an investigation ongoing at Year 7 from the initial date of award.
(c) Year 0 represents the year in which the initial award was awarded to the individual. Year 1 is the first anniversary of this date with the future years following suit.

likely to manifest themselves. Extended deferral periods also allow for more variable remuneration to be subject to malus over a longer time frame.

Recent examples of risk management failings demonstrate the long-term risk horizons involved. The mis-selling of payment protection insurance is an example of a conduct failing which took many years to come to light. Libor rate manipulation is another example where the initial practices took place before the crisis but the conclusion of initial enforcement investigations and subsequent fines came several years after.(1)

Deferral should also seek to align awards to the typical business cycles which banks operate in and underpin the performance of the financial sector. In the November 2012 *Financial Stability Report* the Financial Policy Committee (FPC)(2) noted that short deferral periods make it difficult to evaluate performance effectively. The report demonstrated that the average LTIP length was much shorter (three to five years) than the average business cycle (five and a half years) and the estimated length of the credit cycle (eight to 30 years). However, in determining the most appropriate level of deferral, consideration of the time-discounted value of deferred remuneration to the recipient is also required.

Ex-post risk adjustment: clawback

From 2015, the PRA and FCA extended the principle of *ex-post* risk adjustment to awards that have already been paid or vested. This is called **clawback**.(3) Being able to make employees (or former employees) pay back the value of awards already received is an important extension of the principle, not least because it applies to the whole award, including the undeferred portion. The capacity to apply clawback is required for seven years from the date of the initial award for all MRTs. This may be extended by a further three years for those covered by the SMR where there are ongoing enquiries into a possible cause for clawback in the seventh year. Thus clawback increases both the amount and the period over which an award is at risk (**Figure 3**).

The minimum grounds for which clawback may be applied are narrower than malus with the scope excluding cases where there is a material downturn in firm performance. The PRA concluded that clawback is most appropriate in cases where the individual has some responsibility or culpability for circumstances giving rise to the grounds for action.

Aggregate payouts and capital levels

A firm's profits, its remuneration payouts and its capital position are all interrelated. When a bank makes profit it can elect to use it in a number of ways. These include keeping it in the firm, thereby increasing the bank's capital base (and hence its capacity to absorb losses); paying dividends to shareholders; or paying it out, in the form of variable remuneration, to its employees.

The FSB P&S require that sufficiently large financial institutions should ensure that total variable remuneration does not limit their capacity to strengthen their capital bases. This has been an important element of the rules in recent years as banks have built up their capital bases in the aftermath of the crisis in response to higher regulatory capital requirements. For the major UK banks in particular, the PRA needs to be satisfied that any distributions through variable remuneration or distributions to shareholders are consistent with a sustainable capital plan.

The bonus cap

CRD IV includes a 'bonus cap' whereby variable remuneration is limited to 100% (or 200% with shareholder approval) of the value of fixed pay, this is applicable to all MRTs. The premise behind the bonus cap is that the expectation of large variable remuneration awards inherently creates adverse risk incentives which cannot be solely mitigated by *ex-ante* and *ex-post* risk adjustments. Therefore a ceiling on variable pay should limit excessive risk-taking as the upside gains are limited.

However a significant consequence of limiting variable remuneration is a shift to higher levels of fixed pay to offset the reduction in variable remuneration. The problem is that this reduces the amount of remuneration which is at risk. This is covered in more detail in the next section.

Looking ahead: the policy agenda

International discussions

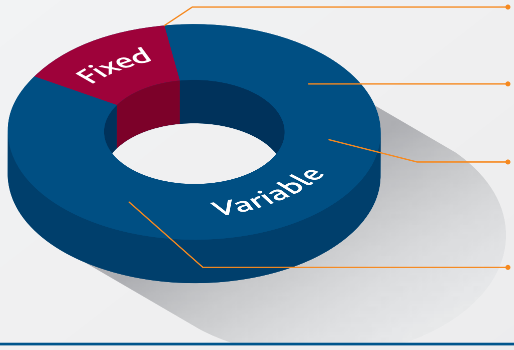
Remuneration remains very much a live issue for regulators around the world. Through the FSB, regulators continue to work to ensure the effective implementation of the reforms introduced since 2009, and to focus on how to secure more effective alignment between risk-taking incentives and remuneration. The United Kingdom has been one of the leading jurisdictions in implementing the FSB P&S. However, implementation has been uneven around the world, with ten out of 24 jurisdictions having gaps remaining in their national implementation of the FSB P&S as of November 2015.(4)

Following its March 2015 plenary meeting in Frankfurt, the FSB said it would review the impact of regulatory reforms including how remuneration structures had helped to reduce misconduct and whether any additional measures were needed.(5) Remuneration regimes have a role to play in incentivising good conduct in banks. This includes individuals losing rewards when a risk management failing comes to light.

(1) Libor stands for the London interbank offered rate and is the benchmark rate that banks charge each other for short-term loans.
(2) The FPC is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system as a whole.
(3) See Bank of England (2014).
(4) See Financial Stability Board (2015a).
(5) See Financial Stability Board (2015b).

How have remuneration rules changed in the banking sector?

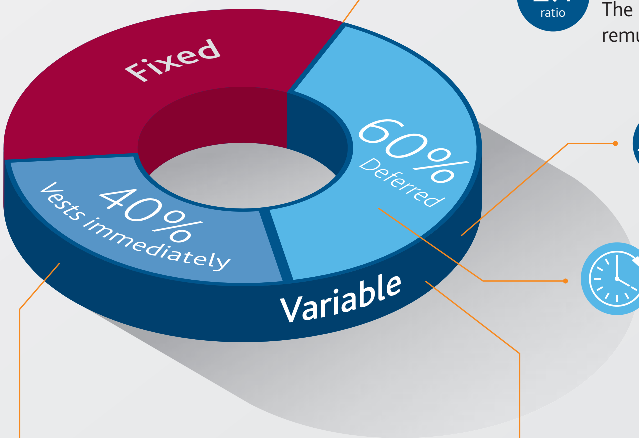
Pre-crisis



- No restrictions on the size of variable remuneration relative to fixed remuneration.
- No restrictions on how much variable remuneration packages are paid out in cash versus non-cash instruments (such as shares).
- Performance measures used to determine variable remuneration packages relied heavily on return metrics that were not adjusted for the risks taken.
- Deferral, malus, and clawback arrangements for variable remuneration were not regulatory requirements.

Post-crisis

The following rules have been introduced for the 'material risk-takers' in banks (see main text of the article for more details).



2:1 ratio

Bonus cap

The bonus cap sets a maximum variable to fixed remuneration ratio of 2:1 with shareholder approval.

50:50

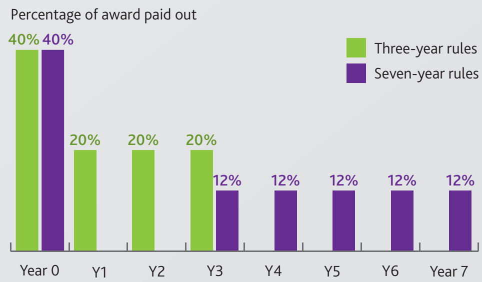
Cash/non-cash

All variable remuneration composed of 50% cash and 50% non-cash.

Deferral and malus

40% of all variable remuneration should be paid upfront with 60% deferred. All deferred remuneration, which has not yet vested, can be subjected to malus to take account of instances of misconduct, risk management failings, or downturn in financial performance.

Comparison of deferral timelines under current (three years) and forthcoming (seven years) rules(a)



(a) The current rules on deferral were introduced in 2010. The forthcoming rules (no less than seven-year deferral) will apply from January 2016 to senior managers in banks. See main text of the article for more details.

Performance metrics

Balanced suite of performance metrics contribute to *ex-ante* adjustment of all variable remuneration.

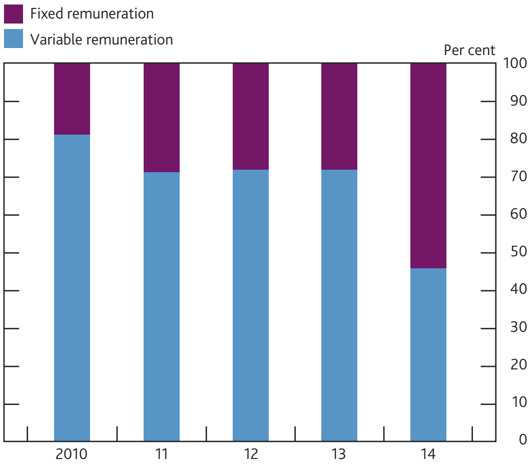
Clawback

All variable remuneration is subject to clawback. This is the process whereby banks are able to take back vested variable remuneration as a result of misconduct or risk management failings.

The rise in fixed remuneration

The proportion of fixed pay has increased since the rules were introduced in 2010, particularly in response to the introduction of the EU bonus cap in 2014. This approach of capping bonuses has not gone unchallenged. Governor Carney and Deputy Governor and CEO of the PRA, Andrew Bailey, have argued strongly in favour of variable remuneration constituting a substantial portion of overall pay in order to align incentives appropriately.(1) Indeed the bonus cap is counterproductive: it reduces the scope for beneficial risk adjustment to affect incentives through malus and clawback and it reduces flexibility in banks' cost bases. A recent European Systemic Risk Board report also raised concerns regarding the increase in fixed remuneration at the expense of variable remuneration.(2) The significance of this argument has been underscored by the clear shift to fixed pay from 28% to 54% across the MRT population from 2013 to 2014 (**Chart 7**), during which period overall remuneration costs in the major UK banks have remained broadly constant. An increase in the proportion of fixed pay has also been the case elsewhere in the EU.(3)

Chart 7 Fixed versus variable remuneration as a proportion of total remuneration for the MRTs in the major UK banks



Sources: Pillar 3 remuneration disclosures and Bank calculations.

The United Kingdom's Fair and Effective Markets Review (FEMR) also noted the shift towards higher levels of fixed remuneration and cited regulatory concerns on aligning incentives.(4) To address this, FEMR said that the FSB should work to ensure that an appropriate proportion of total remuneration was variable.

Misconduct and new remuneration structures

FEMR also concluded that there was scope for firms to improve further the link between conduct and remuneration. A series of misconduct failings in the global banking industry, including the Libor and foreign exchange manipulation incidents, evidence this further. The United Kingdom's introduction of extended deferral and clawback periods aim to strengthen this link.

The issue of whether a greater proportion of total remuneration should be put at risk of downward adjustment, potentially for ten years, was also a feature of proposals put forward by William Dudley, President and CEO of the Federal Reserve Bank of New York. In a speech in October 2014 he proposed the concept of 'performance bonds' for senior executives — funds built up over time from senior executives' remuneration and available to recapitalise the firm or to meet substantial regulatory fines.(5) This would require executives to hold a meaningful component of long-term unsecured debt. Thus the performance bond would be a form of contingent liability for the firm to the employee that could be reduced in certain circumstances.

Governor Carney has supported further exploration of this approach as it could provide a solution to address the rise in fixed pay and any future misconduct or prudential failings (Carney (2014)). It is important to look further at ways in which beneficial risk incentives are strengthened, including ways to ensure that a greater proportion of remuneration remains at risk for longer if misconduct or management failures come to light.

Conclusion

Poorly aligned incentives which encouraged excessive risk-taking behaviours contributed to the financial crisis and led to the regulation of remuneration. However, close alignment between risk and reward, including the use of variable remuneration, can contribute to the safety and soundness of firms and the stability of the financial system. The PRA, and other major international regulators, have implemented regulation on remuneration with the objective of ensuring employees' incentives align with the longer-term interests of the firm and society. The key tools are effective risk adjustment and the use of deferral, malus and clawback. However, challenges remain and the future regulatory focus is likely to centre on ensuring that a sufficient proportion of total remuneration remains at risk, and on the role of compensation in addressing misconduct.

(1) See Carney (2014) and Bailey (2014).
(2) See European Systemic Risk Board (2015).
(3) See Figure 3.2, International Monetary Fund (2014).
(4) See Bank of England, Financial Conduct Authority and HM Treasury (2015).
(5) See Dudley (2014).

References

Bailey, A (2014), 'Andrew Bailey's speech at the City Banquet, London', available at www.bankofengland.co.uk/publications/Documents/speeches/2014/speech763.pdf.

Bank of England (2013), 'PRA expectations regarding the application of malus to variable remuneration', *PRA Supervisory Statement 2/13*, October, available at www.bankofengland.co.uk/pra/Documents/publications/policy/2013/appofmalusss2-13.pdf.

Bank of England (2014), 'Clawback', *PRA Policy Statement 7/14*, July, available at www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps714.pdf.

Bank of England and Financial Conduct Authority (2015), 'Strengthening the alignment of risk and reward: new remuneration rules', *PRA Policy Statement 12/15, FCA Policy Statement 15/16*, June, available at www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps1215.pdf.

Bank of England, Financial Conduct Authority and HM Treasury (2015), 'Fair and Effective Markets Review — Final Report', available at www.bankofengland.co.uk/markets/Documents/femrjun15.pdf.

Carney, M (2014), 'The future of financial reform', available at www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf.

Dudley, W C (2014), 'Enhancing financial stability by improving culture in the financial services industry', available at www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html.

European Systemic Risk Board (2015), 'Report on misconduct risk in the banking sector', available at www.esrb.europa.eu/pub/pdf/other/150625_report_misconduct_risk.en.pdf.

Financial Stability Board (2009), 'FSB principles for sound compensation practices', available at www.financialstabilityboard.org/wp-content/uploads/r_090925c.pdf?page_moved=1.

Financial Stability Board (2015a), 'Implementing the FSB principles for sound compensation practices and their implementation standards: fourth progress report', available at www.financialstabilityboard.org/wp-content/uploads/FSB-Fourth-progress-report-on-compensation-practices.pdf.

Financial Stability Board (2015b), 'Press release FSB Plenary Frankfurt 26 March', available at www.financialstabilityboard.org/wp-content/uploads/Press-Release-FSB-Plenary-Frankfurt-final-26Mar15.pdf.

Financial Stability Forum (2009), 'FSF principles for sound compensation practices', available at www.financialstabilityboard.org/wp-content/uploads/r_0904b.pdf.

House of Commons Treasury Committee (2009), 'Banking crisis: dealing with the failure of the UK banks', available at www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf.

International Monetary Fund (2014), 'Risk taking by banks: the role of governance and executive pay', available at www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/c3.pdf.

Parliamentary Commission on Banking Standards (2013), 'Changing banking for good', available at www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/.