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Financial Services Reward – reward regulatory developments February 2023

We have summarised below key reward regulatory developments impacting firms in the financial services sector in recent months.

Key reward regulatory developments in the UK

Joint Consultation Paper on the removal of the limit on variable remuneration ('bonus cap') for banking sector firms

Overview: On 19 December 2022, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) published a joint Consultation Paper on the proposal to remove the bonus cap applicable to banks, building societies and PRA-designated investment firms.

Timings: The consultation phase will run until 31 March 2023.

The amended rules are expected to come into force the day after the publication of the final policy (currently anticipated to take place in Q2 2023) and would apply to firms' first performance years starting after this date.

Key provisions: The UK regulators are proposing to remove the bonus cap in its entirety. However, under the amended rules, firms would continue to be subject to the provision within the current rules which requires that firms set an '*appropriate ratio between the fixed and variable components of total remuneration*'.

Firms would also remain subject to the provisions requiring fixed and variable remuneration to be '*appropriately balanced*' and for the fixed component to be sufficiently high so as to allow the firm to maintain a fully flexible policy on variable remuneration, including the possibility to award no variable remuneration.

The Consultation Paper notes that firms will therefore be required to set their own ratios for Material Risk Takers (MRTs) and that these ratios should reflect the individuals' roles and potential for excessive risk-taking, noting that different ratios may be set for different categories of staff. This approach is consistent with the FCA's approach for investment firms under the MIFIDPRU Remuneration Code (SYSC 19G).

The regulators note that the bonus cap has resulted in increases to fixed pay levels since its introduction. The regulators consider that the removal of the bonus cap would provide firms with the opportunity to restructure their remuneration frameworks over time and increase the proportion of remuneration which is performance-based and therefore subject to the reward regulatory framework, including performance scorecards, payment in instruments, deferral and risk adjustment (including malus and clawback).

The Consultation Paper confirms that the regulators are not proposing any changes to the rules on deferral, payment in instruments or risk adjustment at this time.

A link to the full Consultation Paper can be found here.

A link to our detailed update regarding key considerations for firms in light of the removal of the bonus cap can be found here.

FCA observations on approaches to Diversity & Inclusion (D&I) in financial services

Overview: On 12 December 2022, the FCA published its observations of how financial services firms are designing and embedding diversity and inclusion strategies, together with an overview of initiatives to improve diversity and inclusion which firms can consider.

This follows the publication of the Discussion Paper on diversity and inclusion, which the FCA published jointly with the PRA and Bank of England in July 2021. The Discussion Paper discussed the current state of diversity and inclusion in the financial services sector and proposed some areas for potential policy intervention.

Impacted firms: This review should be of interest to all FCA regulated firms.

Timing: The FCA has indicated that it will consult on its proposals relating to D&I in the course of 2023.

Key provisions: For the purposes of the review, the FCA selected a sample of twelve generally larger firms across multiple financial services sub-sectors on the basis of their gender pay gaps. Eight of the firms selected had larger gender pay gaps and four had smaller pay gaps.

The FCA noted that the firms were committed to making progress; however, the FCA noted that many D&I strategies were generic and without a holistic view. Strategies were noted to lack clear purpose and actions, and the FCA observed that some firms are not using data effectively to identify solutions and track which solutions are effective.

The FCA noted that, while firms were focusing on actions to measure diversity and address specific issues, few firms were approaching diversity and inclusion as a fundamental culture issue. The FCA is of the view that "*firms are likely to struggle to make sustainable, meaningful change without greater attention to culture, including a long-term plan to deliver change, backed by senior level commitment*."

The FCA noted that gender representation was the area most focused upon by the sampled firms, with ethnicity beginning to receive more attention. At both a gender and ethnicity level, the FCA noted that firms are focusing most on senior leadership representation, despite data showing the largest gap in representation is from junior to middle management grades. The FCA notes that "*such focus, in isolation, risks creating a culture where firms attempt to 'poach' diverse senior talent rather than develop their own pipelines. This is not a sustainable approach and is unlikely to bring meaningful, long-lasting change.*"

Firms' D&I strategies were noted not to be consistently based on specific circumstances, with the FCA commenting that this may mean that actions and initiatives may not be appropriately focused. In addition, if the effectiveness of these strategies is not successfully tracked, the FCA noted that there was a risk for firms in not seeing meaningful results despite expending considerable resource.

The FCA observed that firms with better data on diversity had a better understanding of circumstances and relevant actions, whilst firms lacking in data were less able to carry out intersectional analysis and implement targeted interventions. The variation in data quality was linked to staff declaration rates. The FCA noted that few firms had useable data beyond gender and ethnicity. However, it was observed that even firms with the best data are not utilising insights efficiently.

The FCA also noted that international firms tended to rely on a group-wide international strategy and global data that was often not tailored to the needs of the UK.

Specific initiatives were deemed to be likely to have a positive effect, but the FCA considered that there was an overreliance in some firms on measures such as training, network groups and allyship which cannot in isolation bring systemic change.

The majority of firms held senior management accountable with diversity and inclusion goals affecting pay and bonuses, but the FCA considered that it was often unclear how performance would actually lead to a tangible adjustment to reward outcomes. There was also not sufficient evidence that Boards were fully engaged.

A link to the FCA's full findings can be found here.

FCA letter to the Chief Executive Officers (CEOs) of wholesale broker firms

Overview: On 11 January 2023, the FCA published a letter to the CEOs of wholesale broker firms, setting out what the FCA considers to be the most important risks arising for wholesale brokers and its supervisory focus for the next two years.

Impacted firms: Wholesale broker firms.

Timing: The FCA has indicated that, in 2023, it will focus on ensuring that wholesale broker firms are appropriately applying the rules relating to deferral and malus/clawback, as required under the new Investment Firm Prudential Regime (IFPR) remuneration requirements, as set out in the MIFIDPRU Remuneration Code (SYSC 19G).

Key provisions: In its letter, the FCA highlights its four key areas of supervisory focus for wholesale broker firms, namely financial resilience, governance and culture, the role of control functions and firms' remuneration structures.

In relation to remuneration, the letter picks up on the issues that the FCA highlighted in its 2019 "Dear CEO" letter to wholesale broker firms, noting, for example, the disproportionate weighting towards cash bonuses seen within some firms, which may lead brokers to focus on achieving short-term financial targets at the expense of clients' interests and limit the firm's ability to penalise brokers for misconduct if it is identified after bonuses have been paid.

The FCA notes that it continues to see brokers receiving lower salaries with large cash bonuses based on the value and volume of trades that they conclude for clients, which the FCA notes may lead individuals to focus on achieving short-term financial targets at the expense of client interests.

The FCA also reminds firms that individual performance must take account of both financial and non-financial criteria, of which a substantial part of the non-financial criteria may include metrics on conduct.

Noting the provisions introduced under the new MIFIDPRU Remuneration Code, which were designed to support prudential soundness and risk management by promoting accountability, discouraging poor conduct and prioritising positive outcomes by helping to instil a healthy firm culture, the FCA notes that it expects the Boards and CEOs of wholesale brokers to ensure that their firms' remuneration structures comply with the new MIFIDPRU requirements.

The FCA also notes that, where firms have failed to evidence that they have taken appropriate steps to implement the applicable MIFIDPRU remuneration requirements, the FCA will consider using its range of regulatory tools, including its ability to impose additional capital requirements to account for the increased risk that weak incentives can drive.

A link to the FCA letter can be found here.

Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise

Overview: On 21 October 2022, the PRA published its thematic observations on the approach of firms to embedding supervisory expectations for the management of climate-related financial risks.

Although the PRA expects that firms' approaches will continue to develop, the letter outlines a non-exhaustive list of areas where firms would currently be expected to demonstrate capabilities in meeting supervisory expectations. Examples of effective and less effective practice are also given.

Impacted firms: All UK banks, building societies and PRA-designated investment firms, as well as UK insurance and reinsurance firms and groups, as the firms in scope of the PRA's earlier Supervisory Statement on managing the financial risks from climate change (SS3/19).

Timing: The PRA expected firms to have fully embedded their approaches to managing climate risks by the end of 2021 and, in 2022, the active supervision of firms against supervisory expectations in this area began.

The letter summarises the capabilities which the PRA expects firms to be able to demonstrate by now. Compliance will be assessed on an ongoing basis and firms judged not to have made sufficient progress may expect to be asked to provide a roadmap explaining how they intend to overcome the gaps.

Key provisions: Overall, while the PRA acknowledged that significant progress has been made (for example, through the implementation of an effective level of climate governance, and appropriate training for key personnel to understand and manage climate risk), the PRA has identified certain areas where further progress is needed.

From a remuneration standpoint, the PRA noted that the examples of effective practice that it saw included "*embedding climate risk factors into strategic planning activities and senior remuneration targets*", as well as *"linking scenario analysis outputs to business strategies;*

firm-wide training to build capabilities; and continuing development of the scope, quality, and frequency of climate-related information provided to senior committees."

The PRA also noted that a majority of firms now include an allocated Senior Manager Function (SMF) with responsibility for the financial risks from climate change, who provide oversight of risks, and that some firms had incorporated climate-related objectives into the SMF's remuneration.

A link to the full letter can be found [here](#).

Broader regulatory developments in the UK

Financial Services: Edinburgh Reforms

Overview: On 9 December 2022, HM Treasury (HMT) unveiled the so-called "Edinburgh Reforms" - an extensive package of regulatory reforms for the UK financial services sector. The package builds on the reform agenda that HMT is taking forward through the Financial Services and Markets Bill (FSM Bill), setting out a series of measures that aim to make the UK financial services sector "*open, sustainable and technologically advanced*".

The Edinburgh Reforms represent the most significant package of regulatory change since the UK left the EU, covering a broad range of financial services regulations.

The package is a lengthy collection of individual and diverse initiatives, some of which are potentially significant and far-reaching. It comprises over 30 items of correspondence, draft policy papers, and other documents and announcements.

This does not yet amount to a full blueprint for the future of financial services regulation in the UK, largely because, in many cases, HMT has not yet set out concrete proposals for reform but has instead launched a series of consultations and calls for evidence.

Whilst at this stage there are no specific remuneration-related developments, potential areas of interest include the following:

New recommendation letters for the PRA and FCA

The Chancellor of the Exchequer has issued new recommendation letters to the PRA and FCA.

The letters anticipate the forthcoming secondary competitiveness objectives, which the FSM Bill will enact when it takes effect (expected to be spring 2023).

They are significant as the Government is for the first time formally asking both regulators to facilitate the international competitiveness of the UK economy and its growth in the medium to long term, subject to aligning with relevant international standards.

The letters also outline some of the Government's other priorities for the regulators to take into account, including swiftly repealing retained EU law with rules designed for the UK.

While there is no specific mention of remuneration within the new recommendation letters, it is worth noting a speech made by Sam Woods, CEO of the PRA on 27 October 2022, in which he touched upon the potential future direction of travel for the regulation of remuneration. This speech suggested that, in due course, the PRA may look more broadly at the structure of rules concerning remuneration, and that it will consider how the current mix of EU and UK regulations can be "*streamlined and made more effective and proportionate*", with a view to the UK's competitiveness as a global financial centre.

Updating banking regulation and the ring-fencing regime

A key announcement to note is HMT's confirmation that it will consult on the reforms to the ring-fencing regime in mid-2023 with a view to bringing forward secondary legislation in the latter part of the year.

The reforms HMT plans to make could have significant implications for some UK banks. They include:

- taking banking groups without major investment banking operations out of the ring-fencing regime;
- removing blanket geographical restrictions on ring-fenced banks operating subsidiaries or servicing clients outside the EEA; and
- assessing whether certain activities now restricted for ring-fenced banks could be undertaken safely from within the ring-fence in order to improve the supply of financial services.

Alongside these measures, HMT will also consult in mid-2023 on plans to increase the deposit threshold at which ring-fencing becomes mandatory from £25 billion to £35 billion.

Taken together, these changes are intended to make the regime more flexible and compatible with the resolution framework. Their effect will be either to take some banks with de minimis investment banking activities – such as some challenger banks - completely outside the scope of ring-fencing or reduce the point at which ring-fencing becomes mandatory.

Senior Managers & Certification Regime

The Government and regulators will separately commence a review of the

Senior Managers & Certification Regime in Q1 2023.

The Government is intending to launch a Call for Evidence to look the legislative framework and the PRA and FCA will review the regulatory framework.

The Government's Call for Evidence will be an information gathering exercise to garner views on the regime's effectiveness, scope and proportionality, and to seek views on potential improvements and reforms.

No further details are provided at this stage.

Sustainable finance

The Government is set to publish an update Green Finance Strategy in early 2023

The Government will also consult in Q1 2023 on bringing ESG ratings providers into the regulatory perimeter, stating that the services are "*increasingly a component of investment decisions, and the government wants to ensure improved transparency and good market conduct*."

> A link to the summary statement and accompanying papers concerning the Edinburgh Reforms can be found here.
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> A link to a Deloitte Blog summarising the reforms in full can be found here.
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> A link to Sam Woods' October 2022 speech can be found here.

PRA's supervisory priorities for UK deposit-takers and international Banks operating in the UK

Overview: On 10 January 2023, the PRA published its letters to the CEOs of UK deposit-takers and international banks operating in the UK, which set out its supervisory priorities for 2023. While not intended to be an exhaustive list, the letters are intended to provide a helpful overview of the PRA's priorities for 2023.

Key provisions: The PRA highlights the following areas of supervisory focus for 2023:

- The financial resilience of firms in the current economic climate, to ensure that they can continue to support businesses and households.
- The importance of operational risk and resilience, including in response to increasing digitisation, changes in payment systems and the need to address legacy IT systems.
- Ensuring the submission of complete, timely and accurate regulatory reporting, with appropriate controls over data, governance and systems.
- The embedding of the PRA's supervisory expectations in relation to the material financial risk that climate change presents to firms and the financial system, and the ability of firms to now be able to demonstrate their capabilities in meeting these expectations.
- For UK deposit-takers, the importance of ensuring that their credit risk management practices are robust and that customer support and collections arrangements are appropriately scaled.

The PRA also makes clear that diversity, equity and inclusion remain an important area of regulatory focus and an area that the PRA expects firms to continue to embed in their cultures.

> The PRA's letter to UK deposit-takers can be found here. Its letter to international banks operating in the UK can be found here.

FCA sector letters on the implementation of the Consumer Duty

Overview: On 3 February 2023, the FCA published letters to firms within eight financial services sub-sectors, which outline its expectations for the implementation of the new Consumer Duty. Part of the FCA's engagement programme for supporting firms with their transition to implementing the new Duty, the letters provide detail on how the Duty will apply to key areas within each sub-sector including in relation to scope, application and interaction with existing rules; the key considerations for firms; and examples of good and poor practice based on the FCA's thematic review of implementation plans.

Impacted Firms: The FCA sent letters to firms in the following sub-sectors: retail banks and building societies; mortgage lenders and administrators; firms dealing in asset management, custody and fund services, and alternatives portfolios; firms in the consumer investments sector; general insurance and pure protection firms; life insurance firms; mainstream consumer credit lenders; and credit reference agencies and providers of credit information services.

Key provisions: The FCA highlighted certain aspects of remuneration for the different sub-sectors:

- For **retail banks and building societies**, as well as **mortgage lenders and administrators**, the FCA expects firms to consider how fee structures might incentivise poor conduct or poor customer outcomes. As set out in more detail in the Final Guidance on the new Duty, the FCA expects firms to act in good faith towards customers and to avoid the use of incentives and remuneration structures where these are likely to cause detriment to customers, including via the distribution chain.

- For firms involved in **asset management, custody and fund services and alternatives**, the FCA notes that the Duty imposes obligations on distributors as well as manufacturers. Where firms act as distributors, the FCA highlights that they will need to consider if distribution arrangements, including remuneration, could result in a product ceasing to provide fair value.

- For firms responsible for **consumer investments**, the FCA reminds firms that they should not structure remuneration or sales targets in a way that could provide an incentive to employees to recommend a particular product or service when an alternative would better meet a customer's needs and that a firm is unlikely to be able to act in good faith if it uses staff incentives, performance management or remuneration structures which are likely to cause detriment to its customers.

- For **general insurance and pure protection firms**, the FCA notes that, under the Duty, firms should avoid causing foreseeable harm, including for example where claim handling processes cause unreasonable delays and staff incentives may lead to harmful claims settlement practices.

- **Mainstream consumer credit lenders** were reminded that a Board's annual assessment of the level of the firm's compliance with Consumer Duty, should include an assessment of its people policies, including incentives at all levels, as well as of the firm's strategies, governance, leadership and processes.

A link to the FCA's sector letters can be found here.

Key reward regulatory developments at an EU and international level

Publication of the European Banking Authority (EBA) roadmap on sustainable finance

Overview: On 13 December 2022, the EBA published its roadmap outlining the objectives and timeline for delivering mandates and tasks in relation to sustainable finance and ESG risks. This roadmap builds on and replaces the first action plan on sustainable finance published in December 2019. The roadmap explains the EBA's approach and objectives in the area of ESG, as well as the mandates and tasks received from EU legislators and the European Commission, and the EBA's planned timeline.

Key provisions: The roadmap focuses on the work that the EBA will undertake to ensure the resilience of the banking sector and to support the EU and international agenda on sustainable finance.

The EBA's activities on ESG risks and sustainable finance cover areas including transparency and disclosures, risk management and supervision (including transition plans), greenwashing and supervisory reporting.

From a remuneration standpoint, the roadmap indicates that an update to the EBA Guidelines on internal governance and to the EBA Guidelines on remuneration policies may be undertaken to elaborate further on aspects related to ESG risks.

A link to the EBA's roadmap can be found here.

EBA Report on incorporating ESG risks in the supervision of investment firms

Overview: On 24 October 2022, the EBA published its report on the integration of ESG risks into the supervision of investment firms.

Addressed to local regulators, the report sets out the foundations for integrating ESG risk-related considerations into the supervisory process for investment firms. It provides an initial assessment of how ESG factors and risks could be included in the supervisory review and evaluation process (SREP).

Impacted firms: Investment firms that are subject to EU Investment Firm Directive (IFD).

Key provisions: The report is intended to build on and complement the publication in June 2021 of the EBA's report on the management and supervision of ESG risks for credit institutions and investment firms and, as such, is expected to be read in conjunction with this.

From a remuneration standpoint, investment firms are expected to align their remuneration policies for all staff "*with their business and risk strategy, including ESG-related objectives, corporate culture and value*", as well as their *"risk culture, including with regard to ESG risks, long-term interests of the investment firm, and the measures used to avoid conflicts of interest, encourage prudent risk taking and responsible business conduct*."

As ESG factors and risks by nature can have a long-term effect on investment decisions, particularly where the effect is likely to material, the EBA expects local regulators to ensure that such factors and risks are considered by firms as part of their remuneration policies.

The EBA goes onto note that the impact from an ESG perspective in terms of the "*achievement of sound and effective long-term risk management objectives*" is more significant for MRTs, given the nature of their organisational roles and responsibilities.

The report makes clear that the EBA expects ESG considerations to be "*proportionately incorporated in the assessment of the investment firm's internal governance and firm-wide controls.*" The EBA expects this to include an *"assessment of how ESG factors and risks are incorporated into internal governance, the functioning of the management body, the risk culture, remuneration policies and practices, risk management, information systems and internal controls*" of the investment firm.

A link to the EBA's report on incorporating ESG risks can be found here.

EBA Report on High Earners Data

Overview: On 19 January 2023, the EBA published its Report on high earners for 2021. The analysis shows a significant increase of the number of individuals working for EU banks and investment firms who received remuneration of more than EUR 1 million in respect of the 2021 performance year.

The EBA considers that this is likely to be linked to the overall good performance of firms in 2021, in particular in the area of investment banking and trading and sales, the continuing relocation of staff from the UK to the EU and a general increase in salaries. The EBA also noted that, over time, inflation also contributes to an increase of the number of high earners, especially in the EUR 1 to 2 million pay bracket.

Key provisions: In 2021, the number of high earners receiving remuneration of more than EUR 1 million increased by 41.5%, from 1,383 in 2020 to 1,957. 70% of the increase in terms of the number of all high earners came from firms located in Italy, France and Spain.

The largest population of high earners in the EU27/EEA was in Germany (with 30% of the total number of high earners in 2021). France had the second largest number of high earners (with 19%), followed by Italy (with 18%).

A link to the EBA's report on High Earners data can be found here.

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