



Financial Services Reward – key considerations for firms in relation to the lifting of the bonus cap

September 2022

Overview

Earlier this morning (23 September 2022), during the Mini Budget, the Chancellor announced that the Government is planning on reforming the UK financial services sector remuneration rules. One of the main proposals is the removal of the bonus cap which applies to staff identified as Material Risk Takers (MRTs) under the Capital Requirements Directive (CRD V).

Within the announcement, there were limited details on practical issues, including timing, however, the Chancellor noted that further details would follow in the Autumn.

The bonus cap currently applies to banks, building societies and the largest investment firms and limits the amount of variable pay that MRTs may receive in respect of a given performance year to 100% of fixed pay (or 200% with shareholder or member approval).

This update focusses on some of the key considerations for firms and Remuneration Committees if the bonus cap were to be amended or removed.

What should firms expect from the potential reforms?

While specific details of any proposals (and their timing) are yet to be announced, the Government's focus appears at this stage to be on the potential removal of the bonus cap rather than on any other aspects of the

remuneration rules, such as deferral or malus and clawback.

Notably, the UK Government and the Bank of England did not endorse the bonus cap at the time it was introduced in 2014, with the latter observing that the cap could result in higher levels of fixed pay (a point that was re-affirmed as being a practical consequence by the Chancellor in the Mini Budget) and limit the amount of remuneration that could be used to absorb losses in a downturn, and which is aligned to long-term risks.

Separate to the specific bonus cap, it should be noted that, under the current rules, firms are in any case required to set an 'appropriate ratio' between the fixed and variable components of remuneration for MRTs (and are encouraged to do so for all staff), ensuring that these components are 'appropriately balanced' and allow the operation of a fully flexible policy on variable remuneration, including the possibility to pay no variable remuneration at all.

What would be the impact for firms and MRTs in different locations?

The removal of the bonus cap in the UK would not remove the requirement for the cap to be applied by EU-headquartered CRD V firms or UK firms with EU operations subject to the CRD V rules. In summary:

- **For UK-headquartered firms**, the bonus cap would not need to be applied to MRTs identified in relation to UK or non-EU group entities. The cap would, however, still need to be applied to individuals identified as MRTs in relation to EU-regulated entities within the group (including MRTs of branches of UK firms operating in the EU), which could potentially include staff based in the UK.
- **For EU-headquartered firms**, the bonus cap would continue to apply

for all MRTs identified at Group or other EU-group entity level.

Individuals identified as MRTs at the UK level would not be subject to the bonus cap (unless they have also been identified as MRTs in relation to the Group).

- **For non-UK/EU firms**, the cap would no longer apply for MRTs identified in relation to any UK-regulated entity.

Firms will therefore need to review their group entity MRT lists carefully to determine the overall impact of any lifting of the cap.

Considering the impact on remuneration for affected staff

The impact of any lifting of the bonus cap would depend upon the nature of the amended rules.

It is unclear at this stage whether the bonus cap would be removed entirely, with firms only required to ensure an "appropriate balance" between fixed and variable pay, or whether firms may be required to set an "appropriate fixed to variable pay ratio" in their remuneration policies, akin to the pay ratio requirement under the new Investment Firms Prudential Regime ('IFPR'), which took effect for investment firms for performance years beginning on or after 1 January 2022.

Rebalancing the pay mix

Since the cap was introduced, many firms have increased salaries or introduced role-based allowances in order to maintain competitive levels of total compensation while remaining within the cap.

If the cap were abolished, firms may look to consider the removal of fixed allowances and the rebalancing of the pay mix towards higher variable pay. This would reduce the fixed cost base and provide greater performance linkage, while maintaining long-term risk

alignment through the continued use of the pay-out process rules.

However, the potential unwinding of high levels of fixed pay would need to be considered carefully and may need to be phased over time.

From a legal perspective, firms should carefully consider whether they have the appropriate legal basis for introducing any change to either base salary or fixed allowances.

We would anticipate that few firms would have the contractual flexibility to unilaterally reduce an individual's fixed salary, and so the relevant documentation and communications or commitments to employees should be reviewed from this perspective. Firms may have more flexibility with regard to changes to current fixed pay allowances, although firms will also need to review carefully the specific terms of those allowances (and any communications to employee recipients in relation to these) in order to determine whether the firm has the contractual ability to make such changes unilaterally and in what circumstances, or whether employee consent will be required.

In any event, any change to salary and payment terms would need to be handled sensitively and carefully in order to avoid giving rise to employee claims. Firms should also be alive to the potential for differential treatment where any changes to the bonus cap rules could mean that employees are not treated consistently for bonus purposes across a group structure.

From a commercial perspective, firms rebalancing the pay mix from fixed to variable will need to consider an appropriate level of substitution. The removal of the cap should not necessarily mean an increase in levels of total compensation, and given that fixed pay provides greater certainty for employees, this then becomes a question of considering the 'expected value' of the

overall package. Firm (and employee) expectations around bonus projections are likely to be relevant here.

One potential route for firms may be to transition towards a higher variable pay mix over time, grandfathering levels of fixed compensation for existing employees while rebalancing the offering for new hires. In such instances, firms should consider the potential challenges around pay equity and internal mobility where different pay structures are adopted.

From a reward regulatory standpoint, policy documentation around role-based allowances will also need to be reviewed if the firm ceases offering such allowances to individuals moving into those roles where existing role-holders continue to receive an allowance.

More fundamentally, firms should also review the extent to which a rebalancing of the compensation package could impact conduct, risk-taking and effective risk management as these aspects are central to the wider rules and priorities of the regulators.

Shareholder perspective

For UK-listed firms that are required to have their directors' remuneration policy approved by shareholders, the shareholder perspective will be a key consideration where changes to executive pay are pursued, in light of any lifting of the bonus cap.

In the current climate, investor and proxy voting body reaction and the wider external scrutiny that goes alongside this will need to be carefully managed, albeit that there may be appetite from shareholders for proportionate rebalancing to variable pay to further align executives with firm performance and the shareholder experience. Firms will need to consider the rationale for and the articulation of any revised approach to executive reward in external communications. Pro-active shareholder engagement is also likely to be needed in

order to ensure there is effective understanding and support for any new approach.

Firms which have obtained shareholder approval for a bonus cap higher than 1:1 should review the terms of the relevant resolutions to determine whether shareholder approval will be required to remove the cap.

What practical next steps can firms and Remuneration Committees take?

We have set out below a number of practical next steps that are likely to need to be considered:

- **Determine who may be impacted** – firms should review the MRT lists of their different group entities in order to identify who would be impacted by the removal of the cap, taking into account the location of each entity's headquarters and primary regulator. Firms should also consider the impact on cross-border employees.
- **Consider the appropriate pay mix** – the removal of the bonus cap would not necessitate material changes to pay structures. Firms should, however, consider what an appropriate pay mix would be if the cap were removed, taking account of their own business activities and associated risks, and all other factors that may be relevant. This may include consideration of the talent market, which may itself be impacted by the actions other firms take in response to the lifting of the cap.
- **Review the legal implications** – firms considering a potential rebalancing of the pay mix, including the operation of fixed pay allowances, should review carefully the specific terms and associated communications of those allowances in order to determine any contractual risks or implications,

including whether employee consent will be required. Any review of salary levels will also require careful consideration from an employment law standpoint.

- **Consider governance and documentation** – Remuneration Committee approval will be required for any changes in the approach to pay in light of the removal of the cap. For the UK operations of EU-headquartered firms, the approach would also likely require group-level approval.
- **UK-listed firms** - The shareholder and wider external perspective should be considered, which will likely, in due course, include considering how / where any re-balancing of remuneration would be appropriate (e.g. short-term vs long-term variable pay) and pro-active shareholder consultation. All firms with a shareholder-approved higher bonus cap should consider whether shareholder approval would be required to remove the cap.
- **Communications to employees** – firms would need to carefully consider how they communicate and manage employee expectations in light of any removal of the cap and any subsequent changes to pay structures.

Contact us:

If you would like to discuss this, or any other related matter, please speak to your usual Deloitte contact or any of the following:

John Cotton

Partner

020 7007 2345 - [email](#)

Clare Edwards

Partner

020 7007 1997 - [email](#)

Iqbal Singh Jit

Partner

020 7303 4101 - [email](#)

Juliet Halfhead

Partner

0121 695 5684 - [email](#)

Mitul Shah

Partner

020 7303 2368 - [email](#)

Marian Bloodworth

Partner – Deloitte Legal

020 7303 3565 - [email](#)

Julia Gorham

Partner – Deloitte Legal

020 7007 5801- [email](#)

Emily Buzzoni

Director

020 7303 2710 - [email](#)

Amy Douthwaite

Director – Deloitte Legal

020 7303 3486 - [email](#)

Sarah Keith

Director

020 7007 4927 - [email](#)

Elliot Abrahams

Associate Director

020 7007 6289 - [email](#)

Sean Davies

Associate Director

020 7303 4039 - [email](#)

Rowena Gaukroger

Associate Director

020 7007 8975 - [email](#)

Susannah Hill

Associate Director

020 7303 8289 - [email](#)

Liz Loubser

Associate Director

020 8039 8073 - [email](#)

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