First take

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Key points from the UK's final bonus compensation rule

On June 23rd, the UK's Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)[1] finalized a joint bonus compensation rule that was proposed last July. While the industry (including subsidiaries and branches of US banks in the UK) had hoped for a more lenient approach, the final rule generally retains the proposal's stringent requirements, especially with respect to bonus deferral periods and clawbacks.[2]

The rule applies to "senior managers"[3] and other "material risk takers"[4] at UK banks and certain investment firms. As finalized, the rule establishes the toughest regulatory approach to bonus compensation of any major jurisdiction, going beyond the EU-wide CRD IV.[5] Therefore, unless regulators in other major jurisdictions take a similar approach, institutions that are active in the UK are placed at a competitive disadvantage compared to their peers elsewhere.

1. **UK regulators sidestep recently proposed EU bonus cap guidance.** The final rule does not include changes to reflect the CRD IV bonus cap guidelines proposed by the European Banking Authority (EBA) in March. Most notably, UK regulators did not follow the EBA's proposed language for preventing alleged circumvention of the EU's bonus cap when institutions categorize compensation as "allowances" rather than bonuses.[6] While this is welcome news for the industry, it will create uncertainty if the EBA's guidelines are finalized as proposed.
2. **Limited relief provided with respect to deferrals.** The final rule maintains the proposal's requirement that bonuses be deferred for seven years for senior managers (with no vesting in the first three years, and no faster than pro rata vesting thereafter), and five years for other material risk takers (again, no faster than pro rata vesting). Thus, UK regulators did not meet the industry's request for shorter deferral periods for senior managers, consistent with CRD IV (i.e., as few as three years). The industry, however, received limited relief, as under the final rule the five year deferral period applies only to those material risk takers who supervise risk-taking activities or significant risk functions.
3. **Clawback period extension for senior managers.** Under a 2014 rule, bonuses paid to material risk takers are subject to a seven-year clawback period. The final rule extends this period to up to ten years for senior managers associated with an investigation that could lead to a clawback of their compensation, consistent with the proposed language.

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[1] The PRA is charged with the prudential supervision of banks and major nonbank financial institutions while the FCA focuses on industry conduct and consumer protection.

[2] For a more detailed analysis of the final rule, see PwC UK's *UK regulators finalise the Remuneration Codes* (June 2015).

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4. **For PRA-supervised institutions, bonus pools remain subject to risk adjustment.** The final rule retains the proposal's requirement that the calculation to determine the size of the institution's bonus pool be subject to "prudent valuation adjustment" to exclude, e.g., unrealized profits from illiquid markets. This prudent valuation adjustment applies to subsidiaries of US banks located in the UK (but not branches of US banks), but only applies to their UK profits that contribute to the global bonus pool. The final rule also prohibits the use of certain bonus calculation metrics (including return on equity, total shareholder return, and earnings per share), unless these metrics are part of a broader, risk-adjusted set of measures.
5. **Buy-out bonuses remain permissible, for now.** A buy-out bonus is paid by a firm to a new employee to make up for any unvested compensation that is cancelled when the employee leaves the previous employer. These bonuses have caused regulatory concerns, as they are viewed as potentially undermining the objectives of the vesting period. To address the issue, the proposed rule had contemplated several options, including banning buy-out bonuses, requiring buy-outs to be maintained in a cancellable form, or applying clawbacks to buy-outs. The final rule leaves the issue undecided, but indicates that regulators are especially considering requiring the new employer to maintain buy-out bonuses in a cancellable form.

What's next for US institutions?

The final rule becomes effective on July 1, 2015 (adding to CRD IV requirements that have been effective since 2014), except for the extended clawback and deferral provisions which will apply to performance years starting on January 1, 2016. This gives UK-located subsidiaries and branches of US firms (and US-located branches and subsidiaries of UK firms) a short window to prepare for compliance, especially given the lack of clarity around bonus pool calculations using prudent valuation adjustment.[7]

Meanwhile, US institutions anxiously await related requirements expected to be proposed by US regulators. Recent remarks by senior officials such as the OCC's Thomas Curry suggest that regulators are focusing less on hard limits on bonuses and more on incentives provided by compensation structures, including clawbacks and deferral provisions. We believe the US proposal (which replaces an existing 2011 proposed rule that was never finalized), will likely also incentivize the use of debt, rather than equity, as part of deferred compensation packages in order to further discourage excessive risk taking.

The US proposal has been expected for some time but has continued to be delayed due to complexities involved in aligning several agencies (Dodd Frank requires that the rule be jointly issued) and in establishing requirements for a broad range of financial institutions with different compensation practices (e.g., asset managers).

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[3] Senior managers are defined under the UK's Senior Manager Regime generally as individuals who manage high-risk functions within the firm, in either an executive capacity (e.g., CEO, CFO, and CRO), or a non-executive capacity (e.g., Board Chairman and the heads of risk, audit, and compensation committees).

[4] Material risk takers are employees whose professional activities can substantially impact the risk profile of the institution. See PwC's *Regulatory brief, EU bonus cap: Proposed expansion curtailed* (December 2013).

[5] CRD IV includes bonus deferrals and clawbacks applicable to the UK, although CRD IV is most commonly known for capping bonuses. See PwC's *Regulatory brief, EU bonus cap to take effect January 1, 2014* (July 2013).

[6] See PwC's *Regulatory brief, EU bonus cap: The net widens* (March 5, 2015).

[7] More specifically, it is not clear whether regulators would expect firms with December 31st financial year-ends to adjust their 2015 bonuses for the full year, or only partially to reflect the July 1st effective date of the rule.

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