Financial Conduct Authority

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Strengthening the alignment between risk and reward – remuneration rules for banking sector (Policy statement in PS15/16; consultation and cost-benefit analysis in CP14/14)

Lead regulator: FCA

Date of assessment: 10 October 2016

Commencement date: 1 January 2017

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? UK Banks, building societies and dual-regulated investment firms; UK branches of overseas banks

Brief outline of proposed new or amended regulatory activity

Following the 2008-09 financial crisis, in June 2012 Parliament established the Parliamentary Commission on Banking Standards (PCBS) to consider and report on professional standards and culture of the UK banking sector, and lessons to be learned about corporate governance, remuneration and conflicts of interest, and their implications for regulation and for Government policy.

The PCBS concluded that public trust in banking was at an all-time low and recommended changes to the Remuneration Code to address weaknesses in the alignment between risk and reward. In particular, the remuneration recommendations in the PCBS report aimed to address the misalignment between risk and reward with the objective of ensuring that the rewards of banking flowed in accordance with the full long-term costs and benefits of the risk taken. The PCBS recommended the following changes:

- **Deferral -** Longer deferral periods to align the risk horizons of key individuals further with the longer-term safety and soundness of the firms for which they work. The PCBS suggested that the regulators should have a power to require that a substantial part of remuneration be deferred for up to ten year. We mandated a seven year deferral period for Senior Managers, and three to five years for all other material risk takers;

- **Clawback** – PCBS recommended that regulators should be able to recover vested remuneration in the most egregious cases. We introduced a rule that requires variable remuneration, both deferred and undeferred, to be subject to clawback for a period of at least seven years from the date of award, with the option to extend the clawback period for Senior Managers of up to a further three years if there is an ongoing investigation;

Exceptional government intervention – PCBS recommended that the regulators be able to void or cancel all deferred remuneration in the event a bank receives state aid. We extended the presumption against payment or vesting of variable remuneration extends to all discretionary payments, including payment for loss of office and discretionary pension benefits.

Which type of business will be affected? How many are estimated to be affected?

Our new rules apply to UK banks, building societies, and dual-regulated investment firms. The remuneration policies include non-EEA branches and therefore the number of firms in scope is around 285 (240 banks and 45 building societies), at the time of the cost-benefit analysis in 2014.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2014	2016	10	-£42.2m	£4.7m	£23.5m

Please set out the impact to business clearly with a breakdown of costs and benefits

We have assessed the compliance cost impacts on the affected businesses for each of the three remuneration policies: Deferral, Clawback, and Exceptional government intervention. The tables below summarise the one-off and ongoing compliance costs for each of these policies, split by policy measure, firm size, firm type (banks and investment firms, or building societies).

Banks and investment firms:

	Large firms		**Small firms**	
Remuneration policies	**One off costs**	**Ongoing costs**	**One off costs**	**Ongoing costs**
Deferral	£4.8m	£0.6m	£6.0m	£0.9m
Clawback	£6.7m	N/A	£11.5m	N/A
Exceptional government intervention	Negligible	Negligible	Negligible	Negligible
Sector cost	£11.5m	£0.6m	£17.5m	£0.9m

Building Societies:

	Large firms		Small firms	
Remuneration policies	**One off costs**	**Ongoing costs**	**One off costs**	**Ongoing costs**
Deferral	£0.11m	£0.02m	Negligible	Negligible
Clawback	£0.02m	Negligible	Negligible	Negligible
Exceptional government intervention	Negligible	Negligible	Negligible	Negligible
Sector cost	£0.13m	£0.02m	Negligible	Negligible

Total one-off costs: **£29.13m**

Total ongoing costs per annum: **£1.52m**

For further detail on the breakdown and calculation of compliance costs, see *FCA Consultation Paper 14/13, Annex: FCA Cost Benefit Analysis*.

Cost modelling

We have taken a bottom up modelling approach, using the quantitative results of our structured interviews to estimate the total costs per firm in our sample, and then extrapolating up across the industry. Where individual firm data were not provided, for example on salaries or legal fees, we have used benchmark data from pervious compliance cost research. Where firms have identified a cost but have not been able to provide quantitative estimates we have imputed costs based on the other firms in the sample, adjusting for scale differences.

The costs gathered from our sample firms are then extrapolated to construct a cost estimate for the industry as a whole. In order to account for differences in size among the firms in each sector, we separate the one-off and ongoing costs into fixed and variable costs. We separate out fixed and variable costs based on the compliance cost questions asked in the interviews, and define them as follows:

- Fixed costs relate to activities that would be undertaken largely regardless of firm size. These include, for example, understanding the regulatory requirements; developing internal policies, guidance and other documentation; and setting up systems to record and report data.
- Variable costs are linked to the size of the firm (in particular the number of employees) and include time spent by individuals on training, reviewing documents, monitoring and reporting.

Fixed costs are multiplied up by the number of firms in the sector (with a distinction between large and small); variable costs are multiplied up as a proportion of turnover. As the extrapolation of fixed costs in particular is influenced by the number of firms classified as large or small, we conducted sensitivity tests using different thresholds.

The average fixed costs across the large and small categories in our sample were multiplied up by the total number of large and small firms in each sector. The variable costs were expressed as a percentage of turnover and then multiplied up by the total turnover across large and small firms in each sector. We present the data used in each sector when reporting the sector-wide compliance costs.

Large banks and investment firms are defined as the largest firms that collectively account for 80% of the sector income; this translates to 18 firms out of the total of 240 banks and investment firms, with the remainder defined as small firms.

Large building societies are defined as those with over £100m of annual income; this definition results in a split of 6 large firms (accounting for 90% of the sector income) and 39 small firms.

Population statistics for firms

Type of institution	**# of firms**	**Sector income (2013)**
Banks and investment firms	240	£115 bn
Building societies	45	£4.5 bn

Compliance costs

Compliance cost cover both one-off and ongoing costs, defined as follows:

- One-off costs are those incurred once off in complying with the policy.
- Ongoing costs are those incurred annually as a result of the policies

Deferral of variable remuneration

The costs of complying with the deferral policy largely consist of one-off costs of reviewing and updating guidance around the firms' deferral policy, including legal advice. There would also be one-off costs involved in communicating the changes to affected staff and dealing with queries etc. However, most banks would not need to change individual contracts as variable remuneration is communicated to staff by means of an annual statement which could easily be altered.

Ongoing costs would also be incurred as a result of additional monitoring of deferred payments to ensure they are paid on time and to account for an increase in the complexity of deferral arrangements covering a wider population of employees.

The cost impacts of the remuneration policies in general were not felt to be significant by the small banks given the limited scope of variable remuneration payouts.

Clawback

The likely one-off costs of this policy are:

- Revision of contracts
- Development of guidance and rules, including legal advice.

Ongoing costs of implementing clawback proceedings would be incurred if the new policies resulted in an increase in the occasions where clawback was implemented.

The one-off costs would most likely include a revision of contracts otherwise the enforcement of extended clawback would be very difficult. Firms would also need to develop guidance and rules, and receive legal advice on this. Small banks did not see this as a significant cost given the low scale of variable remuneration paid.

The legal costs associated with clawback could be significant, although these would vary on a case by case basis and it is unclear the extent to which these might increase as a direct result of the policies.

Exceptional government intervention

The costs related to this policy could include one-off costs of revising policies and the implications of applying the Code in the case of exceptional government intervention. The banks in our sample did not foresee any notable costs in complying with this policy, with possibly negligible costs of documentation changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

The changes made by the Accountability Regime reflect the recommendations of the Parliamentary Commission on Banking Standards and implement changes required by the amendments which the Financial Services (Banking Reform) Act 2013 made to the Financial Services and Markets Act 2000 (FSMA).

Given the significance of these changes and the one-off and on-going compliance costs to firms, we believe that had this policy initiative taken place in the future it would be reasonable for the FCA to split the costs of implementation with HMT. As a retrospective measure we have not attempted to split the costs in this instance.