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The PRA Remuneration Code's revised clawback obligations

Briefing

September 2014

Summary

This briefing examines the final revised clawback obligations which will apply to PRA-regulated firms in remuneration levels one and two from January 1, 2015, and highlights key points for firms to consider when implementing their clawback policies.

Introduction

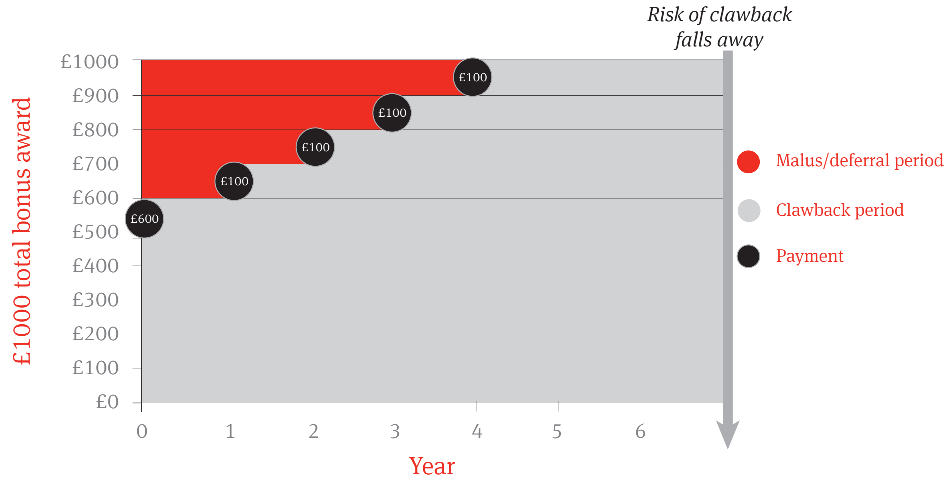
On July 30, 2014, the PRA published a policy statement (PS7/14) announcing the revised clawback obligations which will apply to PRA-regulated firms in remuneration levels one and two following the earlier clawback consultation paper published in March 2014 (CP6/14). The changes come as regulators in both the UK and Europe focus on the rights of banks to require repayment of bonuses in the light of a number high-profile controversies.

What's changing?

Following the amendments to the PRA Remuneration Code which is currently set out in Chapter 19A of the FCA's Systems and Controls Handbook, all variable remuneration (both short and long-term, cash and non-cash) awarded to material risk takers on or after January 1, 2015 must be subject to ex-post risk adjustment through combined malus and clawback provisions:

- At least 40 per cent must be deferred and at risk of downward adjustment through 'malus' provisions for at least three and up to five years, with amounts vesting within the applicable deferral period no faster than on a pro-rata basis.

- Both deferred and undeferred elements of all variable remuneration must be subject to 'clawback' provisions for a period of seven years during which, if relevant circumstances arise, an 'amount corresponding' to the variable remuneration awarded must be paid back to the company by the individual. The beginning of the clawback period is measured from payment for any undeferred element and for any deferred element from award (i.e. the beginning of the deferral period). The following example illustrates how this works in practice:



An executive is awarded £1,000 cash bonus, £600 of which is paid up-front, and £400 of which is deferred for four years, with 25 per cent vesting each year. Clawback applies for the overall seven year period.

The particular circumstances in which firms are required to provide for clawback are where:

- there is reasonable evidence of employee misbehaviour or material error and/or
- the firm or relevant business unit suffers a material failure of risk management, taking into account when the material failure arose, the proximity of the particular employee and their level of responsibility.

Following the consultation, the PRA have recognised the need to limit requirements to pay back remuneration to serious individual misconduct and risk failure, whereas the wider malus provisions are triggered where the firm or relevant business unit suffers a material downturn in its financial performance (without individual culpability), as well as for individual misconduct and risk failure as set out above. The revised rule requires firms to ‘make all reasonable efforts’ to recover an appropriate amount, with the policy statement acknowledging that firms are able to take a proportionate approach based on the assessment of individual cases. This addresses concerns expressed by respondents to the original consultation about the difficulties of seeking recovery where an individual is resident in a jurisdiction in which clawback is not enforceable.

Interpreting the new clawback requirements

Whilst some elements of the new requirements are clear and the clarifications on measuring the clawback period from the date of award (rather than vesting) are welcome, in establishing their clawback policies firms should consider their approach to the following questions:

What level of employee misbehaviour would be required to trigger clawback?

The policy statement does not require that behaviour leading to clawback should be the subject of regulatory investigation or sanction and as such, the focus is on a firm's internal investigations and determinations. In addition, whilst the policy statement makes it clear that the PRA believe clawback is most appropriate in circumstances involving individual culpability, it may be difficult in practice to distinguish between an individual's misbehaviour and an organisational cultural failure.

What is the 'amount corresponding to' variable remuneration which must be at risk of clawback?

For example, where instruments have been awarded, should it be the value of the instruments at the time of award, or at a later date such as vesting or when the clawback provisions are triggered? And should amounts be recouped on a gross or net of tax basis? Firms will need to ensure that the relevant documentation specifies how the requisite amount is to be determined.

Implementing enforceable and workable clawback rights

Given that firms may need to clawback amounts which were paid several years previously and are likely to have been converted into cash and spent, it is vital to ensure that clawback provisions are both enforceable and operable in practice. Whilst the simplest approach would be to require all variable remuneration to be held by a nominee or in escrow until the clawback period expires, this would understandably be unacceptable to most executives, therefore, firms should ensure that:

- Clawback terms are explicit and agreed with the executive before the entitlement to payment or award arises.

- The agreed terms include mechanics for automatic recoupment from as wide a variety of sources as possible, including reducing or cancelling other outstanding, unvested awards and the right to deduct the requisite amount from any salary, bonus or other cash amounts due.

It nevertheless may be particularly difficult to enforce recoupment from an individual once they have left and in these circumstances firms may wish to consider whether it would be desirable to require departing executives to place any money or share awards in escrow until the clawback rights fall away.

What next?

As well as the new clawback provisions, the PRA and FCA have also announced a number of proposals designed to further strengthen the alignment of risk and reward, including:

- extending minimum deferral periods to seven years for senior managers and five years for other material risk takers
- the possibility of extending the clawback period by up to three years for senior managers if, at the end of the normal seven year period, internal or external investigations are underway which could potentially lead to the application of clawback
- potential approaches to ensuring that buy-out arrangements do not undermine the impact of the clawback obligations.

The proposed categorisation of senior managers for these purposes is set out further in PRA CP14/14.

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