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European Banking Authority Guidance on Financial Services Bonus Cap

Affected financial institutions and investment firms will need to overhaul the way they remunerate many of their highest-paid staff.

On 21 May, the European Banking Authority (EBA) published a consultation paper containing draft guidance on exactly who will be affected by the European Commission's proposed cap on bonuses for the highest-paid individuals within European financial institutions and investment firms. The release of the guidance follows the European Parliament's recent approval of the Capital Requirements Directive IV (CRD IV), the legislative instrument that contains the new bonus cap rules. Affected entities should consider the significant impact of these rules now, in anticipation of implementation as early as 1 January 2014.

Who will be affected by the new bonus cap rules contained in CRD IV?

The new rules will apply to individuals who are "material risk takers" within all credit institutions and investment firms that are (1) based in the European Economic Area (EEA), (2) non-EEA-based subsidiaries of institutions and firms with headquarters in the EEA, or (3) EEA-based subsidiaries of institutions and firms with headquarters outside the EEA. The guidance contained in the EBA's consultation paper suggests that an individual will be a "material risk taker" for the purposes of CRD IV if

I. the individual's total remuneration exceeds €500,000 per year;
II. the individual is part of the 0.3% of staff with the highest remuneration in the institution or firm;
III. the individual's remuneration bracket is equal to or greater than the lowest total remuneration of senior management and other risk takers; or
IV. the individual's bonus payments exceed €75,000 and 75% of the fixed component of remuneration.

What are the new bonus cap rules?

Once in force, CRD IV will apply to all bonus payments made to "material risk takers" other than payments due under existing contractual arrangements entered into before the draft CRD IV was first published on 27 June 2012. It introduces **a maximum limit for bonus payments of 100% of an individual's basic salary**. This cap can be raised to 200% of basic salary but only with shareholder approval, which it appears (although it is not entirely clear) will be required on an annual basis.

In addition, CRD IV specifies the following:

- 25% of any bonus payment that exceeds 100% of an employee's basic salary will need to be deferred for a period of no less than five years. The specifics of the deferral mechanisms will be developed by the EBA by March 2014.
- 100% of bonus payments will need to be capable of being clawed back in situations where an individual is culpable in future financial losses or where the individual's performance falls below the requisite standard.
- Subject to the legal structure of the organisation, at least 50% of the bonus payment will need to be in shares or an equivalent financial instrument.

- Early termination payments must be performance specific (the idea being that exiting employees will no longer be rewarded for misconduct and failures).
- Remuneration committees will have to take into account “public interest” when deciding the bonus, if any, that will be paid.
- Remuneration polices will need to identify and make a distinction between criteria used to determine base salary and criteria used to determine bonus payments.

When will the rules come into force?

If CRD IV is approved by the European Council (as is expected) and published in the Official Journal of the European Union by 30 June 2013, the deadline for implementation in EEA member states will be 1 January 2014. Otherwise, the deadline will be pushed back to 1 July 2014.

What will the impact be?

The impact of these changes is expected to be considerable. Affected financial institutions and investment firms will need to radically overhaul the way they remunerate many of their highest-paid staff. Significant increases to base salary, the introduction of additional contractual allowances, and the increase of “fixed benefits” may all need to be considered. These rules may also deter some of the highest performers within non-EEA-headquartered organisations from moving to London or elsewhere within the EEA. Accordingly, there appears to be a real risk that, in seeking to constrain what it views as the excesses of the banking culture, the European Commission may damage the competiveness of the European Union’s financial sector to the potential benefit of New York, Zurich, Hong Kong, and other major non-EEA financial centres around the world.

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