

# Insight: Employment & Benefits

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## New Directive capping bankers' bonuses

The European Parliament agreed today (7 July 2010), at its plenary in Strasbourg, on the wording of the new Capital Requirements Directive (the "**Directive**") following the agreement reached between the European Council and Parliament on 29 June. Whilst the full text is not yet available, a summary of the key issues is set out below.

The Directive imposes restrictions on the way in which bankers' bonuses are to be paid and aims to promote the long term health of the financial system by preventing risk-taking and encouraging stability including the introduction of new rules concerning capital. The bonus provisions of the Directive are due to take effect in January 2011, whilst the capital requirement provisions will take effect by 31 December 2011 at the latest. The Directive will require implementation into UK law through the adoption of domestic legislation. Each Member State must implement the Directive within prescribed time limits, usually in the region of 2 years after the Directive takes effect.

### The new rules

- (i) Bonuses will be capped to salary in accordance with EU guidelines, in order to reduce the disproportionate use of bonuses in the banking sector.
- (ii) Cash bonuses will be capped at 30% (or 20% for particularly large bonuses). This strict limit aims to ensure that bonuses are linked to the long term benefit of the bank, rather than short term risk-taking.
- (iii) 40-60% of any bonus must be deferred and will be clawed back in the event that investments do not perform as expected.
- (iv) At least 50% of the total bonus will be paid in the form of contingent capital and shares whereby such money or shares can be called upon at first instance in the event of bank difficulties.
- (v) Bonus-like pensions will be regulated. In particular, exceptional pension arrangements will be held back and linked to the underlying strength of the bank in question.
- (vi) Banks which were bailed out by taxpayers will receive additional stringent restrictions restraining the amounts to be paid out in bonuses. The Directive seeks to make it clear that the top priority of such banks shall be the repayment of the taxpayer.
- (vii) Details of pay and bonus practices must be made publicly available in order to aid transparency and accountability.



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- (viii) New capital rules for re-securitisations are included to encourage banks to sufficiently cover the risks which are exercised.
- (ix) The way in which banks assess the risks connected with their trading books (their portfolio of securities) will be reformed in order to increase substantially levels of capital held against it.
- (x) Corporate governance reforms are included which are aimed at addressing current failures. These reforms include the requirement to establish Remuneration Committees, comprised solely non-executive directors.

## Commentary

The new Directive aims to deliver a clear message to banks, as well as to the general public, regarding the activities of bankers and the impact that such activities have had on the recent global economic crisis. In the context of a new era where excessive risk-taking and short-termism are frowned upon and where employees in the financial sectors are being forced to address their previous behaviour, this new Directive will set into law, once implemented in the UK, a further layer of regulation and scrutiny.

As stated by Arlene McCarthy, Vice Chair of the Economic and Monetary Affairs Committee,

*"Tough new rules on bonuses will transform the bonus culture and end incentives for excessive risk taking....In the last two years the banks have failed to reform, and we are now doing the job for them."*

Whilst the aim of the legislation is to reward long term performance over short term risk-taking, there is a school of thought which highlights various concerns, particularly regarding the dampening of competition and returns. In fact, whilst this is a European Directive, unless these changes are reflected globally, such caps on bankers' bonuses could lead to an inevitable brain drain as top executives search for higher salaries. The only way to prevent this would be to achieve a global consensus. The Directive is in fact in line with the G20 communique, which took place just over a week before the agreement between the Council and Parliament was finalised. As yet there is no global cap on banking bonuses, however Western nations are likely to follow in the near future.

On a practical note, both bankers and regulators have been caught by surprise following the agreement reached at the end of June. Each side is now trying to figure out how the rules will work and how the Directive will be implemented into law in each of the EU Member States.