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EU Debate on Enforcement of the 'Banker Bonus Cap' Approaches End Game

Michel Barnier, vice president of the European Commission, recently wrote to the chairman of the European Banking Authority (the EBA), asking the EBA to report by the end of this month on whether allowances paid by EU banks to key staff count as variable compensation, which is subject to the EU bonus cap. A copy of the letter can be found here.

Mr. Barnier's letter is the latest contribution to a debate among EU law makers and regulators on the EU's bonus cap. This alert summarises that debate and identifies some potential next steps.

By way of background, the EU's Capital Requirements Directive (CRD)[1] requires EU-established banks to limit variable compensation paid to key bank staff to 100 percent of fixed pay. This ratio can be raised to 200 percent in the event of approval by a super-majority of the bank's shareholders not directly affected by the ratio. The provision was introduced at a late stage of the CRD legislative process by the European Parliament and played no part in the European Commission's and EU Member States' original proposals. Although styled as a "banker bonus cap," the provision also affects staff employed in an EU bank's worldwide non-banking (as well as banking) subsidiaries. The bonus cap also potentially applies to EU investment firms that have permission to trade on their own account, custodise client assets or hold client money.

The CRD does not have direct effect in each EU Member State and, therefore, must be transposed by each Member State into local law and regulation. The EBA, a pan-EU banking regulator responsible for promoting the convergence of EU bank regulatory standards, has a role to play in ensuring consistent application across the EU of the CRD's bonus cap requirements.

Any legal obligation that interferes with a business' ability to pay its staff will naturally be controversial, no matter how politically popular. The bonus cap has received sustained criticism from banks and some EU governments. In particular, the U.K., which has the EU's biggest financial centre, has challenged the validity of the bonus cap before the European Court of Justice (ECJ), in a case that is currently being heard. From a prudential regulatory perspective, the bonus cap puts pressure on banks to increase fixed pay, as EU banks need to compete for global talent with banks in the U.S. and Asia. However, an increase in fixed pay increases a bank's fixed costs against which more regulatory capital must be applied. Further, increases in fixed pay limit a bank's ability to reduce overall pay in more challenging economic and business conditions. Therefore, there is an argument that the bonus cap counteracts the ultimate prudential policy goal of ensuring a stable banking sector that is strong enough to lend to the real economy. In addition, to the extent bonuses are subject to vesting and clawback whereas fixed pay is not, the effect could be to reduce the proportion so affected.

As a solution to the issues that the bonus cap raises, some EU banks have begun to pay role-based allowances as part of the fixed salary component paid to key staff. Allowances are not guaranteed to be paid every year and are not pensionable. The U.K.'s Prudential Regulation Authority has reportedly agreed with some U.K.-licensed banks that

1 Directive 2013/36/EU.

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allowances count towards fixed pay. However, it is clear that the European Commission and a sizeable bloc of European Parliament lawmakers do not agree with the U.K.'s stance, hence Mr. Barnier's recent letter. The EBA, which has been investigating the issue since the beginning of this year, is now under pressure to come to a quick conclusion.

Where does this leave the EU banking market, and what are the possible permutations?

It is possible that the ECJ will decide to strike down, or significantly reduce the impact of, the bonus cap. This would benefit the EU banking industry by removing an obstacle to the hiring of key staff that U.S. and Asian competitors presently are better able to avoid. It would certainly help the U.K., and it may assist the EBA, which would be relieved of having to make a politically contentious decision on whether allowances count as fixed or variable compensation.

However, assuming that the ECJ does not make its decision soon or upholds the bonus cap, the EBA will have to give its view on whether allowances are variable compensation. An EBA decision that allowances do in fact constitute variable pay subject to the bonus cap would likely set the EBA against the U.K. In the event of a continued dispute, the EBA's founding regulation[2] gives the EBA power to:

- issue guidelines and recommendations, following a consultation period, with which EU national regulators and financial institutions must make every effort to comply.[3] National regulators are given a two-month period to confirm compliance. It is possible that the EBA may use the time needed to complete the guidelines process to help identify and broker a solution to the issue;
- investigate a suspected breach of the bonus cap law and make a recommendation to U.K. regulators as to the steps they need to take to remedy the breach.[4] One month after U.K. regulators receive the EBA recommendation, the European Commission can issue a formal opinion to the U.K. to take formal steps to comply with the EBA's interpretation of the bonus cap law. If the U.K. does not comply with the formal opinion within the specified time period, the European Commission can bring enforcement proceedings against the U.K. before the ECJ. It is doubtful, however, that the EBA has power to direct U.K.-regulated banks to comply with its interpretation of the bonus cap once the time period for compliance with the European Commission's opinion has expired, in the unlikely event that the EBA wanted to explore such power's use. In any event, it is important to note that national regulators are given rights of appeal to an Appeal Board and then to the ECJ against EBA decisions that prolong an already contentious process. Clearly, an EBA decision to initiate a form of enforcement action without issuing guidelines would be a radical step, especially in circumstances where EU institutions prefer consensus to confrontation. We think it more likely that the EBA, if it decides that allowances are variable compensation, will first look to use the guidelines process referred to above, although a more aggressive approach cannot be ruled out.

The EBA could of course decide that allowances with specific features count towards fixed pay, and are not, therefore, subject to the bonus cap, thereby benefitting the EU banking sector and helping to avoid an EU confrontation with the U.K. Such a decision may not be appreciated by certain members of the European Parliament. Although it is not currently clear how the EBA would achieve a result that would keep both sides in the debate happy, the possibility of an EBA decision that allows the payment of allowances in tightly prescribed circumstances to count towards fixed pay should not be excluded.

The final outcome of these deliberations over the bonus cap is yet to be known. However, it is clear that something of a fight back has begun and that a close watch is warranted by those affected by the EU banking compensation regime or still deciding on their EU staff footprint.

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2 Regulation (EU) 1093/2010.

3 See Article 16, Regulation (EU) 1093/2010.

4 See Article 17, Regulation (EU) 1093/2010.