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Banker Bonuses:
UK and EU Remain on Collision Course

Since 1 January 2014, the EU's Capital Requirements Directive (CRD)[1] has required EU-regulated banks (EU Banks) to limit variable compensation paid to key bank staff to 100 percent of their fixed compensation (or 200 percent with approval of a super majority of non-staff shareholders) — the so-called "banker bonus cap." A number of EU Banks have paid role-based "allowances" to certain staff that they categorised as "fixed compensation" in an attempt to preserve flexibility in remuneration practices and avoid the significant issues the banker bonus cap raises.

On 15 October 2014 the European Banking Authority (EBA)[2] issued a formal *Opinion* and *Report* (Opinion) stating that:

- Such allowances should be treated as variable compensation subject to the banker bonus cap, and not as fixed compensation; and
- EU national regulators should take all necessary steps to ensure that the EU Banks they supervise comply with the EBA's views on role-based allowances by 31 December 2014.

If EU national regulators comply with the Opinion, EU Banks' no longer will be able to use role-based allowances to address banker bonus cap issues. Compliance by 31 December 2014 would significantly impact EU Banks' existing compensation plans in view of the looming bonus season. The Opinion has increased tensions between the EBA and European Commission (the Commission) on the one hand, and the U.K. on the other. The U.K. currently has the EU's largest banking centre and is in the process of challenging the bonus cap in the European Court of Justice (ECJ). This alert gives more detail on the EBA's Opinion and examines whether it is immediately enforceable.

Background

The CRD sets an initial limit on the amount of variable compensation that EU Banks can pay to key staff at 100 percent of their fixed pay. This ratio can be raised to 200 percent with approval by a super-majority of the bank's shareholders not directly affected by the ratio. Banks and some EU governments (particularly the U.K.) have criticised the banker bonus cap for resulting in higher fixed salaries and reducing the scope for later clawback, increasing a bank's fixed costs against which more regulatory capital must be applied and disadvantaging EU Banks in the competition for global talent. As a solution to these issues, some EU Banks have begun to award role-based allowances as part of the fixed compensation component paid to key staff. Banks argue that these payments should be classified as fixed compensation, not variable compensation subject to the bonus cap, because they are not performance-linked. However, at the beginning of 2014 the Commission raised significant doubts and asked the EBA to investigate the issue and report back.

1 See Article 94, Directive 2013/36/EU.

2 The EBA is a pan-EU banking regulator, which has an executive. It also has a college made up of national banking regulators from each EU Member State. One of the EBA's functions is to foster regulatory convergence across the EU as seen in the practices of the EU national regulators.

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The EBA Opinion and Report

The EBA states in its Opinion that most of the role-based allowances it examined were not fixed compensation because:

- They are paid at banks' full discretion;
- They are reviewable at any time;
- Future payments may be adjusted upwards or downwards depending on certain non-transparent and discretionary factors;
- Future payments are subject to forfeiture, even during notice periods; and
- They are at least indirectly linked to performance because they are intended to retain cost flexibility, even though they are not explicitly based on performance criteria.

In the EBA's view, role-based allowances only can be categorised as fixed compensation if they are:

- permanent, *i.e.*, maintained over a period tied to the specific role and organisational responsibilities for which they are granted;
- predetermined, in terms of conditions and amount; and
- nondiscretionary, nonrevocable and transparent to staff.

Effectively, the EBA envisages role-based allowances counting towards fixed compensation in significantly narrower circumstances than U.K. regulators and a significant number of EU Banks currently believe is warranted.

Next Steps

What happens next? Will EU Banks that have paid role-based allowances be required to re-classify those payments by 31 December 2014 as variable compensation subject to the banker bonus cap? The answer to the question depends on whether the Opinion is directly enforceable and whether EU member states intend that their national regulators comply with the EBA's views.

As a general observation, it is doubtful that the EBA's opinion is directly enforceable for a number of reasons:

- The EBA issued an opinion under its power to build a common, EU-wide supervisory culture.[3] This does not have the obvious enforcement mechanisms that come with other EBA powers in the case of a breach of EU banking regulations;[4]
- The EBA has yet to issue official guidelines on remuneration policies and practices, which would provide EU national regulators with more clarity on its views. These guidelines are due to be issued for consultation by the end of 2014, with finalization expected by the first half of 2015. We expect that EU national regulators that are unenthusiastic about the EBA's Opinion will join the U.K., which has said that it will await publication of those guidelines before considering what further steps need to be taken.

The Commission does have power under Article 258 of the EU's Founding Treaty to take infringement proceedings before the ECJ directly against the U.K. and other EU countries whose national regulators decline to follow the EBA's interpretation of role-based allowances. However, this would

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3 Articles 29(1)(a) and 34(1) of Regulation (EU) No.1093/201.

4 See, for example, the enforcement scheme set out in Article 17 of Regulation (EU) No.1093/201.

be a time-consuming process, involving the issuing of a separate Opinion by the Commission, and would be complicated by the fact that the ECJ is currently hearing the U.K.'s case contending that the banker bonus cap should be struck down in its entirety. The ECJ is expected to rule in February 2015. It is difficult to see how the ECJ could consider any Commission infringement proceedings before then.

Therefore, we believe that each EU national regulator effectively has to volunteer to enforce the EBA's Opinion this year. If they do not, then it is not clear that anything can be done to prevent EU Banks from awarding bonuses and allowances as planned for this calendar year. Nevertheless, if the ECJ does not strike down the bonus cap, it is likely that the EBA and the Commission will eventually move into a position in which their attack on role-based allowances can be launched from firmer ground. Therefore, affected institutions will still need to be sure that they can alter compensation packages to reflect any action that EU national regulators could take and consider the legal and tax ramifications of such retrospective changes.