



# The Capital Requirements Directive and bankers' bonuses: some questions and answers

On 7 July 2010, the European Parliament approved various amendments to the Capital Requirements Directive in relation to bankers' remuneration. The Council of the European Union is expected to rubber-stamp these amendments in the coming days. The European Parliament has described the amendments as 'some of the strictest rules in the world on bankers' bonuses'. This briefing examines the new remuneration provisions, their scope and their impact on UK national law.

## 1 What are the most important amendments to the EU Capital Requirements Directive (CRD)?

The key remuneration provisions affecting certain types of employees are:

- upfront cash bonuses will be capped at 30 per cent of total variable remuneration (20 per cent for particularly 'high' awards);
- at least 40 per cent of variable remuneration should be deferred for at least three to five years (60 per cent for particularly high awards);
- at least 50 per cent of variable remuneration should be in shares and, where appropriate, contingent capital; and
- discretionary pension benefits should be paid to the employee in shares or, where appropriate, contingent capital subject to a five-year retention period.

## 2 Why is the CRD being amended?

The CRD came into force on 1 January 2007. It implemented the international prudential framework for capital requirements for credit institutions and investment firms, known as Basel II, and requires credit institutions and investment firms to have arrangements, strategies, processes and mechanisms to manage the risks to which they are exposed.

Since the adoption of the CRD the European Commission has produced, as part of its work on preventing a future financial crisis and strengthening the financial system, a series of proposals that make significant amendments to the CRD. These proposals are labelled CRD 2, CRD 3 and CRD 4. This briefing focuses on CRD 3.

CRD 3, published by the Commission in July 2009, aims to amend the CRD to make the principles of the Recommendation on remuneration policies in the financial services sector (2009/384/EC) binding. The Recommendation, published in April 2009, reflects the Financial Stability Board's (FSB) remuneration principles, as endorsed by the G20.

On 30 June 2010, the European Parliament announced that further amendments, more prescriptive than the FSB's remuneration principles, had been agreed with the Council of the European Union. The agreed text was submitted to the Parliament's plenary session on 6 July 2010 and was approved by a vote on 7 July 2010.

## 3 Are the new provisions binding?

CRD 3 will need to be implemented by each member state, rather than having direct effect. This follows from article 288 of the Treaty on the Functioning of the European Union, under which 'a directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods'.

## 4 Is there a risk that divergent implementation will result in an unlevel playing field for bankers' remuneration across the EU?

The CRD and its subsequent amendments intend to make the principles of Recommendation 2009/384/EC binding on all member states. They are aimed at developing a core set of standards for banks to be applied consistently throughout the member states. Implementation will be

monitored by the Committee of European Banking Supervisors (CEBS) and its successor, the European Banking Authority (EBA), and the national supervisory authorities. In addition, the Commission will review member states' implementation of CRD 3 in December 2012 to minimise divergence between member states.

However, while the new bonus rules are largely consistent with the FSB's remuneration principles, EU banks may be at a competitive disadvantage internationally. For example, the US has issued guidelines rather than legislation, and it is likely that US banks will seek to exploit this difference as the global economy recovers.

In addition, the further provisions that apply to credit institutions that benefited from exceptional government intervention (see question eight) will place affected institutions at a competitive disadvantage among their peers.

## **5 How will the new provisions be implemented into UK national law?**

In the UK, it is anticipated that CRD 3 will be implemented through changes to the Financial Services Authority's (FSA) Handbook and its Remuneration Code. Following the financial crisis, the FSA published a consultation paper (CP09/10) on reforming remuneration practices in financial services, as a result of which it implemented, on 1 January 2010, the FSA Remuneration Code. While the FSA's recent consultation (CP09/29) on its proposals for implementing additional changes introduced by CRD 3 did not cover the remuneration provisions, the FSA confirmed that, if appropriate, it will amend the Remuneration Code in line with the agreed international approach. The FSA also confirmed that it intends to publish a statement in the third quarter of 2010 assessing the effectiveness of the Remuneration Code so far and giving an update on international implementation and alignment.

CRD 3 empowers national supervisory authorities to impose financial and non-financial penalties for failure to comply.

## **6 What prospect is there that the existing FSA Remuneration Code will be 'fit for purpose'?**

According to recent press, the FSA may approach the Commission to seek exemption from further implementation on the basis that the Remuneration

Code already complies with the new provisions ('FSA to seek exemption for the City from tough EU rules on bankers' pay', *Daily Telegraph*, 7 July 2010).

However, CRD 3 does go further than the Remuneration Code in various respects, specifically that 50 per cent of variable remuneration must be in shares and, where appropriate, contingent capital (see question nine), discretionary pension benefits and termination payments are caught, and clawback arrangements must be introduced. As previously stated, both the CEBS (or EBA) and the Commission will be monitoring member states' implementation of CRD 3. The Commission may pursue cases of non-compliance with the infringement procedure.

In addition, the CRD applies, on the face of it, to all investment firms. Although there is scope for the remuneration provisions to be applied flexibly, this would represent a significant widening of the Remuneration Code's application.

## **7 What changes are being introduced and how much further do they go than existing requirements applicable to the UK?**

The table below sets out the key remuneration provisions being introduced by CRD 3 and compares these to the existing FSB remuneration principles and the FSA Remuneration Code.

Under the new provisions, upfront cash bonuses will be capped at 30 per cent of total variable remuneration (20 per cent for particularly 'high' awards – to be determined by national supervisory authorities based on guidelines to be published by the CEBS or the EBA, before CRD 3 is implemented).

CRD 3 introduces an element of proportionality: credit institutions and investment firms retain a level of discretion in establishing and applying the new provisions, which should be applied in a way and to an extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. The scope for flexible application of the remuneration provisions may allow the FSA to relax or even disapply these principles to certain categories of investment firms such as investment managers, advisory firms and brokers who are not currently subject to the Remuneration Code. The preamble to the CRD specifically states that it may not be

CRD 3	FSB remuneration principles	FSA Remuneration Code
<b>Scope</b>		
<p>Applies to:</p> <ul style="list-style-type: none"> <li>□ credit institutions: ‘an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account’; and</li> <li>□ investment firms within the meaning of article 4(1) of the Markets in Financial Instruments Directive (2004/39/EC): ‘any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis’. Applies to credit institutions and investment firms at group, parent company and subsidiary levels, including those established in offshore financial centres.</li> </ul>	<p>Applies to significant financial institutions.</p>	<p>Applies to a firm that is:</p> <ul style="list-style-type: none"> <li>□ a UK bank or building society that had capital resources exceeding £1bn on its last accounting reference date;</li> <li>□ a BIPRU 730k firm that had capital resources exceeding £750m on its last accounting reference date;</li> <li>□ a full credit institution, a BIPRU 730k firm or a third country BIPRU 730k firm that is part of a group and on the firm’s last accounting reference date total capital resources held within the group either: by UK banks or building societies exceeded £1bn; or by BIPRU 730k firms exceeded £750m.</li> </ul>
<p>Applies to senior management, risk takers and control functions, and any employee whose total remuneration, including pension provisions, takes him into the same remuneration bracket as those categories of staff.</p>	<p>Applies to senior executives and other employees whose actions have a material impact on the firm’s risk exposure.</p>	<p>Applies to a person who performs a significant influence function, and employees whose activities have, or could have, a material impact on the firm’s risk profile.</p>
<b>Remuneration policy</b>		
<p>The remuneration policy is consistent with and promotes sound and effective risk management, and does not encourage excessive risk-taking.</p>	<p>The board of directors of major financial firms should exercise good stewardship of their firms’ compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures.</p>	<p>A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.</p>
<p>The remuneration policy introduces a degree of fairness between the highest and lowest remunerations within the same institution.</p>	<p>No equivalent provision.</p>	<p>No equivalent provision.</p>
<b>Multi-year performance assessment</b>		
<p>Performance assessment is set in a multi-year framework to ensure that the assessment process is based on longer-term performance, and the actual payment of the performance-based component of remuneration must be spread over a period that takes account of the firm’s underlying business cycle and its business risks.</p>	<p>Performance assessment is set in a multi-year framework.</p>	<p>The assessment process for the performance-related component of an employee’s remuneration should be designed to ensure assessment is based on longer-term performance.</p>
<b>Guaranteed bonuses</b>		
<p>Guaranteed variable remuneration is exceptional, occurs only when hiring new staff and is limited to the first year.</p>	<p>Guaranteed bonuses should not be part of prospective compensation plans. Exceptional minimum bonuses should only occur when hiring new staff and be limited to the first year.</p>	<p>Guaranteed minimum bonuses that run for more than one year are likely to be inconsistent with the requirement for effective risk management.</p>

---

**Ratio of fixed to variable remuneration**

---

Fixed and variable components of total remuneration should be appropriately balanced – the fixed component should be sufficiently high to allow a firm to operate a fully flexible policy on variable remuneration, including the possibility of paying no variable remuneration. CEBS guidelines will set specific criteria to determine the appropriate ratios between fixed and variable remuneration.

No equivalent provision.

The fixed component of remuneration should be a sufficient proportion of total remuneration to allow a firm to operate a fully flexible bonus policy.

---

**Variable remuneration and deferral**

---

At least 40 per cent of variable remuneration should be deferred for at least three to five years (60 per cent of variable remuneration for particularly high amounts). Remuneration payable under deferral arrangements vests no faster than on a pro-rata basis.

A substantial portion of variable remuneration, such as 40 to 60 per cent, should be payable under deferral arrangements over a period of not less than three years.

The majority of any bonus (ie two-thirds) should be deferred with a minimum vesting period if, when compared with the fixed component of an employee's remuneration, the bonus is a significant proportion of that fixed component. The vesting period of the deferred element should be at least three years.

---

At least 50 per cent of variable remuneration should be in shares and, where appropriate, contingent capital – to be retained for an appropriate period.

A substantial proportion, such as more than 50 per cent of variable remuneration, should be awarded in shares or share-linked instruments.

No equivalent provision.

---

**Clawback**

---

Without prejudice to the general principles of national contract and labour law, the total variable remuneration is generally considerably contracted where subdued or negative financial performance occurs, including through malus or clawback arrangements.

Subdued or negative financial performance should lead to a considerable contraction of the firm's total variable compensation, including through malus or clawback arrangements.

A firm should be able not to pay a bonus in a year in which it (or part of it) makes a loss.

---

NB Certain member states' national labour laws (eg Germany) prevent the use of malus or clawback arrangements.

---

**Pensions contributions**

---

If an employee leaves before retirement, discretionary pension benefits should be held by the credit institutions for five years in shares or, where appropriate, contingent capital. For employees reaching retirement, discretionary pension benefits should be paid to the employee in shares or contingent capital, subject to a five-year retention period.

No equivalent provision.

No equivalent provision.

---

**Termination payments**

---

Payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure.

Termination payments should be re examined.

Payments in addition to an employee's salary that are not based on performance during the period under review are likely to be inconsistent with the need for effective risk management.

---

proportionate for certain types of investment firm that carry on no – or limited – trading activities to comply with all the provisions.

## **8 What additional changes are being introduced for the banks that benefited from government intervention?**

Credit institutions that benefited from exceptional government intervention are subject to additional restrictive provisions: variable remuneration must be strictly limited as a percentage of net revenues when it is inconsistent with maintaining a sound capital base and timely exit from government support; the relevant authorities will require credit institutions to restructure compensation in line with sound risk management and long-term growth; and no variable remuneration may be paid to the directors unless it is justified.

## **9 How does CRD 3 interact with the Financial Services Act 2010?**

CRD 3 is broadly in line with the Financial Services Act 2010, which received royal assent in April 2010.

Under the Financial Services Act, the FSA is required to make general rules requiring authorised persons to have and to act in accordance with a remuneration policy that is consistent with effective risk management. Similarly, under CRD 3, national supervisory authorities must require every credit institution to have robust governance arrangements, including remuneration policies and practices that are consistent with and promote sound and effective risk management.

The Financial Services Act also empowers the Treasury to make regulations on preparing, approving and disclosing executives' remuneration reports. The draft Executives' Remuneration Reports Regulations require banded<sup>1</sup> disclosure of various categories of remuneration:

- the aggregate amounts of remuneration attributable to basic salary, expenses and bonuses (cash, shares and other benefits);
- the aggregate of the amount of money paid or receivable, and the net value of assets (other than money) received or receivable, under long-term incentive schemes;

<sup>1</sup> £500,000-£1m; £1m-£1.5m; £1.5m-£2m; £2m-£2.5m; £2.5m-£3m; £3m-£3.5m; £3.5m-£4m; £4m-£4.5m; £4.5m-£5m; £5m-£6m; and in successive bands of £1m.

- the aggregate value of share options granted; and
- the aggregate value of any pensions contributions by the bank.

CRD 3 requires aggregate disclosure of quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution, in very similar categories:

- amounts of remuneration for the financial year, split into fixed and variable remuneration and number of beneficiaries;
- amounts and form of variable remuneration, split into cash, shares and share-linked instruments and other;
- amounts of outstanding deferred remuneration, split into vested and unvested portions;
- amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;
- new sign-on and severance payments made during the financial year, and number of beneficiaries of these payments; and
- the amounts of severance payments awarded during the financial year, number of beneficiaries, and the highest award to a single person.

## **10 What is contingent capital?**

The concept of 'contingent capital' is new to existing FSB and UK remuneration policies. Contingent capital is not defined in the CRD, although the definition is under consideration in CRD 4. Contingent capital is a form of hybrid capital instrument that involves converting debt into equity that, because of its subordination to other capital instruments, is better for absorbing losses. Regulators are attracted to contingent capital because it can be used to boost an institution's tier one capital (ie equity) when it gets into distress. From a regulatory viewpoint, the attraction of requiring deferrals to be in contingent capital lies in the subordination that this achieves, rather than in the capital raised. For example, where a bank is unable or unwilling to use equity for deferral, an employee holding contingent capital is in the position of an equity holder should distress occur.

## **11 Who will be affected by the CRD?**

The 26 large banks and building societies already subject to the FSA Remuneration Code will be subject to the new

provisions. A key question remains as to whether – and if so, how – the FSA will apply the new provisions beyond this group.

Hedge funds and private equity firms that are investment firms and that will be subject to separate remuneration provisions in the Alternative Investment Fund Managers Directive when it enters into force, will be caught by the CRD. However, how precisely the remuneration provisions will be applied to such investment firms is less clear and, as stated above, there is scope within the CRD for a flexible application to such firms. Further guidance may be provided by the FSA when it implements the CRD.

### **12 When will the new provisions take effect?**

Following approval of the new provisions by the European Parliament on 7 July, it is likely that the Council of the European Union will rubber-stamp the amended CRD in the coming days. The remuneration provisions will then take effect in January 2011. The provisions will apply to: remuneration due on contracts concluded before the effective date of implementation in each member state and awarded or paid after that date; and to remuneration awarded, but not yet paid, before the date of effective implementation in each member state, for services provided in 2010. The capital requirements provisions will take effect no later than 31 December 2011.

### **13 Will the new provisions' effectiveness be kept under review?**

The European Commission will review the efficiency, implementation and enforcement of the amended CRD by December 2012, taking into account any international developments and, in particular, any further proposals by the FSB.

### **14 Is there anything else I need to know about?**

The amended CRD also introduces higher capital requirements for re-securitisations and the trading book and upgrades disclosure standards for securitisation exposures.

A non-legislative resolution on remuneration of directors of listed companies and remuneration policies in the financial services sector, drafted by MEP Saïd El Khadraoui, was recently adopted by 594 votes to 24. The resolution calls for remuneration principles

to be extended to cover all listed companies and suggests setting a maximum limit of two years of the fixed component of directors' pay on severance pay ('golden parachutes') for early termination, and banning severance pay in cases of non-performance or voluntary departure.

For further information please contact

Simon Evans  
T +44 20 7832 7358  
E [simon.evans@freshfields.com](mailto:simon.evans@freshfields.com)

Kathleen Healy  
T +44 20 7832 7689  
E [kathleen.healy@freshfields.com](mailto:kathleen.healy@freshfields.com)

James Smethurst  
T +44 20 7832 7478  
E [james.smethurst@freshfields.com](mailto:james.smethurst@freshfields.com)

Michael Raffan  
T +44 20 7832 7102  
E [michael.raffan@freshfields.com](mailto:michael.raffan@freshfields.com)

Freshfields Bruckhaus Deringer LLP is a limited liability partnership registered in England and Wales with registered number OC334789. It is regulated by the Solicitors Regulation Authority. For regulatory information please refer to [www.freshfields.com/support/legalnotice](http://www.freshfields.com/support/legalnotice). Any reference to a partner means a member, or a consultant or employee with equivalent standing and qualifications, of Freshfields Bruckhaus Deringer LLP or any of its affiliated firms or entities.

This material is for general information only and is not intended to provide legal advice.

© Freshfields Bruckhaus Deringer LLP 2010  
[www.freshfields.com](http://www.freshfields.com)