New EU Directives for the Regulation of Bonus Payments in the Banking Industry

Introduction	The European Union is the first economic area in the world to introduce legally binding restrictions for bonus payments in the banking business. On June 7, 2010, the European Parliament adopted with a large majority of votes appropriate amendments to Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (Basel II), which represent a compromise reached during the preceding negotiations between the European Parliament, European Commission and member states. The new rules provide – in a nutshell – that in the future bonus payments must be based on long-term financial performance. Under the rules, upfront bonus payments may in the future generally not exceed 60% of the total bonus. The rest must be deferred no less than 3 to 5 years. The cash percentage of non-deferred bonuses and deferred bonuses may not exceed 50%; the rest must be paid in stock or other appropriate financial instruments. Deferred bonuses as well as non-deferred bonuses must, in addition, be subject to forfeiture and claw-back provisions, which are tied to the future financial performance of the bank. Moreover, performance-compensation components must in the future be reasonably proportionate to an employee's fixed salary, although bonuses are not subject to any absolute limits. Banks that received bailout funds from the government are allowed to pay bonuses only in compliance with substantially more stringent requirements. Finally, new equity capital requirements are supposed to be introduced and take effect at the latest by the end of 2011.
Specific Rules	Specifically, the amended Directives provide for the following rules: • **Institutions subject to the new rules** The new rules apply to all financial institutions, whether an institution is a group, parent company, or subsidiary. The new rules apply to third-country subsidiaries of EU banks, as well as to EU-subsidiaries of third-country banks. • **Staff subject to the new rules** The rules apply to senior management, risk takers, controllers, and any employees compensated at a level similar to that of senior management and risk takers. The rules therefore apply to all bank employees whose professional activities have a material impact on the bank's risk profile. In contrast, the rules do not apply to commissions earned by bank employees from the sale of the bank's products to customers.

- **Payment terms**

Under the new rules only up to 60% – in the case of large bonuses even less, only 40% – may be paid immediately after the end of each business year. The rest must be deferred for at least 3 to 5 years, with deferred bonus amounts vesting at least on a *pro rata* basis. No more than 50% of the non-deferred bonus and deferred bonus may be paid in cash. The rest must be paid as a mixture of stock or other appropriate financial instruments on the one hand, and contingent capital – that is, funds to which the bank resorts only in case of financial difficulties – on the other hand. For all bonuses – whether deferred or non-deferred – malus or clawback clauses in the employment agreement must within the limits of the laws applicable in each member state ensure that bonuses are appreciably reduced if the financial performance of the bank stagnates or even goes into the negative.

The above rules are illustrated by the following example:

An employee is awarded a bonus in the normal amount of €100,000. At least €40,000 must be deferred. Of the non-deferred portion of the bonus in the total amount of €60,000 – i.e., €30,000 – only 50% may be paid in cash, while the rest must be paid as a mixture of stock or other financial instruments and contingent capital.

It will be up to the national supervisory authorities, i.e. in Germany the Federal Financial Services Regulatory Authority (BaFin), to decide what constitutes a "large" bonus. BaFin must base its decisions on EU standards in turn.

The European Parliament backed away from placing any specific upper limits on bonuses – for example, by limiting bonuses to annual salaries. Rather, each bank must on the basis of EU-wide guidelines set maximum limits on bonus amounts, which must be proportional to salary.

Guaranteed bonuses will in the future be permitted only in exceptional cases and will be limited to bonuses paid to new employees in the first year.

- **Prevention of excessively high pension payments**

The just lined out principles shall also apply to pension payments with bonus character. As a result, also discretionary pension benefits shall be deferred and be paid in financial instruments which are linked to the bank's performance. Intention is that unlike in the past bank employees cannot be sent into retirement any more under promise of excessively high pension payments while the bank itself has stumbled into financial turmoil (golden parachute).

- **Banks receiving bailout funds**

The amending Directive provides for special rules applicable to banks that received bailout funds from the government. Because such banks are subject to upper limits on the total amount of bonus payments, they have an incentive to increase their equity capital ratio. Directors of such banks generally should receive no bonus payments.

	The amendments to EU Directives 2006/48/EC and 2006/49/EC are shown on pages 35 to 41 of the PDF file available at the following link: http://register.consilium.europa.eu/pdf/en/10/st11/st11527.en10.pdf
Deadline for Implementing Amended EU Directives into National Law	According to the amending Directive, the new rules regarding bonus payments should be implemented into binding national law by the legislature of each member state on or before January 1, 2011. The time period for implementing the new equity capital rules is one year longer. The amended Directives cannot be applied directly to banks as they have no legally binding effect in relation to the banks. They will therefore have to be implemented into national law by the legislature first. The amending Directive provides that the new rules already apply to bonus payments due under agreements concluded before the effective date of implementation in each member state. Likewise, the new rules also apply to bonuses for the year 2010, which were awarded, but not yet paid before the effective date of implementation.
Outlook	By implementing the above amendments to the Directives 2006/48/EC and 2006/49/EC, it is apparent that the European legislature has now taken an aggressive stance on the topic of bonuses. While the new rules set out in the amended Directives, for the most part, are in line with the G20 recommendations, they are substantially more specific in that they specify percentages for deferred and non-deferred bonuses and for the splitting of bonuses into cash payments and other compensation components. Unlike the circular published by the Federal Financial Services Regulatory Authority (*BaFin*) on December 21, 2009 with respect to regulatory requirements for compensation systems of financial institutions, and unlike a recent draft bill for regulations governing the compensation systems of financial institutions, the EU appears intent upon preventing that the introduction of new bonus rules founders on pre-existing, conflicting contract terms. It is therefore with much anticipation that the market is awaiting the decision of the German legislature on how to intervene in the autonomy of private contracting parties to agree on compensation terms. In any event, national regulatory authorities are expected to have authority to impose fines and penalties on banks that fail to comply with the new rules. Another question is how the contemplated rules can be made to fit into the statutory framework governing general terms and conditions (§§ 305 et seq. German Civil Code). The anticipated national laws may also make it necessary for works agreements on bonus payments in non-compliance with the new rules to be terminated at the appropriate time. In our opinion, it should be expected – because the new EU rules must be implemented into national law by each member state within a rather short timeframe – that the current draft bill for regulations governing compensation system of financial institutions will not be implemented without amendments in Germany.
Contact Persons	**Caroline Bitsch** (c.bitsch@justem.de) **Dr. Jens Jensen** (j.jensen@justem.de) **www.justem.de**