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# The EU Reaches a Deal on the Proposed Ratio Cap on Bank Bonuses

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

## Contacts

**John J. Cannon III**  
New York  
+1.212.848.8159  
[jcannon@shearman.com](mailto:jcannon@shearman.com)

**Kenneth J. Laverriere**  
New York  
+1.212.848.8172  
[klaverriere@shearman.com](mailto:klaverriere@shearman.com)

**Doreen E. Lilienfeld**  
New York  
+1.212.848.7171  
[dlilienfeld@shearman.com](mailto:dlilienfeld@shearman.com)

**Linda E. Rappaport**  
New York  
+1.212.848.7004  
[lrappaport@shearman.com](mailto:lrappaport@shearman.com)

**Sam Whitaker**  
London  
+44.20.7655.5954  
[sam.whitaker@shearman.com](mailto:sam.whitaker@shearman.com)

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On 27 February 2013 the European Union (“EU”) reached a provisional deal on imposing a cap on the variable remuneration that can be paid by financial institutions in the EU. If, as expected, this provisional deal is formally approved by the EU Parliament and Council later this year, far-reaching changes will need to be implemented in the remuneration structures of many EU-headquartered banks and non-EU headquartered banks operating in the EU.

## The Key Proposals

As part of negotiations on the new capital requirements under the Basel III rules, a provisional deal has been reached on proposed ratio caps on variable pay. The key proposals are<sup>1</sup>:

- Variable remuneration cannot exceed a maximum of one times fixed remuneration.
- The cap on variable remuneration of one times fixed remuneration can be increased to two times fixed remuneration with shareholder approval.
- For shareholder approval to increase the permitted ratio to two times fixed remuneration, the approval will need the votes of at least 65% of shareholders owning half the shares represented, or of 75% of the votes if there is no quorum<sup>2</sup>.
- If a ratio of more than one times fixed remuneration is approved by shareholders, 25% of the variable remuneration must be paid in long-term deferred instruments. The deferral period for such instruments must be a minimum of five years.
- In calculating the value of these long-term deferred instruments for the purposes of ensuring compliance with the ratio cap, it will be possible to discount the present value of those instruments thereby increasing the (effective) ratio cap beyond 1:2. So, for example, if (i) a ratio cap of 1 (fixed remuneration) to 2 (variable remuneration) was approved by

<sup>1</sup> The detailed text of these proposals is yet to be published and this client publication is based on press announcements by the EU on 28 February 2013. Accordingly, it is possible that the detail of some of these proposals when published may be different.

<sup>2</sup> These shareholder voting requirements are as published in the EU's press announcements. The detail of some of these requirements is not entirely clear at present and the detailed legislative text is awaited for clarification on what exactly these requirements will mean in practice.

shareholders, (ii) 25% of the variable remuneration was paid in qualifying long-term deferred instruments, and (iii) a 50% discount rate were permitted for those long-term deferred instruments, this would effectively enable a maximum ratio cap between fixed and variable remuneration of 1 to 2.5.

- The applicable discount rates that may be applied to qualifying long-term deferred instruments will be determined in due course by the European Banking Authority (“EBA”), taking into account matters such as inflation, levels of risk and the length of the deferral period. It is expected that, whilst any permitted discounting would enable institutions to set an effective ratio of greater than 1 to 2, the effective ratio would be closer to 1 to 2 rather than 1 to 3.
- The long-term deferred instruments will be subject to clawback during the deferral period and may also be “bail-in-able” (meaning that they are subject to full or partial write-down in the event of an insolvency event of the institution).
- Two years after implementation of the new provisions, the European Commission will lead a review into what practical impact the new limits on variable remuneration have had, and in particular whether they have resulted in restrictions on competitiveness and any institutions relocating outside of the EU.

### When Will the New Rules Come Into Force?

Assuming that the proposals are approved through the formal legislative procedure (the formal EU Parliament vote is expected in its 15 to 18 April plenary session), the new rules would come into effect on 1 January 2014 and member states will also be required to implement the new rules by that date. For most institutions which operate a bonus payment cycle where bonuses are paid in the first quarter following the end of a performance year, this will therefore affect the variable remuneration payable in the first quarter of 2014 in respect of the 2013 performance year.

The detailed legislative text for the proposals has yet to be published by the EU. In addition, guidance is expected from the EBA on various matters, such as the permitted discounting of long-term deferred instruments. Local country regulators such as the UK’s Financial Services Authority (“FSA”), will also need to issue local implementing rules or amend existing rules.

### To Which Institutions Will the Proposals Apply?

A proposal that would have exempted the non-EU based operations of EU-headquartered banks from the scope of the new rules was rejected. The scope of application of these rules is therefore likely to be the same as under the current Capital Requirements Directive III (“CRDIII”), which applies to all credit institutions and investment firms (that is, firms that fall within the scope of the Markets in Financial Instruments Directive). In broad terms, this means that the global operations of all such institutions that are headquartered in the EU will be caught. The EU operations of institutions that are headquartered outside the EU will also be covered.

Hedge funds, private equity houses and investment managers will be subject to the requirements on remuneration under the Alternative Investment Fund Managers Directive (“AIFMD”) which, in general terms, mirrors the current remuneration requirements under CRDIII and does not include any such ratio cap. There has, however, been growing pressure from some elements within the EU for the proposed ratio cap on variable remuneration eventually to be incorporated within AIFMD and thereby extended to hedge funds, private equity houses and investment managers.

### Which Staff Will be Affected by the New Rules?

It is currently unclear whether the new rules will be applicable only to “Identified Staff”<sup>3</sup> (known as “Code Staff” in the UK) or all staff of an institution. Our expectation is that the rules would apply only to Identified Staff.

<sup>3</sup> “Identified Staff” essentially includes senior management, material risk-takers, control function staff and other staff whose total remuneration takes them into the same remuneration bracket as senior management and risk-takers where their activities have a material impact on the firm’s risk profile.

It should, however, be borne in mind that, separately, the EBA is currently considering whether the criteria for determining who should be categorised as Identified Staff should be amended. The EBA is concerned that there are considerable discrepancies between different institutions and EU member states as to how the existing criteria have been applied. They are likely to report on this later in 2013. It is possible that the EBA may propose much more rigid criteria, possibly including criteria solely by reference to the total remuneration levels of staff. If such changes are introduced, clearly the new ratio caps may, even if limited in application only to Identified Staff, have significantly wider impact, particularly in countries such as the UK where numbers of Identified Staff have been conspicuously lower than in some other EU member states.

### **How Will the Shareholder Approval Requirement Apply for Non-EU Headquartered Institutions?**

As set out above, the 1:1 ratio cap on fixed to variable remuneration can be increased to 1:2 with shareholder approval. It is not currently clear how this provision will be applied to non-EU-headquartered institutions with operations in the EU. One possibility is that the EU may expect that the shareholders of the non-EU parent company would have to vote on the issue at a general meeting. The other possibility is that the non-EU parent company would effectively be deemed as the shareholder for these purposes. Our expectation is that the former is the more likely outcome, but this issue remains unclear.

### **Will Banks be Able to Disapply the Requirements Through Proportionality?**

Under the existing remuneration requirements of CRDIII, those institutions that are of a smaller size and whose activities present less systemic risk can, under the so-called “proportionality principles”, choose to disapply certain of the more restrictive remuneration requirements, including the requirements that a minimum of 40% of variable remuneration be deferred for at least three to five years, a minimum of 50% of variable remuneration must be paid in shares or other instruments and deferred but unvested remuneration must be subject to performance adjustment. It remains to be seen whether such institutions will also have the opportunity to disapply the ratio cap on fixed to variable remuneration under such proportionality principles.

In the UK, our expectation is that the option to disapply the ratio cap is only likely to be possible for a very limited group of institutions. Firms are generally categorised in the UK into three different “proportionality tiers” under the Remuneration Code implemented by the FSA. Only those in proportionality tier three can generally disapply the remuneration-related requirements set out above. However, one requirement that must still be applied by most proportionality tier three firms is the current requirement to set ratios between fixed and variable remuneration that are determined internally. Those firms within proportionality tier three that can choose to disapply this requirement fall into a very limited category, namely only certain “limited licence” and “limited activity” firms. In our view, it is possible that the new proposed caps on fixed to variable remuneration will be introduced in the UK as part of that same requirement and, accordingly, it may be the case that only that narrow category of proportionality tier three firms could choose to disapply the new ratio cap requirement.

### **Implications**

Clearly, for those institutions used to paying variable remuneration which is a multiple of several times fixed remuneration, these changes will apply considerable pressure to decrease overall levels of pay. If, due to competitive pressures or other considerations, institutions find it unacceptable to reduce total compensation they may resort to increasing base salaries significantly. For many institutions, however, there will be reluctance for various reasons to do so. The challenge will therefore be to find ways in which payments or benefits can be made to employees, with such payments or benefits being categorised for the purposes of the ratio cap as fixed remuneration rather than variable remuneration, whilst conceptually still being seen as separate from and different in nature to base salary. In anticipating the proposed ratio cap, various approaches have been considered as to how such payments and benefits might be structured, including one-off payments to employees for entering into new employment contracts or new contractual restrictions or providing various forms of fixed employment allowances.

Other mitigation strategies that have been considered involve the possibility of increasing base salaries but including contractual provision to decrease salaries after some time (for example, two years) as well as the use of short fixed-term

employment contracts. Some institutions have also considered the use of possible new classes of shares for employees with very low initial values (but the potential for significant growth) which would therefore not result in the value of the variable remuneration exceeding the cap.

Whether any of these approaches will work in practice is uncertain at present and much will depend on the detail of the forthcoming legislative text, guidance from the EBA and implementing rules from local regulators.

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599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

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