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Europe Set to Limit Bank Bonuses

By Jeroen van Kwawegen

On March 27, 2013, European Union ambassadors endorsed new rules that will limit bankers' bonuses. Under the new rules, bankers' bonuses will be capped at an amount equal to their annual salary. In exceptional circumstances, a bonus may be up to twice the annual salary but only with the approval of a supermajority of the bank's shareholders. If the bonus exceeds the base salary, at least 25% of the entire bonus must be deferred for five years. The new rules are expected to take effect on January 1, 2014, and will apply to all European banks, European units of foreign banks, and employees of European banks overseas, including New York. European lawmakers are considering similar rules for hedge funds and investment managers.

The overriding goals of the EU regulation are to reduce the risk of another financial crisis requiring a taxpayer-funded bailout and to realign the financial incentives of senior bankers with the long-term interests of the banks and their shareholders.

The bonus cap is part of a broader package of new banking regulations that the European Commission, the European Parliament, and the 27 countries in the EU have been preparing in response to the financial crisis. Bank loans account for 70% of all company financing in the EU, and European policy-makers have focused most of their attention on the banking sector to limit the fallout of the financial crisis. In addition to a bonus cap for bankers, the new regulations will also impose stronger capital requirements, increased liquidity requirements, and new requirements to account for counterparty risk linked to the exposure of derivatives. The overriding goals of the EU regulation are to reduce the risk of another financial crisis requiring a taxpayer-funded bailout and to realign the financial incentives of senior bankers with the long-term interests of the banks and their shareholders.

European policy-makers generally agree that excessive bonuses and ill-designed compensation schemes contributed to the financial crisis by encouraging bankers to behave inappropriately. Many bankers were instantly rewarded for creating toxic financial products and taking excessive risks, knowing that the banks' shareholders would suffer the losses when those risks materialized. As the Chairman of the UK Financial Services Authority, Lord Turner, noted in March 2009 that "[s]ome bankers have been encouraged by the promise of big bonuses to take excessive risks with other people's money." The President of the European Central Bank, Jean-Claude Trichet, similarly said in July 2009 that "[i]n looking back on the years prior to the eruption of the crisis, we have to acknowledge that there was a dramatic shift in focus in large parts of the financial sector — away from facilitating trade and real investment towards unfettered speculation and financial gambling."

The British government vigorously opposes the bonus cap. Financial services play a much larger role in the UK. economy than anywhere else in the EU, and a bonus cap could harm London's ability to compete with other global financial centers like New York and Singapore. The mayor of London, Boris Johnson, commented that the bonus cap is "possibly the most deluded measure to come from Europe since Diocletian tried to fix the price of groceries across the Roman Empire." However, the British government cannot veto the new regulations and, despite initial support from the German government, now stands alone in opposing the bonus cap. Indeed, public outrage has grown across Europe, including the UK, over large bonuses for bank executives that received taxpayer-funded bailouts during the financial crisis. In Britain, the former CEO of the Royal Bank of Scotland ("RBS"), Fred Goodwin, was scrutinized and stripped of his knighthood for "services to banking" after it became public that he received £16 million in benefits when he left RBS shortly before that bank reported the largest loss in British corporate history — £24 billion.

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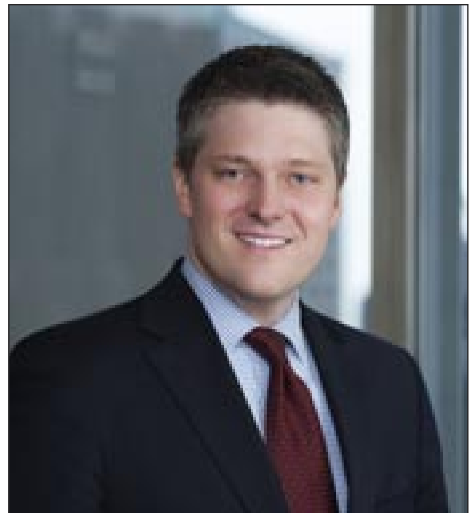
The new regulations still need to be approved by the European Parliament and a majority of European finance ministers later this year. Commentators have little doubt, however, that the new banking regulations — including the bonus cap — will be approved and take effect on January 1, 2014. The European Parliament insisted on the bonus cap in return for its support of the broader package of the increased capital and liquidity requirements and is unlikely to reverse course now that its demands have been met. The governments of all EU countries other than Britain are also committed to approving the new regulations. As the Associated Press noted, "[t]he final approval by parliament and government leaders of the package is expected to be a formality."



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