Regulating bankers' bonuses

Bankers' bonuses have been under debate with the review of the Capital Requirements Directive (CRD IV). The Directive, meant to regulate the amount of capital banks hold, already includes guidelines on the remuneration of bankers, but the European Parliament has sought to introduce a fixed cap on bankers' variable pay proportionate to their fixed pay.

Financial and sovereign debt crisis

During the financial and sovereign debt crisis, banks proved vulnerable to shocks. They remain exposed to euro-area sovereign debt and continue to face a lack of confidence. To limit contagion effects to the real economy (e.g. limitations on credit provision), national governments bailed out several European banks whilst the European Central Bank provided them with long-term loans.

Causes claimed to be at the root of the crisis range from the US housing bubble, to rating agencies' flawed assessments, increased complexity of financial products and regulatory failures. But the corporate culture of investment banks is also regularly cited as cause. Often said to be about making as much money as possible, these cultures are thought to attribute great importance to bonuses. In economic theory, this form of variable compensation aims to align individual behaviour (agents), and its natural tendency towards risk-averseness, with the expectations of shareholders (principals) who want to maximise the value of the company, for which taking risks is a prerequisite. Sceptics of this principal-agent theory have questioned the efficiency of current compensation schemes in actually aligning the interests of both parties, and they also doubt the appropriateness of large bonuses for bankers.

Criticism of bankers' bonuses

Criticism of bankers' pay mostly focuses upon these (cash) bonus payments. Whilst lower in comparison to pre-crisis figures, incentives in the form of variable pay of senior executives at European banks are nearly three times larger than their fixed pay (i.e. a ratio of 1:3) according to a 2011 Towers Watson estimate.

Criticism of bankers' bonuses has two angles:

- Much criticism is social and political: in the sensitive context of the crisis, media highlighting of the size of bankers' bonuses has incensed many taxpayers.
- Economically speaking, it is claimed that bonuses stimulate excessive risk-taking. Whilst bonuses can benefit productivity through motivating employees, they may also encourage excessive focus on earnings in the short (evaluation) term. Creating value results in bonuses but destruction of that same value has no negative effect on the bonus payment, possibly leading to opportunistic behaviour.

The association of banks' bonus cultures and the crisis seems to be commonly accepted. Yet, when looking for conclusive evidence on the causative relationship between the crisis and bankers' bonuses, there is room for debate. A 2011 study by the University of Bath found that, although pay is high in the UK financial services industry, the profits and losses of companies in this sector, compared to those of other sectors, are not more dependent on the magnitude of executive pay.

Existing legislation

In response to criticism, several Member States have acted to regulate bankers' pay through the imposition of executive-pay limits for recapitalised banks (e.g. Spain and Germany). Other countries chose to tax bonuses at these banks at rates of up to 50% (e.g. UK, France).

After pressure from the European Parliament, the EU integrated limits on bankers' bonuses into the Capital Requirements Directive in 2010 (CRD III), through remuneration guidelines. Covering all bonuses for banks' senior management and risk-takers, payable as of January 2011, the guidelines include the following:
- The cash part of bonuses is capped at 30% of the total bonus with a 20% limit for particularly large bonuses.
- Payment of 40 to 60% of the bonus should be deferred for a period of at least three years.
- At least 50% of any bonus should be paid as "contingent capital", making it the first funds to be "clawed back" if the bank runs into financial difficulties.

These points are in line with the 2009 G20 (Financial Stability Board) principles, but the European Banking Authority (EBA) concluded in April 2012 that not all Member States had fully implemented the guidelines in their legislative frameworks. National authorities are required to report to the EBA on remuneration practices, facilitating benchmarking. Based on this reporting, the EBA believes there remains room for improvement and that stronger supervisory guidance would help implementation. Areas of concern include the identification of employees concerned by the guidelines, the adjustment of pay packages to their specific situations and the identification of appropriate risk management measures.

**European Parliament initiative**

The fourth version of the Directive (CRD IV) now under consideration would transpose the Basel III framework into EU legislation. The Basel III package will strengthen capital and liquidity requirements in banks, but only includes restrictions on dividend and bonus payments relative to a bank's capital.

As a second step towards regulating bankers' bonuses, the EP's Economic and Monetary Affairs Committee has pushed to strengthen restrictions on remuneration policy in the draft CRD IV text (rapporteur Othmar Karas, EPP, Austria). Parliament has consistently argued to introduce a cap on bonuses through a 1:1 ratio between fixed and variable pay, meaning a bonus could not exceed fixed pay.

Whilst bankers' bonuses have been stoutly defended by politicians close to the City of London, Internal Market Commissioner Michel Barnier said he was "not shocked" by the EP's amendments, and had earlier supported a fixed ratio. Barnier has considered there would be reason to act if "banks are incapable of self-discipline with regards to bonuses." He has none the less underlined the importance of shareholders' control over remuneration policies in this context. The Commission is planning to propose an initiative in 2013 that would increase transparency on remuneration policies, as well as granting shareholders the right to vote on a firm’s remuneration policy.

The EP and Council have repeatedly discussed the issue of bonuses within trilogue negotiations on CRD IV since the Committee adopted its report in May 2012. The bonus issue was one of the last to be settled, at a trilogue meeting on 27 February. As a result, the 1:1 ratio will apply automatically from 1 January 2014. A company's annual general meeting may vote to allow a ratio of up to 1:2 but this would imply significant deferral of payment. The agreement must now be approved by the plenary and the Council.

**Scepticism on pay curbs**

Sceptics continue to make a range of arguments against the proposed cap:

- Restricting variable pay would lead to higher fixed costs as banks raise basic salaries. This increase could reduce banks' flexibility to cut costs in difficult times.
- Due to their incentivising nature, limiting bonuses risks disconnecting pay and performance, which could affect the overall performance of banks.
- Without global coordination, EU action could lead to relocation of banks outside the EU, or even towards a transfer of their activities outside the regulated banking system (known as "shadow banking"), as a means to gain a more favourable environment for attracting high-pay employees.

Sceptics also doubt that the proposed legislation affects the right level of employees within banks. The industry has criticised politicians for exploiting a "populist issue."

**Alternatives** to regulating bankers' bonuses through a cap include taxation of bonuses, the establishment of a ratio between bonuses and size of the bank's balance sheet, the increase of obligatory capital ratios to decrease risks or the limitation of bank size to enhance control measures.