



Background

Frequently Asked Questions on the Capital Requirements and Bonuses Package (CRD3)

The text agreed by Council and European Parliament negotiators on bank capital requirements and bonuses, which would subject them to the capital requirements directive, is set to be endorsed at Parliament's July plenary session. Below are some replies to the most frequently asked questions.

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Background

What did Parliament secure in negotiations on this directive ?

For the first time, bankers' remuneration will be included in the scope of the capital requirements directive. This was planned in the Commission's initial proposal, but Parliament has made the requirements much more specific.

Parliament won various concessions on bonus caps, and particularly up front cash bonuses (only 30% of a total up front bonus may be paid in cash and only 20% of large bonuses), a minimum cap of at least 50% of a bonus being paid in contingent capital (funds which can be called upon first in case of bank difficulties), and shares, and stricter limits on bonuses paid by bailed-out banks.

It also secured tighter requirements on the capital that banks must set aside to deal with problems arising from their trading activities and re-securitisations (the pooling of existing assets, then issuing newly packaged securities backed by these assets and their cash flows).

Background

Are the remuneration rules binding ?

Yes. The directive empowers national supervisory authorities to take action against the financial institutions governed by this directive if they fail to comply with any part of it. National supervisors may impose penalties or measures specifically to put an end to observed breaches or the causes of such breaches. The new rules will also empower supervisors to impose financial and non-financial penalties or measures.

Background

Do the remuneration rules also apply to foreign banks, e.g. from Japan or the USA, that are established in the EU ?

Yes. The remuneration rules will apply to credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres. This applies to EU banks' third-country subsidiaries, as well as to third country banks' subsidiaries in the EU.

Background

Why must cash bonuses be reduced ?

Up front cash bonuses that are based on expected rather than actual performance are a key driver of excessive risk taking. Staggering payments over time and linking them to the bank's health and actual performance should ensure that these risks are tackled.

Background

Who will decide what a "large" bonus is for the purpose of applying the 30% or 20% cap on up front cash bonuses ?

It will be up to the national supervisory authorities to decide what a "large" bonus means for this purpose. They must base their decisions on EU guidelines to be established by the Committee of European Banking Supervisors (CEBS). Once the European Banking Authority (EBA) replaces the CEBS, the national authorities' decisions will be based on EBA's technical standards.

Background

And what about judging a bank's bonus vs fixed salary policy ?

Each bank must set a maximum limit on the size of staff bonuses, which must be proportional to salary. It will be up to the national supervisory authorities to evaluate whether the bank's limit ensures that fixed and variable components of total remuneration are appropriately balanced. These evaluations will be guided by EU guidelines drawn up by the CEBS and later by EBA technical standards.

Background

How will bonuses be paid out ?

The rules require that at least half a bonus be paid as a mix of contingent capital and shares - applied to both deferred and non-deferred income. The contingent capital and shares must be retained for an appropriate period.

They also require at least 40% of a bonus to be deferred (60% for a large bonus) for no less than 3-5 years, in line with business cycle, and to be paid pro rata with a claw-back if performance turns out to be weaker than predicted when the bonus was awarded.

For example:

Example for a normal bonus [1] :

EUR 100,000 bonus

EUR 40,000 minimum deferred

EUR 30,000 minimum paid in contingent capital and shares

EUR 30,000 maximum paid in up front cash

Example for a large bonus¹:

EUR 1,000,000 bonus

EUR 600,000 minimum deferred

EUR 200,000 minimum paid in contingent capital and shares

EUR 200,000 maximum paid in up front cash

[1] The figures are used only to facilitate understanding and are not in any way intended to indicate what a "normal" or "large" bonus will be considered to be. See question above for more information on the process involved for judging what a large bonus will be.

Background

Will the bonus rules apply to all bank employees or only senior people ?

The rules will apply to senior management, risk takers, controller functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers. What these people have in common is that their professional activities have a material impact on the bank's risk profile. The rules would not apply to the commissions earned by bank employees when selling the bank's products to customers.

Background

Do the remuneration rules also apply to hedge fund managers ?

Hedge funds as such will be subject to separate legislation - the alternative investment fund managers directive - which is currently under negotiation. Hedge Fund managers who are investment firms as defined by the markets in financial instruments directive are covered, although the text makes it clear that these rules should be applied proportionately to investment firms. The underlying principle is that when investors' money is put at risk, the investing firm's incentives should be aligned with theirs.

Background

Do the remuneration rules in this directive go beyond what was agreed by the G20 ?

The rules set out in this directive are all in line with the G20 recommendations. The difference is that the directive will have more specific provisions than the political commitments given by G20 leaders. For example, the directive caps up front cash bonuses at 30% of the total bonus and 20% for large bonuses and also applies rules to pensions. To further limit incentives for short-term profit chasing, it requires that part of the bonus be paid in "contingent capital" (funds which can be called upon first in case of bank difficulties), in addition to shares.

Background

Which authority will be responsible for establishing the EU-wide guidelines on which banks will establish their bonus limits ?

Until the European banking Authority (EBA) is established, this task will be performed by the Committee of European Banking Supervisors (CEBS). Once established, the EBA will take over and be responsible for issuing technical standards.

Background

What are the new rules on capital requirements ?

There are two key areas addressed here: stricter rules on trading, and higher standards for re-securitisations.

More capital to cover trading risks

The rules require banks to take a more conservative stance towards the risks they face from their trading activities. Investments held by banks to be sold, or traded, are held in the trading book (as opposed to the banking book, for assets like a normal mortgage that are held for their full life, and are already subject to stricter rules).

Events in recent years have shown that the risk carried by trading book investments needs to be re-evaluated, as does the capital required to cover this risk. The rules are expected to lead to banks having to hold three to four times more capital against their trading risk than they do at present.

Higher standards for re-securitisations

The rules will require banks to hold more capital against securities which repackage other securities. The most well known of these securities are the mortgage backed securities which were at the root of the recent financial crisis. Credit Rating Agencies seriously underestimated the risk of these complex investments and so new rules will apply to ensure that additional capital is held to cover them.

Background

When will the rules come into force ?

The rules will take effect in January 2011 for the bonus provisions and not later than 31 December 2011 for the capital requirements provisions. Bonuses committed before January 2011 but paid after this date will also be covered by the rules. There is also a transition period for re-securitisations in the trading book, allowing firms to use the highest of the sum of their long or short positions, rather than the sum of the two, until 31 December 2013.