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Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks

Law Working Paper N° 169/2010
Revised June 2011

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-169-2010

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ECGI Working Paper Series in Law

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Abstract

In this Article we submit that the compensation structures at banks before the financial crisis were not necessarily flawed and that recent reforms in this area largely reflect already existing best practices. In Part I we review recent empirical studies on corporate governance and executive pay at banks and suggest that there is no strong support for regulating bankers' compensation structures. We also argue that detailed regulation of incentives would subtract essential decisionmaking powers from boards of directors and make compensation structures too rigid. In Part II we note that political support for regulating bankers' pay has been strong and led to reforms promoting long-term incentives to executives on the assumption that short-term incentives were a cause of the crisis. The Financial Stability Board Principles for Sound Compensation Practices (the "Principles") follow this trend, at the same time representing a political compromise between the various interest groups concerned. They pick up traditional compensation criteria from pre-crisis best practices, adapting them to the post-crisis setting, while leaving some flexibility in pay structures. We suggest that a certain degree of flexibility should be kept when implementing the Principles in national jurisdictions. In Part III we analyze the regulatory developments concerning executive pay at banks in Europe and find variations in the implementation of the Principles. We also show that remuneration policies at large European banks are converging towards the international Principles, while varying in the implementation of individual standards. However, recent EU reforms may change the situation considerably by imposing detailed requirements as to pay structures in the financial sector.

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** Research Fellow, University of Genoa, Centre for Law and Finance. This Article is part of a research project conducted under the sponsorship of the European Central Bank ("ECB") Legal Research Program. A preliminary draft was presented at a seminar held at the ECB in Frankfurt in January 2010. We are grateful to seminar participants and, in particular, to Chiara Zilioli for valuable comments and encouragement throughout the project. We express our gratitude to Jeffrey Gordon, who generously dispensed precious comments as a discussant of a previous version of this Article, and to other participants at the Vanderbilt Law Review Symposium of February 2010. We also thank Patrick Bolton, Paul Davies, Paolo Giudici, Peter Mülbert, and Holger Spamann for valuable comments.

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INTRODUCTION

In the quest for possible causes of the recent financial crisis, commentators often argued that bank executives had poor incentives. Critics have claimed, in particular, that executive compensation was not properly related to long-term performance, while regulators have

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sought ways to change practices to better align pay with long-term performance.[1]

At least two questions arise with respect to incentive practices, which we answer in Part I of this Article. The first is whether executive compensation at banks before the crisis was predominantly short-term oriented. Politicians argue, with the support of the media, that widespread short-term incentives to bank managers were at the root of the recent crisis. This claim led the Financial Services Forum ("FSF")—which later became the Financial Services Board ("FSB")—to adopt two international schemes: the Principles for Sound Compensation Practices ("the Principles")[2] and the Principles for Sound Compensation Practices: Implementation Standards ("the Standards").[3] The main thrust of these principles concerns the long-term orientation of incentives, which should assure an optimal alignment of executives' motivations with prudent risk taking. The European Union ("EU") and national reforms that we analyze in this Article follow a similar path, emphasizing the need for long-term orientation of pay and its importance for the control of risk taking by banks.

However, recent empirical studies found no proof that short-term incentives led to excessive risks. In the United States, pay generally was aligned with the long-term interest of shareholders.[4] Indeed, CEOs of large U.S. financial institutions were heavily invested in the equity of their firms at the onset of the crisis. Similar studies are not yet available for Europe, because the data needed to calculate

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1. *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (Harvard Univ. Press 2009); Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1917 (2010); John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital To Mitigate Systemic Risk* (Columbia Law & Econ. Working Paper Series, No. 380, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015. For numerous media articles dedicated to the topic, see Alan S. Blinder, *Crazy Compensation and the Crisis*, WALL ST. J., May 28, 2009 at A15; Deborah Solomon & Damian Paletta, *U.S. Eyes Bank Pay Overhaul: Administration in Early Talks on Ways to Curb Compensation Across Finance*, WALL ST. J., May 13, 2009, at A1, *available at* http://online.wsj.com/article/SB124215896684211987.html.

2. FIN. STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES (2009) [hereinafter PRINCIPLES], *available at* http://www.financialstabilityboard.org/publications/r_0904b.pdf.

3. FIN. STABILITY BD., FSB PRINCIPLES FOR SOUND COMPENSATION PRACTICES: IMPLEMENTATION STANDARDS (2009) [hereinafter STANDARDS], *available at* http://www.financialstabilityboard.org/publications/r_090925c.pdf.

4. Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, J. FIN. ECON. (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859.

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the value of stock options and long-term incentives is either insufficient or disclosed heterogeneously.[5] Our analysis finds that, according to their disclosure before the crisis, most large European banks adopted remuneration policies that were fairly balanced between fixed and variable pay and included long-term incentives. This was true both for ailing and non-ailing banks, making it unlikely that, before the crisis, bank managers followed a short-term approach induced by the structure of their incentives. Equity investments of European CEOs in their own firms are not easily assessed, due to the lack of consistent and detailed data on the value of stock options and long-term incentives. However, the available data on managers' holdings of shares in their firms indicate that CEOs' equity investments at large European banks were lower than those of their U.S. counterparts.[6] This is a remarkable difference between the United States and Europe, consistent with the fact that executive compensation at listed companies is generally lower in Europe.[7] The lack of large equity investments of CEOs in their firms makes the empirical results of U.S. academic research less meaningful for European practices.[8]

The second question that we analyze in Part I is whether banking regulation should cover compensation arrangements, either by mandating pay structures or by requiring their adjustment in order to avoid excessive risk taking. Several commentators have recently addressed this policy issue in papers discussing how to limit excessive risk taking by tying managers' pay to some measure of the value of bank debts.[9] These commentators agree that regulators should either require or at least recommend the relevant pay structures in order to overcome the collective action problems of their adoption by banks. In

5. This is primarily due to the limits of mandated disclosure in this area. *See* Guido Ferrarini et al., *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis*, (Eur. Corp. Governance Inst., Law Working Paper No. 126, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463.

6. *See infra* Part III.B (describing this difference in equity investments).

7. *See* Martin J. Conyon, Nuno Fernandes, Miguel A. Ferreira, Pedro Matos and Kevin Murphy, *The Executive Compensation Controversy: A Transatlantic Analysis*, paper presented at the Annual FRDB (Fondazione Rodolfo Benedetti) conference in Cagliari, May 29, 2009, *available at* http://www.frdb.org/upload/file/First_report.pdf; Randall S. Thomas, *International Executive Pay: Current Practices and Future Trends* (Vanderbilt Law & Econ. Res. Paper, No. 08–26, 2009), *available at* http://ssrn.com/abstract=1265122.

8. For a comprehensive analysis of the evolution in equity pay practices with focus on the U.S. landscape, see David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting* (Boston Univ. Sch. of Law, Working Paper No. 09–34, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1443170&rec=1&srcabs=1361149.

9. *See infra* Part I.B.2 (describing the views of these commentators in greater detail).

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this Article, we submit that regulators should not replace boards in setting pay structures and that regulatory intervention concerning executive compensation at banks should be limited in scope, so as to maintain the flexibility of executive pay arrangements. We also argue that regulating pay too strictly would only have limited and indirect effects on bank soundness and stability, making it preferable for supervisors to use the powers traditionally granted to them under prudential regulation provisions. By exercising their traditional powers, supervisors are able to monitor executive pay arrangements and to assess incentives from a risk-taking perspective.

Answering these two questions allows us to critically examine recent reforms in Part II. We first consider the European approach to bankers' remuneration throughout the recent crisis, with particular regard to the troubled banks that were rescued by their governments. We then analyze the Principles and the Standards, issued in 2009 by the FSB,[10] and critically assess the same in light of our preceding discussion. The FSB adopted the Principles following coordinated action by the G20 governments, which rapidly responded to heavy political pressure deriving, domestically and internationally, from the financial crisis and repeated bank failures. Through swift adoption of the Principles, authorities intended to show that reforms of the international financial system were put in place in a timely manner with respect to executive compensation,[11] which the public and mass media widely considered to be among the crisis' culprits.[12] Moreover, international coordination was needed to solve collective action problems among states. Few governments would have been willing to

10. PRINCIPLES, *supra* note 2; STANDARDS, *supra* note 3.

11. *See, e.g.*, Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors (Apr. 23, 2010), *available at* http://www.reuters.com/article/idUSN2319500120100423http (describing actions taken in reaction to the financial crisis and its effects on global recovery); *see also* Chris Giles & Krishna Guha, *Leaders Seek to Retool Global Economy*, FIN. TIMES, Sept. 25, 2009, at 8, *available at* http://www.ft.com/cms/s/0/199b024e-a96c-11de-9b7f-00144feabdc0.html#axzz194wijjsy (describing the framework and goals of the 2009 G20 meeting); James Wilson, *Germans to Speed up Pay Reform*, FIN. TIMES, Dec. 11, 2009, at 4, *available at* http://www.ft.com/cms/s/0/85b986f6-e5f5-11de-b5d7-00144feab49a.html#axzz194xFPMcC (outlining how several of the largest German banks agreed to speed up reform of rules governing bonuses).

12. Public and media hostility at payments to leaders of failed institutions has been widespread. *See, e.g.*, *In Depth: Bank Bonuses*, FIN. TIMES, http://www.ft.com/indepth/bank-bonuses (collecting articles); *Outraged Americans Want AIG Bonus Money Recovered*, GALLUP (Mar. 18, 2009), http://www.gallup.com/poll/116941/outraged-americans-aig-bonus-money-recovered.aspx (discussing Gallup Poll results revealing that three in four Americans wanted the government to take actions to block or recover the bonuses insurance giant AIG paid its executives after receiving federal bailout funds).

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regulate executive pay in the absence of similar interventions by other jurisdictions, for fear of competition from foreign financial institutions in both the financial markets and the market for managers.[13]

Despite being regarded as a fundamental piece of the post-crisis financial reform,[14] the Principles are less innovative than is often believed. To a large extent, they track compensation practices that were already diffuse before the crisis. As shown by the empirical studies analyzed in this Article, pre-crisis compensation practices of large U.S. banks mainly were long-term oriented. Our analysis of remuneration policies at large European banks in Part III shows that a balanced mix of short-term and long-term incentives appeared to be in place at most banks, including the ones that failed. The Principles and Standards enhance the international pressure in this direction, and some results already emerge from our analysis of post-crisis remuneration structures at large European banks.[15] One novelty of the Principles is their emphasis on the alignment of incentives with prudent risk taking. This reflects the consideration given to the interests of stakeholders, such as depositors and taxpayers, in addition to those of shareholders. Compensation structures should therefore not only maximize shareholder value, but also avoid excessive risk taking.

On the whole, the Principles represent a political compromise between the various interests at stake and the different views concerning executive compensation's role in the financial crisis. Those claiming that pre-crisis pay structures were too focused on short-term gains and led to excessive risk taking by financial institutions should be satisfied with the Principles' recognition of the need for long-term orientation and alignment of incentives with prudent risk taking. Financial institutions should not be disconcerted with the Principles' ratification of what was known as sound compensation practice before

13. *See* Joel P. Trachtman, The International Law of Financial Crisis: Spillovers, Subsidiarity and Cooperation (June 26, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1630523 (providing an analytical template for prudential financial regulation while recognizing that our ability to predict future crises is limited and that any such institution must be flexible).

14. *See, e.g.*, INST. OF INT'L FIN. (IIF), COMPENSATION REFORM IN WHOLESALE BANKING 2010: PROGRESS IN IMPLEMENTING GLOBAL STANDARDS, Introductory Statement (2010) (considering FSB Principles "widely viewed as a set of global benchmarks for compensation reform"); *International Cooperation and Financial Regulatory Modernization: Testimony Before the Subcomm. on Sec. and Int'l Trade and Fin. of the S. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. (2010) (statement of Daniel K. Tarullo, Gov. Fed. Reserve Bd.), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20100720a.htm#f1.

15. *See infra* Part III.

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the financial turmoil.[16] They should also approve the Principles' rejection of a "one size fits all" approach to executive compensation issues, leaving room for differences in compensation structures based on individual circumstances. Financial regulators undoubtedly are among the winners in the political contest that produced the Principles, which require incentives to be aligned with prudent risk taking and extend the remit of prudential supervision to compensation practices at financial institutions.[17]

However, the success or failure of the Principles in practice will largely depend on the ways in which they are implemented and enforced at national levels. Domestic regulation could either enhance or limit their flexibility. Supervisors might exert more or less pressure on financial institutions to achieve compliance. Banks could experiment with new structures, along the lines suggested by the literature reviewed below,[18] provided that sufficient discretion is left to their boards. We advocate throughout this Article for principles-

16. Even before the crisis, several best practice guidelines emphasized the importance of aligning incentives with long-term performance through adopting long-term incentive plans in equity form. *See, e.g.*, DE NEDERLANDSE CORPORATE GOVERNANCE CODE (Neth.), *available at* http://www.commissiecorporategovernance.nl/page/downloads/CODE%20DEF%20ENGELS%20COMPLEET%20III.pdf (English translation); BOURSE DE LUXEMBOURG [LUXEMBOURG STOCK EXCHANGE], CORPORATE GOVERNANCE: THE 10 PRINCIPLES OF CORPORATE GOVERNANCE OF THE LUXEMBOURG STOCK EXCHANGE (2006), *available at* http://www.ecgi.org/codes/documents/luxembourg_en.pdf (English translation); INT'L CORPORATE GOVERNANCE NETWORK (ICGN), REMUNERATION GUIDELINES § 3.4.2 (2006), *available at* http://www.icgn.org/files/icgn_main/pdfs/best_practice/exec_remun/2006_executive_remuneration.pdf ("The ICGN believes equity ownership guidelines and holding requirements should be an integral component of company's equity plan and overall compensation philosophy."); ASS'N OF BRITISH INSURERS (ABI), PRINCIPLES AND GUIDELINES ON REMUNERATION § 9.1 (2005), *available at* www.abi.org.uk/Media/Releases/2005/12/39942.doc ("Strong encouragement is given to use of longer performance measurement periods of more than 3 years and deferred vesting schedules, in order to motivate the achievement of sustained improvements in financial performance."); TIAA–CREF, POLICY STATEMENT ON CORPORATE GOVERNANCE (2004), *available at* http://www.tiaa-cref.org/ucm/groups/content/@ap_ucm_p_tcp/documents/document/tiaa01007871.pdf (providing a best practices guide to corporate governance). For further explanations, see *infra* Part II.B.2.

17. For various initiatives taken by the financial regulators, see CODE BANKEN (Neth.), *available at* http://www.ecgi.org/codes/documents/code_banken_netherlands_9sep2009_en.pdf (English translation); Federation Bancaire Francaise [FBF] [French Banking Federation], Normes professionnelles concernant la gouvernance et les rémunérations variables des professionnels des marchés financiers (2009); Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin] [Federal Agency for Financial Market Supervision], Anforderung an die Vergütungssysteme der Banken [Supervisory Requirements for Institutions' Remuneration Systems], Circular 22/2009 (2009) (Ger.); Swiss Financial Markets Supervisory Authority (FINMA), Remuneration Schemes, Minimum Standards for Remuneration Schemes of Financial Institutions, Circular 2010/1 (2010).

18. *Infra* Part I.B.2.

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based regulation that is flexible enough to allow for innovation and diversity in executive pay structures, while preventing excessive risk taking. This is also in light of the recent economic literature on the role of executive pay in the financial turmoil.[19] At the same time, we emphasize the important role of the boards and the disclosure of compensation practices, reiterating our claim for EU harmonization of remuneration reports.[20]

In Part III we analyze the implementation of the Principles and Standards in Europe by examining the laws, corporate governance codes, and regulatory guidelines of eight jurisdictions, in addition to EU regulations. We also analyze the remuneration policies of forty large European banks to check their conformity with international standards. We find that convergence is on the rise, particularly at the regulatory level; in addition, we assess current trends and perspectives in light of the arguments developed throughout the Article.

I. THEORIES AND POLICIES: IS REGULATION OF BANKERS' PAY JUSTIFIED?

In this Part, we look for possible grounds for the regulation of bankers' pay by analyzing the empirical and theoretical literature recently developed in this area. We examine empirical works showing that failures of corporate governance at European banks were not necessarily at the root of the recent crisis and that weak pay structures did not necessarily contribute to the crisis. We also analyze theoretical works modeling optimal pay structures for bank executives and claiming that these structures should be either mandated or promoted by regulation. We conclude by suggesting a softer approach to regulating bankers' pay, which would leave banks' boards relatively free to decide on pay structures. A softer approach also would leave regulators empowered to monitor both the boards' organization and functioning and the relevant pay structures in order to assess their impact on bank risks and activities.

19. *See* NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE 184 (2010). *See generally* N.Y. UNIV. STERN SCH. OF BUS., RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (Viral Acarya & Matthew Richardson eds., 2009).

20. For an analysis of executive remuneration disclosure, see Guido Ferrarini et al., *Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe*, 10 J. CORP. L. STUD. 73, 73–118 (2009).

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A. Bank Governance and the Financial Crisis

Executive remuneration is one of the key issues of today's corporate governance. It is also critical for banks, as for all firms, whose executives need incentives to maximize the wealth of their shareholders. However, banks' corporate governance has unique features relative to that of non-financial corporations.[21] In fact, bank shareholders and managers have incentives to take more risks than is economically and socially efficient, absent prudential regulation and supervision. Moreover, due to the special nature of banks, they are more prone to moral hazard than are non-bank managers and shareholders.[22] After examining what determines this unique framework, we review recent literature exploring whether failures of corporate governance were among the determinants of the recent crisis.

1. Why Bank Governance Is Special

Banks are different from other firms for several reasons that matter from a corporate governance perspective. First, they are more leveraged than other firms, with the consequence that the conflict between shareholders and fixed claimants, which is present in all corporations, is more acute for banks.[23] Second, banks' liabilities are

21. For scholarly analysis of some of these unique features, see Renée B. Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, 9 ECON. POL'Y REV., Apr. 2003, at 123, 123–42 (2003); Guido Ferrarini & Maria Cristina Ungureanu, *Unique Features in the Governance of Bankers' Compensation*, *in* MET RECHT 123 (P. Essers, et. al. eds., Kluwer 2009); Kose John & Yiming Qian, *Incentive Features in CEO Compensation in the Banking Industry*, 9 ECON. POL'Y REV. Apr. 2003, 109, 109–21; Jonathan Macey & Maureen O'Hara, *The Corporate Governance of Banks*, ECON. POL'Y REV. Apr. 2003, at 91, 91–107; Peter Mulbert, *Corporate Governance of Banks after the Financial Crisis: Theory, Evidence, Reforms* (Eur. Corp. Governance Inst., Law Working Paper No. 130, 2009).

22. *See* E. Gerald Corrigan, *Are Banks Special?*, *in* THE FEDERAL RESERVE BANK OF MINNEAPOLIS: 1982 ANNUAL REPORT (1982); *available at* http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm (analyzing whether banks are "special" or simply another provider of financial services and how financial regulation should be shaped based on this determination); *see also* E. Gerald Corrigan, *Are Banks Special? A Revisitation*, THE REGION (2000), *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3527 (revisiting his 1982 essay to determine how the financial sector has changed in the interim). *See generally Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, COM (2010) 285 final (June 2, 2010) (discussing the special corporate governance regime of banks).

23. *See* Macey & O'Hara, *supra* note 21, at 98 (explaining the role that corporate governance plays in corporate performance and arguing that commercial banks pose unique corporate governance problems for managers and regulators); William H. Meckling & Michael C.

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largely issued as demand deposits, while their assets, such as loans, often have longer maturities. The mismatch between liquid liabilities and illiquid assets may become a problem in a crisis situation, as we vividly saw in the recent financial turmoil, when bank runs took place at large institutions, threatening the stability of the whole financial system.[24] Third, despite contributing to the prevention of bank runs, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk taking. Moral hazard is exacerbated when a bank approaches insolvency, because shareholders do not internalize the losses from risky investments, but instead benefit from potential gains (for example, by having an implicit put option at strike price zero).[25] While risk taking by non-bank corporations close to insolvency is constrained by market forces and contractual undertakings, banks in a similar condition can continue to attract liquidity, thanks to deposit insurance.[26]

Fourth, asset substitution is relatively easier in banks than in non-financial firms.[27] This allows for more flexible and rapid risk shifting, which further increases agency costs between shareholders and stakeholders (and bondholders and depositors in particular) and also increases moral hazard of managers. In addition, banks are more

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Jensen, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305–60 (1976) (discussing the agency costs of debt).

24. *See* Macey & O'Hara, *supra* note 21, at 97 (discussing bank runs as collective action problems of depositors). Regarding the run on Northern Rock, see TREASURY COMMITTEE, THE RUN ON THE ROCK, 2007–8, H.C. 56–I (U.K.), *available at* http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf.

25. For a discussion of the possible remedy of "double liability," see Jonathan P. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 31–62 (1992). *See also* Andrea Polo, *Corporate Governance of Banks: The Current State of the Debate* (MPRA Paper No. 2325, 2007), *available at* http://mpra.ub.uni-muenchen.de/2325 (analyzing how the debate on the corporate governance of banks has a direct bearing on the current discussions on the future of banking regulatory design).

26. Macey & O'Hara, *supra* note 21, at 98. For a lively account of public bailouts similar to those seen in the recent crisis, see ANDREW R. SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2009). *See also* THE HIGH-LEVEL GROUP OF FINANCIAL SUPERVISION IN THE EU: REPORT 33 (2009) [hereinafter DE LAROSIÈRE REPORT], *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (describing moral hazards generated by public bailouts).

27. *See* Ross Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence* 1–19 (World Bank Pol'y Research Grp., Working Paper No. 3404, 2004), *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2004/10/08/000012009_20041008124126/Rendered/PDF/WPS3404.pdf (discussing the special attributes of banks).

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opaque—it is difficult to assess their risk profile and stability.[28] Information asymmetries, particularly for depositors, hamper market discipline and, in turn, increase moral hazard of managers.

For all these reasons, "good" corporate governance (that is, aligning the interests of managers and shareholders)[29] may lead bank managers to engage in more risky activities.[30] This is due to the fact that a major part of the losses would be externalized to stakeholders, while gains would be fully internalized by shareholders and managers (if properly aligned by the right incentives). Prudential regulation and supervision aim to reduce the excessive risk propensity of shareholders and managers in order to guarantee the "safety and soundness" of banks. An exogenous "regulatory" cost is allocated on excessively risky behavior of bank managers, reducing agency costs between shareholders and stakeholders.

2. Did "Bad Governance" Contribute to the Financial Crisis?

Recent empirical research confirms that good governance may not be enough for bank soundness. A paper by Andrea Beltratti and René Stulz investigates whether banks' poor performance in the recent crisis was "the outcome of a financial Tsunami that hit them unexpectedly" or the result of some banks being more inclined to experience large losses.[31] The authors analyze possible determinants (regulation, corporate governance, balance sheets, and profitability) of bank performance measured by stock returns during the crisis for a sample of ninety-eight large banks across the world, of which nineteen are U.S. banks. Beltratti and Stulz find no evidence for the thesis advanced in a report by the Organization for Economic Co-operation and Development ("OECD") that the "financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate

28. *See id.* at 7–9 (noting that there is greater opaqueness in banks than other industries).

29. For an appraisal of corporate governance criteria, see *infra* Part I.A.2.

30. *See* Luc Laeven & Ross Levine, *Bank Governance, Regulation and Risk Taking*, 93 J. FIN. ECON. 259, 259–75 (2009) (showing that bank risk taking varies positively with the comparative power of shareholders within the corporate governance structure of each bank).

31. *See* Andrea Beltratti & René M. Stulz, *Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation* 2 (Eur. Corp. Governance Inst., Fin. Working Paper No. 254, 2009), *available at* http://ssrn.com/abstract_id=1433502 (using the significant variation in stock returns of large banks across the world between July 2007 and December 2008 to evaluate the importance of factors that have been discussed as having contributed to the poor performance of banks during the credit crisis).

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governance arrangements."[32] In particular, they find no evidence that banks with better governance performed better during the crisis.[33] On the contrary, banks with more pro-shareholder boards performed worse.

According to Beltratti and Stulz, similar results are consistent with "the view that banks that were pushed by their boards to maximize shareholder wealth before the crisis took risks that were understood to create shareholder wealth, but were costly ex post because of outcomes that were not expected when the risks were taken."[34] In their opinion, bank balance sheets and bank profitability in 2006 explain the performance of banks in the subsequent two years better than governance and regulation.[35] Indeed, banks with the highest returns in 2006 had the worst returns during the crisis. In addition, banks that had a higher Tier 1 capital ratio in 2006 and more deposits in most cases performed better during the crisis.[36]

Renée Adams reaches similar results in a paper assessing to what extent the crisis can be attributed to bad governance of financial firms.[37] Her study aims to answer this question by comparing the governance characteristics of financial firms that received bailout money from the U.S. government under the Troubled Asset Relief Program ("TARP") with those that did not. Her research indicates that banks receiving TARP funds had more independent boards, larger boards, more outside directorships for board members, and greater incentive pay for CEOs than non-TARP banks. Except for the finding of more independent boards, these results are consistent with the idea that TARP banks had worse governance. However, Adams finds it striking that TARP banks had boards that were more independent.[38]

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32. Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, FIN. MARKET TRENDS (OECD, Paris, Fr. 2009) (manuscript at 52), *available at* http://www.oecd.org/dataoecd/32/1/42229620.pdf.

33. *See* Beltratti & Stulz, *supra* note 31, at 11 (measuring corporate governance using the Corporate Governance Quotient ("CGQ score"), which is a relative measure of a firm's investment in internal governance, i.e., its adoption of governance attributes that increase the power of minority shareholders; the authors select forty-four attributes covering four broad categories: board, audit, takeover and compensation).

34. *Id.* at 2 ("This evidence is most consistent with the Tsunami explanation for the crisis: the attributes that the market valued in 2006, for instance a successful securitization line of business, exposed banks to risks that led them to perform poorly when the crisis hit.").

35. *Id.* at 3–5.

36. *Id.* at 6, 14.

37. Renée B. Adams, *Governance and the Financial Crisis* (Eur. Corp. Governance Inst., Fin. Working Paper No. 248, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1398583.

38. *Id.* at 13–14.

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One explanation could be that independent directors are less likely to have in-depth knowledge of their banks and the financial expertise to understand complex transactions like securitizations. In other words, greater independence may be detrimental for a bank board because a more independent board will not have sufficient expertise to monitor the actions of the CEO.[39]

The criteria for examining corporate governance employed by the studies mentioned above are open to discussion. For instance, independent directors are used as a proxy for good monitoring by the board, but this monitoring depends on professional qualities and levels of engagement in board activities that are not necessarily captured by current definitions of independence. Similarly, international corporate governance indexes make reference to aspects such as internal controls, which do not necessarily reflect the detailed requirements for proper monitoring of complex risk management processes by a bank board.[40] Thus, while establishing a prima facie case for excluding corporate governance as a main determinant of the crisis, the above studies cannot be used for asserting that what appeared to be good governance at banks that failed was satisfactory in practice and in no need of reform. A similar statement calls for proof that banks failed despite the best monitoring efforts deployed by their boards, a proof no doubt difficult to offer, particularly in light of the egregious risk management failures seen in most troubled banks.[41]

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39. *See id.* at 15 (investigating the influence of corporate governance on financial firms' performance during the 2007–2008 financial crisis and finding that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis). For similar results, see David Erkens et al., *Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide* (Eur. Corp. Governance Inst., Fin. Working Paper No. 249, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1397685. The authors find that firms with more independent boards suffered from worse stock returns and recognized larger write-downs during crisis.

40. *See* Sanjai Baghat et al., *The Promise and Perils of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1803–82 (2008) (detailing the limits of corporate governance indexes for measuring corporate performance); Rene M. Stulz, *Risk Management Failures: What Are They and When Do They Happen?*, J. APPLIED CORP. FIN., Fall 2008, at 39, 39–48 (detailing the complexities of risk management).

41. For a description of risk management failures, see, for example, SENIOR SUPERVISORS GRP., OBSERVATIONS ON RISK MANAGEMENT DURING THE RECENT MARKET TURBULENCE (2008), *available at* http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf; Stulz, *supra* note 40.

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B. Empirical Studies and the Regulation of Bankers' Pay

Empirical research focusing on executive pay and its role in the banking crisis offers results that are on the whole consistent with the above studies. In this Subpart, we review this research and examine the recent law and economics literature dealing with the optimal structure of pay at banks. We conclude with some remarks on what we believe is the right answer to the question of whether executive pay calls for regulation. Principally managerial incentives should be taken into account by supervisors; however, their design should be left to bank boards.

1. Does Empirical Evidence Support a Claim for Regulation of Bankers' Pay?

The above-cited paper by Rüdiger Fahlenbrach and René Stulz analyzes a sample of ninety-eight U.S. banks and finds "no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis."[42] Rather, the authors identify "some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity."[43] According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006.[44] Similar equity holdings should have led CEOs to focus on the long term, avoiding too much risk and excessive leverage for their banks.[45] Instead, the study shows that a bank's stock return performance in 2007 and 2008 was negatively related to the dollar value of its CEO's holdings of shares in 2006, and that a

42. Fahlenbrach & Stulz, *supra* note 4, at 1.

43. *Id.*

44. *See id.* at 4 (specifying that changes in the bank's stock price could have easily wiped out all of the CEO's annual compensation).

45. *See id.* at 2 (arguing that, if the market is efficient, stock prices will reflect changes in a bank's long term performance). Therefore, CEOs with a large investment in their bank's equity should find it advantageous to improve their banks' long-term performance, whenever it makes sense to do so. If the market is inefficient, CEOs might be pushed into focusing on short-term profit maximization for fear of losing their job if their banks did not grow as aggressively as the market would require. However, in a similar case, the structure of incentive pay would not really matter, for executives would pursue a short-term perspective despite their long-term equity incentives. *Id.*

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bank's return on equity in 2008 was negatively related to its CEO's holdings in shares in 2006.[46]

These data suggest that CEOs took exposures that they felt were profitable for their shareholders ex ante but performed very poorly ex post.[47] Moreover, CEOs with better incentives to maximize shareholder wealth took significantly greater risks than CEOs having lower incentives. The fact that these risks translated into poor outcomes is not evidence of CEOs acting against the interest of shareholders, given that CEOs had large equity stakes in their own institutions and did not try to reduce the same in anticipation of the crisis.[48] All of this is consistent with both the hypothesis that the crisis was unexpected by top bank executives and the hypothesis that CEOs focused knowingly and sub-optimally on the short term.[49]

Short-termism is explored in a recent paper by Ing-Haw Cheng, Harrison Hong, and Jose Scheinkman on the link between compensation and risk taking during the 1992-2008 period.[50] Their empirical research establishes a persistent relationship between risk taking and compensation. In particular, they show that "aggressive firms who did well in the 1990s and were 'yesterday's heroes' were the largest risk-takers and are today's outcasts in the crisis."[51] The same firms also tend to be high-compensation firms, suggesting that "risk taking may be related to a firm-fixed effect such as firm culture that is picked up by [the paper's] compensation measure."[52] Moreover, the paper explores the idea that risk taking and executive compensation

46. *Id.* at 4–5 (stating that an increase of one standard deviation in dollar ownership was associated with lower returns of 9.6 percent and with a lower return on equity of 10.5 percent).

47. *Id.* at 5.

48. *Id.* at 25.

49. *Id.* at 6.

50. Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking* 7 (NBER Working Paper No. 16176, 2010), *available at* http://www.nber.org/papers/w16176.pdf. This Article tries to identify incentives other than those created by the traditional measure of inside ownership, which does not have much explanatory power for financial institutions performing worse in the crisis. Top executives, notwithstanding their high ownership stakes, face "high-powered incentives related to market pressure from short-termist investors to out-perform rivals," which can be described as "implicit incentives related to firing." Moreover, higher annual payouts to top managers might reveal a firm culture for high-powered incentives, in the form of either bonuses or "higher sensitivity of firing to short-term performance." The authors utilize a "residual pay measure," defined as total executive compensation controlling for firm size, as a proxy for explicit and implicit short-termist incentives.

51. *Id.* at 7.

52. *Id.* at 7, 8.

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may be related to heterogeneous shareholder preferences.[53] Far from establishing causal links, the paper supports a story where short-termist investors use short-term incentives to induce managers to take large bets on risky positions.[54]

Also focusing on the link between short-term incentives and risk taking is the study by Lucian Bebchuk, Alma Cohen, and Holger Spamann on executive compensation at Bear Stearns and Lehman Brothers in the 2000-2008 period.[55] This study takes issue with Fahlenbrach and Stulz, who argue that the huge losses suffered by executives during the financial turmoil indicate that incentives cannot be blamed for the credit crisis or for the dismal performance of banks. The authors further argue that executives managed their firms in a manner they believed would benefit shareholders. Bebchuk, Cohen, and Spamann reject this argument with specific reference to the cases of Bear Stearns and Lehman Brothers, which commentators used to show that disastrous risk-taking decisions were the result of top executives' inability to perceive risks, not their compensation structures.[56]

The authors argue that the large losses on shares that the top financiers suffered when their firms melted down do not offer a full picture of their payoffs, which should include both what the same executives cashed out during these years and what they owned initially. In the observed period, the relevant executives received large amounts of cash bonus compensation and "regularly took large amounts of money off the table by unloading shares and options."[57] On the whole, performance-based compensation provided top executives at Bear Stearns and Lehman Brothers with cash flows of about $1.4 billion and $1 billion, respectively. These amounts substantially exceed the value of the top executives' holdings at the beginning of the period, which the authors estimate in the order of $800 million and

53. *Id.* at 25 (referencing short-termist investors—like mutual funds—"who want certain firms to take more risks and hence give them short-term incentives to do so").

54. *Id.* at 27.

55. Lucian Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 257–82 (2010).

56. *Id.* at 259.

57. *Id.* at 269–70. The authors note that both Bear Stearns and Lehman limited how quickly executives were able to unload equity awards, allowing this to take place only five years after the making of the award. However, Lehman also granted stock options that became exercisable usually within a year of the option grant. Moreover, the members of the top teams were all long-serving executives who each year were able to unload the equity incentives awarded to them five years earlier, which they usually did.

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$600 million, respectively.[58] Even though the value of the remaining shares was relatively modest for Bear Stearns' executives ($17 million) or nonexistent for Lehman's executives, their aggregate cash benefits from performance-based compensation were "quite sizable."[59]

As to the implications of their findings, Bebchuk, Cohen, and Spamann argue that the two cases analyzed in their paper provide a basis for concern about the incentives of the two banks' executives. Rather than producing a "tight alignment" of their interests with long-term shareholder value, the design of performance-based compensation provided executives of the relevant firms with substantial opportunities "to take large amounts of compensation based on short-term gains off the table and retain it even after the drastic reversal of the two companies' fortunes."[60] Indeed, executives were incentivized "to seek improvements in short-term results even at the cost of maintaining an excessively elevated risk of an implosion at some point down the road."[61] Other incentives, however, such as non-monetary motivations or simply "excessive optimism" could have affected their decisions. Nonetheless, the authors suggest that regulators should carefully consider the design of performance-based compensation in general and try to prevent the creation of perverse incentives.

Overall, the three papers reviewed above do not offer clear support for either regulating bankers' pay or suggesting that the same should be more long-term oriented than it was in large banks before the crisis. The Fahlenbrach and Stulz paper shows that the interests of executives of troubled banks were substantially aligned with those of shareholders through large equity stakes that executives held in their firms. The Cheng paper identifies a correlation between risk taking, high compensation, and the presence of short-termist investors, suggesting that the latter may push financial firms' executives with explicit and implicit incentives to excessive risk taking. The Bebchuk paper focuses on short-term incentives, highlighting their potential in inducing executives to take excessive risks even in the presence of large equity investments in their firms. None of these papers, however, establishes that before the crisis, incentives in troubled banks were mainly short-term, or that

58. *Id.* at 261.
59. *Id.* at 270.
60. *Id.* at 274.
61. *Id.*

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short-term incentives led banks' executives to undertake excessive risks. All three papers acknowledge that bank executives might have been motivated to take excessive risk by non-monetary incentives. Only the Bebchuk paper recommends looking at short-term incentives and their impact on risk taking by banks more seriously, from a reform perspective. This approach is more in line with the international trends, which will be analyzed in Part II.

2. Recent Proposals on the Optimal Structure of Executive Pay at Banks

Calls for regulating bankers' pay have been advanced post-crisis by financial economists and lawyers exploring, on theoretical grounds, the incentives for excessive risk taking created by remuneration structures and possible remedies from a regulatory perspective. After reviewing these works, we offer our own perspective on the possible goals and scope of regulation in this area.

A recent paper by Patrick Bolton, Hamid Mehran, and Joel Shapiro models a similar claim for regulation, starting from the proposition that the traditional theory of executive compensation does not directly apply to levered firms.[62] In the presence of risky debt, shareholders have an incentive to shift risk to creditors: "Not surprisingly, structuring CEO incentives to maximize shareholder value in a levered firm tends to encourage excess risk taking."[63] Bolton, Mehran, and Shapiro suggest, therefore, that the CEO's compensation at similar firms, including financial institutions, "ought to be structured to maximize the whole value of the firm—equity and debt value—and not just the value of equity."[64]

They propose, in particular, to tie CEO compensation, at least in part, to a measure of default riskiness of the firm, such as a bank's credit default swap ("CDS") spread over the performance evaluation period. An increase in the CDS spread would result in lower compensation, thus limiting risk shifting by the managers.[65] Bolton,

62. PATRICK BOLTON ET AL., FED. RESERVE BANK OF N.Y.C STAFF REPORT NO. 456, EXECUTIVE COMPENSATION AND RISK TAKING (2010), *available at* http://www.ny.frb.org/research/staff_reports/sr456.pdf.

63. *Id.* at 1.

64. *Id.*

65. *Id.* at 1–2. The authors provide empirical evidence for their proposal by focusing on the disclosure of deferred compensation in proxy statements filed with the SEC. Their results suggest that disclosure of deferred compensation is priced in credit markets through a reduction in the CDS spreads at proxy announcements.

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Mehran, and Shapiro also recognize that it is not obvious that bank's shareholders will make use of similar incentive contracts to reduce risk taking by executives. Indeed, the lower riskiness of the bank should translate into a lower cost of debt and induce shareholders to tie compensation to CDS spreads. However, deposit insurance and investors' misperception of risk would work against a similar compensation structure by reducing shareholders' incentives to limit risk taking by the bank.[66] In the authors' opinion, therefore, regulation should mandate the recommended structure, at least for large financial institutions.[67]

Bebchuk and Spamann advance a similar proposal by recommending regulation of executive pay at banks and designing a pay structure intended to avoid excessive risk taking.[68] In their opinion, "regulation of executive pay would be warranted even if banks had no governance problems." This is for the same reason that traditionally underlies bank regulation: shareholders do not internalize losses that risk taking could impose on bondholders, depositors, and taxpayers. Moreover, mandating pay structures could supplement the traditional regulation of banking activities: "Indeed, if pay arrangements are designed to discourage excessive risk taking, direct regulation of activities could be less tight than it should otherwise be."[69] Bebchuk and Spamann propose, in particular, that executive pay should be tied to the aggregate value of a basket of securities (including common shares, preferred shares and bonds) issued by either a bank holding company or a bank, rather than to the value of common shares only.[70] Both the proposal by Bolton, Mehran, and Shapiro and the one advanced by Bebchuk and Spamann tie executives' incentives to the enterprise value of a bank rather than to shareholder value, inducing bank executives to take the interests of depositors and other creditors into account. However, the two proposals differ to the extent that the former makes reference to CDS for measuring the value of debt, while the latter mainly considers the

66. *Id.* at 14–21.

67. *Id.* at 28 (noting that, at a minimum, bank regulators should recommend compensation committees to study ways in which compensation could be tied to the bank's CDS spread).

68. Lucian Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 247–87 (2010).

69. *Id.* at 254 (stating that, at a minimum, bank supervisors should closely monitor compensation structures and take the same into account when assessing the risks posed by a bank and exercising their supervisory powers).

70. *Id.* at 253.

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value of a basket of securities issued by the same bank (or bank holding company).[71]

Other scholars recommend a mandatory structure for executive pay at banks, similarly designed to control risk taking but making reference to instruments different from those considered so far. Frederick Tung suggests that subordinated debt should be included as part of managers' pay arrangements to align their interests more closely with those of more risk-averse debt holders and ultimately with those of regulators in assuring banks' safety and soundness.[72] Jeffrey Gordon refers to subordinated debt from a different perspective, suggesting that senior executives should receive a significant portion of stock-related compensation in the form of "convertible equity-based pay," that is, "equity that will convert into subordinated debt upon certain external triggering events, such as a downgrade by the regulators to a 'high risk category' or a stock price drop of a specified percentage over a limited time period."[73]

Both Gordon and Tung criticize Bebchuk and Spamann's proposal from various angles, focusing on its technical details,[74] yet sharing the core idea that executives' incentives at banks should take the interests of creditors into account, so as to avoid excessive risk taking. All papers considered in this Subpart also agree that the adoption of similar pay structures would be fraught, in practice, with serious collective action problems and suggest regulatory intervention. The nature of this intervention is still unclear, with references being made either to regulators' promoting or mandating similar

71. Bebchuk and Spamann also make a quick reference to the possibility of using CDS for measuring the value of debt. *Id.* at 285 n.98 ("While shareholders of firms outside the banking sector (or directors elected by such shareholders) should not be constrained by regulators in setting the structure of executive pay arrangements, firms seeking to reduce their borrowing costs should be free, of course, to agree to covenants that require them to tie executive pay to the value of the firm's debt securities.").

72. Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. (forthcoming Summer 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546229.

73. Jeffrey Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay* 2 (Columbia Law and Econ., Working Paper No. 373, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633906.

74. *See* Tung, *supra* note 72, at 29 (noting that as bank managers' individual situations will vary in ways that are not correlated with their bank holding companies' capital structures, there is no conceptual basis for assuming that executive pay in the form of a representative slice of the bank holding companies' securities will offer appropriate incentives to internalize risk at the banking subsidiary); Gordon, *supra* note 73, at 9 (criticizing the proposal for placing a burden on regulators to define the elements of the firm's capital structure that would be included in the compensation formula, while arguing that enterprise value is not trivial to measure and is not necessarily an effective instrument to change managerial conduct).

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structures,[75] or to regulators' encouraging "appropriate amounts of subordinated debt in bankers' pay arrangements, while at the same time preserving the discretion of boards of directors to set pay."[76]

3. On the Optimal Approach to Regulating Bankers' Pay

We argue in this Article that the case for regulating bankers' pay is weak, especially since it is far from proven that pay structures widely contributed to excessive risk taking before the recent crisis. According to some of the studies reviewed above, corporate governance and compensation structures at banks that failed were not necessarily flawed. Even assuming that compensation structures were flawed, the need for regulation would not automatically be established. On the contrary, we believe that mandating pay structures would hamper the flexibility of compensation arrangements, which need to be tailored to individual firms—according to their circumstances—and to individual managers in light of their personal portfolios of their banks' securities.[77]

In theory, regulators could devise different pay structures for different firms and situations, offering a menu of choices to supervised entities. However, this menu could hardly cover all situations that may exist in practice, while a broad set of choices would practically dilute the impact of regulation, an outcome that we would favor in principle. In addition, regulators may not be professionally qualified for designing pay structures and monitoring their implementation in practice. Moreover, banks' boards would partially lose one of their key governance functions—setting executive pay—finding it more difficult to align executives' incentives to corporate strategy and risk profile. This would also create problems in keeping and attracting managerial talent, particularly from countries that have adopted a more liberal stance or from firms that are not subject to such regulatory constraints (such as hedge funds or private equity groups).

No doubt, regulators should take managerial incentives into account when setting the standards for banking activities and organization and when supervising their implementation in practice from the perspective of bank safety and soundness. However, this should be done in ways that are appropriate for prudential regulation, which typically establishes conditions and limits to risk taking, rather

75. BOLTON ET AL., *supra* note 62, at 28; Bebchuk & Spamann, *supra* note 68, at 37.

76. Tung, *supra* note 72, at 49.

77. *Id.* at 48.

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than by fixing the incentive structures directly. Indeed, prudential regulation establishes the conditions for the performance of banking activities, such as capital adequacy requirements and limits to risk concentration, without mandating the structure and contents of the individual transactions.[78] Bankers' remuneration should be treated no differently. Rather than designing compensation structures, which is a matter for boards, regulators should analyze the impact of existing structures on risk taking and should conduct their supervisory action accordingly, for example, by imposing higher capital requirements to institutions adopting "aggressive" remuneration mechanisms.[79]

In addition, regulators could (and to a certain extent have done already)[80] establish requirements for the corporate governance of banks, including compensation governance, and for the disclosure of remuneration policies to investors and supervisors.[81] Rather than interfere with pay structures, this type of regulation aims to ensure that organizational structures and procedures are in place for the setting of pay in compliance with safety and soundness requirements. More generally, regulators should acknowledge that even good corporate governance may not be enough to avoid excessive risk taking

78. Regulation of structure and/or contents of transactions may be introduced for reasons other than prudential concerns, such as consumer protection. On the concept and scope of prudential regulation, see the introductory chapter in PRUDENTIAL REGULATION OF BANKS AND SECURITIES FIRMS: EUROPEAN AND INTERNATIONAL ASPECTS 3–25 (Guido Ferrarini ed., 1995).

79. The four key principles of supervisory review in the Second Pillar of Basel II reflect this. BASEL COMM. ON BANKING SUPERVISION [BCBS], INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2006), *available at* http://www.bis.org/publ/bcbs128.htm. In particular, Principle 3 (stating that supervisors should have the ability to require banks to hold capital in excess of the minimum) and Principle 4 (providing that supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank) promote such increased requirements. *Id.* at 757–60. Basel II also concluded that:

> Supervisors should consider a range of options if they become concerned that a bank is not meeting the requirements embodied in the supervisory principles outlined above. These actions may include intensifying the monitoring of the bank, restricting the payment of dividends, requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan, and requiring the bank to raise additional capital immediately. Supervisors should have the discretion to use the tools best suited to the circumstances of the bank and its operating environment.

Id. at 759.

80. BCBS, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE (2010), *available at* http://www.bis.org/publ/bcbs176.htm.

81. On the impact of remuneration disclosure on corporate governance, see Jeffrey Gordon, '*Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON. LEGIS. 323, 323–67 (2009).

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and therefore strengthen (as indeed they are doing)[82] the traditional tools of prudential supervision that have a direct impact on risk taking by banks (such as capital requirements and risk measurement criteria).

Given the political pressure to regulate executive pay arrangements at banks, which is further illustrated in Part II, we suggest that regulators—in addition to enforcing and strengthening the prudential regulation requirements along the above lines—could follow a soft approach to compensation standards by suggesting which structures, in their view, would hamper excessive risk taking by banks. From this perspective, the studies analyzed above offer useful insights to bank boards and supervisors, showing the pros and cons of different arrangements linking pay to the interests of depositors and other stakeholders.[83] It is also clear that similar recommendations from supervisors would help solve the collective action problems relative to the adoption of pay mechanisms that are not directly tied to wealth maximization purposes, and actually could run against the short-term expectations of shareholders.[84] However, we believe that the ultimate choice of pay structures should be left to the boards, which have better knowledge both of the individual banks' businesses and situations, and of their managers' portfolios of their respective bank securities.

II. POLITICS AND REFORMS: THE RISE OF INTERNATIONAL PRINCIPLES AND STANDARDS

The financial crisis has put the banking industry's compensation policies and incentive models under severe scrutiny from investors, regulators, politicians, and the wider public on both sides of the Atlantic. Two main problems have been discussed in the political arena. One is the level of remuneration at large banks, which appeared to be excessive in the United States and in Europe. The other is the remuneration structure, which, according to widespread

82. BCBS, ENHANCEMENTS TO THE BASEL II FRAMEWORK (2009), *available at* http://www.bis.org/publ/bcbs/basel2enh0901.htm.

83. Bebchuk & Spamann, *supra* note 68, at 253–54 (arguing that regulating bankers pay could well supplement and reinforce the traditional regulation of banks' activities: "Indeed, if pay arrangements are designed to discourage excessive risk taking, direct regulation of activities could be less tight than it would otherwise be").

84. *See* Gordon, *supra* note 73, at 6 (highlighting a particular sort of collective action problem in which the interest of the "large shareholder" (undiversified) minority can outweigh the interests of the "small shareholder" (diversified) majority; the author specifies that large shareholders could either be 'patient' shareholders or 'short-termist' hedge funds).

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opinion, may induce excessive risk taking and encourage short-termism. Social resentment focused on the former. Lavish compensation packages paid by banks, which governments subsequently had to rescue, amplified the social debate, often provoking a populist response by politicians. Regulatory concerns concentrated on the latter, regarding remuneration design as a main contributor to excessive risk taking by rewarding bankers for superior performance, while simultaneously not penalizing failure.[85]

In this Part, we first analyze the impact of the recent crisis on executive compensation at banks and the relevant regulations adopted in Europe. We then consider the rise of international principles and standards, which were influenced by the national measures adopted during the crisis, when governments had to rescue banks and restructure the same in order to assure the survival of the international financial system. We conclude with some critical remarks on these principles and standards in light of the economic studies reviewed in Part I of this Article.

A. The European Approach to Bankers' Pay Through the Crisis

After the EU Heads of State Summit in Paris in October 2008, central banks and governments implemented state aid measures aimed at safeguarding financial stability and restoring the viability of the EU banking sector.[86] Member States intervened not only to rescue distressed institutions from bankruptcy, but also to prevent further collapses that would have seriously affected the whole banking system

85. *See* DE LAROSIÈRE REPORT, *supra* note 26 (launching regulatory reform in the financial sector and providing a good overview on how financial institutions engaged in risky activities, creating perverse incentives, which eventually caused systemic failure; also offering an understanding of the measures that were taken afterwards by regulators to counteract risky incentives, in the area of remuneration structure and incentives' risk management); *see also* COUNTERPARTY RISK MGMT. POL'Y GRP., CONTAINING SYSTEMIC RISK: A ROAD TO REFORM (2008), *available at* http://www.crmpolicygroup.org/docs/CRMPG-III.pdf (concluding that compensation schemes in financial services were one of five primary driving forces of the financial crisis); Kevin J. Murphy, *Compensation Structure and Systemic Risk* (Marshall Sch. of Bus., Working Paper No. FBE 34–09, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1461944 (describing the ways in which compensation in the U.S. financial industry encouraged risk taking).

86. These measures included economic stimulus packages, injections of central bank liquidity, recapitalizations of financial institutions, guarantee schemes for certain types of financial activity and in particular inter-bank lending, asset disposals and "bad bank" solutions, and nationalization of distressed financial institutions, with a view toward restructuring and re-entry into the market. Communications and reports on the activities of the EU for 2008 and 2009 are available at *General Report on the Activities of the European Union*, EUROPA.EU, http://europa.eu/generalreport/en/2008/rg2.htm (last visited Jan. 20, 2011).

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and the real economy.[87] Several governments acquired shareholdings in financial institutions.[88] The level of involvement, its timing, and its exit strategies varied from country to country.[89] All of these measures were accompanied by the adoption of specific requirements concerning executive compensation at ailing banks that we examine below.

1. European Union

Financial institutions recurring to government protection benefited from a certain competitive advantage, which was counterbalanced by several conditions regarding compliance with several EU requirements: a restrictive policy on dividend payments, an increased solvency ratio, and limits to executive remuneration,

87. For an overview of Member States' rescue measures, including individual cases, see Press Release, European Comm'n, State Aid: Overview of National Measures Adopted as a Response to the Financial/Economic Crisis (June 29, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/305; Ana Petrovic & Ralf Tutsch, *National Rescue Measures in Response to the Financial Crisis* (European Cent. Bank, Working Paper No. 8, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=14304; *see also* Didier Martin, Olivier Saba & Forrest G. Alonga, *European Responses to the Financial Crisis*, LA SEMAINE JURIDIQUE (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1337586.

88. State intervention typically takes the form of public ownership or financial support through lending of last resort, taxpayers' money, or transfer of assets. State intervention falls, however, under the state aid regime and has to be communicated and examined by the Commission. *See generally* Elena Carletti & Xavier Vives, *Regulation and Competition Policy in the Banking Sector*, *in* COMPETITION POLICY IN THE EU: FIFTY YEARS ON FROM THE TREATY OF ROME 260 (Xavier Vives ed., 2007).

89. For instance, the U.K. government is a controlling shareholder in RBS and Lloyds, after bailing them out, and fully owns Northern Rock after its nationalization in 2008. The German state owns a significant stake in Commerzbank, whilst the French government has important stakes in BNP Paribas and Société Générale. As of July 2009, the U.K. government held a forty-three percent stake in Lloyds and a 70 percent stake in RBS. *See* U.K. FIN. INVS. LTD. (UKFI), UKFI STRATEGY: MARKET INVESTMENTS AND ANNUAL REPORT AND ACCOUNTS 2008/09, at 2, *available at* http://www.ukfi.co.uk/releases/UKFI%20Annual%20Report%202008-2009.pdf. The French government owned seventeen percent of BNP Paribas and 7.2 percent of Société Générale. *See, e.g.*, *BNP Paribas Launches €4.3bn Rights Issue*, DOW JONES NEWSWIRE, Sept. 29, 2009, http://www.efinancialnews.com/story/2009-09-29/bnp-paribas-launches-rights-issue; Scheherazade Daneshkhu, *French State is BNP's Bigger Investor*, FIN. TIMES, Apr. 8, 2009, at 16, *available at* http://www.ft.com/cms/s/0/587b82a6-23b9-11de-996a-00144feabdc0.html#axzz1AiQGH4xo; *French State Holds 17% of BNP Paribas: Regulator*, FIN. EXPRESS, Apr. 7, 2009, *available at* http://www.financialexpress.com/news/french-state-holds-17-of-bnp-paribas-regulator/444264/. The German government had a twenty-five percent stake in Commerzbank. *See* COMMERZBANK, ANNUAL REPORT 2009, *available at* http://annualreport2009.commerzbank.com/reports/commerzbank/annual/2009/gb/English/0/home.html. The Swiss government had nine percent of UBS and was the first European government to exit. *See* BANK FOR INT'L SETTLEMENTS (BIS), PAPERS NO. 48, AN ASSESSMENT OF FINANCIAL SECTOR RESCUE PROGRAMMES 27 (2009), *available at* http://www.bis.org/publ/bppdf/bispap48.htm.

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including bonuses.[90] Conditions with respect to executive pay initially targeted banks in which governments had a block-holding as a result of recapitalization schemes.[91] Government rules were subsequently extended to other financial institutions, often with the objective of applying them across the financial industry. Proposals for increased transparency, linking remuneration to performance and risk management, and strengthening shareholder rights were discussed globally.[92]

The European Commission initially issued standards on executive remuneration through several Communications related to national state aid. The Banking Communication, which set the framework for rescue operations finalized to prevent bank runs, prohibited management from retaining undue benefits, thereby empowering governments, inter alia, to intervene in remuneration.[93] The Recapitalization Communication, which set standards and safeguards for bank recapitalization to ensure adequate levels of lending to the economy, provided for limitations on executive remuneration and bonuses.[94] The Impaired Asset Communication, which offered the framework for removing toxic assets and

90. For more details on the conditions, see Martin et al., *supra* note 87.

91. Martin et al., *supra* note 87, at 18–20.

92. *See, e.g.*, TREASURY COMMITTEE, BANKING CRISIS: REFORMING CORPORATE GOVERNANCE AND PAY IN THE CITY, 2008–9, H.C. 519, at 8–32 (evaluating remuneration in the U.K. banking sector); *Communication from the Commission Accompanying Commission Recommendation Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies and Commission Recommendation on Remuneration Policies in the Financial Services Sector*, at 2–5, COM (2009) 211 final (Apr. 30, 2009) (evaluating and recommending remuneration policies to the EU financial sector); *Communication for the Spring European Council: Driving European Recovery, Volume I*, at 4–6, COM (2009) 114 final (Mar. 4, 2009) (identifying reforms to ensure that relevant actors are subject to appropriate regulation and oversight); PARL. EUR. DOC. (SEC 580) 3–4 (2009) (providing a detailed analysis of existing European remuneration policies and possible policy changes); DE LAROSIÈRE REPORT, *supra* note 26, at 29–31 (making recommendations for better aligning compensation incentives with shareholder interests); Pittsburgh Summit, Leaders' Statement (Sept. 24–25, 2009), *available at* http://www.pittsburghsummit.gov/documents/organization/129853.pdf (reviewing the progress of the financial recovery); Letter from Gordon Brown, Angela Merkel, and Nicolas Sarkozy to the Members of the European Council (Sept. 3, 2009), *available at* http://image.guardian.co.uk/sys-files/Politics/documents/2009/09/03/BrownMerkelSarkozy.pdf (issuing a joint statement prior to the Pittsburg Summit).

93. Communication from the Commission (EU), The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C 270) 8, 8–9.

94. Communication from the Commission (EU), The Recapitalization of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition, 2009 O.J. (C 10) 2, 8–9.

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underperforming loans, required caps on executive remuneration to be considered by banks applying for asset relief measures.[95]

2. Member States and Switzerland

EU Member States and Switzerland adopted different measures with respect to ailing banks, the relevant criteria of which often were followed by non-ailing banks.[96]

a. United Kingdom

The FSA was the first regulator to publish an industry-wide comprehensive Code on remuneration practices, which was initially aimed at banks in receipt of public funds[97] but subsequently was extended across the U.K. banking sector. The FSA review document issued in response to the crisis (the "Turner Review") highlighted remuneration as a major concern and included proposals that incentives be designed to avoid undue risk taking.[98] Indeed, the FSA

95. Communication from the Commission (EU), The Treatment of Impaired Assets in the Community Banking Sector, 2009 O.J. (C 72) 1, 6–7.

96. We refer to banks as "ailing" if they participated in any of the government rescue schemes in their home state; otherwise, we consider them as "non-ailing." *See* Guido Ferrarini & Maria Cristina Ungureanu, *Executive Pay at Ailing Banks and Beyond: a European Perspective* 5 CAPITAL MARKETS L.J. 197, 197–217 (2010) (analyzing ailing vs. non-ailing banks' remuneration policies).

97. In February 2009, the Financial Services Authority ("FSA") published its draft code on remuneration. FSA, FSA DRAFT CODE ON REMUNERATION PRACTICES (Apr. 2009), *available at* http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2009/cop_remun.shtml. The first revision of the Code was issued in March 2009. FSA, FSA DRAFT CODE ON REMUNERATION PRACTICES (rev. Mar. 18, 2009), *available at* http://www.fsa.gov.uk/pubs/other/remuneration.pdf. The first consultation was issued a few days later. FSA CONSULTATION PAPER NO. 09/10, REFORMING REMUNERATION PRACTICES IN FINANCIAL SERVICES (Mar. 2009), *available at* http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf. This was followed by a statement in August 2009, which reflected feedback from the consultation and an assessment of progress in international alignment. FSA POLICY STATEMENT 09/15, REFORMING REMUNERATION PRACTICES IN FINANCIAL SERVICES: FEEDBACK ON CP09/10 AND FINAL RULES (Aug. 2009), *available at* http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf. Through this statement, the FSA incorporated the Code into its Handbook for a group of the largest banks, building societies and broker dealers, taking effect on January 1, 2010. In its latest consultation paper, the FSA is broadening the scope of its Remuneration Code, from twenty-seven banks to more than 2,500 financial services companies, including the U.K. branches of many overseas businesses. FSA CONSULTATION PAPER 10/19, REVISING THE REMUNERATION CODE 20 (2010), *available at* http://www.fsa.gov.uk/pubs/cp/cp10_19.pdf.

98. FSA, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 7–9 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf. Following the banking crisis, the Chancellor of the Exchequer asked Lord Turner, in his capacity as FSA Chairman, to review and make recommendations for reforming U.K. and international approaches to the way banks are regulated.

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had been widely criticized for failing to spot the excessive risk taking that sparked the financial crisis. In this regard, the U.K. Treasury issued a report arguing that bonus-driven remuneration structures had encouraged reckless and excessive risk taking, contrary to the interests of shareholders and the long-term sustainability of the financial system.[99] The report questioned whether the FSA had attached sufficient priority to handling remuneration at financial institutions and suggested enhanced disclosure of remuneration structures and a greater role for remuneration committees. Furthermore, Sir David Walker's recommendations on corporate governance of banks and other financial entities attempted to increase awareness as to the importance of disclosure and governance of pay for U.K. banks.[100]

Upon rescuing two of the United Kingdom's main banks, Lloyds Bank ("Lloyds") and Royal Bank of Scotland ("RBS"), the U.K. government imposed specific conditions on remuneration policy.[101] Participation in the recapitalization scheme imposed an obligation on both banks to address the remuneration of senior executives. No cash bonuses were paid to board members for 2008. In the following years, incentives had to be reviewed and linked to long-term value creation, taking into account risks and restricting the potential of rewards for failure.[102] Participation in the Asset Protection Scheme carried additional conditions, such as implementing a remuneration policy consistent with the detailed principles set out in the FSA Code on remuneration practices, including a restriction on bonuses.[103] Following Lloyds and RBS, some large non-ailing banks adopted similar changes to their remuneration policies. In particular, Barclays,

99. TREASURY COMMITTEE, *supra* note 92, at 3. The Treasury defined the FSA's approach to remuneration prior to the crisis as "very modest." *Id.* at 19.

100. DAVID WALKER, HER MAJESTY'S TREASURY, A REVIEW OF CORPORATE GOVERNANCE IN BANKS AND OTHER FINANCIAL ENTITIES: FINAL RECOMMENDATIONS 106–07 (2009), *available at* http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

101. TREASURY COMMITTEE, *supra* note 92, at 34–37; Petrovic & Tutsch, *supra* note 87, at 84–85. The United Kingdom also fully nationalized two other banks, Northern Rock and Bradford & Bingley. However, limits to compensation were only set for Lloyds and RBS. *See* Ferrarini & Ungureanu, *supra* note 96, at 210 et seq. (describing the case studies of Lloyds and RBS).

102. Press Release, Her Majesty's Treasury, Statement on Financial Intervention to Support Lending in the Economy (Jan. 19, 2009), *available at* http://www.hm-treasury.gov.uk/press_05_09.htm.

103. Press Release, Her Majesty's Treasury, Statement on the Government's Asset Protection Scheme (Jan. 19, 2009), *available at* www.hm-treasury.gov.uk/press_07_09.htm.

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HSBC, and Standard Chartered adjusted their remuneration levels by reducing or waiving variable compensation.[104]

b. Germany

The German bailout measures were included in the Financial Market Stabilization Act of October 2008.[105] This was complemented by the Financial Market Stabilization Supplementary Act of April 2009, which paved the way for the nationalization of some German banks.[106] The Act established the Financial Markets Stabilization Fund ("SoFFin") with a temporary purpose.[107] In agreement with SoFFin, banks accepting stabilization aid were subject to restrictions on their compensation and dividend policies for the duration of the state aid, depending on the type and amount of aid received and their economic situation. Accordingly, these banks had to reexamine their compensation packages to ensure that overall compensation of board members and managing directors was reasonable, to limit monetary compensation to €500,000 per year, and to ban bonus payments and compensation upon termination.[108] The German restrictions on compensation were among the most restrictive globally.

Commerzbank became Germany's first commercial lender to turn to the government for capital—a total of €18 billion—transferring to the federal government a twenty-five percent stake plus one share. Its rescue was tied to strict restructuring conditions and to the above-mentioned limits on executive remuneration. Deutsche Bank,

104. *See infra* Figures 4–6.

105. Finanzmarktstabilisierungsgesetz [FMStG] [Financial Market Stabilization Act], Oct. 17, 2008, BGBL. I at 1982, n.46 (Ger.).

106. Finanzmarktstabilisierungsergänzungsgesetz [FMStErgG] [Supplementary Financial Market Stabilization Act], Apr. 7, 2009, BCBL. I at 725 (Ger.).

107. Financial Market Stabilization Act §§ 1–2 (Ger.). The SoFFin is managed through the Financial Market Stabilization Act and made €480 billion available to the country's financial institutions rocked by the global finance crisis. SoFFin was used to guarantee refinancing instruments (up to thirty-six months) issued by German banks until the end of 2009. German states were required to contribute financially to the stabilization fund, which also covered subsidiaries of foreign banks licensed in Germany. Possible measures included guarantees, recapitalizations, acquisition of risky positions and nationalization. *Id.*

108. *Id.* In addition, financial institutions had to review their business policies, avoid risky transactions, pay no dividends to shareholders and make no share re-purchases, nor capital reductions, except for reorganization purposes. Strengthening of capital was also required, as some banks—including Commerzbank, Deutsche Postbank and various Landesbanken—had tier-one capital ratios below the minimum of eight percent required by Basel. *See* Klaus J. Hopt et al., *Preventing Bank Insolvencies in the Financial Crisis: The German Financial Market Stabilisation Acts*, 10 EUR. BUS. ORG. L. REV. 515, 534–37 (2009) (providing a detailed analysis of the German bank rescue framework).

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Germany's largest bank, resisted pressure to take government aid. Nonetheless, the global trend toward crisis-conscious compensation principles also impacted Deutsche Bank, whose top executives decided to forgo 2008 bonuses as a signal of difficult times.[109]

c. France

The French banking model, which is traditionally heavily regulated, appears to have endured the crisis better than the traditionally liberal British model.[110] Banks applying for guarantee schemes or recapitalization measures had to comply with several conditions.[111] First, they had to agree with the government that they would keep financing the economy (in particular, by making loans available to small- and medium-sized firms). Second, they had to comply with certain requirements regarding executive pay, including those included in the AFEP-MEDEF guidelines.[112] More recently, executive compensation became one of the hottest topics in the French political debate. In March 2009 the French government responded to public outcry against ailing banks with a decree banning stock options and limiting bonuses for bankers who lay off workers after accepting

109. German labor unions manifested anger in the rising disproportion between manager and worker wages. *See, e.g.*, Hugh Williamson, *Merkel Ally Backs Curbs on Executive Salaries*, FIN. TIMES, May 22, 2008, at 2 (describing the critiques of labor union leaders).

110. The French action plan took the form of a refinancing scheme based on state guarantees granted in relation to debt securities issued by a refinancing company established for this purpose, the Société française de refinancement de l'économie ("SFRE"). This company also provided loans under certain conditions. Recapitalization measures were taken on the basis of state guarantees granted for the financing raised by a recapitalization company, the Société de prise de participation de l'Etat ("SPPE"). In addition, specific legislative provisions authorized the guarantees issued for rescuing Dexia. The French government effected bank recapitalizations, under the Bank Relief Act, Loi 2008–1061 du 16 octobre 2008 de finances rectificative pour le financement de l'économie [Law 2008-1061 of October 16, 2008 on Budgetary Provisions for the Financing of the Economy], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Oct. 17, 2008, with the aim of assuring banks' continuous financing of the real economy. *See* Martin et al., *supra* note 87. In December 2008, a first tranche of €10.5 billion was paid to six banks—BNP Paribas, Société Générale, Crédit Agricole, Caisse d'Epargne, Banque Fédérale des Banques Populaires and Crédit Mutuel—which issued deeply subordinated instruments. In 2009, a second recapitalization tranche was distributed to BNP Paribas and Société Générale in exchange of preferred non-voting shares. *See* Petrovic & Tutsch, *supra* note 87, at 30.

111. Rescue measures in France were essentially founded on Article 6 of the Law on Finance. Law No. 2008–1061 of Oct. 16, 2008, art. 6 (Fr.).

112. ASS'N FRANÇAISE DE ENTREPRISES PRIVÉES & MOUVEMENT DES ENTREPRISES DE FRANCE [AFEP-MEDEF], CORPORATE GOVERNANCE CODE OF LISTED CORPORATIONS 23–29 (2008), *available at* http://www.ecgi.org/codes/documents/afep_medef_code_dec2008_en.pdf.

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government aid.[113] The remuneration requirements were soon extended from ailing banks to the entire banking sector.[114]

d. The Netherlands

The Dutch government made available to the national banking and insurance industry a series of measures designed to ensure the stability of the financial system, including a guarantee scheme and recapitalization measures.[115] The guarantee scheme was limited to banks with a substantial business in the Netherlands. Banks wishing to use the guarantee had to comply with certain conditions regarding corporate governance and remuneration, among other things.[116] Fortis and ING were two of the largest Dutch banks that applied for the guarantee scheme.[117] The recapitalization scheme, based on a declaration made by the Dutch Minister of Finance, was subject to conditions limiting executive pay[118]: bankers needed to relinquish

113. In addition to the release of updated recommendations by the AFEP-MEDEF on executives pay, a series of professional rules relating to the compensation of financial market professionals were released. GROUPE DE TRAVAIL DE PLACE, FBF, RÉMUNÉRATION DES PROFESSIONNELS DES MARCHÉS FINANCIERS (2009), *available at* http://www.fbf.fr/Web /Internet2010/Content.nsf/DocumentsByIDWeb/877H3Y/$File/Rapport-remuneration-operateurs-marches.pdf. Drafted under the aegis of the Haut Comité de Place, these rules were a response to the conditions relating to the access to public financing, as they concerned the remuneration of both directors and market professionals.

114. Regulation n97–02 relating to internal control was first strengthened on January 14, 2009, requiring credit institutions and investment firms to have in place adequate internal control frameworks with respect to the remuneration policies (article 5 g). Regulation n97–02 was complemented a second time in November 2009. Arrêté du 3 novembre 2009 relatif aux rémunérations des personnels dont les activités sont susceptibles d'avoir une incidence sur l'exposition aux risques des établissements de crédit et entreprises d'investissement [Decree of Nov. 3, 2009 regarding remuneration for personnel whose activities might have the effect of placing credit institutions and investment firms at risk], Journal Officiel de la République Française [J.O.] [Official Gazette of France], Nov. 5, 2009 p. 19,115.

115. Ministerie von Financiën [Ministry of Finance], Rules of the 2008 Credit Guarantee Scheme of the State of the Netherlands, *available at* http://www.dsta.nl/dsresource?type=pdf &objectid=minfinbeheer:76729&versionid=&subobjectname= (promulgated Oct. 21, 2008, amended and restated Nov. 27, 2008).

116. Conditions include reporting requirements, maintenance of an agreed solvency ratio, prohibition of bylaw changes or changes in strategy, the implementation of a "sustainable remuneration policy" linked to long-term value creation and limiting "rewards for failure" and a requirement that severance, golden parachutes, or similar termination arrangements be limited to one year's fixed salary. Martin et al., *supra* note 87, at 11.

117. Petrovic & Tutsch, *supra* note 87, at 61.

118. Other conditions relate to guarantees on returns, the financing of operational costs by the financial enterprises concerned and government representation in the executive bodies. Among the Dutch banks Fortis, ING, Aegon and SNS Real were subject to recapitalization measures. *Id.* at 61–63.

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their bonuses for 2008 and redundancy packages had to be restricted to one year's fixed annual pay.[119] The Dutch government set further conditions for bankers' pay within its illiquid assets back-up facility.[120] Accordingly, financial institutions benefiting from the scheme could not pay bonuses until a new compensation policy was established.

e. Switzerland

The two largest Swiss banks, UBS and Credit Suisse, offer an example of voluntary changes to remuneration policies by showing a kind of "race to the top" in this area. The Swiss government took a nine percent stake in UBS when rescuing it, without imposing any executive pay restrictions. Nevertheless, UBS was among the first large European banks to address executive compensation in the wake of the crisis in 2008 by explicitly seeking to improve its corporate culture through a new compensation model.[121] The bank did not pay any bonuses to its executives for that year. Credit Suisse, which did not require financial assistance from the government, also banned bonuses, but only to its CEO and chairman.[122] However, despite emerging from the crisis as one of Europe's winning banks, Credit Suisse was the first bank to change its remuneration policy soon after, and in line with, the principles of the 2009 G20 Summit.[123] Following

119. Press Release, Ministry of Finance, Government Reinforces ING's Core Capital by € 10 Billion (Oct. 19, 2008), *available at* http://www.minfin.nl/english/News/Newsreleases/2008/10/Government_reinforces_ING's_core_capital_by_EUR_10_billion (Neth.).

120. Particularly in the case of ING Bank. BANK FOR INT'L SETTLEMENTS, *supra* note 89, at 22.

121. The bank considered its own approach as a "pioneering approach to executive compensation practices." The new compensation model implemented in 2009 included measures that were subsequently adopted globally by regulators: awards depending on the achievement of performance targets linked to long-term, risk adjusted value creation; three-year deferral period for bonuses; bonus-malus (clawback); performance equity plan linked to the performance of the bank for an initial three-year period; retention by executives of a minimum of seventy-five percent of their shares for five years; non-binding advisory vote on the principles of executive compensation. UNITED BANK OF SWITZ. (UBS), COMPENSATION REPORT 2008 at 1, 15–18 (2008), *available at* http://www.ubs.com/1/ShowMedia/investors/annualreporting/2008?contentId=162881&name=UBS_CompensationReport2008_e.pdf.

122. The bank maintained its approach to variable compensation, introducing only a few changes, such as introducing performance awards linked to the performance of a pool of illiquid assets and a clawback measure applied to a portion of the cash-based component. CREDIT SUISSE, *Compensation*, *in* ANNUAL REPORT 2008, at 171–78 (2008), *available at* https://www.credit-suisse.com/investors/en/reports/2008_annual_report.jsp.

123. The bank announced a shift in the mix of discretionary bonuses and fixed compensation, resulting in the payment of an increased proportion of compensation in the form of fixed salary and some restrictions to variable remuneration. It also devoted particular focus to measures for limiting and deferring compensation. Press Release, Credit Suisse, Credit Suisse Announces its

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Credit Suisse's approach, UBS also announced changes in its 2009 and 2010 pay policies, including payment of bonuses only when the bank returned to profit. The bank reported a loss for 2009, which held back the disbursement of the first tranche of its newly-adopted conditional variable compensation plan.[124]

f. Assessment

This brief overview on European countries shows that curbing bankers' pay was one of the main conditions for accessing state aid.[125] The financial crisis had a sharp impact on the levels and structure of pay at ailing banks, both in 2008 and in following years.[126] Non-ailing banks also experienced a similar impact, particularly in countries where big casualties occurred only at some large banking groups but stimulated public outrage against all banks.[127] Relatively healthy banks in those countries rushed to adopt "virtuous" remuneration policies similar to those implemented at banks accessing state aid in the same countries.

In addition to reacting to public outrage and political pressures, these banks presumably tried to show their commitment to risk management and control both to investors and regulators by changing their remuneration policies.[128] Domestic regulations followed a similar trajectory, initially focusing on bankers' compensation at rescued institutions and only later extending across national banking sectors. As a result, the lessons learned from the crisis rapidly extended to all banks, leading to the adoption of new remuneration policies, generally in conformity with emerging international standards.

Compensation Structure for 2009 and 2010 (Oct. 20, 2009), *available at* https://www.credit-suisse.com/news/en/media_release.jsp?ns=41331.

124. UBS introduced a new forward-looking compensation instrument for senior employees, a Conditional Variable Compensation Plan ("CVCP"). The CVCP had a pool of approximately SFr900 million to vest in three equal tranches in 2010, 2011, and 2012 on the condition that the group returned to profitability and received no further bailout from the Swiss government. Press Release, UBS, UBS' Compensation Decisions (Feb. 10, 2009), *available at* http://www.ubs.com/1/ShowMedia/index?contentId=161992&name=090210%20Compensation%20note_EN.pdf.

125. For similar developments in the United States, see Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-Term*, 7 EUR. COMPANY & FIN. L. REV. 273 (2010), *manuscript available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1506742.

126. *See infra* Figures 4–6.

127. *See infra* Table 2.

128. Ferrarini & Ungureanu, *supra* note 96, at 212.

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B. International Standards

Measures taken post-crisis by the relevant authorities are best encompassed in the Principles issued by the FSF—later changed to the FSB—in April 2009 and in the Standards adopted by the same body in September 2009.[129] In this Subpart, we analyze these Principles and Standards and offer a critical assessment of the same, in light of the economic literature.

1. International Principles and Standards

The FSB Principles and Standards address the areas of governance, remuneration structure, and supervision and disclosure. Some principles are not new to the extent that they require a balanced pay structure and long-term approach, alignment of pay with performance, independence of the pay-setting process, and compensation disclosure. What is relatively new is the emphasis on "effective alignment of compensation with prudent risk taking" and "compensation practices that reduce employees' incentives to take excessive risk."[130]

a. Remuneration Governance

The Principles require a bank's board of directors to actively oversee the compensation system's design and operation, requiring that relevant board members be independent and have expertise in risk management and compensation. They also require the board of directors to monitor and review the compensation system to ensure that it operates as intended. The compensation system should engage control functions (including human resources, finance, and risk management) in its decisions, while its practical operation should be reviewed regularly for compliance with design policies and procedures by the compliance and internal audit functions.[131]

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129. PRINCIPLES, *supra* note 2; STANDARDS, *supra* note 3. A task force was subsequently set up by the BCBS to take forward the implementation of remuneration principles, through issuing an assessment methodology targeted at supervisory authorities. The BCBS accordingly published a supervisory assessment methodology. BCBS, COMPENSATION PRINCIPLES AND STANDARDS ASSESSMENT METHODOLOGY (2010), *available at* http://www.bis.org/publ/bcbs166.pdf. The aim of the task force was twofold: to ensure that all supervisory authorities endorse remuneration policies that are consistent with the Principles, and to agree on common guidelines on how principles should be implemented in practice. *Id.* at 1.

130. BCBS, *supra* note 129, at 11.

131. PRINCIPLES, *supra* note 2, principles 1–2.

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The Standards specify that significant financial institutions should have a board remuneration committee to oversee the compensation system's design and operation on behalf of the board of directors.[132] The remuneration committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital, and liquidity. In addition, the committee should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. It should work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system and ensure that the firm's compensation policy is in compliance with the relevant principles and standards.

b. Compensation Structure

As to the alignment with prudent risk taking, the Principles state that compensation must be adjusted for all types of risk: "Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system[.]"[133] Risk adjustments should account for all types of risk, including those which are difficult to measure, such as liquidity risk, reputation risk, and capital cost.[134] The Standards also require "significant financial institutions"[135] to ensure that total variable compensation does not limit their ability to strengthen their capital base. Compensation outcomes should be symmetric with risk

132. STANDARDS, *supra* note 3, standard 1.

133. PRINCIPLES, *supra* note 2, principle 4.

134. For senior executives and employees whose actions have a material impact on the risk exposure of the firm, "a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm wide measures that adequately measure performance." STANDARDS, *supra* note 3, standard 6.

135. The Principles and Standards both use the term without providing any definition. However, the term probably includes institutions that are significant from a systemic risk perspective, for example, those that have a great systemic impact. *See generally* STAFF OF THE INTERNATIONAL MONETARY FUND & SECRETARIAT OF THE FINANCIAL STABILITY BOARD, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS—BACKGROUND PAPER (2009), *available at* http://www.financialstabilityboard.org/publications/r_091107d.pdf; Anthony Saunders et al., *Enhanced Regulation of Large, Complex Financial Institutions*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM, *supra* note 19, at 139 (discussing "large, complex financial institutions (LCFIs)," referring to the universal banks, investment banks, insurance companies, and hedge funds that dominate the financial industry and are deemed to pose risks that can become systemic).

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outcomes: in particular, compensation systems should link the size of the bonus pool to the overall performance of the firm; employees' incentive payments should be tied to the contribution of the individual and business to such performance; and bonuses should diminish or disappear in the event of poor firm, divisional, or business unit performance.[136] Furthermore, subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.[137]

Malus and clawback clauses are rather new in compensation contracts, although adjustments of incentives according to performance criteria were also made pre-crisis. These clauses are applicable to both cash incentives and share-based payments. They allow boards to reduce or reclaim bonuses paid based on results that are unrepresentative of the company's performance over the long term or later prove to have been misstated. Where cash incentives are deferred, unvested portions should be clawed back in the event of negative business performance. Not all regulations clearly differentiate between malus and clawback clauses, which are still relatively rare in practice.[138]

Deferment of compensation was traditionally used as a retention mechanism on the basis that a "bad leaver" will normally lose unpaid deferrals. Post-crisis reforms give deferral a greater role by providing that compensation payout schedules should be sensitive to the time horizon of risks. Therefore, as "profits and losses of different activities of a financial firm are realized over different periods of time, variable compensation payments should be deferred accordingly."[139] Payments should not be finalized over short periods where risks are realized over long periods. As specified by the relative standard, a substantial portion of variable compensation (such as, for example, forty to sixty percent) should be payable under deferral arrangements over a period of years, and these proportions should increase significantly with the level of seniority and/or responsibility. For most senior management staff and the highest-paid employees, the percentage of deferred variable compensation should be

136. PRINCIPLES, *supra* note 2, principle 5.

137. STANDARDS, *supra* note 3, standard 5.

138. *See infra* Part III.B.

139. PRINCIPLES, *supra* note 2, principle 6.

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substantially higher (for example, over sixty percent).[140] The deferral period "should not be less than three years, provided that [this] period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question."[141] Moreover, compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.[142]

"Guaranteed bonuses" caused much outrage following banks' bailouts.[143] Short-term guarantees are common at banks and are regarded as relatively harmless and often necessary to hire staff mid-year. Contracts guaranteeing variable pay for several years, however, are problematic, as they violate principles of pay-for-performance. The guarantee insulates variable pay from poor performance, which may encourage more risk taking than would otherwise be the case. Pre-crisis rules and standards did not touch upon this issue.[144] Under the FSB Standards, guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses "should only occur in the context of hiring new staff and be limited to the first year."[145]

Severance packages of senior executives fired as a result of their firms' crises also triggered public outrage for the excessive costs they imposed on shareholders.[146] Consequently, the future of

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140. STANDARDS, *supra* note 3, standard 6.

141. *Id.* standard 7.

142. *See id.* standard 9 ("In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.").

143. The issue was first raised in the United States by Bebchuk in an article published in the wake of post-crisis reform. *See* Lucian Bebchuk, Op-Ed., *Bonus Guarantees Can Fuel Risky Moves*, WALL ST. J., Aug. 27, 2009 (discussing risks of guaranteed bonuses); *see also* Ferrarini & Ungureanu, *supra* note 96.

144. *See* Ferrarini et al., *supra* note 5, at 8–10 (discussing how flawed compensation of executives contributed to the financial crisis).

145. STANDARDS, *supra* note 3, standard 11.

146. The issue of severance payments was dealt with by the European Corporate Governance Forum (ECGF). *See* EUROPEAN CORPORATE GOVERNANCE FORUM, STATEMENT OF THE EUROPEAN CORPORATE GOVERNANCE FORUM ON DIRECTOR REMUNERATION 3 (2009), *available at* http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-remuneration_en.pdf ("Severance pay for executive directors should be restricted to two years of annual remuneration and should not be paid if the termination is for poor performance. The two years restriction should not be circumvented by long notice periods or otherwise.") The European Commission also addressed this issue. Commission Recommendation Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies (EC) No. 2009/3177 of 30 Apr. 2009, § 3.5, 2009 O.J. (C 3177) [hereinafter EC C 3177] (regarding termination payments); Commission Recommendation on Remuneration

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severance pay has been changed by the new standards. Existing contractual arrangements related to employment termination should be reexamined and maintained only if there is a clear basis for concluding that the relevant payments are aligned with long-term value creation and prudent risk taking.[147] In perspective, termination payments should be related to performance achieved over time and "designed in a way that does not reward failure."[148]

The Principles further expand on remuneration structures by requiring the mix of cash, equity, and other forms of compensation to be consistent with risk alignment, adjusted according to the employee's position and role.[149] Moreover, under Standard 8, a substantial proportion (such as more than fifty percent) of variable compensation should be awarded in shares or share-linked instruments, as long as they create incentives aligned with long-term value creation and the time horizons of risk. In any event, awards in shares or share-linked instruments should be subject to an appropriate share-retention policy.

c. Disclosure

Pre-crisis compensation regimes, including those in Europe, largely focused on disclosure; however, their enforcement did not always meet the relevant standards.[150] Appropriate disclosure of remuneration in the firm's annual report should benefit not only shareholders but also other stakeholders (like creditors and employees). Disclosure should identify the relevant risk management and control systems and facilitate the work of supervisors in this area. The FSB Principles recommend increased transparency by adding new items of disclosure. In line with the detailed requirements for pay design, new disclosure requirements include deferral, share-based incentives, and criteria for risk adjustment.[151]

Policies in the Financial Services Sector (EC) No. 2009/3159 of 30 Apr. 2009, § 4.5, 2009 O.J. (C 3159) [hereinafter EC C 3159] (addressing payments for early termination of a contract).

147. However this is not seen as overruling existing contracts, rather an invitation from the supervisors to the parties to review any existing contracts that do not meet new standards.

148. STANDARDS, *supra* note 3, standard 12.

149. PRINCIPLES, *supra* note 2, principle 7.

150. *See* Ferrarini et al., *Executive Remuneration in Crisis*, *supra* note 20, at 105–06 (discussing low levels of compliance with disclosure requirements in certain European countries).

151. STANDARDS, *supra* note 3, standard 15.

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d. Supervision

The Principles also require effective supervisory oversight.[152] In the case of a failure by a firm to implement "sound" compensation policies and practices, "prompt remedial action" should be taken and "if necessary, appropriate corrective measures to offset any additional risk that may result from non-compliance or partial compliance [with the Standards]."[153] The FSB's Commentary on the Principles explains what these measures might be by stating, with reference to Principle 8: "Particularly when the totality of a firm's compensation practices are less than sound, supervisors should first exercise suasion on the affected firm, and in the absence of necessary improvement should consider escalation to firmer intervention, which may include increased capital requirements."[154] This approach is consistent with our call for a softer role for regulation of bankers' pay, in contrast to the approach implied by scholars who propose that regulators mandate a given structure of compensation in order to reduce risk taking by the managers.[155]

2. A Critical Appraisal

The FSB Principles incorporate some traditional corporate governance standards, like those concerning the strategic and supervisory role of the board, which also apply to the setting and monitoring of executive pay arrangements. Additionally, the Principles reflect the post-crisis emphasis on bank risk management and monitoring by the board of directors, who should determine the risk appetite of the firm. The Standards reiterate the role of the remuneration committee in the setting and overseeing of executive pay, requiring its members to work with the firm's risk committee to ensure compliance with the relevant requirements. On the whole, the focus placed by the Principles and Standards on "effective governance of compensation" deserves approval and reflects a consolidated trend

152. PRINCIPLES, *supra* note 2, principle 8 ("Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.").

153. STANDARDS, *supra* note 3, standard 18.

154. PRINCIPLES, *supra* note 2, at 14.

155. *See supra* Part I.3.

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in bank regulation in acknowledging the role of corporate governance for financial stability purposes.[156]

a. Reference to Pre-crisis Best Practices

Compensation structures are considered by the Principles along lines that reflect, to a large extent, best practices already found before the crisis.[157] Indeed, the role and limits of equity-based compensation, as well as the perverse effects of short-term incentives, have attracted increasing attention in the last twenty years, particularly after Enron and other accounting scandals that occurred at the beginning of this century.[158] However, the main focus of discussion has always been on the alignment of managers' incentives with shareholder wealth maximization. The FSB Principles break new ground by emphasizing the alignment of compensation with prudent risk taking, as a result of the recent crisis and the problems of ailing banks.

Aligning bank managers' interests with the interest of stakeholders was also pursued to some extent before the crisis through compensation structures that included long-term incentives and stock-based compensation.[159] In particular, the requirement that compensation include a mix of cash, equity, and other forms of compensation consistent with risk alignment,[160] to some degree reflects pre-crisis best practices, as shown by the remuneration policies for 2007 of the European large banks that we analyze below.[161]

156. *See* BCBS, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS 4 (2006), *available at* http://www.bis.org/publ/bcbs122.pdf ("Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole."); BCBS, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS 5–9 (1999), *available at* http://www.bis.org/publ/bcbs56.pdf (discussing mechanisms of corporate governance that can enhance financial stability); *see also* BCBS, *supra* note 80, at 1 ("Given the important financial intermediation role of banks in an economy, the public and the market have a high degree of sensitivity to any difficulties potentially arising from any corporate governance shortcomings in banks.").

157. *See* Ferrarini et al., *supra* note 20, at 115–18 (discussing aspects of the Principles that are based on pre-crisis practices).

158. *See* Bhagat & Romano, *supra* note 125 (manuscript at 6–7) (discussing the impact of corporate accounting scandals on equity- and option-based compensation).

159. *See infra* Part III.B (describing compensation plans at large European banks), and *supra* Part I.B (studies describing compensation plans for US banks).

160. PRINCIPLES, *supra* note 2, principle 7.

161. *See infra* Part III.B.

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b. Prevention of Excessive Risk Taking

As clarified in their Introduction, the Principles should not be viewed as too prescriptive.[162] They are flexible enough to accommodate differences between firms and among managers within the same firm. Even the requirement to treat differently "two employees who generate the same short-run profit but take different amount of risk on behalf of their firm"[163] should not be construed too literally. While compensation structures and amounts should reflect differences in risk taking, other factors that justify similarities in pay, such as the need to promote new businesses within the firm or to attract new talent, could also be considered.[164]

The FSB's ultimate goal is to prevent excessive risk taking by reducing incentives created by remuneration arrangements to do so. It is implicit in the Principles that a bank's board should pursue a similar objective when setting and monitoring executive pay. Directors should check that compensation arrangements do not lead the bank's managers to excessive risk taking. This could become, under applicable law, a discrete duty of directors, who will be accountable to supervisors for compliance with this duty. However, the difficulties in defining "excessive risk-taking incentives" should not be underestimated.[165] Moreover, one should consider that "taking on the right amount of investment and operating risk is essential to successfully compete within any industry, and that even creditors want firms to prudently take on some risk."[166]

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162. *See* PRINCIPLES, *supra* note 2, intro. ("The Principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are not intended to prescribe particular designs or levels of individual compensation. One size does not fit all—financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking."); *see also* BCBS, *supra* note 129, at 22 ("The mix of cash, equity and other forms of compensation [e.g. options] must be consistent with risk alignment. The mix will vary depending on the employee's position and role [in the bank].").

163. PRINCIPLES, *supra* note 2, principle 4.

164. This may explain why Principle 4 has been slow to be implemented. *See also* Eric Dash, *Feds Finding Status Quo in Bank Pay*, N.Y. TIMES, June 9, 2010, at B1 (noting that "banks tend to set similar bonus formulas for broad sets of employees and often do not adjust payouts to account for risks taken by traders or mortgage lending officers").

165. One should first identify what are "appropriate" risk-taking incentives. *See* John E. Core & Wayne R. Guay, Is There a Case for Regulating Executive Pay in the Financial Services Industry? 26 (Jan. 25, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544104 (explaining that similar incentives "generally stem from non-linearities in compensation payoffs, whereby the sensitivity of payoffs on the downside is lower than the sensitivity of payoffs to the upside").

166. *Id.* at 25.

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As discussed above, the Standards attempt to provide some guidance with regard to the equity portion of variable compensation.[167] However, this can also be problematic. In fact, the incentives deriving from equity-based compensation depend on the individual executives' portfolios of securities of their respective banks.[168] In the case of executives holding substantial equity stakes in their companies, as observed for U.S. banks, stock-based compensation could "exacerbate" the incentive alignment problems.[169] As a result, the standard in question should be applied, taking into account the managers' equity holdings in their firms (which are in any case lower for European banks).[170] Interestingly, neither the Principles nor the Standards attach detailed requirements to the vesting conditions of stock options and stock grants.[171] Moreover, banks are asked to establish a share-retention policy. While the terms of this policy must be disclosed in the annual report on compensation, banks are free to set these terms as they see fit.[172]

c. Deferment as a Key Principle

Deferment of variable compensation is critical to controlling risk-taking incentives. Bolton, Mehran, and Shapiro conducted empirical research on the link between deferred compensation at

167. STANDARDS, *supra* note 3, standard 8.

168. *See* Tung, *supra* note 72, at 54 (noting the "strong influence that managers' personal portfolios exert on their risk taking incentives").

169. *Id.* at 26. On the so called "Fuld problem" (after the name of Lehman's CEO, who held a large equity stake in Lehman until the time of bankruptcy), Gordon noted that a key systemic risk problem at Lehman and Bear Stearns was that, when these firms ran into financial difficulties, their "executives' large equity stakes created an ever-widening gap between their interests and the interests of nonmanagerial shareholders (as well as the social interest)." Gordon, *supra* note 73, at 2. In fact, these executives "would face a much greater proportionate wealth loss than a diversified shareholder from a dilutive capital raise or sale," whereas "a diversified shareholder would face a much greater proportionate wealth loss from the systemic distress that would follow the failure of a systemically important firm." *Id.*

170. *See infra* Part III.

171. *See* FSB, THEMATIC REVIEW ON COMPENSATION: PEER REVIEW REPORT 10–11 (2010) [hereinafter THEMATIC REVIEW], *available at* http://www.financialstabilityboard.org/publications/r_100330a.pdf (noting that some jurisdictions ask financial institutions to specify the proportions of deferment and the vesting period). For instance, some jurisdictions ask "whether it is intended that the total deferral period should be at least three years, but that part of an award may vest sooner (as soon as one year) albeit no faster than on a pro-rata basis." *Id.* at 10 n.13.

172. STANDARDS, *supra* note 3, standard 15. For a proposal to issue restricted stock for a relatively long holding period (from two to four years after employment ends), see Bhagat & Romano, *supra* note 125, (manuscript at 14).

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banks and credit quality and found that disclosure of deferred compensation is priced in credit markets through a reduction in CDS spreads at proxy announcements.[173] They explain this reduction by arguing that "banks are likely to be more conservative in terms of the riskiness of their investment choices" as a result of larger investments in CEO deferred compensation.[174] As we show in our analysis of remuneration policies at large European banks, deferment is one of the aspects of variable remuneration more frequently found in 2007 and on the rise after the crisis.[175] This trend is also true for regulations in force in the various countries examined below, where deferment is the principle with which legislation, best practices, and prudential guidelines most often comply.[176] However, the detailed requirements for deferment, such as the percentage (forty to sixty) of variable remuneration that it should cover and the time of deferral (minimum three years) may appear too rigid, as this is an area which should be left to bank boards to decide.

III. IMPLEMENTATION OF THE INTERNATIONAL STANDARDS IN EUROPE

In this Part, we examine how the FSB Principles and Standards were implemented in Europe. We also review the remuneration policies of forty large European banks to assess their compliance with the new standards and compare pre-crisis (2007) and post-crisis (2009) policies to identify trends and developments. We conclude by explaining the banks' relative resistance to the adoption of the new standards.

A. European Reforms

We initially provide an overview of the European pre-crisis approach to executive compensation at banks; this approach was mainly grounded on corporate governance and disclosure, even though the amount of information published was still subject to substantial differences among Member States. We then consider recent reforms, which mainly were adopted in light of the new international Standards, and measure their level of conformity with the new Standards. We find that the Standards have only been partially

173. BOLTON ET AL., *supra* note 62, at 27.

174. *Id.*

175. *See infra* Table 1 and Figures 1–3.

176. *See infra* Table 1 and Figures 1–3.

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implemented through national reforms and identify the level of conformity with respect to the main Principles and Standards.

1. Pre-crisis Approach

The European Commission issued two Recommendations ("2004-2005 Recommendations") aimed at improving remuneration governance and disclosure in 2004 and 2005, respectively.[177] A number of directives adopted under the Financial Services Action Plan also form part of the EU's executive compensation package, addressing pay transparency and insider-dealing issues.[178] Research conducted by Niamh Moloney and one of us on the Member States' laws and practices prior to the 2004-2005 Recommendations showed a correlation between incentive pay, its regulation, and corporate ownership structures. It also found less sophisticated regulation of executive pay in block-holding systems and a closer focus on the effectiveness of governance and the pay-setting process in dispersed ownership countries.[179]

Following the 2004 and 2005 reforms, we examined the extent to which regulation of executive pay adopted by listed companies had changed and assessed the effectiveness of the Commission's voluntary convergence model.[180] We based our analysis on the legal regimes of

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177. *See* Commission Recommendation: Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies (EC) No. 2004/913 of 14 Dec. 2004, 2004 O.J. (L 385/55) [hereinafter EC C 913] ("Remuneration systems should therefore be subjected to appropriate governance controls, based on adequate information rights."); Commission Recommendation on the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board (EC) No. 2005/162 of 15 Feb. 2005, 2005 O.J. (L 52/51) [hereinafter EC C 162] (listing, as one of its main objectives, "adapting company law and corporate governance rules appropriately for different categories of company").

178. The Transparency Directive requires annual disclosure concerning remuneration policies, total remuneration paid, any contingent or deferred compensation, and benefits in kind granted to each member of the administrative, management or supervisory bodies. Council Directive 2004/109, On the Harmonisation of Transparency Requirements, 2004 O.J. (L 390/38) (EC). The Accounts Modernization Directive encourages consistency across Member States in the level of narrative reporting presented in the annual report. The Market Abuse Directive requires senior executives to notify their share transactions and prohibits insider dealing. Council Directive 2003/51, Amending Directives, 2003 O.J. (L 178/16) (EC). The Prospectus Directive governs disclosure concerning certain share offerings, including employee share plans. Council Directive 2003/71, On the Prospectus, 2003 O.J. (L 345/64) (EC).

179. *See* Guido Ferrarini & Niamh Moloney, *Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 267 (Guido Ferrarini et al. eds., 2004); Guido Ferrarini et al., *Executive Pay: Convergence in Law and Practice Across the EU Corporate Government Faultline* , 4 J. CORP. L. STUD. 243 (2004).

180. Ferrarini et al., *supra* note 5, at 4; Ferrarini & Ungureanu, *supra* note 96.

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seventeen Member States and the governance and disclosure practices of the EU's largest public companies.[181] Our sample of listed companies included forty-eight banks, which were significant in their home states and generally had complex organizational structures and cross-border operations.

Our results did not reveal major differences in disclosure practices between banking and non-banking firms, consistent with other studies.[182] A possible explanation of this result is that pre-crisis regulation did not differentiate between financial and non-financial firms. Similar to non-financial firms, most banks complied only with basic requirements, particularly when room was left for discretion.[183] Banks focused primarily on core disclosure requirements, while information related to important details, such as the link between performance and variable pay, often was missing from the reports. Presumably, market pressure for more comprehensive disclosure was limited.

Nearly all banks had a remuneration committee, which did not always consist of a majority of independent directors. This trend can be explained by more general differences in governance structures as reflected by domestic corporate governance codes.[184] Levels of disclosure, particularly with respect to remuneration policy, were different across states and individual firms. Some banks were more transparent on individual pay rather than on remuneration policy; others had the opposite approach. With the exception of the United Kingdom, most European banks lacked comprehensive disclosure. Elements of their remuneration policies were scattered throughout their annual reports, making it difficult to properly assess their remuneration systems. Generally, banks did not provide enough details regarding the terms of contracts, while their decisionmaking

181. Research was based on public disclosures by members of the FTSEurofirst 300 relating to 2007; data was provided by FTSE (U.K.) upon direct request.

182. *See* Adams, *supra* note 37 (finding that the governance of financial firms is, on average, not obviously worse than in nonfinancial firms, and even the issue of executive compensation is not as clear-cut as portrayed by the media).

183. For analysis of the implementation of European Community rules in Member States, see Ferrarini et al., *supra* note 5, at 6.

184. For example, German banks do not have separate remuneration committees; the German Corporate Governance Code, whilst recommending the presence of a special committee that deals with the remuneration of directors, requires not majority independence of its membership but rather what the supervisory board "considers an adequate number of independent members." DEUTSCHER CORPORATE GOVERNANCE KODEX [DCGK] [GERMAN CORPORATE GOVERNANCE CODE], Feb. 26, 2002, ELEKTRONISCHER BUNDESANZEIGER [EBANZ.] § 5.4.1, *available at* http://www.corporate-governance-code.de/index-e.html.

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processes often lacked clarity.[185] Moreover, few banks adopted, or at least disclosed, a forward-looking remuneration policy. Our study concluded by recommending that the EU regulate disclosure through a directive.[186]

2. Post-crisis Reforms

The European Commission sought to address the problems of poorly designed executive compensation structures by issuing two Recommendations in 2009 ("2009 Recommendations"), one on the remuneration of directors of listed companies and the other on remuneration policies in the financial services sector.[187] While the 2004-2005 Recommendations focused on governance structures and disclosure,[188] the 2009 Recommendations seek to address the design of pay packages and remuneration policies.[189] In the same period, the Committee on European Banking Supervisors ("CEBS") also

185. Policy disclosure should focus on company policy for the following financial year and subsequent years (where appropriate) and overview the manner in which policy has been implemented in previous years. It should include: [1] an explanation of the relative importance of the variable and non-variable components of directors' remuneration; [2] sufficient information on the performance criteria on which shares or variable compensation is based; [3] sufficient information on the linkage between remuneration and performance; [4] the main parameters and rationale for any annual bonus scheme and non-cash benefits; [5] a description of the main characteristics of supplementary pension or early retirement schemes; [6] a summary of company policy on directors' contracts, including the terms and duration of contracts and provisions for termination payments; and [7] a discussion of the decisionmaking process used for determining the remuneration policy. *See* EC C 913, *supra* note 177, at 3 (presenting "Disclosure of the Policy on Directors' Remuneration").

186. *See* Ferrarini & Ungureanu, *supra* note 96, at 114–16. At the same time, the European Commission in its 2009 evaluation finds that endorsement of the disclosure provisions of the 2004 Recommendation has increased and that, indeed, there is also a trend among Member States to regulate these issues in a binding way. The report refers to firms across sectors. *Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee, and the Committee of the Regions on the Application by Member States of the EU of the Commission 2009/385/EC Recommendation*, COM (2010) 285 final (Feb. 5, 2010) [hereinafter *Report on the Application of 2009/385*], *available at* http://ec.europa.eu/internal_market/company/docs/directors-remun/com-2010-285-2_en.pdf; *Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions on the Application by the Member States of the EU of the Commission 2009/384/EC Recommendation on Remuneration Policies in the Financial Sector*, COM (2010) 286 final (Feb. 6, 2010) [hereinafter *Report on the Application of 2009/384*], *available at* http://ec.europa.eu/internal_market/company/docs/directors-remun/com-2010-286-2_en.pdf.

187. EC C 3177, *supra* note 146; EC C 3159, *supra* note 146.

188. EC C 913, *supra* note 177; EC C 162, *supra* note 177.

189. *See* Ferrarini et al., *supra* note 5 (providing a critical analysis of the Commission's Recommendations); Ferrarini & Ungureanu, *supra* note 96 (further critical analysis).

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developed principles on remuneration policies applicable across financial institutions.[190] In 2010, the Commission published a report on Member States' application of the 2009 Recommendations, showing that it had been neither uniform nor satisfactory.[191]

As a result, the Commission decided to issue principles on remuneration in financial institutions through a directive, including them in the revised Capital Requirements Directive ("CRD III").[192] The CRD III requires banks to have remuneration policies accounting for risk management and subject to supervisory review.[193] Furthermore, under the CRD III the CEBS issued guidelines on sound remuneration policies in the financial sector in order to facilitate implementation.[194]

Through the CRD III, the Commission aims to increase EU compliance with, and even go beyond the FSB Principles and Standards in Europe, by introducing more rigidity in pay structures. The criticism that we suggested above—that detailed regulation of executive pay would undermine the flexibility of pay arrangements, which is needed in the context of complex financial organizations—applies as a result.[195]

Before the crisis, most EU Member States already had some form of corporate governance code or legislation covering executive

190. Directive 2010/76/EU, of the European Parliament and of the Council of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC as Regards Capital Requirements for the Trading Book and for Re-securitisations, and the Supervisory Review of Remuneration Policies, 2010 OJ (L329/3).

191. *Report on the Application of 2009/385*, *supra* note 186, at 3–4. In particular, at the time only sixteen Member States took measures to fully or partially promote the application of the Recommendation on remuneration policy in the financial sector at the national level. The remaining eleven countries did not adopt any national measures or were in the process of doing so. As to the general Recommendation on directors' pay, only ten Member States implemented more than half of its provisions.

192. *Proposal for a Directive of the European Parliament and of the Council Amending Directives 2006/48/EC and 2006/49/EC as Regards Capital Requirements for the Trading Book and for Re-securitisations, and the Supervisory Review of Remuneration Policies*, COM (2009) 362 final (July 13, 2009).

193. Article 22 of the revised CRD lays down the cardinal principle whereby banks are required to ensure that their remuneration policies and practices are consistent with their organizational structure and promote sound and effective risk management. According to Article 54, competent authorities shall "have the power to impose financial and non-financial penalties or measures." *Id.* arts. 22, 54.

194. COMMITTEE OF EUROPEAN BANKING SUPERVISORS [CEBS], CONSULTATION PAPER NO. 42, GUIDELINES ON REMUNERATION POLICIES AND PRACTICES (2010), *available at* http://www.eba.europa.eu/documents/Publications/Consultation-papers/2010/CP42/CP42.aspx. The CEBS has become the European Banking Authority.

195. *See supra* Part I.B.3.

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remuneration. Many of the existing corporate governance codes, which generally apply only to listed companies, were revised in light of the new global standards. The primary target of recent national reforms, however, is the financial sector, with respect to which recourse to legislation is on the rise.

An analysis of the remuneration reforms implemented by individual Member States during 2010 reveals some common features, particularly with regard to the core principles, while more significant variations are found in the detailed requirements. We analyze twenty-five texts issued by the European Commission and by regulatory authorities from eight jurisdictions selected for having adopted specific measures to implement the international standards, including laws, corporate governance codes, and guidelines by financial supervisors. Annex 1 provides a list of these regulations, which are classified as either binding or nonbinding.[196] We benchmark these texts against twenty-five international principles and standards grouped in three areas: remuneration governance, pay structure, and disclosure. Annex 2 presents the criteria considered in our assessment.[197] Annex 3 includes a matrix giving a clear picture of the mix of regulations adopted in each of the major European markets post-crisis.[198] Figure 1 provides an overview of the implementation of the international principles and standards in the eight countries and twenty-five texts examined.[199] The highest level of implementation has been achieved in the area of remuneration governance,[200] while principles related to remuneration structure and its disclosure met lower adoption. Nevertheless, we note a trend toward increased requirements for disclosure of remuneration compared to our pre-

196. Recommendations issued by the European Commission, such as, for example, the Commission Recommendations cited *supra* note 146, are also considered among the benchmarked positions. The other eight benchmarked jurisdictions are: the United Kingdom, Germany, the Netherlands, Italy, France, Switzerland, Belgium, and Sweden.

197. In grouping the criteria, we closely followed the categorization employed by the BCBS in its Methodology Assessment, which, more specifically, defines the supervisory review framework with regard to the three issues addressed by the FSB Principles: (i) effective governance of compensation, (ii) effective alignment of compensation with prudent risk-taking, and (iii) effective supervisory oversight and engagement by stakeholders. BCBS, *supra* note 129, at 1. For the specific twenty-five criteria we closely followed the global measures adopted by the FSB Principles and Standards.

198. The matrix provides a breakdown of the type of rules (for example, law, best practices, and guidelines issued by the financial supervisor) and states the scope for each of these rules.

199. The graph depicts the frequency of each criterion in the analyzed regulatory texts.

200. As per Annex 2, the governance area includes criteria relative to the existence of a remuneration committee, its independence, the responsibility of the board in the pay process, and the independence of risk control functions.

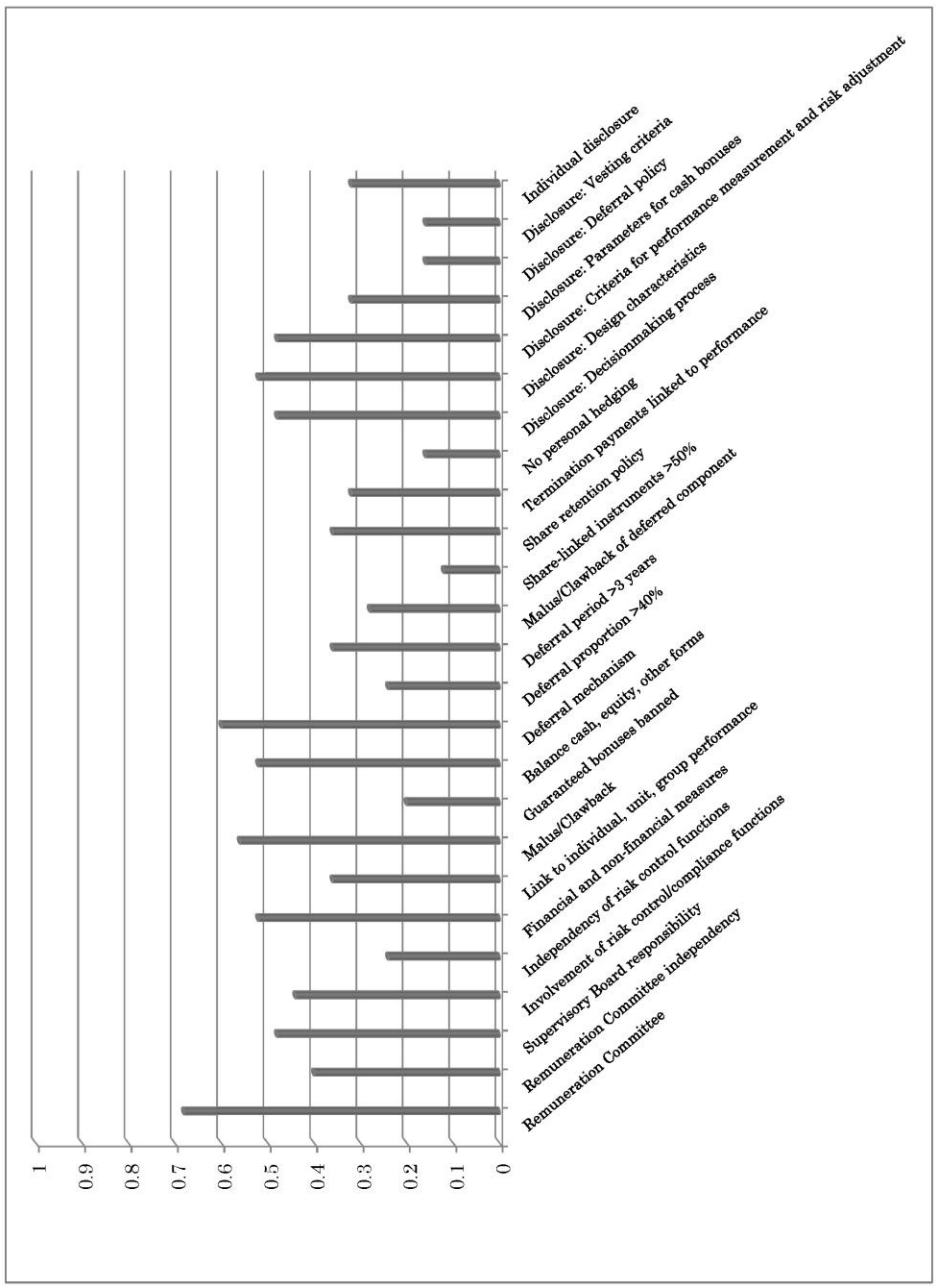
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crisis assessment. As to pay structure, the highest level of implementation occurred with respect to deferral, the balance between fixed and variable pay, and the requirement for financial and non-financial performance criteria; limits on guaranteed bonuses and criteria regarding share-linked instruments have not met much support among the jurisdictions.[201] Disclosure measures regarding pay design characteristics and pay process are better implemented.

201. The European Commission and FSB evaluation reports similarly point out better levels of adoption of principles related to remuneration governance. Concerning the remuneration structure, they also reveal some progress in the area of adjusting pay structures with risk management through deferral mechanisms, recognizing however that further work is needed to raise standards of risk adjustment of pay structures across the banking industry. *See, e.g.*, *Report on the Application of 2009/385*, *supra* note 186, at 8 (noting the need for further reform). The FSB, reporting on several countries also outside the EU, emphasizes the more pronounced differences in implementing its principles, for example by way of enforcing them through legally binding requirements—in some countries—whilst in others implementation is by way of supervisory guidance. THEMATIC REVIEW, *supra* note 171, at 6.

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Figure 1. Implementation of the International Principles



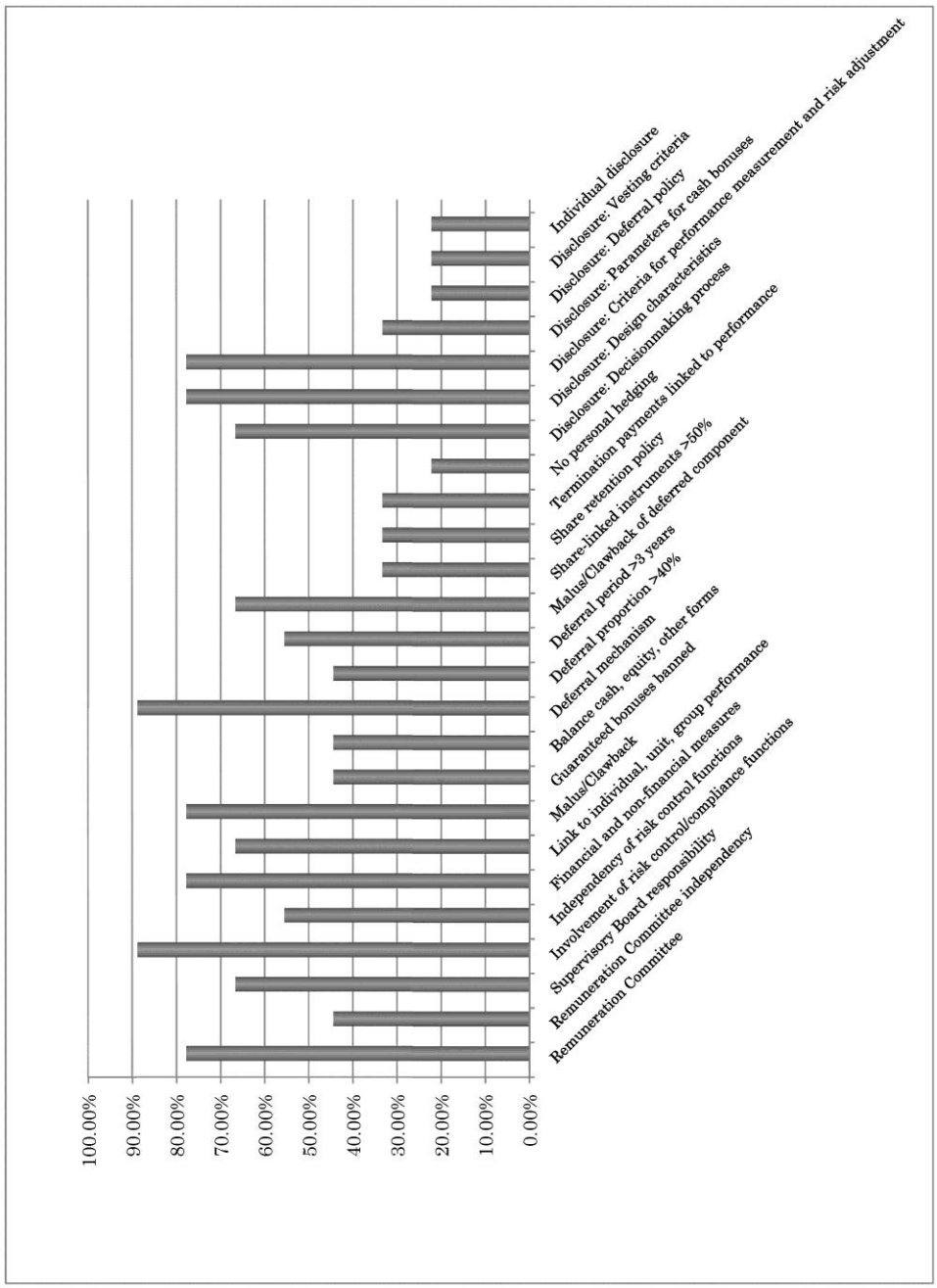
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In order to specifically assess the principles and standards adopted by national supervisory authorities, in a second stage of our analysis we do not consider the corporate governance codes and laws, which apply to all listed companies, including non-financial firms. We examine, among the twenty-five texts analyzed, the nine regulations issued by financial supervisors, illustrating the results in Figure 2. In line with our first assessment, remuneration governance principles achieved the highest level of implementation, whereas disclosure had the lowest level. As to governance, the standards most complied with are those concerning the role of the risk management and compliance functions in the remuneration system. Regarding pay structure, the principle most often complied with is deferment of variable pay. As to disclosure, two requirements come up most frequently in regulations: those concerning the design characteristics and the criteria for pay measurement and risk adjustment.[202]

202. In line with our observations, both the FSB and the Commission evaluation reports reveal an improvement in requiring minimum standards for disclosure, however noting a lower endorsement of principles concerning detailed disclosure, particularly with respect to incentive structures. *See Report on the Application of 2009/385*, *supra* note 186, at 8 ("[E]ndorsement of the disclosure and shareholder vote provisions of the 2004 Recommendation has increased significantly in recent years."); THEMATIC REVIEW, *supra* note 171, at 10 (noting that "[s]everal jurisdictions have incorporated deferral and malus features into their (existing or planned) regulatory frameworks").

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Figure 2. Implementation of the International Principles by Supervisory Authorities



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B. The Remuneration Policies of Large European Banks

In this Subpart, we compare large European banks' remuneration policies as established before the crisis (2007) with the policies adopted following the post-crisis reforms (2009). We take our sample from two indexes, FTSEurofirst300 and Dow Jones Stoxx 600 Banks.[203] We overmatch the two indexes and select a sample of forty banks, which are representative of the major listed EU banks in terms of market capitalization. The list is provided in Annex 4.

We consider twenty-three banks in our sample as "ailing," on the basis of the fact that they received some form of government support during the crisis, and the remaining seventeen banks as "non-ailing." We analyze the remuneration policies applied by these banks in 2007, which reflect their approach before the crisis, and the standards adopted or carried over after the crisis, in 2009. We mainly rely on the FSB Principles as benchmarks for our assessment, as in major part they have been followed by the European Commission's regulatory framework. Some of the principles had already been stated before the crisis, primarily in corporate governance codes, although in a generic manner.[204]

Annex 5 identifies the criteria used in our analysis. Considering that annual reports on compensation should include, under the applicable rules, comprehensive information on the relevant decisionmaking process and the main design characteristics, we assume that banks behaved *de facto* as described in their remuneration policy. If an item is not reported, we consider it to be non-applicable.

More than half of all banks (62.5 percent) reviewed their remuneration policies in light of the new international Principles. Some banks underwent major changes to their pay structure, while others experienced only minor changes, either to the pay structure or to their decisionmaking process. Most banks made amendments in

203. We have used the FTSEurofirst 300 in a previous study, when analyzing banks' approach to remuneration governance and disclosure before the crisis. Ferrarini et al., *supra* note 5, at 57.

204. *See* Ferrarini et al., *supra* note 5, at 69 (on the policy for LTIPs in various corporate governance codes); *Index of Codes*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE, http://www.ecgi.org/codes/all_codes.php (providing a list and texts of European codes of corporate governance and reviews).

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2009 and implemented them either in the same year or in 2010.[205] However, a few banks pledged to adopt new remuneration policies in 2010. As a result, 2009 still appears to be a year of transition.[206]

As to remuneration governance, we observe that most amendments regard the risk function (or, where existent, the risk committee, which must be involved in the decisionmaking process) as recommended by the FSB. Few banks enhanced the responsibility of the boards in their remuneration system. In particular, German banks followed a unique approach, assigning full responsibility for executive remuneration to the supervisory board, as now required by the law on adequate remuneration.[207]

We analyze pay alignment with long-term performance by checking the presence of Long-Term Incentive Plans ("LTIPs") in remuneration policies. Pre-crisis the majority of banks in our sample (87.5 percent) had a mix of base salary, annual bonuses, and long-term equity-based incentives.[208] The situation has not changed significantly post-crisis. In fact, we find a minor decrease in long-term incentives, which may be explained by the fact that some banks did not launch new share plans or grant shares or options to their senior management immediately after the financial turmoil.

Deferment of variable pay also reflects a long-term perspective. Interestingly, forty percent of banks already had a deferment mechanism in 2007.[209] However, banks do not generally indicate the proportion of deferred compensation and the relevant periods, occluding a proper evaluation of the banks' deferral policies. This behavior has not changed significantly in 2009: although a greater number of banks (sixty-five percent) disclose a deferment mechanism,[210] identifying either the proportion or the timing of the deferral is still uncommon. Only thirty-eight percent of banks with a deferment mechanism in place specify a minimum forty percent

205. Ailing banks such as Lloyds, RBS, Allied Irish Banks, ING, KBC Group applied more significant changes to their remuneration policies than their French ailing peers, Société Générale and BNP Paribas, and Spanish non-ailing peers, such as BBVA and Banco Santander.

206. Also the European Commission acknowledges that, as most regulatory changes are still ongoing, the new principles' application in practice is still difficult to assess. *Report on the Application of 2009/384*, *supra* note 186, at 10.

207. Gesetz zur Angemessenheit der Vorstandsvergütung [GzAdV] [Act on the Appropriateness of Management Board Remuneration], Aug. 5, 2009, BGBl. I §§ 2509–11.

208. Among the banks which did not include a LTIP in their pay structure were Deutsche Postbank, UBI Banca, DnB NOR, Banco Popolar, and Handelsbanken.

209. Especially the U.K., Irish, and Swiss banks, which were in fact among the worst performers during the crisis.

210. Among the new adopters are some French, Italian, and Belgian banks.

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proportion for the deferral component,[211] while approximately seventy percent of banks set a three-year minimum deferral period.

Most banks already had indicated the vesting period for LTIPs in 2007, with their number increasing in 2009 (from eighty-nine percent to ninety-five percent). However, vesting periods are not always three years or more, as recommended by the new Standards. Only forty-five percent of the banks with an LTIP in place had such a time frame before the crisis.[212] After the crisis, the number of banks adopting a minimum three-year vesting period amounts to sixty percent. The new Standards also require a share-retention policy for equity-linked pay. This policy was uncommon both before the crisis (only eleven percent of banks had a similar policy in place) and after (about thirty percent of banks with LTIPs adopted it).[213]

A small number of banks had some form of bonus-malus in place before the crisis, while clawback clauses were not present. Immediately after the crisis, the situation is not much different. In most cases, only one of these mechanisms is in place or information given in the remuneration report does not allow differentiation.[214] In most cases these mechanisms do not apply to all elements of variable pay, such as the annual cash bonus and the deferred pay component.

Termination payments are another major issue in the reform discussion. The FSB requires these to be aligned with long-term value and prudent risk taking. However, this Standard is not yet widely followed. Most firms disclosing a termination contract in their remuneration reports indicate the relevant amount in one to two years of annual pay, without conditioning its payment-to-performance criteria.

As to the performance sensitivity of senior management pay, the new Standards recommend the use of performance measures that account for current and future risks, such as economic profit rather than net profit or revenues. Regulators strongly support non-financial

211. For example Lloyds, HSBC, UBS, and Credit Suisse adopted a minimum forty percent proportion, while Barclays and Bank of Ireland maintained a twenty-five percent for the deferral element.

212. In particular all U.K., Swiss, and Irish banks from our sample set minimum vesting periods of three years; Greek and Portuguese banks generally set a two-year minimum vesting period.

213. Lloyds, HSBC, and BNP Paribas were among the banks adopting a share retention policy both prior and following the crisis. Mediobanca and Unicredit were among the banks introducing a share retention policy as part of their post-crisis remuneration policies.

214. UBS and HSBC were among the few banks having a malus/clawback arrangement in place before and after the crisis. Commerzbank and BNP Paribas adopted partial malus mechanisms.

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criteria. Most banks have used net profit and revenue as measures of their executives' performance; only twenty percent, however, accounted for risks in their performance criteria before the crisis.[215] In addition, most banks considered non-financial measures before the crisis (sixty-five percent), and that approach has been reinforced post-crisis (seventy-five percent).

Table 1 and Figure 3 illustrate the level of banks' compliance with the new standards regarding pay structure, in 2007 and 2009.

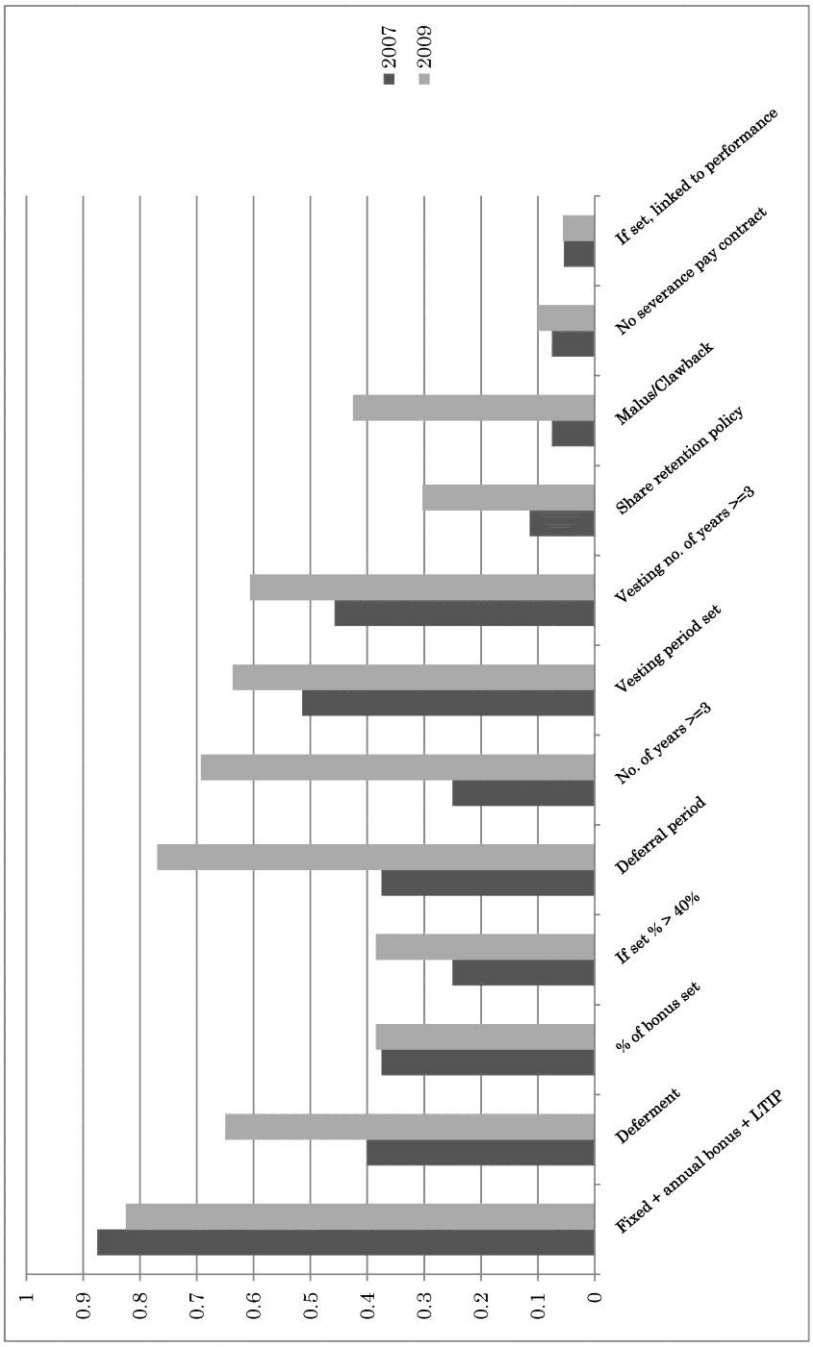
Table 1. Mechanisms for Pay Structure

Pay Structure	**2007 (No. of Banks)**	**2009 (No. of Banks)**	**2007 (%)**	**2009 (%)**
Fixed + annual bonus + LTIP	35	33	87.50%	82.50%
Deferment	16	26	40.00%	65.00%
% of bonus set	6	10	37.50%	38.46%
If set % > 40%	4	10	25.00%	38.46%
Deferral period	6	20	37.50%	76.92%
No. of years >=3	4	18	25.00%	69.23%
Vesting period set	18	21	51.43%	63.64%
Vesting no. of years >=3	16	20	45.71%	60.61%
Share-retention policy	4	10	11.40%	30.30%
Malus/Clawback	3	17	7.50%	42.50%
No severance pay contract	3	4	7.50%	10.00%
If set, linked to performance	2	2	5.41%	5.56%

215. In particular, all U.K. banks already used economic profit as a performance measure for their incentives before the crisis.

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Figure 3. 2007–2009 Mechanisms for Pay Structure



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A comparison between ailing and non-ailing banks in Table 2 shows no significant differences in approach between the two categories. In fact, surprisingly, LTIPs are slightly more diffuse in ailing than in non-ailing banks, both prior to and after the crisis.[216] Ailing banks also were more likely to adopt minimum vesting periods.[217] This pattern would confirm that in Europe the role of long-term equity incentives is similar to that in the United States pre-crisis.[218]

Table 2. Ailing vs. Non-ailing Banks' Approach

Non-ailing (17 banks)	**2007**	**2009**	**2007**	**2009**
Remuneration policy: year change		11		64.71%
LTIP (share-linked)	12	12	70.59%	70.59%
Deferment Yes/No	8	11	47.06%	64.71%
Share vesting period (min)	5	6	29.41%	35.29%
Malus/Clawback	1	6	5.88%	35.29%

Ailing (23 banks)	**2007**	**2009**	**2007**	**2009**
Remuneration policy: year change		15		65.22%
LTIP (share-linked)	23	21	100.00%	91.30%
Deferment Yes/No	8	15	34.78%	65.22%
Share vesting period (min)	11	13	47.83%	56.52%
Malus/Clawback	2	11	8.70%	47.83%

An analysis of cash remuneration earned by executives between 2007 and 2009 shows that nearly all banks responded to the public criticism about excessive remuneration in the financial sector by reducing bonuses both in the crisis year (2008) and in the following year. Figures 4, 5, and 6 show the cash remuneration (fixed and bonus) earned by CEOs and executives of the banks in our sample during the three-year period.

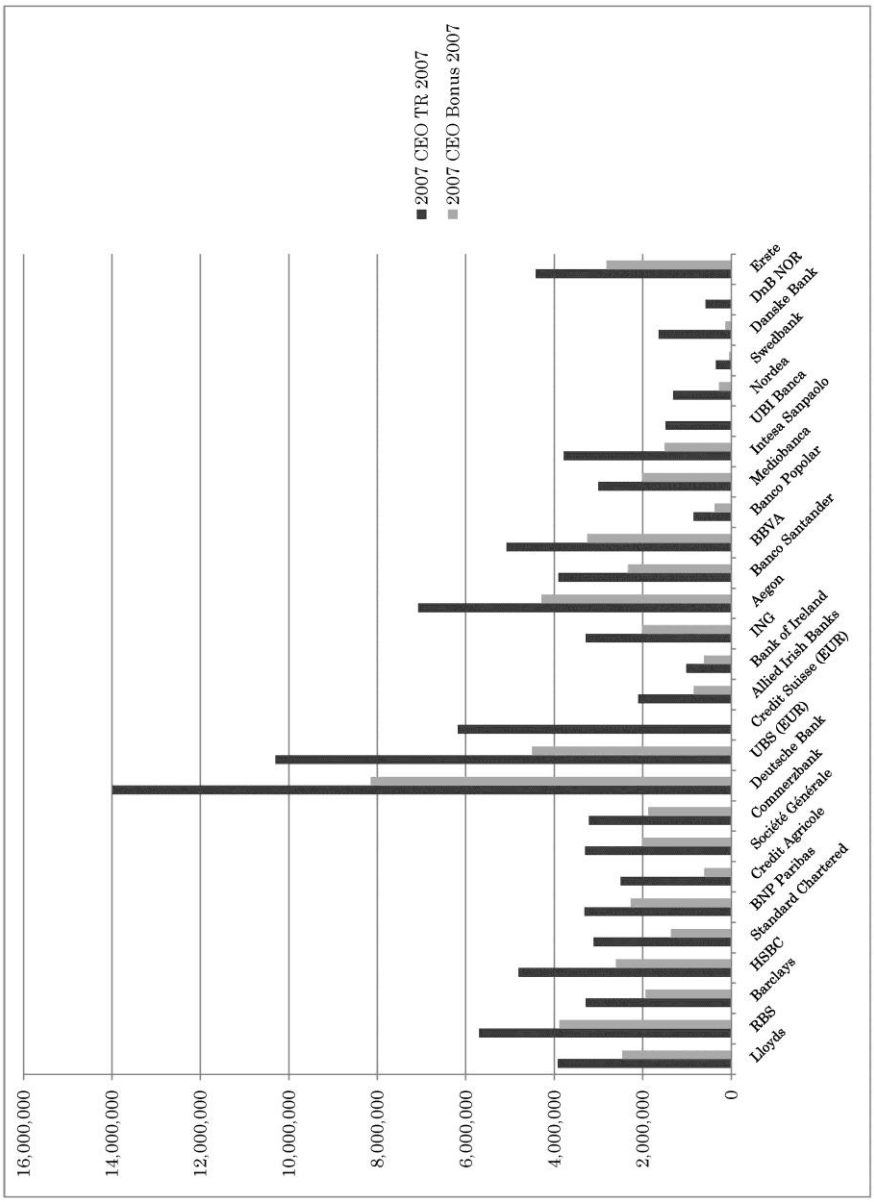
216. Among ailing banks that gave up on LTIP as part of their post-crisis remuneration structure, as opposed to their policy before the crisis, are Banco Comercial and Danske Bank.

217. For example, while Commerzbank adopted a minimum five-year vesting period, its main peer Deutsche Bank did not adopt similar criteria. Similarly, U.K. banks such as Lloyds and RBS were among the adopters of a minimum vesting period, while Barclays was not.

218. *See supra* Part I.B.1 (finding "no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis").

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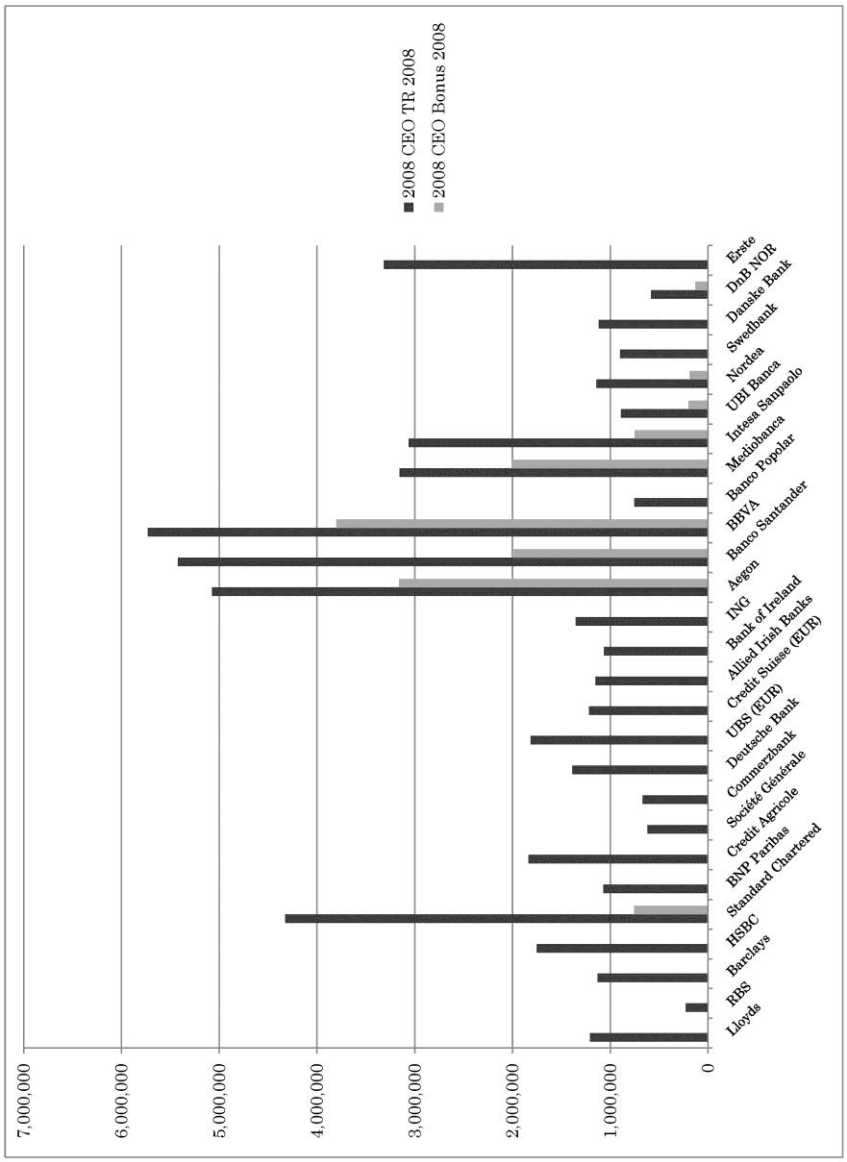
Figure 4. CEO Cash Compensation in 2007



Figures are in Euros.
Total Remuneration ("TR") = fixed pay + annual cash bonus (+ perks + pension as disclosed by each bank).
Credit Suisse TR includes the annual cash bonus, as disclosed by the bank.

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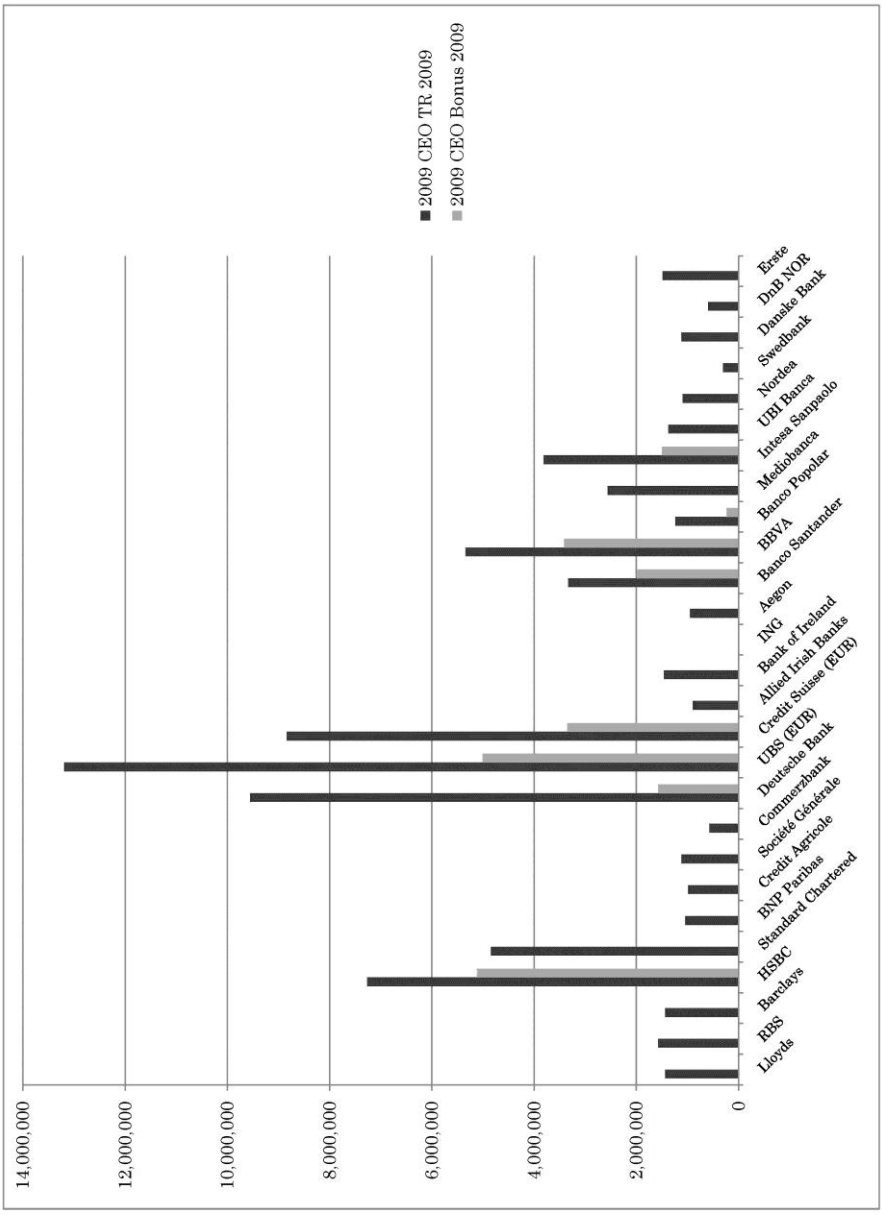
Figure 5. CEO Cash Compensation in 2008



Figures are in Euros.
TR = fixed pay + annual cash bonus (+ perks + pension as disclosed by each bank).
RBS's CEO was appointed during the financial year; his fixed pay reflects the period when he was in charge.

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Figure 6. CEO Cash Compensation in 2009



Figures are in Euros.
TR = fixed pay + annual cash bonus (+ perks + pension as disclosed by each bank).

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Nearly all banks adopted long-term equity plans for their senior management. Due to inconsistencies and gaps in the disclosure of equity incentive plans, we did not conduct a comparative analysis of the total value of their LTIPs. In order to estimate the value of the equity-linked component of CEOs' pay packages before the crisis, we calculated the value of the shares they owned in 2007.

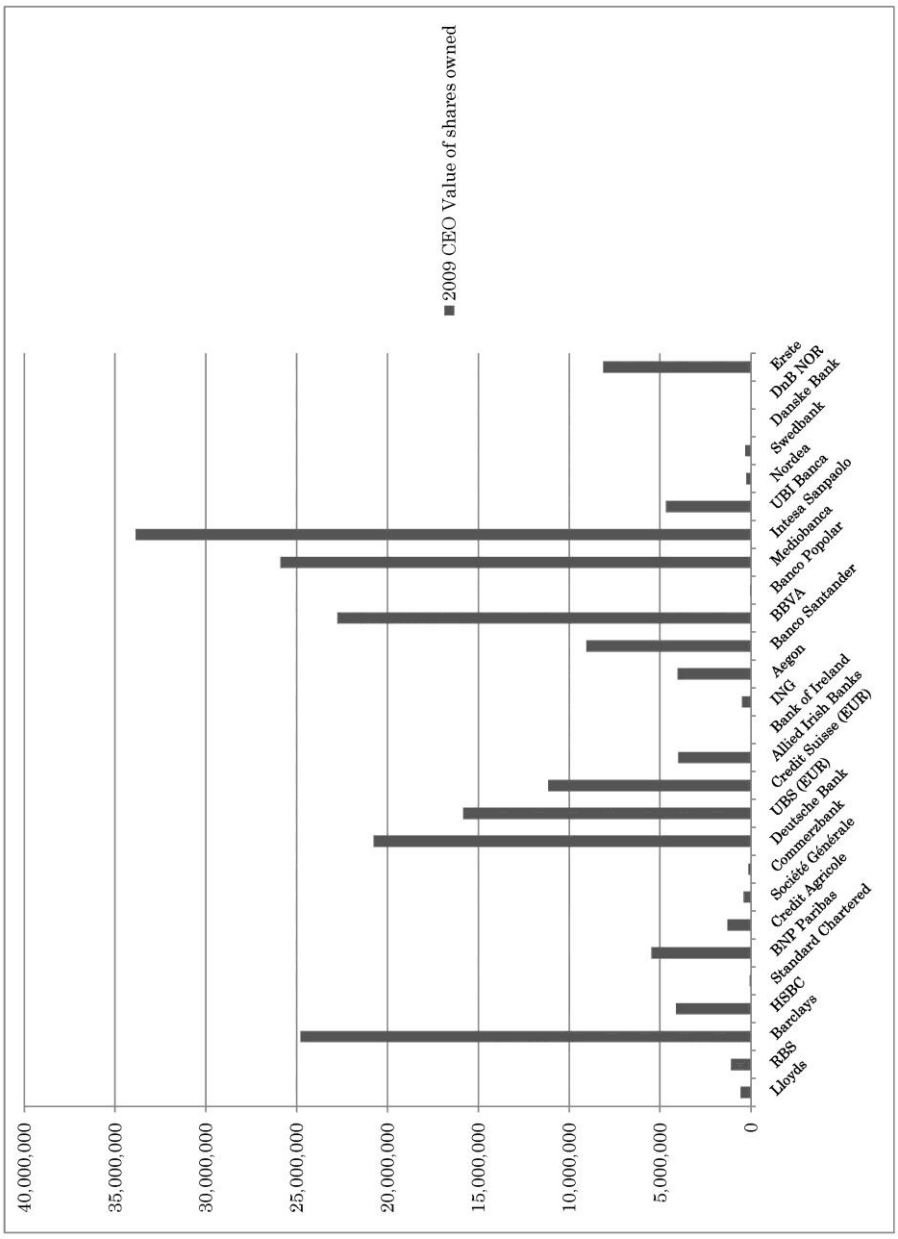
The equity-based compensation as a proportion of total pay is significant at both U.S. and European banks; however, the value amount varies considerably. Although lack of disclosure in Europe impedes proper benchmarking, a rough analysis supports this statement. The study by Fahlenbrach and Stulz finds that in 2006 bank CEOs had substantial wealth invested in their banks. In their sample of twenty-one top U.S. banks, the median CEO equity compensation is valued at more than $100 million.[219] Some individual equity positions are valued as high as $1.062 billion (CEO of Bear Stearns) and $911.5 million (CEO of Lehman Brothers). Equity values in Europe stay at much lower levels than in the United States.[220] Our research shows that the median interest in shares owned by the CEOs of the top fourteen European banks is valued at €14 million. Figure 7 shows the value of CEOs' interest in their firms' shares at end of the 2007 fiscal year.

219. Authors define the total dollar value of equity of a CEO at the end of fiscal year 2006 as the sum of unrestricted and restricted shares held multiplied by the end-of-year share price plus the Black-Scholes value of exercisable and unexercisable stock options plus the fair value of unearned equity incentive plans. Fahlenbrach & Stulz, *supra* note 4, at 12.

220. See Conyon et al., *supra* note 7, at 76, which compares 2008 CEO pay in the USA and 10 European countries after controlling for sales and industry; the authors classify the relevant industry as 'financial industry', without delimiting banks.

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Figure 7. CEO Value of Shares Owned in 2007



Figures are in Euros.

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C. Assessment

The data analyzed in this Part show that European law and practice are converging toward the FSB Principles and Standards. However, convergence is mainly focused on a subset of standards, while for others some resistance to implementation remains, both from regulators and banks in our sample. Not surprisingly, adherence to the new Standards is more commonly found for corporate governance than for remuneration structures. Regulating board organization and processes is less intrusive than intervening directly on remuneration arrangements. Also, disclosure standards such as information on the decisionmaking process, compensation design characteristics, and individual compensation amounts, still meet resistance to implementation, suggesting—as already argued in our previous studies[221]—that this is an area for EU harmonization. In fact, lack of sufficient disclosure in most European countries forecloses proper understanding of executive compensation practices and monitoring of the same by the markets. However, financial regulators recently improved disclosure of pay practices under the influence of the FSB Principles.[222]

In general, we find that convergence is stronger at the regulatory level, particularly with respect to executive pay structures, than in practice. This finding is likely due to the fact that banks still need to fully implement national reforms in their remuneration policies. Moreover, weak disclosure may conceal compliance with some standards, making convergence appear lower. It is also foreseeable that the level of banks' compliance with the international Standards will rise once national reforms giving effect to them are fully implemented. Moreover, enforcement of the new Standards at a national level will depend on the intensity of supervisory action in this area. Supervisors will be in a position to influence both corporate governance and remuneration practices, leading them in the direction of convergence, which is detached from detailed regulatory prescriptions.

We also find that compliance is higher with respect to some core principles, such as deferment of variable pay, and lower with respect to more detailed standards, such as those concerning the proportion of deferred pay of the total variable remuneration or the deferral period. This trend reflects a more general resistance to

221. Ferrarini et al., *supra* note 5; Ferrarini & Ungureanu, *supra* note 96.

222. *See supra* Part II.B.1.

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detailed regulation of pay structures, which may be too rigid and hinder the efficient tailoring of compensation contracts. In addition, new mechanisms, such as bonus-malus and clawback arrangements, still find some resistance to implementation in practice. This resistance is likely due both to their novelty and to the fact that they increase the uncertainty of variable pay for executives, who could be asked to pay back what they already received in addition to forfeiting future payments.[223]

On the whole, we do not think that the limits to convergence found in our analysis should be negatively assessed. As explained throughout the Article, the case for regulating bankers' pay is, to some extent, dubious and further research and experimentation should be done on the optimal pay structures at financial institutions. Therefore, regulation of bankers' pay should be restricted in scope and flexible enough to allow for diversity and innovation. In essence, only core principles should be found in regulation, focusing on the prudential implications of executive pay and the need to avoid incentives for excessive risk taking. Given that each institution should define, when setting strategy at the board level, its overall level of risk tolerance, remuneration policies should no doubt be consistent with similar determinations, as further specified through the firm's risk management policies. However, banking supervisors should avoid micromanaging executive compensation by interfering with the details of pay structures beyond what is strictly required by the overarching goal of preventing excessive risk taking. Moreover, convergence should not be sought at any cost, including that of rigidity. While the benefits of convergence cannot be ignored, given that international coordination is required for bankers' pay to be regulated in competitive global markets, requirements for pay structures that are too specific would possibly increase the total amounts of compensation, reflecting the limited adaptability of pay arrangements to individual circumstances. Moreover, rigid requirements could make it more difficult for banks to compete with other firms in the market for managers.

223. In the case of a mere deferment of variable pay, what was already paid to the manager cannot be asked back by the company. The manager could only forfeit future payments if the performance targets are not met. In the case of either a bonus-malus or a clawback arrangement, on the contrary, the manager could lose also what was already paid to him if the performance targets are not met in future years or if the accounts turn out to have been improperly stated.

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CONCLUSIONS

In this Article, we argue that there is no strong support for regulating bankers' compensation design at banks. According to some recent empirical studies, corporate governance and compensation structures at banks that failed in the recent crisis were not necessarily flawed. Other studies analyzing the optimal remuneration structures for financial institutions suggest that regulation should promote incentives enhancing enterprise value rather than shareholder value. However, prudential bank regulation is undergoing reforms in areas like capital adequacy and prompt corrective action, which tackle excessive risk taking by financial institutions directly. Regulation of executives' incentives, in contrast, would only have an indirect impact on these institutions' safety and soundness. Therefore, while the case for regulating bankers' compensation cannot be totally rejected, we suggest that any reform in this area should carefully consider the overall regulatory framework and the different tools that can be deployed to control risk taking. In addition, regulation of bankers' pay should mainly be principles-based and flexible enough to allow for experimentation and innovation in pay structures.

This Article also notes that political support for regulating bankers' pay has been significant as a result of the recent crisis and pressures to adopt reforms in this area are difficult to resist. Indeed, public opinion and mass media regard flawed compensation structures and short-term incentives as main determinants of the crisis, leading to claims for legal reforms as well as for moderation in pay measures. As a result, post-crisis reforms focus on requiring long-term incentives (although this was already the practice for most financial institutions before the crisis, including those that later failed). The FSB Principles follow a similar pattern without meeting much resistance from the main financial circles, precisely because they reflect pre-crisis best practices. However, the Principles also widen the powers of supervisors by explicitly acknowledging that executive pay is an area for prudential regulation.

The Principles represent a political compromise between the various interest groups by incorporating traditional criteria and adapting the same to new circumstances. We suggest that a similar degree of flexibility should be kept when implementing the Principles in national jurisdictions. Domestic regulations of bankers' pay should be general in character and delegate to boards of directors and financial supervisors the respective tasks of defining the incentive

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structures applicable to individual institutions and prudentially monitoring the same.

Our analysis of domestic regulations in some European states finds a certain degree of flexibility in the implementation of the Principles. However, only eight jurisdictions were considered, as the implementation process is still ongoing. Our analysis of remuneration policies at large European banks also shows that these are converging toward the international Principles, while varying in the implementation of the Standards. However, the CRD III may push remuneration practices more in the direction of uniformity, making the relevant structures more rigid and converting the international Standards into national regulatory prescriptions. These prescriptions will likely be enforced by banking supervisors in line with the CEBS guidelines, which seem to leave little room for flexibility and will therefore further enhance the uniformity of bankers' compensation practices across Europe. It is unclear whether a similar outcome was contemplated by the G20 governments when the FSB Principles were adopted. It also remains to be seen whether a similar path will be followed globally or national variations will emerge in the implementation of the international Principles. If countries move more along the lines advocated in this Article, the role of corporate governance in the prudential regulation of banks will clearly be enhanced.

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Annex 1. List of Regulations

Global
- Financial Stability Forum: FSF Principles for sound compensation practices (2009)
- Financial Stability Board: Principles for sound compensation practices. Implementation standards (2009)

European Commission
1. Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (C(2009) 3177)
2. Commission Recommendation on remuneration policies in the financial services sector (C(2009) 3159)
3. Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies (2009)

United Kingdom
4. Code of Corporate Governance (2010)
5. Financial Services Authority: Policy Statement 09/15, Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules (2009)
6. Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (2009)

Germany
7. Code of Corporate Governance (2009)
8. Act on the Appropriateness of Management Board Remuneration (Gesetz zur Angemessenheit der Vorstandsvergütung, "VorstAG") (2009)
9. BaFin Circular 22/2009 (BA) - Supervisory Requirements for Institutions' Remuneration Systems (2009)

Netherlands
10. Corporate Governance Code (2009)
11. Association of Dutch Banks: Banking Code (2009)

Italy
12. Code of Corporate Governance, Art. 7 Remuneration of Executive Directors (2010)
13. Bank of Italy: Supervisory provisions concerning banks' organization and corporate governance (2008)
14. Bank of Italy: Remuneration and Incentivation Systems (Sistemi di Remunerazione e Incentivazione) (2009)

France
15. AFEP/MEDEF: Corporate Governance Code (2009)
16. Ministerial Decree: 'Arrêté du 3 novembre 2009 relatif aux rémunérations des personnels dont les activités sont susceptibles d'avoir une incidence sur l'exposition aux risques des établissements de crédit et entreprises d'investissement' (2009)
17. French Banking Federation: 'Normes professionnelles concernant la gouvernance et les rémunérations variables des professionnels des marchés financiers' (2009)

Switzerland
18. Swiss Code of Best Practice for Corporate Governance (2008)
19. The Swiss Financial Market Supervisory Authority (FINMA): Compensation Regulations Issued for Swiss Banks and Insurance Companies (2009)

Belgium
20. The Belgian Code on Corporate Governance (2009)
21. The Belgian Banking Finance and Insurance Commission (CBFA): Recommendation on sound remuneration policies in financial institutions (2009)
22. Belgian Law on Corporate Governance (2010)
23. Febelfin Code of Conduct as for remuneration of certain categories of financial staff members (2010)

Sweden
24. Code of Corporate Governance (2009)
25. Finansinspektionen (Swedish Financial Supervisory Authority) binding regulations and guidelines on remuneration policies (2010)

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Annex 2. Criteria—Regulations

GOVERNANCE	**REGULATORY PROVISIONS**
Remuneration Committee	Existence of Remuneration Committee
Remuneration Committee independence	Independence of the Remuneration Committee: composition and judgment
Supervisory Board responsibility	Enhanced responsibility of the Supervisory Board in the remuneration system
Involvement of risk control/compliance functions	Input from the risk committee/risk and compliance function in the remuneration process
Independence of risk control functions	Independence of staff involved in the remuneration process, including independent compensation
PAY STRUCTURE AND RISK ALIGNMENT	
Financial and non-financial measures	Adoption of both financial and non-financial criteria for measuring performance
Link to individual, unit, group performance	Linking individual pay to individual, unit and group performance
Malus/Clawback	Adoption of malus/clawback mechanisms in case of subdued or negative performance
Guaranteed bonuses banned	Banning guaranteed bonuses; exceptional for new hiring, limited to one year
Balance cash, equity, other forms	Pay structure ensuring balance between cash, equity and other forms of payment
Deferral mechanism	Annual incentives to be deferred over a certain period of time
Deferral proportion >40%	Proportion of deferred component to be set at minimum 40%
Deferral period >3 years	Deferral period set at minimum 3 years
Malus/Clawback of deferred component	Malus/clawback mechanisms applied to the deferred component in case of subdued or negative performance
Share-linked instruments >50%	Minimum 50% of the variable compensation to be awarded in shares
Share retention policy	Adoption of a share retention policy
Termination payments linked to performance	Termination payments subject to performance achievement, avoiding rewards for failure
No personal hedging	Employees to commit not to use personal hedging strategies
DISCLOSURE	
Decisionmaking process	Disclosure of the decisionmaking process
Design characteristics	Disclosure of the main design characteristics
Criteria for performance measurement and risk adjustment	Disclosure of criteria for performance measurement and risk adjustment
Parameters for cash bonuses	Disclosure of the parameters for cash bonuses
Deferral policy	Disclosure of the deferral policy
Vesting criteria	Disclosure of the vesting criteria

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Annex 3. Regulations—Matrix

RULES	EU		GE		NL	IT	FR		UK		SW	BE			SE	
Law	Proposal CRD		VorstAG	Draft act compensation			Min. Decree		Financial Services Bill			Law on corporate governance				
Scope	Banks and investment firms		All listed firms	All listed FI			All listed FI		All listed FI			All listed firms				
Recommendations Guidelines CG codes	EC Rec. all sectors	EC Rec. fin. sector	CG Code		Banking Code	CG Code	CG Code	FBF Profess. guidelines	CG Code		CG Code	CG Code	Febelfin Code of Conduct	CG Code	Finansinspektionen regulation and guidelines	
Scope	All listed firms	All FI	All listed firms		All listed banks		All listed firms	All FI	All listed firms		All listed firms	All listed firms	All FI	All listed firms	All FI	
Financial supervisor			BaFin Circular		DNB and AFM principles	Bank of Italy: Supervisory Provisions Bank of Italy: Remuneration and Incentivisation Systems			FSA Code	Walker Review	FINMA Circular	Circular CBFA				
Scope			All FI		All listed banks	All banks	All banks		Specific FI	All FI	Listed and non-listed FI					
Government intervention (still in place)			SoFFin													

Jurisdiction	Abbreviation
European Union	EU
Germany	GE
The Netherlands	NL

Jurisdiction	Abbreviation
Italy	IT
France	FR
United Kingdom	UK

Jurisdiction	Abbreviation
Switzerland	SW
Belgium	BE
Sweden	SE

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Annex 4. List of Banks

Country Code	**Stock Exchange**	**Bank**
GB	LSE	HSBC
ES	SIBE	BCO SANTANDER
FR	EURONEXT	BNP PARIBAS
ES	SIBE	BCO BILBAO VIZCAYA ARGENTARIA
CH	SIX	UBS
GB	LSE	BARCLAYS
IT	MIL	UNICREDIT
CH	SIX	CREDIT SUISSE GRP
FR	EURONEXT	GRP SOCIETE GENERALE
DE	XETRA	DEUTSCHE BANK
IT	MIL	INTESA SANPAOLO
GB	LSE	STANDARD CHARTERED
SE	OMX	NORDEA BANK
GR	ATHEX	NATIONAL BANK OF GREECE
FR	EURONEXT	CREDIT AGRICOLE
GB	LSE	LLOYDS BANKING GRP
SE	OMX	SVENSKA HANDELSBANKEN
GB	LSE	ROYAL BANK OF SCOTLAND
DK	OMX	DANSKE BANK
SE	OMX	SKANDINAVISKA ENSKILDA BK
IT	MIL	UBI BCA
AT	XETRA	ERSTE GROUP BANK
NO	OSE	DNB NOR
DE	XETRA	COMMERZBANK
SE	OMX	SWEDBANK
BE	EURONEXT	KBC GRP
GR	ATHEX	ALPHA BANK
ES	SIBE	BCO POPULAR ESPANOL
BE	EURONEXT	DEXIA
IT	MIL	MEDIOBANCA
ES	SIBE	BCO SABADELL
IT	MIL	BCO POPOLARE
GR	ATHEX	PIRAEUS BANK
GR	ATHEX	EFG EUROBANK ERGASIAS
FR	EURONEXT	NATIXIS
PT	EURONEXT	BCO ESPIRITO SANTO
IE	XETRA	BANK OF IRELAND
IE	XETRA	ALLIED IRISH BANKS
AT	XETRA	RAIFFEISEN INTERNATIONAL BANK
DE	XETRA	DEUTSCHE POSTBANK

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Annex 5. Criteria—Banks

1. Review of the remuneration policy

Any changes in the remuneration policies refer to the year 2009 or are formulated for implementation in 2010. We consider changes in remuneration policies if banks have applied relevant amendments to their principles for 2009/2010, in accordance with new reforms.

2. Changes in remuneration governance

We follow the FSB Principles regarding the governance of remuneration.

3. Pay structure

A. Pay: Fixed + Variable + LTIP
Analysis of banks' pay package, including base pay, annual bonus and long term incentives

B. Deferment Y/N
Whether banks had a deferment mechanism

C. % of bonus set Y/N
Whether banks with a deferment mechanism in place set a proportion for the deferred component

D. If set % >= 40%
Whether banks with a deferment mechanism in place set a proportion for the deferred component of 40% or above

E. Deferral period Y/N
Whether banks with a deferment mechanism in place set a deferral period

F. No. of years >= 3
Whether banks with a deferment mechanism in place set a deferral period of 3 years or above

G. Setting of vesting period for the LTIP
Whether banks with a LTIP have set a vesting period for exercising the shares

H. Vesting period >= 3 years
If set, whether this period is minimum 3 years

I. Share retention policy
Whether banks that have a LTIP in place have a share retention policy in place

J. Malus/Clawback
We consider this criterion to be complied with if either of the two mechanisms is included in the remuneration policy.

K. No severance payment contract: Y/N
Whether banks specified that they did not have termination payment contracts in place for directors.

L. If set, whether linked to performance: Y/N
Whether severance pay is awarded based on performance.

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