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Bank Governance

Law Working Paper N° 316/2016
June 2016

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Abstract

According to a common narrative, in addition to inadequate capital and liquidity, the failure of banks in the financial crisis also reflected their poor governance. By governance we mean broadly the oversight that comes from banks' own shareholders and other stakeholders of the way in which they are run. The problem of bank governance stems from the way in which banks are financed and regulated, from the externalities bank failures produce, and from the nature of their assets. In the period leading up to the financial crisis, it was believed that regulation would cause banks to internalize the costs of their activities, meaning that what maximized bank shareholders' returns would also be in the interests of society. Consequently large banks used the same governance tools as non-financial companies to minimize shareholder-management agency costs, namely independent boards, shareholder rights, the shareholder primacy norm, the threat of takeovers, and equity-based executive compensation. Unfortunately, such tools had the adverse effect of encouraging bank managers to take excessive risks: as we describe in this chapter, banks that had the most 'pro-shareholder' boards and the closest alignment between executive returns and the stock price were those which took the most risks prior to, and suffered the greatest losses during, the crisis. Consequently, a significant rethink about the way in which banks are governed is required. The structure and function of bank boards, the compensation of bank executives and the function of risk management within organizations needs careful crafting if governance reforms are to address not exacerbate bank failures.

Keywords: Financial regulation, bank governance, executive compensation, financial sector pay, independent directors, board structure

JEL Classifications: G21, G28, G32, G38, K22

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Principles of Financial Regulation

JOHN ARMOUR, DAN AWREY, PAUL DAVIES,
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17

Bank Governance

17.1 Introduction

So far, our analysis of the regulation of banks has focused on the imposition of rules relating to their capital structure and liquidity to reduce risks of failure and on resolution processes in the event of failure. According to a common narrative, however, in addition to inadequate capital and liquidity, the failure of banks in the financial crisis also reflected their poor corporate governance.[1] By 'corporate governance', commentators mean the mechanisms by which managers are selected, motivated, and rendered accountable to shareholders, as well as those by which managers oversee the activities of other employees. Yet empirical studies report that the banks with the 'best' corporate governance practices, as measured by ordinary standards, were the ones that did worst during the financial crisis. The weakness in pre-crisis bank governance was not that banks had ignored 'best practices' in corporate governance. Rather, it was a failure to appreciate that the ways in which banks differ from non-financial firms imply that 'best practice' for bank governance should also be different.

Banks are materially different in their financing, business model, and balance sheets from most non-financial firms. First, banks are highly leveraged institutions: shareholders may gain at creditors' expense from an increase in risk and associated returns. If things go well, shareholders keep the higher returns; if things go badly, the creditors suffer. If banks were companies like any other, depositors and other creditors would take notice of the risk of shareholder opportunism and either charge a higher interest rate (making financing through debt more expensive and therefore less predominant) or insist on having stronger governance and control rights.[2]

Yet various factors stand in the way of creditors themselves playing an important part in disciplining shareholder opportunism. Depositors have no oversight rights, are dispersed, and are protected by deposit insurance. Banking regulation and supervision are there precisely to prevent shareholder opportunism of this kind, so that (at least unsophisticated) market participants may over-rely on their effectiveness. And perhaps most importantly, as we have seen in Chapter 16, creditors of larger banks could (and perhaps still can) reasonably expect a state bail-out that will avoid them any losses should the bank become insolvent.

[1] See eg OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* 41 (2009); European Banking Authority, *EBA Guidelines on Internal Governance* 3 (2011).

[2] On the important role of creditors in the governance of listed companies even in a highly shareholder-focused corporate governance system such as the US, see DG Baird and RK Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 *University of Pennsylvania Law Review* 1209.

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In addition, as Chapter 16 also illustrated, bank failures have the ability to impose large costs on society at large—externalities—which are not borne by bank shareholders. Finally, a bank's assets (its loans) are hard to monitor for any outsider, which makes any external monitoring mechanism less effective.

In the period leading up to the financial crisis, the peculiarities of banks' balance sheets, their regulation, and the externalities they can create were thought not to necessitate any difference in the structure of bank governance from that of non-financial firms. Regulators, it was believed, would cause banks to internalize the costs of their activities, meaning that what maximized bank shareholders' returns would also be in the interests of society. On this view, which we might call the 'assimilation' theory of bank governance, it was thought appropriate for banks to use the same governance tools as non-financial companies to minimize shareholder-management agency costs, namely independent boards, shareholder rights, the threat of takeovers, and equity-based executive compensation.

Unfortunately, tightening the linkage between shareholders and managers in banks had the adverse effect of encouraging bank managers to test the limits of regulatory controls and take excessive risks. As we describe in this chapter, the banks that had the most 'pro-shareholder' boards and the closest alignment between executive returns and the stock price were those that took the greatest risks prior to, and suffered the greatest losses during, the crisis.

As a result, a significant rethink about the way in which banks are governed is required. The revised perspective might be termed a 'bank exceptionalism' theory of governance.[3] The structure and function of bank boards, the compensation of bank employees, and the function of risk management within banks need careful crafting if governance reforms are to address, and not exacerbate, bank failures. In the last few years, a plethora of special 'bank governance' rules have been introduced. While these initiatives recognize that assimilation was an error, we shall see that it remains unclear how effectively the new measures get to grips with the exceptional challenges of bank governance.

The rest of this chapter is structured as follows. Section 17.2 reviews the goals and mechanisms of 'ordinary' corporate governance, and explains their limitations when applied to banks. Sections 17.3–17.6 then consider, respectively, the operation of boards of directors, executive pay, shareholder rights, and directors' duties in relation to banks, reviewing empirical evidence and describing regulatory initiatives. By the end of this chapter, you should have a good understanding of why the corporate governance tools that have prevailed for listed companies generally in the last thirty years may have led to undesired consequences when applied to banks. In addition, you should have an idea of which bank governance reforms have been implemented on each side of the Atlantic and how they may support the goal of a more resilient banking system.

[3] To the extent that the factors differentiating banks are also relevant for other, non-bank, financial firms, then this 'bank exceptionalism' theory of governance should also extend *mutatis mutandis*.

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17.2 Corporate Governance: How are Banks Different?

17.2.1 The conventional approach to corporate governance

The standard approach to corporate governance exhorts managers to run their firm in the interests of shareholders. This is because shareholders are 'residual claimants': that is, they receive what is left after all fixed claimants have been paid. Focusing on maximizing the residual surplus gives incentives to maximize the overall value of the firm: that is, to run it as efficiently as possible. Moreover, amongst those who contract with the firm—investors, creditors, employees, customers, and suppliers—the shareholders have the most homogeneous interests in the financial performance of the firm.[4] Their interests relate simply to the maximization of the value of their claims, which, in the context of a publicly traded firm, is reflected in the firm's stock price. Consequently, maximizing the stock price should be management's objective.

To implement this, shareholders are given the right to appoint directors, who in turn select the managers.[5] The significance of the directors derives from the fact that ownership of shares in large public corporations is typically widely dispersed. As a consequence, shareholders face high coordination costs in exercising their rights. A number of mechanisms are relied upon to overcome this problem.

First, the board of directors has increasingly come to be viewed as performing the function of monitoring managerial performance on behalf of the shareholders. If the shareholders are too dispersed to be able to engage in effective monitoring themselves, then the elected board of directors can do so in their stead. The problem here is that the shareholders' very lack of coordination may undermine the process of election of effective monitors. The managers may influence the list of candidates and ensure that only their friends and associates are represented on the board. In response to this concern, directors are increasingly expected to be 'independent' of the firm: that is, they should have no family, financial, or employment ties to the firm or its managers. Independent directors, it is thought, will make better delegated monitors on behalf of shareholders. The problem remains that in the absence of effective shareholder input, the 'independence' of directors means simply the absence of a conflict of interest; it does nothing to ensure the presence of the necessary qualities to be an effective monitor.

Executive pay comprises a second mechanism, which has in recent years become the most important focus of governance activity in the US. Tying managerial compensation to the stock performance gives very direct incentives. A drawback with conditioning pay on financial performance is that it requires managers to bear the risk of the firm's underperformance, even for reasons beyond their control. This may result in managers adopting an unduly risk-averse approach to decision-making, passing up valuable but risky opportunities in favour of safer, more conservative, strategies. One way to encourage managerial risk-taking and stock price maximization at the same

[4] H Hansmann, *The Ownership of Enterprise* (Cambridge, MA: Belknap Press, 1996).

[5] R Kraakman, J Armour, P Davies, L Enriques, H Hansmann, G Hertig, K Hopt, H Kanda, M Pargendler, G Ringe, and E Rock, *The Anatomy of Corporate Law*, 3rd ed (Oxford: OUP, 2016), s 1.2.5.

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time is to pay managers by way of options. These have the potential to offer managers rewards for increasing the stock price, but with no associated loss if the share price falls. However, the incentives associated with options are highly sensitive to the way in which the strike price is set. These contracts are normally negotiated by the compensation committee of the board of directors. Their success, therefore, is a function of the quality of the board. Because of this, some influential scholars argue that the rise in option-based compensation is not so much a function of improved corporate governance, but of a combination of changes to the US tax code that made it cheaper for firms to grant options than cash compensation, and of thinly veiled managerial self-interest.[6]

Third, shareholder rights provide channels through which shareholders may exercise control, for example by voting on major business decisions or more generally by removing directors. The exercise of shareholder rights requires some concentration of ownership, so as to overcome coordination problems. It is sometimes suggested that takeovers are a mechanism by which external discipline is brought to bear on management even in the presence of dispersed shareholdings. Poorly performing management faces the threat of acquisition by another company, and the mere threat of this occurring may be sufficient to encourage management to pursue the interests of their shareholders vigorously.

Recently, we have witnessed the emergence of a second mechanism by which external discipline is brought to bear on management in the presence of dispersed shareholders. Activist shareholders, and in particular hedge funds, have acquired significant but not necessarily controlling shareholdings in firms to effect changes in corporate policy and management. They frequently act in conjunction with other institutional investors in promoting change. The rise of institutional activists has had a profound impact on the conduct of management in dispersed ownership systems in the UK and US particularly.

Fourth, directors and officers are subject to legal duties to avoid conflicts of interest and to take appropriate care in the running of their company. These may be enforced by shareholders through derivative or class actions, which enable a single shareholder or group of shareholders to represent the rest in claims against errant directors. However, it is unlikely that the shareholders who initiate such an action, or the judges called upon to adjudicate them, will know as much about the business as the incumbent managers. This makes litigation a blunt instrument. To avoid overzealous enforcement, there are typically checks on shareholder litigation in relation to good faith business decisions that grant considerable discretion to management in the running of their businesses, leaving shareholder plaintiffs to focus on more egregious cases of conflicts of interest.

[6] See L Bebchuk and J Fried, *Pay Without Performance. The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004); JC Coffee, 'A Theory of Corporate Scandals: Why the USA and Europe Differ' (2005) *Oxford Review of Economic Policy* 198, 202.

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17.2.2 How are banks different?

As anticipated in the introduction, governance problems and mechanisms may play out differently in banks than in ordinary firms, reflecting how banks differ from non-financial firms in three important respects. The first difference is that banks are highly leveraged. The core of a bank's business model is to transform short-term deposits into long-term loans, implying that most of its capital is raised through debt. In addition to deposits, banks raise money via short-term and long-term debt which, together with deposits, typically make up most of the liability side of their balance sheets. As a result, shareholders may stand to benefit at creditors' expense from changes in the bank's investment projects that increase risk and associated returns. If things go well, the shareholders keep the increased returns, whereas if things go badly, the creditors suffer losses. Perversely, mechanisms that succeed in tying executives to the interests of shareholders may actually exacerbate these financial agency costs. Creditors should therefore satisfy themselves that there are strong checks in place to ensure that the riskiness of the bank's activities is kept within acceptable limits. However, depositors usually have only modest amounts at stake and are widely dispersed, so they do not wish to, or feel able to, monitor bank lending effectively.

The second difference is that bank failure imposes greater costs on society. A bank failure can trigger contagion in other parts of the financial system, and, by impeding the operation of the financial system, can harm the ability of businesses to obtain finance. Since losses are purely economic, they are not generally susceptible to compensation through the tort system.[7] Moreover, as the source of contagion is usually the failure of a financial firm, governments have incentives to throw money at troubled firms to avert such failure.[8] The more systemically important the bank, the more likely it will be able to rely on government support should it get into difficulties. This gives banks a perverse incentive to structure their operations such that they are systemically important and, in the eyes of policymakers, 'too big to fail'.[9] The implicit government guarantee means that such firms enjoy a lower cost of credit,[10] and that creditors' incentives to monitor the firms' performance is undermined. What this does is to morph the creditors' problem described in the previous paragraph into a problem for society more generally, through the implicit subsidy that creditors receive.

[7] This is ordinarily justified on the basis that economic harms to one party often represent opportunities to someone else: a power outage closing firm A's factory for a week (and resulting in lost profits) represents an opportunity for A's competitors to earn extra profits by selling more products instead. However, if contagion is *systemic* in the sense that it affects the entire financial sector, competitors will not profit from a bank's difficulties, nor will competitors of manufacturing firms who are unable to raise finance be readily able to profit from their circumstances. And even if the economic losses caused by contagion were in principle recoverable, the way in which they are triggered ensures they will not be visited on shareholders. Banks trigger contagion through their financial distress and there would consequently be no assets to pay tort liabilities.

[8] This is distinct from other cases of catastrophic industrial accidents, where governments intervene to ameliorate the consequences but nevertheless are content to bankrupt the firm in the process.

[9] See M Roe, 'Structural Corporate Degradation Due to Too-Big-To-Fail Finance' (2014) 162 *University of Pennsylvania Law Review* 1419.

[10] See VV Acharya, D Anginer, and AJ Warburton, 'The End of Market Discipline? Investor Expectations of Implicit Government Guarantees', Working Paper (2016).

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'IBG–YBG'

To be sure, bank shareholders will lose money if their bank fails, but, because of limited liability, the shareholders' maximum loss is set by the initial value of their shares. Consequently, other than the extent to which it affects creditors' willingness to lend, shareholders have no incentive to take precautions that might reduce the total losses consequent upon failure: as far as the shareholders are concerned, they have lost everything anyway by that point. There is even a Wall Street acronym, used by market participants to reassure themselves they need not worry about marginal losses consequent upon failure: 'IBG–YBG'—'I'll be gone, You'll be gone': I'll have taken my commission, you'll have sold out to the next guy.[11] Yet the costs to society from bank failure can greatly exceed the losses to shareholders, given the risk of domino effects that may bring down the entire financial system and freeze loan markets across the economy.

The third difference is that certain types of financial assets are hard to observe and measure. The rationale for bank lending, as previously described in Chapter 13 is that banks may be able to collect information on borrowers that is not available to others. Hence, the value of their loan portfolio may not readily be subject to external scrutiny by shareholders as well as potential hostile bidders and creditors themselves.[12]

As a result of the first and second of these differences, regulators—in lieu of creditors—are tasked with monitoring and controlling bank risk-taking. However, the very difficulty of monitoring financial assets—the third of the differences described above—makes it particularly challenging for regulators, as well as investors, to perform this task effectively.[13] And the efficacy of regulatory control is further compromised by very intense managerial incentives to maximize the share price. Managers may, therefore, seek to avoid regulation and to minimize the costs of regulation by influencing regulators, rather than taking desired actions and precautions to minimize risks of failure.

17.2.3 Bank governance before the crisis

For much of the postwar period, banks were treated as utilities subject to a form of rate regulation: both entry to the sector, and profits, were restricted. This gave shareholders a steady stream of returns, and no great incentive to push managers. Managers in turn had no great incentive to push to increase the firm's performance. From the 1980s onwards, there was significant deregulation in banking in the US, the UK, and many other countries. This introduced greater competition to the sector and volatility to shareholder returns. Bank governance, therefore, became more intensely focused on

[11] See eg E Dash, 'What's Really Wrong with Wall Street Pay', *New York Times Economix Blog*, 18 September 2009 (http://economix.blogs.nytimes.com/2009/09/18/whats-really-wrong-with-wall-street-pay/).

[12] Banking supervisors control over banks' ownership structure also makes hostile bids more difficult. See JC Coates IV, 'Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence' (2000) 79 *Texas Law Review* 271, 290.

[13] See Chapter 4, section 4.2 and Chapter 24, section 24.2.

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share price maximization. To the extent that banks were different, it was thought that financial regulation could be relied upon to correct any problems. Consequently, policymakers and industry participants sought to apply ordinary 'best practice' in corporate governance to banking firms. For example, guidance by the Basel Committee concerning corporate governance in banks emphasized the monitoring role of the board of directors.[14]

Of the governance mechanisms described in section 17.1, incentive pay was perhaps the most heavily relied upon to control bank executives. This tracked the rise of executive compensation as a governance mechanism generally. Moreover, variable pay has long been a feature of employment in the investment banking sector. When the major investment banks converted from partnerships to corporations in the 1990s, profit-sharing that had previously been effected through partnership status came to be managed through variable pay for risk-takers instead. As investment banks merged with commercial banks, these pay practices were rationalized as promoting shareholder value and extended to the commercial banking divisions of the resulting financial conglomerates.

However, reliance on incentive compensation has a serious drawback in the context of financial institutions. Correctly calibrating incentive pay depends on assessments of the state of financial assets, which by definition are hard to observe. For example, consider a loan officer, who agrees to loans on the bank's behalf. The number of loans she writes, and the interest charged, are easy to observe. But the quality of the borrowers she lends to is not. If the bank were to offer her 'incentive' compensation, this should condition amongst other things on the quality of borrowers, but because borrower quality is hard to observe, the bank may only be able to make the contract conditional on loan size and interest rates, which will lead to predictably problematic results.

The failure to appreciate that the differences between banks and non-financial firms had implications for governance, and that these could not readily be solved by regulators, had unfortunate consequences. An emerging body of literature reports that the bank executives subject to the strongest incentives to maximize the value of their shares—as reflected in stock-based compensation, oversight by independent directors, and shareholder power—worked at banks that took the greatest risks and suffered the greatest losses.[15] In other words, financial firms that had the 'best' governance mechanisms, as conventionally understood before the crisis, actually did *worst* during the crisis.

We now review the application to financial institutions of each of the corporate governance mechanisms described in section 17.1. We begin with boards of directors, then consider compensation practices, then shareholder rights, and conclude with a discussion of legal duties. In each case, we consider first what we have learned from pre-crisis practices, and then review critically recent regulatory initiatives.

[14] BCBS, *Enhancing Corporate Governance for Banking Organisations* (1999), 6–7; ibid (2006), 6–15.
[15] See section 17.3.1 for references.

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17.3 Bank Boards of Directors

17.3.1 Before the crisis

Historically, bank boards in the UK and the US were typically larger, and had more independent directors, than non-financial firms.[16] However, the size of bank boards around the world had been shrinking during the decade prior to the financial crisis, making these boards look more like those in non-financial firms.[17] Yet banks' compliance with general norms of 'good' corporate governance was associated with their failure during the financial crisis.[18] Two studies of banks around the world report that those with more 'shareholder-oriented' boards had greater levels of risk prior to the crisis and experienced greater losses subsequently.[19] There are at least two, likely complementary, explanations for these results. The first is that independent directors in banks may have assumed that regulators were exercising appropriate risk controls and consequently became less intensive in their own scrutiny. The second is that, because of the externalities associated with bank risk-taking, shareholders would have wanted banks to take greater risks. In other words, since financial gains benefit shareholders and losses that are so large as to put banks into bankruptcy are borne by creditors, shareholders benefit from the firm's pursuit of more risky investments.

17.3.2 Bank internal controls

An important role of the board of directors is to oversee internal controls within a firm. In most firms, these are primarily concerned with ensuring operational decisions are actually made in accordance with the firm's strategy. However, the business of financial institutions is principally concerned with the allocation of risk. As a result, these firms need to engage in risk management: that is, ensuring that the financial risks assumed by the organization are consistent with its objectives.[20] At the core of this is the need to

[16] RB Adams and H Mehran, 'Bank Board Structure and Performance: Evidence for Large Bank Holding Companies' (2012) 21 *Journal of Financial Intermediation* 243 (study of thirty-five bank holding companies over 1964–99, reporting a positive relationship between board size and shareholder returns, and no link between number of independent directors and shareholder returns); cf D Walker, *A Review of Corporate Governance in UK Banks and other Financial Industry Entities* (2009) 41; RB Adams, 'Governance and the Financial Crisis' (2012) 12 *International Review of Finance* 7, 27.

[17] M Becht, P Bolton, and A Röell, 'Why Bank Governance is Different' (2012) 27 *Oxford Review of Economic Policy* 437, 448. In contrast to non-financial companies, some studies report a positive association between bank board size and shareholder returns: see Adams and Mehran, n 16.

[18] For reviews, see Becht, Bolton, and Röell, n 17.

[19] A Beltratti and RM Stulz, 'The Credit Crisis Around the Globe: Why Did Some Banks Perform Better? (2012) 105 *Journal of Financial Economics* 1, 10–11, 14–15 (sample of 503 deposit-taking banks around the world; reporting positive association between index of 'shareholder-friendliness' compiled from twenty-five ISS board variables and pre-crisis default risk, and a negative association with post-crisis performance); DH Erkens, M Hung, and P Matos, 'Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2012) 18 *Journal of Corporate Finance* 389 (panel of 296 financial firms worldwide; reporting positive association between proportion of independent directors and pre-crisis risk-taking, and negative association with post-crisis performance).

[20] AM Santomero, 'Commercial Bank Risk Management: An Analysis of the Process' (1997) 12 *Journal of Financial Services Research* 83, 89–90; DH Pyle, 'Bank Risk Management: Theory', in D Galai, D

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assess whether (a) the risks are justified by the returns associated (for particular contracts), and whether (b) the portfolio of risks taken on by the firm as a whole is appropriately constructed.

Banks' risk management systems can be subdivided into four components:[21] (i) the assimilation and communication of information about exposures, in the form of standards and reports; (ii) the application of rules governing limits on positions that employees with a given level of authority may enter into on the firm's behalf; (iii) the development of strategies and guidelines governing investment; and (iv) the design of employee compensation so as to generate appropriate incentives. Each component needs to be monitored and reviewed on a continuing basis, as does its relationship with the others.

A number of aspects of bank risk management are particularly problematic. First is the gross level of complexity. In addition to the inherent difficulty of observing financial assets, noted in section 17.2, bank risk management systems have evolved gradually over time, following different trajectories in relation to different categories of risk. Credit risk management differs from interest rate risk or liquidity risk, for example. The level of complexity involved in the management of each of these has evolved in accordance with the limit of the competence of the most highly skilled teams of experts. This makes it extremely difficult for senior management to synthesize and assess overall risks to the firm.[22]

Second, there is a particular conflict between risk management and high-powered financial incentives for employees. Employees with strongly incentive-based compensation will seek to maximize whatever performance benchmark has been set for them. The more intense the incentive to maximize a particular benchmark, the more single-minded the focus on that measure will be, which may be to the detriment of other business objectives. Worse still, intense incentives can lead employees to seek to 'game' the performance benchmark through steps that are positively harmful to the business as a whole, or even fraudulent. Given the great difficulties in monitoring financial assets, the appropriate calibration of employee compensation schemes and the policing of the way in which employees meet their performance targets are extremely important for the successful operation of the business. They therefore demand significant levels of internal oversight. This needs to be effected not just at the level of individual compensation targets and behaviour, but also at group- and firm-wide levels, ensuring that individual (group) targets are set in a way that are mutually consistent at the level of the firm as a whole.

Consistent with intuition, there is evidence that the level of resources devoted to risk management has a meaningful impact on bank overall returns. Ellul and Yerramilli constructed an index of risk management intended to capture the strength and independence of risk management functions at US bank holding companies. They

Ruthenberg, M Sarnat, and BZ Schreiber, *Risk Management and Regulation in Banking* (New York, NY: Kluwer, 1999), 7, 8.

[21] Santomero, ibid, 86. [22] Ibid, 110–12.

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report that bank holding companies with higher scores in this index were less risky prior to the crisis and enjoyed better returns during the crisis.[23]

17.3.3 EU Regulation of bank board structure and risk management

The EU has, under the aegis of the Capital Requirements Directive IV ('CRD IV') and the accompanying Capital Requirements Regulation ('CRR'),[24] introduced a wide-ranging and prescriptive set of guidelines for bank governance, dealing *inter alia* with board structure and risk management. In contrast, the US has steered clear of imposing prescriptive rules on bank boards, save as respects compensation committees (discussed in section 17.4) and for risk management, for which a board committee with oversight over risk management policies is required under Dodd-Frank and the implementing regulations, with heightened requirements for the largest firms.[24a]

CRD IV, which applies to credit institutions and investment firms, emphasizes the obligations of the board to monitor the performance, risk controls, compensation strategy, and integrity of disclosures of the firm.[25] It imposes regulatory duties of care and loyalty on board members.[26] It does not impose any minimum requirements for the proportion of independent directors, or the extent of their 'independence', save for separation of Chair and Chief Executive and the composition of the nomination, remuneration, and risk committees.[27] However, it does require that board members 'commit sufficient time to perform their functions in the institution', and to encourage this, mandates that not more than two non-executive roles at other organizations may be combined with one executive role, and not more than four non-executive roles in total may be held by any individual director.[28] It also requires firms to promote diversity in the boardroom, on the theory that this will assist in 'recruiting a broad set of qualities and competences'.[29] To this end, nomination committees must specifically introduce targets for representation of women on the boards, although not as regards ethnicity.[30]

CRD IV also imposes both procedural and substantive requirements regarding risk management. Procedurally, it emphasizes the importance of overall risk management functions that are proportionate to the nature, scale, and complexity of the risks inherent in the firm's business model.[31] It also requires boards to 'devote sufficient time to consideration of risks', and for large firms to establish a risk committee of the board comprised of non-executive directors.[32] Firms are also required to ensure that they have a 'risk management function', which is independent of the operational

[23] A Ellul and V Yarramilli, 'Stronger Risk Controls, Lower Risk: Evidence from US Bank Holding Companies' (2013) 68 *Journal of Finance* 1757.

[24] Directive 2013/36/EU of the European Parliament and of the Council on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, Amending Directive 2002/87/EC and Repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338; Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1.

[24a] Dodd-Frank Act sec. 165(h); 12 CFR 252.22, 252.33.

[25] CRD IV, Art 88(1). [26] Ibid, Art 91(7)–(8). [27] Ibid, Arts 88(2) and 95.

[28] Ibid, Art 91. [29] Ibid, Art 91(10).

[30] Ibid, Arts 88(2)(a) and 91(10). For a critical overview of the measures described in this paragraph see L Enriques and D Zetzsche, 'Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive' (2015) 16 *Theoretical Inquiries in Law* 211.

[31] CRD IV, Art 74(2). [32] Ibid, Art 76(2)–(3).

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decision-makers, reports to the board, has sufficient stature and resources to ensure that 'all material risks are identified, measured, and properly reported', and is capable of delivering a 'complete view of the whole range of risks of the institution'.[33] Turning to substantive requirements, the Directive requires regulators to specify guidelines regarding the management of various types of risk run by financial institutions.[34] Ironically, however, to the extent that these detailed guidelines adopt different measurement technologies for different types of risk, they may actually make it harder for boards and risk committees to comply with their procedural obligations.[35]

Institutions must also disclose their recruitment and diversity policies for the board and its members' relevant knowledge and expertise, whether or not the firm has a risk committee, and if so, how frequently it meets, and a description of the information flow on risk to the management body.[36]

17.4 Executive Pay in Banks

17.4.1 History and problems

Prior to the crisis, the financial sector made enthusiastic use of performance-related pay.[37] In keeping with the pattern for non-financial firms, CEOs of US banks typically received far more variable pay than base salary.[38] For example, Fahlenbrach and Stulz ('F&S'), studying compensation of US bank CEOs in 2006, report a mean base salary of $760,000, which is less than a sixth of the mean variable pay (comprising cash bonus and equity compensation) of $5.3 million.[39] This heavy weighting towards variable pay—characterized as 'performance-related'—was relatively recent. Historically, US bank executives received a greater fraction of fixed pay than was the norm in non-financial firms.[40] Following the deregulation of banking in the 1990s, the use of equity-based pay rose sharply in the sector, such that by the turn of the century, bank executive pay looked very similar to other sectors.[41]

Just as before the crisis no one questioned the application to banks of ordinary governance standards, it has now become an article of faith that high levels of variable pay for bank executives tend to encourage 'excessive' risk-taking. Yet such a

[33] Ibid, Art 76(5). [34] Ibid, Arts 77–87. [35] See nn 21–2. [36] CRR, Art 435(2).

[37] Most is known about the compensation of US CEOs and 'top five' executives, because US disclosure rules require the most detailed information to be made public about their compensation.

[38] Nevertheless, in comparison to non-financial firms, when controlling for firm characteristics (especially size), banks typically have less CEO total and incentive compensation, and less director compensation: Adams, n 16, 27.

[39] R Fahlenbrach and RM Stulz, 'Bank CEO Incentives and the Credit Crisis' (2011) 99 *Journal of Financial Economics* 11, 16.

[40] See JF Houston and C James, 'CEO Compensation and Bank Risk: Is Compensation in Banking Structured to Promote Risk Taking?' (1995) 36 *Journal of Monetary Economics* 405; L Angbazo and R Narayanan, 'Top Management Compensation and the Structure of the Board of Directors in Commercial Banks' (1997) 1 *European Finance Review* 239.

[41] DA Becher, TL Campbell II, and MB Frye, 'Incentive Compensation for Bank Directors: The Impact of Deregulation' (2005) 78 *Journal of Business* 1753; V Cuñat and M Guadalupe, 'Executive Compensation and Competition in the Banking and Financial Sectors' (2009) 33 *Journal of Banking and Finance* 495; R DeYoung, EY Peng, and M Yan, 'Executive Compensation and Business Policy Choices at US Commercial Banks' (2013) *Journal of Financial and Quantitative Analysis* 1.

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generalization might be just as misleading as the pre-crisis complacency. We need to look carefully at the details in order to understand the mechanisms in play.

Did having 'skin in the game' restrain risk-taking? First, we should note that bank executives typically held significant holdings of stock in their firms. In F&S' sample, the mean value of the stock CEOs held in their own firm was $87.5 million, approximately 0.4 per cent of the outstanding stock.[42] In part this would have been because stock awards were often 'restricted' for five years, meaning that the CEO could not sell until five years after grant. However, these very large holdings also reflected a significant degree of voluntary exposure by executives: that is, not selling their stock holdings even when they were no longer restricted. As a result, bank CEOs suffered huge losses—averaging $31.5 million—over the period 2006–8.[43] Should we conclude that because managers had such a substantial amount of 'skin in the game', they did not have incentives to indulge in 'excessive' risk-taking?

Apparently not. While managers clearly had significant downside exposure, looking solely at their holdings of stock does not take account of cash already received from bonuses and stock sales. Bebchuk, Cohen, and Spamann report that the top five executives in Bear Stearns and Lehman Brothers received aggregate cash flows of $2.4 billion over the period 2000–8.[44] Although these executives suffered losses of approximately $1.4 billion through their holdings of stock in their firms, taking cash flows into account showed they were still ahead by approximately $1 billion over these eight years.[45] In other words, even for the financial firms that failed outright, managers' payouts from good years had greatly exceeded their eventual losses when the firms failed. This asymmetry—upside returns exceeding downside—seems to generalize. Thus F&S report that, taking into account options and cash bonuses, the mean CEO in their sample would receive 2.4 per cent of the value of any increase in the stock price.[46] However, their downside losses would only be 0.4 per cent of any decrease, tracking their holdings of the firm's stock. In short, incentives on the upside were five times as strong as on the downside.

Moreover, this asymmetry of incentives appears linked to underperformance during the financial crisis. F&S report that the greater the managers' incentives to increase the stock price—as measured by the proportion of the increase in value they captured—the worse were bank shareholders' returns during the financial crisis.[47] This suggests that powerfully asymmetric financial incentives encouraged managers to pursue strategies

[42] Fahlenbrach and Stulz, n 39.

[43] Ibid, 23. Note that the median was only $5.1m, however.

[44] LA Bebchuk, A Cohen, and H Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008' (2010) 27 *Yale Journal on Regulation* 257.

[45] Similarly, Bhagat and Bolton look at CEO payoffs in the largest fourteen crisis institutions, and find that they took $1.77bn in net stock sales plus $0.89bn in cash compensation during the period 2000–8, a total cash flow of $2.66bn. In 2008, their equity holdings suffered an aggregate loss of $2.01bn. Nevertheless, they were better off, on net, over the period by $0.65bn: S Bhagat and P Bolton, 'Financial Crisis and Bank Executive Compensation' (2014) 25 *Journal of Corporate Finance* 313, 319–23.

[46] Fahlenbrach and Stulz, n 39, 17.

[47] F&S gauge the incentive effect for managers by measuring the dollar value CEOs earn from a 1 per cent increase in stock price. Ibid. This measure—the change in managerial pay associated with a change in the stock price—is known as the 'delta' of the compensation package.

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that, at least *ex post*, turned out to be harmful to shareholders. We need to understand why this may have been the case.

One answer may be that stock options gave incentives to take risks in excess of what was optimal even from the shareholders' perspective. The basic rationale for using options is that—assuming they are correctly priced (that is, 'out-of-the-money')—they provide a powerful upside incentive to take actions that will increase the stock price. But might managers be pushed too far? Could options encourage them to pursue risky projects simply for the sake of it? An increase in the volatility of a firm's stock price will increase the value of an out-of-the-money option on that stock[48] and if the incentive is sufficiently powerful, then managers may be induced to select projects with lower net present values simply because they are more risky. F&S did not find any evidence of a link between the risk-sensitivity of managers' portfolios and shareholder returns.[49] In other words, they found no evidence that option compensation led managers to select projects with lower expected values—thus harming even shareholders—simply because they are more risky. However, this does not imply that option contracts do not encourage a degree of risk-taking that is detrimental to creditors.

Were the risks excessive from a societal perspective? The costs of financial firm failure are not borne entirely by shareholders. Implicit or explicit government guarantees of creditors mean that these costs are only partially priced into credit agreements. As a result, shareholders as a group may stand to benefit from strategies that increase default risk but generate more positive cash flows in other states of the world. Consistently with this, Balachandran et al report a positive relationship between managerial equity compensation and default risk.[50] That is, firms whose managers had the strongest incentives to maximize share price were also those most likely to fail. However, this cynical perspective fails to explain why managers did not reduce their holdings of shares in anticipation of the financial crisis. Had managers simply been ramping up risk in order to transfer losses to the state, it would make no sense for them to remain holding shares at the time the losses crystallized. Moreover, this perspective also overlooks the fact that—in the US and the UK at least—most bank shareholders are diversified, meaning that they incur significant losses through their other portfolio firms should systemic harms materialize.[51] Such shareholders would not want bank managers to take socially excessive risks.[52]

[48] This is because the increase in volatility implies an increase in the states of the world in which the option will be in-the-money. The extent to which an increase in the volatility of the share price results in an increase in the value of managerial compensation is known as the 'vega' of the latter.

[49] Ibid, 18–19. But see Bhagat and Bolton, n 45.

[50] S Balachandran, B Kogut, and H Harnal, 'Did Executive Compensation Encourage Extreme Risk-Taking in Financial Institutions?', Working Paper (2011).

[51] J Armour and JN Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35.

[52] On the other hand, the private incentives of asset managers who control institutional portfolios may have led financial firms to engage in excessive risk taking. Recent theoretical and empirical work suggests that the riskiest firms, which generally outperformed in the pre-financial crisis period, gave the highest levels of variable pay, to compensate executives for the extra risk-taking: see I-H Chang, H Gong, and JA Scheinkman, 'Yesterday's Heroes: Compensation and Risk at Financial Firms' (2015) 70 *Journal of Finance* 839. Asset managers, who are evaluated on relative performance, would encourage risk-taking by portfolio companies that would lead to outperformance. On the corporate governance issue, see section 17.5 and Armour and Gordon, n 51, 56, 60–1.

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What about more junior employees? We have so far focused on the compensation of senior managers, primarily because these are the only group for whom detailed compensation information must be disclosed. Consequently, far less is known about the compensation of less senior employees. However, such literature as exists suggests that incentive problems stemming from miscalibrated 'performance' pay may have been most egregious at the level of trading and sales staff, rather than senior executives. Shortly after the onset of the financial crisis, the FSA carried out a study of bank employee compensation practices in the UK.[53] They found that cash bonuses accounted for a large proportion of employees' pay. However, these bonuses were typically not linked to the stock price, but to *net revenues* in that financial year. Conditioning bonuses on revenues, rather than stock price, means that not even the market's (perhaps imperfect) assessment of the downside risk for shareholders of the firm's strategies was priced-in. In fact, it seems an astonishingly poor way to motivate employees, as the box text explains.

'Performance Pay' and Insurance Contracts

Where a financial firm takes on a risk under a contract, it is functionally—albeit not legally—providing insurance to the counterparty in respect of that risk. We would expect the premium for providing this insurance to be reflected in the price of the contract. It is clearly a mistake to reward people for writing insurance based only on the size of the premium they earn, without taking into account the risks insured. This simply gives them incentives to commit their firm to the biggest risks they can find, because these will attract the highest premiums. But this is precisely the effect of rewarding employees in a financial firm on the basis of revenues, without any adjustment for risk.

This disturbing picture is reinforced by Acharya et al's innovative study of the impact of employee incentive compensation.[54] These authors identify the aggregate compensation for sub-board-level employees by subtracting the (disclosed) compensation for 'top five' executives from the (disclosed) aggregate total compensation paid by financial firms, and then determine how sensitive this total compensation is to the firm's revenues (not stock price). This gives a measure of the extent to which employees are incentivized to maximize revenues in a given year. The authors go on to report that greater revenue-sensitivity of aggregate employee cash pay was associated with greater default risk for the firm. This implies that incentive contracts of the type the FSA reported—linking pay to revenues—were associated with greater default risk.

In light of our discussion in section 17.4 about the deficiencies of internal monitoring, we can offer a conjecture about the ways in which senior management may have made mistakes about risk-taking. Management with strong incentives to increase the stock price may have been more inclined to focus simply on revenues generated by

[53] FSA, 'Reforming Remuneration Practices in Financial Services', Consultation Paper 09/10 (2009).

[54] V Acharya, LP Litov, and SM Sepe, 'Seeking Alpha, Taking Risks: Evidence from Non-Executive Pay in US Bank Holding Companies ', Working Paper NYU/University of Arizona (2014); see also SM Sepe and CK Whitehead, 'Paying for Risk: Bankers, Competition and Compensation' (2015) 100 *Cornell Law Review* 655.

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employees and (mistakenly) reflected in the stock price, paying insufficient attention to appropriate risk-adjustment of returns. That is, there was likely a negative synergy between the extent to which managers were encouraged to 'manage the stock price' and the extent to which the stock price failed—owing to opacity—to take into account the true downside costs of firms' strategies.

17.4.2 The new regulation of executive compensation in banks

Bank executive compensation became an early target for regulatory reform. At the G20 summit in Pittsburgh in September 2009, member countries circulated a *Statement of Principles* regarding executive pay in the financial services sector.[55] This encompassed a programme of reform with the following three pillars: first, internal governance mechanisms were to be strengthened as regards the process of setting compensation; second, the substance of compensation packages should be more closely aligned with 'prudent risk-taking'; and third, there should be more disclosure, and effective supervisory oversight, of both the process and substance of compensation arrangements.

These principles were first implemented in Europe through CRD III,[56] and subsequently tightened considerably in CRD IV,[57] which goes significantly beyond what is envisaged by the FSB's *Statement of Principles*. In the US, the Dodd–Frank Act requires the appropriate Federal regulators to introduce rules in relation to internal governance,[58] disclosure of executive pay, and substantive regulation of compensation contracts.[59] Rules regarding internal governance, in particular the role of compensation committees, have been implemented by the Securities and Exchange Commission ('SEC'), and in 2016 there was a revised interagency rule proposal regarding enhanced disclosure of compensation in financial firms and substantive standards on compensation contracts.[60] Table 17.1 sets out the firms and executives to which the regulations apply in the EU and the US, respectively. We now turn to consider specific details of the rules that have emerged.

The Process of Setting Compensation. The FSB's first pillar proposed more active internal oversight of the setting of compensation.[61] At the centre is the idea of a remuneration committee of the board with sufficient independence and expertise to exercise appropriate judgement on remuneration policies. The remuneration committee should work with the firm's risk committee to evaluate the incentives created by the

[55] Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, 2 April 2009.

[56] Directive 2010/76/EU [2010] OJ L329/3. In the UK specifically, this was implemented under the Financial Services Act 2010, ss 4–6, and amendments to the FSA's (now FCA's) Remuneration Code: FSA, *Revising the Remuneration Code*, Consultation Paper 10/19 (2010).

[57] Directive 2013/36/EU [2013] OJ L176/338.

[58] §952, inserting new §10C into the Securities Exchange Act of 1934.

[59] §956 (enhanced disclosure and reporting of compensation arrangements at financial institutions and provision for prohibition of 'types of incentive-based compensation arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions').

[60] US Department of the Treasury et al, 'Notice of Proposed Rulemaking and Request for Commen: Incentive-Based Compensation Arrangements' 21 April 2016.

[61] FSB, *FSB Principles for Sound Compensation Practices: Implementation Standards*, 25 September 2009, 2.

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Table 17.1 To which financial firms does the regulation of executive compensation apply?

	EU	US
Which firms?	CRD IV Art 3, CRR Art 4(1). '*Credit institutions*' (firms both taking deposits and granting credit); '*Investment firms*' (firms providing investment services or engaging in investment activities, including brokers, dealers, investment managers, underwriters, and market operators).	Dodd–Frank Act of 2010, §956 '*Covered financial institutions*' (firms taking deposits or their holding companies, registered broker-dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution that Federal regulators jointly determine should be treated as such) with assets > $1 billion.
Which employees?	CRD IV Art 92(2) and Delegated Regulation (EU) No 604/2014. '*Material risk-takers*' (categories of employee whose professional activities have a material impact on [the firm's] risk profile). Identification based on both internal criteria developed by the firm and qualitative (functions performed) and quantitative (compensation value) criteria applied by supervisors. *Qualitative criteria*: Board and senior management; staff with the authority to commit significant credit risk exposures. *Quantitative criteria*: (i) Total gross remuneration > €500,000; or (ii) among firm's 0.3 per cent most highly paid staff; or (iii) remuneration equal to senior managers; or (iv) variable pay could exceed €75,000 and 75 per cent of fixed pay.	Dodd–Frank Act of 2010, §956 and proposed Rule 'Senior executive officers and significant risk-takers': senior executive officers, and any other executive officer or employee who received total compensation in top 5% (for firms with assets >$250bn) or 2% (for firms with assets >$50bn) of payroll or who can expose 0.5% or more of the firm's net worth.

firm's compensation arrangements so as to ensure that these are consistent with the risk committee's assessment of the firm's financial condition and prospects, and with regulatory guidelines. It should also oversee an annual review of compensation practices which should be produced for regulators. Employees working in the firm's risk and compliance function should have their remuneration set independently of the firm's performance, at a level sufficient to attract qualified and experienced staff, and their performance should be assessed on the basis of the achievement of the objectives of their functions (that is, risk management).

This was the least controversial aspect of the FSB's proposals, and—with the addition of a nod to greater involvement by risk management officials in the process—largely reflected existing best practice.[62]

Substantive Regulation of Executive Compensation Arrangements. Much more significant are the substantive guidelines regarding the content of executive compensation, which are to be overseen by regulators. At their heart is a commitment to continued use of performance-related pay, but in a manner better aligned with the

[62] See eg FSA, *Revising the Remuneration Code*, Consultation Paper 10/19 (2010), 24–5.

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long-term and risk-adjusted performance of the firm. There are two principal routes by which the guidelines seek to do this. First, variable compensation awards must be adjusted *ex ante* in accordance with the riskiness of the activities undertaken by the employee and/or the firm.[63] While this idea is easy to state in principle, it is harder to implement in practice, because it requires a benchmark of risk. Any such benchmark in turn creates incentives to game the system.

The second limb operates in part as a check against such gaming. It requires that performance-related pay should vary with *ex post* realizations of risk outcomes, over a sufficiently long period of time. The FSB consequently prescribes that for senior executives and other employees whose actions have a material impact on the firm's risk exposure ('material risk-takers'), a 'substantial proportion' of pay should be performance-related over time.[64] A large part of this variable pay (no less than 40 per cent, rising to at least 60 per cent for the most senior executives) should be deferred for a period of at least three years, but possibly longer depending on the risks associated with the business.[65] This is most easily done for equity-related pay (stock and options), by restricting the manager's ability to sell stock or exercise the options for a longer period. The FSB also suggests that at least half of variable pay should be awarded in equity. Some part of cash bonuses can also be deferred, with the possibility that it will not vest if negative performance is realized. This deferred compensation must then be subject to clawback—a so-called 'malus' award—if poor performance outcomes are realized within the vesting period.[66]

Although the EU first implemented these guidelines under CRD III, it then went significantly beyond them with CRD IV.[67] CRD IV imposes an outright cap on the amount of variable compensation that may be paid.[68] It may not exceed the amount of fixed pay for any individual, although with the approval of a supermajority of the shareholders, it may be up to twice the size of fixed pay. What is more, the rules regarding the identification of material risk-takers (to whom the restrictions apply) are extensive in their coverage.[69] They apply to all employees of EU-based groups, including, for example, those working in New York or Singapore.[70] Up to 25 per cent of variable compensation may be discounted (for the purposes of the cap) at a supervisor-determined rate, provided that it is deferred for at least five years.[71] Moreover, up to

[63] See CRD IV, Art 92(a) and (g)(ii). [64] FSB, n 61, 3. [65] Ibid.

[66] The FSB's guidelines also seek to ensure that the payment of variable compensation does not occur at times when the firm's capital is, or is likely to become, impaired, or when it is in receipt of government assistance.

[67] At least 50 per cent of any variable compensation must be equity-linked; at least 40 per cent of variable compensation must be deferred for more than three years; at least 60 per cent where it is 'particularly high'. And the deferral period must relate to the risks of the business: CRD IV, Art 94(1)(l)–(m).

[68] CRD IV, Art 94(1)(g).

[69] Commission Delegated Regulation (EU) No 604/2014 supplementing Directive 2013/36/EU with regard to regulatory technical standards on with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile [2014] OJ L167/30.

[70] CRD IV, Art 92(1). [71] Ibid, Art 94(1)(g)(iii).

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100 per cent of variable compensation (not just that part which has been deferred) is subject to 'malus' or clawback provisions.[72]

In the US, implementation of the FSB *Principles* will be through an inter-agency rule made under the mandate conferred by section 956 of the Dodd–Frank Act. The current draft outlines standards as regards incentive-based compensation, such that it must not 'encourage inappropriate risks' by either providing 'excessive compensation, fees, or benefits', or 'that could lead to a material financial loss'.[73] Moreover, for institutions with assets in excess of $50 billion, there are detailed rules requiring deferral of 40–60 per cent (depending on seniority and size of firm) of variable compensation for at least three years (or four years for firms with assets of more than $250 billion), and its adjustment downwards to reflect losses realized during this period.

The EU's step of capping the ratio of variable pay to fixed pay is likely to lead to an increase in base rates of pay, given an internationally competitive market for executive talent. It may also have a counterintuitive impact on risk-taking. This is because, according to some commentators, the base pay in a traditional investment banking compensation scheme was set below the competitive rate, such that the bonus already incorporated a significant amount of downside performance sensitivity. Increasing the proportion of fixed pay will reduce this. Decreasing the proportion of variable pay will also reduce the upside payoffs. As a result, executives will have less incentive to take risks with upside components, and more incentive to take risks with downside components.[74] Moreover, incentives to increase performance will entirely dry up once the bonus has been 'maxed out'. Coupled with deferrals and realized performance contingencies, it will create incentives to 'manage' performance into subsequent periods as well. There are also likely to be employment selection effects. Making pay less performance-sensitive will select away from highly talented individuals and in favour of less talented types. Resistance to the variable pay cap has been particularly vigorous in the City of London, and various efforts have been made to camouflage elements of compensation. This has provoked serious skirmishing with the European Banking Authority, which writes the rulebook on the compensation regulation.

Disclosure and Supervision of Compensation Practices. The FSB's third pillar exhorts that information about both the process of setting compensation and the quantum of pay for top executives should be disclosed publicly, at least annually.[75] Process information should include information about the composition and mandate of the remuneration committee; the most important criteria used in setting compensation are performance measurement, risk adjustment, pay-performance linkage, deferral policy and vesting criteria, and the parameters used for choosing between cash and other forms of compensation. As regards substantive pay, there should be aggregate disclosure of the total (and the breakdown into various components) paid to all senior executives and material risk-takers. This level of disclosure was already largely in place in the US under existing rules for disclosure by public corporations of executive

[72] Ibid, Art 94(1)(n). [73] US Draft Rule, n 60 (rule _.4).

[74] K J Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (2013) 19 *European Financial Management* 631.

[75] FSB Principles, 2009, para 3; Implementation Standards para 15.

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compensation arrangements. In the EU, the relevant disclosure obligations are found in the Capital Requirements Regulation accompanying CRD IV.[76]

The FSB also called for 'rigorous and sustained' domestic supervisory engagement with the implementation of the FSB Principles.[77] In particular, compensation practices should be taken into account as part of supervisory risk review of financial service firms. Failure by firms to implement appropriate compensation policies should result in 'prompt remedial action' to offset any associated risks. This is to be implemented in the US through rules made under section 956 of the Dodd–Frank Act, and will require covered financial institutions to keep records for at least seven years of incentive-based compensation plans. In the EU, this will be implemented by Article 75 of CRD IV.

17.5 Shareholder Rights

Early responses to the financial crisis suggested that lack of shareholder oversight was part of the problem in the governance of financial institutions. For example, the Walker Review, commissioned by the UK government in 2009, concluded that greater engagement by institutional shareholders with boards of financial institutions was desirable.[78] Similarly, the Dodd–Frank Act in the US introduced powers for the SEC to strengthen shareholders' rights, in particular their ability to put forward candidates for the board not supported by incumbent management and a right to vote to approve the compensation of senior executives.[79]

It is far from clear that such proposals are appropriate. As shareholders enjoy limited liability, in the presence of imperfectly priced deposit insurance, or the expectation of a bail-out for 'too big to fail' firms, we might think they would have incentives to encourage firms to take more risk than is socially desirable.[80] Consistently with this, Ferreira et al report that US banks in which shareholders enjoy objectively greater power—in terms of shareholder rights and ability to control management—were more likely to be bailed out during the financial crisis.[81]

We might expect this concern to be ameliorated where investors hold shares in banks as part of a diversified portfolio. Such investors will internalize a large part of the costs to society of bank failure through losses to their other portfolio firms.[82] On the other hand, the problems will be exacerbated by the presence of controlling shareholders, who will be in a position to make more of a difference to the control of the firm than dispersed shareholders, and who will be less diversified and so care less about impacts on other firms. In a study of large banks from across forty-eight countries, Laeven and Levine report that the proportion of the cash-flow rights enjoyed by large

[76] CRR, Art 450.
[77] FSB Principles 2009 para 3, Implementation Standards para 16.
[78] D Walker, *A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations* (2009), 12, 68–89.
[79] Dodd–Frank Act of 2010 §§951 and 971. [80] See nn 50–1.
[81] D Ferreira, D Kershaw, T Kirchmaier, and E-P Schuster, 'Shareholder Empowerment and Bank Bailouts', ECGI Finance Working Paper No 345/2013.
[82] Armour and Gordon, n 51.

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shareholders is positively correlated with bank risk-taking.[83] To this end, many regimes require regulatory approval of the identity of major shareholders as a condition of bank licensing.[84] Similar restrictions apply to changes of control, with regulators reserving the right to refuse to approve such deals.[85] A key factor as regards such approval is the reputation of the controlling shareholder.[86]

17.6 Liability Rules

Is it enough simply to moderate the 'upside' returns that those running a bank receive, by altering the terms of executive compensation? Or should we also push for the imposition of more 'downside' liability? The classic objections to liability for those controlling a business firm—at least for business decisions (as opposed to conflicts of interest)—are that judges lack the capacity to review such decisions effectively, and that fear of liability will induce undiversified managers to take less risk than diversified shareholders might want. In the case of firms whose activities have the propensity to create systemic risk, this logic might actually be reversed. Diversified shareholders may actually stand to lose proportionally more, in the case of default, than executives who have a stake in the firm through equity-based compensation. This is because systemic harms can impact negatively on their entire portfolios, not just on their holding in the bank. Consequently, for banks with diversified share ownership and managers with equity-based pay, fear of liability would not lead to undesirable risk-aversion on the part of managers. Rather, it might simply rein in undesirably risky activities such managers might otherwise take.[87]

Such liability is in principle available in the US in the case of banks entering FDIC receivership proceedings.[88] However, for other banks, directors and officers are shielded from liability for errors and omissions in relation to business judgement and oversight, unless they are so egregious as to evince a lack of good faith.[89] In the UK and many other European countries, directors and officers do in principle owe a duty of care in relation to business decisions, but this is almost never enforced. Civil procedure rules make it costly for shareholder litigation to be commenced. Enforcement by public agencies seems a more worthwhile strategy in this case. Here, the problem has been that agencies lack standing to pursue private law obligations, but rather enforce a parallel regulatory regime. Within this, there has been a lack of clarity as to individual versus organizational responsibility.[90] Upon the input of the UK's Parliamentary Commission on Banking Standards, UK supervisory authorities have approved a new regime aimed at focusing regulatory responsibility onto specific

[83] L Laeven and R Levine, 'Bank Governance, Regulation and Risk Taking' (2009) 93 *Journal of Financial Economics* 259.

[84] Eg CRD IV, Art 14. [85] Ibid, Arts 22–3.

[86] Ibid, Art 23(1)(a). [87] Armour and Gordon, n 51.

[88] See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ('FIRREA'), Pub. L. No 101-73, Title II, §212(k), 103 Stat 243, codified at 12 USC §1821(k).

[89] *Stone v Ritter*, 911 A.2d 362, 370 (Del Sup 2006); *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del Ch 2009).

[90] Parliamentary Commission on Banking Standards, *Changing Banking for Good*, Volume II (2013), 289–90.

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individuals, who should then become natural targets for regulatory enforcement.[91] Moreover, a new criminal offence for bank senior managers whose reckless misconduct causes their firm to fail has been introduced.[92]

17.7 Conclusion

In this chapter, we have explored why the corporate governance framework that is applied for most businesses, in which managers are encouraged to focus on maximizing the stock price, is less well suited to the case of banks. Financial assets are particularly hard to monitor, and so managerial agency costs are unusually high. Banks' business model makes them unusually fragile, and their failure imposes costs on society beyond those borne by their investors. As a consequence, ordinary mechanisms of corporate governance, which rely on stock market prices to incentivize managers, are liable to yield perverse results. Managers may exploit the opacity of financial assets to game the measures, and regulators will face an uphill struggle to uncover this. Maximizing the stock price may not be the right approach in any event, as shareholders' interests may diverge from those of society. Reforms since the financial crisis have gone some way to address these problems. Two particularly beneficial steps have been the push towards greater resources being deployed in risk management and internal monitoring functions, and an attempt to better calibrate incentives in relation to executive pay. The latter task will be extremely challenging for regulators to get right, but the former seems more promising.

[91] See FCA, CP15/22 Strengthening accountability in banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities (2015).

[92] Financial Services (Banking Reform) Act (2013) s 36.

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