CRD IV and the Mandatory Structure of Bankers' Pay

Law Working Paper N° 289/2015
April 2015

Guido Ferrarini
University of Genoa and ECGI

ECGI Working Paper Series in Law

CRD IV and the Mandatory Structure of Bankers' Pay

Working Paper N°. 289/2015
April 2015

Guido Ferrarini

This is a draft chapter for H. Eidenmüller, M. Habersack and L. Klöhn (eds), European Banking Regulation, Beck and Hart (forthcoming).

Abstract

In this paper, I analyse the rise of mandatory structure of bankers' pay in Europe as outcome of criticism of pre-crisis remuneration practices at financial institutions. Whether flawed bankers' pay contributed to the financial crisis is still debated amongst scholars. It appears more likely that insufficient prudential regulation and flawed risk management contributed to banks' undertaking risks that were later proven to be excessive from a societal perspective. All this would have suggested improving risk management systems and reforming areas of prudential regulation such as capital adequacy and organizational requirements, rather than intervening directly on bankers' incentives. Nonetheless, governments and legislators, under the pressure of the media and public opinion, proceeded to extensive reforms of bankers' remuneration, with reference to both the top executives and other risk-taking/high-earning employees at various levels of the institutions concerned. Indeed, the FSB principles and standards cover not only remuneration governance and disclosure, but also remuneration structures. Both the fixed and the variable remuneration components and the relationship between the same are subject to detailed regulation. As a result, the international standards have nature of "rules" and have been implemented as such. The EU in particular has followed a strict approach to the implementation of the FSB standards and has also departed from the latter by introducing an unprecedented cap on variable remuneration in CRD IV. I analyse this cap from a legal and economic perspective, showing that its rationale is flawed and that unintended consequences may derive from it as a result. Moreover, the cap is inconsistent with other aspects of CRD IV which incorporate the international standards on variable pay.

Keywords: Executive Remuneration, Corporate Governance, Banks, Financial Crisis, Prudential Regulation, Supervision, CRD IV

JEL Classifications: G20, G21, G28, G30, G32, G34, G38, K22, K31, M12

Guido A. Ferrarini*
Professor of Law
University of Genoa, Law School
Via Balbi, 22
16126 Genova
Italy
phone: +39 010 2099951 , fax: +39 010 2099890
e-mail: guido.ferrarini@unige.it

*Corresponding Author

CRD IV and the Mandatory Structure of Bankers' Pay

Guido Ferrarini

University of Genoa and ECGI

Abstract: *In this paper, I analyse the rise of mandatory structure of bankers' pay in Europe as outcome of criticism of pre-crisis remuneration practices at financial institutions. Whether flawed bankers' pay contributed to the financial crisis is still debated amongst scholars. It appears more likely that insufficient prudential regulation and flawed risk management contributed to banks' undertaking risks that were later proven to be excessive from a societal perspective. All this would have suggested improving risk management systems and reforming areas of prudential regulation such as capital adequacy and organizational requirements, rather than intervening directly on bankers' incentives. Nonetheless, governments and legislators, under the pressure of the media and public opinion, proceeded to extensive reforms of bankers' remuneration, with reference to both the top executives and other risk-taking/high-earning employees at various levels of the institutions concerned.*

Indeed, the FSB principles and standards cover not only remuneration governance and disclosure, but also remuneration structures. Both the fixed and the variable remuneration components and the relationship between the same are subject to detailed regulation. As a result, the international standards have nature of "rules" and have been implemented as such. The EU in particular has followed a strict approach to the implementation of the FSB standards and has also departed from the latter by introducing an unprecedented cap on variable remuneration in CRD IV. I analyse this cap from a legal and economic perspective, showing that its rationale is flawed and that unintended consequences may derive from it as a result. Moreover, the cap is inconsistent with other aspects of CRD IV which incorporate the international standards on variable pay.

Keywords: Executive Remuneration, Corporate Governance, Banks, Financial Crisis, Prudential Regulation, Supervision, CRD IV

JEL Classification: G20, G21, G28, G30, G32, G34, G38, K22, K31, M12

This is a draft chapter for H. Eidenmüller, M. Habersack and L. Klöhn (eds), *European Banking Regulation*, Beck and Hart (forthcoming)

I. INTRODUCTION

The topic of bankers' remuneration raises some interesting issues at the frontier between corporate governance and banking regulation that I try to highlight in this paper by analysing recent international and European developments. Excessive pay at financial institutions has often been indicated as one of the possible causes of the recent financial crisis and the claim has consequently been advanced that bankers' pay should be regulated. However, the relevance of bankers' pay to the financial crisis is still debated in academia, as I show in section II of this paper.

Even assuming that excessive pay had something to do with the crisis, the type of regulation needed is widely debated. Mandatory disclosure of pay structures and amounts raises little controversy, for the benefits of transparency are well set and the costs are relatively low. Also remuneration governance is an easy candidate to regulation, given that bank governance – particularly risk governance - is generally considered as a suitable subject for regulation and supervision since before the financial crisis. Regulating pay structures is more controversial, as it directly affects the competition between firms in the market for managerial services and limits the autonomy of boards and shareholders. Indeed, the design of pay structures and incentives is a traditional function of boards of directors and top managers (with respect to the compensation of their subordinates), so that it may be difficult to accept that regulators mandatorily set similar structures and incentives *ex ante* for all firms and with the public interest primarily in mind. Nonetheless, the international regulatory trend after the crisis has been to fix the criteria for the design of pay structures along the lines of the international principles and standards issued by the Financial Stability Board (FSB) that I analyse in section III.

This trend raises a general question, which is relevant to the analysis in section IV concerning the implementation of the FSB principles. The question is whether a regulatory or supervisory approach should be followed, i.e. whether regulation should set the details of pay structure *ex ante* or firms should be free to make their choices subject to *ex post* supervision. Underlying this question is the more fundamental one, concerning the choice between rules and standards.[1] Should regulation set some general standards or should detailed rules be formulated *ex ante*, limiting the discretion of the supervisor? As I show in this paper, the EU has made a very clear choice in favour of detailed rules, which are fixed through primary legislation. These rules largely reflect the FSB principles and standards, but also go beyond the same by fixing a maximum ratio for the proportion between fixed and variable pay. This cap on variable remuneration was introduced at the request of the European Parliament responding to widespread political concerns with respect to "excessive" levels of bankers pay especially before the financial crisis. In section V, I criticize this cap's rationale and highlight the relative inconsistency between the international regulation of bankers' pay – which is focused on remuneration governance, disclosure and a few requirements on the structure of incentive compensation – and the EU solution of capping variable pay.

II. Theories and policies

A. *Role of incentives and their governance in the crisis*

Official policy documents issued after the crisis argue that the recourse to flawed remuneration structures, including the excessive use of short-term incentives for managers and other risk-taking employees, contributed to the failure of many banks and other financial institutions.[2] As shown in paragraph 1 below, some scholars take issue with this hypothesis, while

[1] See Louis Kaplow, "Rules Versus Standards: An Economic Analysis", Duke Law Journal (1992), 42, 557-629.
[2] See The High-level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, 25 February 2009 (De Larosiére Report), 30 (the excessive level of remuneration and remuneration structure induced too high risk-taking and encouraged short-termism); Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector (2009/384/EC), OJ 15.5.2009, L120/22 (whilst not the main cause of the financial crisis, inappropriate remuneration practices in the financial services industry induced excessive risk-taking and thus contributed to significant losses of major financial undertakings); Commission Staff Working Document, Corporate Governance in Financial Institutions:

others offer empirical evidence in support of the same. This topic is intertwined with the more general one concerning the role of corporate governance in the crisis, as governance structures shape managerial incentives and monitor risk-taking by financial institutions. Official policy documents agree on the fact that the malfunctioning of corporate governance at banks and other financial institutions contributed to their crisis in the financial turmoil.[3] Once again, scholars are divided: some argue that failed banks often complied with best corporate governance standards (or at least appointed a majority of independent directors to their boards), while others criticize pre-crisis bank governance practices for lack of adequate monitoring on internal control and risk management systems (as shown in paragraph 2).

1. *Did variable pay contribute to the financial crisis?*

(a) Some empirical studies analyse the structure of bank CEOs' pay before the crisis asking whether short term incentives may have distorted risk taking by their institutions. A paper by Rüdiger Fahlenbrach and René Stulz analyses a sample of ninety-eight large banks across the world, but finds "no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis."[4] The authors rather 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."[5] According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including

---

Lessons to be drawn from the current financial crisis, Accompanying document to the Green Paper, Corporate governance in financial institutions and remuneration policiesBrussels, Brussels 2.6.2010, SEC(2010) 669, 9; A review of corporate governance in UK banks and other financial industry entities (the Walker Review), 16 July 2009, 90 ff.

[3] See the de Larosière Report, 29 ff. (corporate governance is one of the most important failures of the present crisis); Commission Green Paper, Corporate governance in financial institutions and remuneration policies, 2.6.2010, COM(2010) 284 final, 2 (boards of directors rarely comprehended either the nature or scale of the risks they were facing); Basel Committee on Banking Supervision, Principles for enhancing corporate governance, October 2010; OECD, Corporate Governance and the Financial Crisis. Conclusions and emerging good practices to enhance implementation of the principles (2010).

[4] Rüdiger Fahlenbrach and René Stulz, "Bank CEO Incentives and the Credit Crisis", Journal of Financial Economics 99 (2011), 11-26.

[5] Ibid. at 12.

stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006. Similar equity holdings should have led CEOs to focus on the long term, avoiding too much risk and excessive leverage for their banks. Instead, the study shows that a bank's stock return performance in 2007-2008 was negatively related to the dollar value of its CEO's holdings of shares in 2006, and that a bank's return on equity in 2008 was negatively related to its CEO's holdings in shares in 2006.

Lucian Bebchuk, Alma Cohen, and Holger Spamann offer a different view in a paper on executive compensation at Bear Stearns and Lehman Brothers, focusing on the link between short-term incentives and risk taking.[6] 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 what the same executives cashed out in the 2000-2008 period and what they owned initially. In the observed timeframe, 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."[7] Indeed, performance-based compensation paid to top executives at Bear Stearns and Lehman Brothers substantially exceeded the value of their holdings at the beginning of the period. Bebchuk et al. argue that this provides 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."[8]

While the first study reviewed in this paragraph argues that the interests of executives of troubled banks were substantially aligned with those of shareholders, the second highlights the potential of short-term incentives in inducing executives to take excessive risks even in the presence

[6] Lucian Bebchuk, Alma Cohen and Holger Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", Yale Journal on Regulation (2010), 27, 257 – 282.
[7] Ibid., 260.
[8] Ibid., 274.

of large equity investments in their firms.[9] It does not claim, however, that incentives in troubled banks before the crisis were mainly short-term, or that short-term incentives necessarily led banks' executives to undertake excessive risks. Rather, the paper recommends looking at the issue of short-term incentives and their impact on risk-taking seriously from a reform perspective.

Other scholars offer different explanations for the intriguing results of the study by Fahlenbrach and Stulz, especially with regard to the circumstance that CEOs were heavily invested in their firms (like Richard Fuld at Lehman Brothers who owned 1 billion USD worth his firm's stock) and lost tremendous amounts when the latter were brought down by the crisis. What could have led top managers to take huge risks threatening their firms' survival if they were heavily invested in the same? One possible explanation is sheer incompetence of these managers, who arguably knew little of what was really going on at their firms.[10] However, it is hard to apply a similar explanation to the majority of top managers at financial institutions in the early 2000s, given that "the corporate hierarchy is inherently a tough climb and weeds out a lot of incompetents, especially in the unforgiving and fiercely competitive financial sector".[11] A seemingly better explanation focuses on CEOs competing "for prestige by making more profits in the short-term or by heading league tables for underwriting or lending, regardless of the longer-term risk involved".[12] Another explanation may be found in a study showing that some banks had a culture of risk taking and of compensating very heavily over the short-term which influenced their performance.[13] When

[9] Sanjai Bhagat and Brian Bolton, Bank Executive Compensation and Capital Requirement Reform, unpublished paper available at ssrn.com/abstract=1781318, support the findings of Bebchuk et al., note …, by focussing on the CEOs' buys and sells of their bank's stock and finding that CEOS are 30 times more likely to be involved in a sell trade compared to an open market buy trade. They find this data inconsistent with the "culture of ownerhip", i.e. with the idea that if senior executives have significant stock ownership in their banks, their incentives are aligned with those of the long-term shareholders.
[10] Raghuram Rajan, *Fault Lines*. How hidden fractures still threaten the world economy (Princeton 2010), 141 ff.
[11] Ibid., 142.
[12] Ibid., 143, making reference to a previous study by the same author: Ranghuram Rajan, "Why Bank Credit Policies Fluctuate: A Theory and Some Evidence", Quarterly Journal of Economics, 109 (1994), 399.
[13] Ing-Haw Cheng, Harrison Hong, and Jose Scheinkman, "Yesterday's Heroes: Compensation and Creative Risk Taking" Journal of Finance (2014) (pay and risk are correlated not because misaligned pay leads to creative risk-taking; rather, as principal-agent theory predicts, riskier firms have to pay more total compensation to provide the same incentives for a risk-averse manager than less risky firms).

these banks did well during boom times, their CEOs were acclaimed as heroes; however, in the recent crisis the same banks either did poorly or failed, and their CEOs became villains. Indeed, aggressive risk taking in some banks paid off handsomely for a considerable period of time, but this was largely based on luck. Similar bets made by bank managers more recently led to disastrous outcomes in the financial crisis, once the tail risks which had been taken materialised.[14]

(b) The studies by Fahlenbrach and Stulz and by Bebchuk et al. cited above focus on the remuneration of top executives at large banks. However, also the remuneration of other bank employees should be taken into account, particularly that of high-earners who contribute to risk-taking by the firm. Even though precise empirical data are lacking, it is well known that many of these employees were paid short-term incentives in amounts much greater than that of their fixed salaries. As explained by Diamond and Rajan, in the case of traders "many of the compensation schemes paid for short-term risk-adjusted performance. This gave traders an incentive to take risks that were not recognized by the system, so they could generate income that appeared to stem from their superior abilities, even though it was in fact only a market-risk premium".[15]

No doubt, assuming that CEOs and other top managers had the right incentives – i.e. not only short-term, but also long-term incentives – the fact that other employees had mainly short-term incentives should not have been a big problem, provided that sound risk management systems were in place and an effective oversight was exercised on risk-takers by their superiors. However, as widely acknowledged in the aftermath of the crisis, this was not always the case at large banks, where risk management systems were often deficient and top managers did not always understand, either as a result of flawed risk management systems or just out of sheer incompetence, what their subordinates were doing. The problem was exacerbated by the huge amounts at play both for employers and employees, who were often incentivised to place financial bets in the crazy way

[14] Rajan, note 10, at 144-145.

[15] Douglas Diamond and Raghuram Rajan, "The Credit Crisis: Conjectures about Causes and Remedies", American Economic Review (2009), 99(2), 606-10, 607.

aptly described by Professor Alan Blinder: "Heads, you become richer than Croesus; tails, you get no bonus, receive instead about four times the national average salary, and may (or may not) have to look for another job… Faced with such skewed incentives, they place lots of big bets. If heads come up, they acquire dynastic wealth. If tails come up, OPM [other people money] absorbs almost all losses".[16]

2. *Did bank governance contribute to the crisis?*

Assuming that bankers' pay was to some extent flawed before the crisis, as the ambiguous outcomes of research in this area tend to show, the question needs to be answered whether distorted incentives depended on deficiencies in bank governance. A similar question is dealt with in the studies that have considered whether the corporate governance of banks and other financial institutions contributed to the 2008 crisis, which I briefly analyse below.

(a) In general, banks are different from other firms for several reasons that matter from a corporate governance perspective. Firstly, they are more leveraged, with the consequence that the conflict between shareholders and fixed claimants, present in all corporations, is more acute for banks.[17] Secondly, their liabilities are largely issued as demand deposits, while their assets (e.g. 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. Thirdly, despite contributing to bank runs' prevention, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk taking. Similarly, the expectation that governments will bail-out large institutions without letting them fail enhances moral hazard of the managers, while reducing monitoring by creditors. Fourthly, asset

[16] Alan Blinder, *After the Music Stopped. The financial crisis, the response, and the work ahead* (Penguin 2013), 82.
[17] Jonathan Macey and Maureen O'Hara, "The Corporate Governance of Banks", FRBNY Economic Policy Review (2003), 9, 91-107.

substitution is relatively easier in banks than in non-financial firms.[18] This allows for more flexible and rapid risk shifting, which further increases agency costs between shareholders and stakeholders (in particular bondholders and depositors) and moral hazard of managers. In addition, banks are more opaque, i.e. it is difficult to assess their risk profile and stability. Information asymmetries, in particular for depositors, hamper market discipline and, in turn, increase moral hazard of managers.[19]

For all these reasons, "good" corporate governance (i.e. aligning the interests of managers and shareholders) may simply lead bank managers to engage in more risky activities. This is due to the fact that a major part of the losses are externalized to stakeholders, while gains are fully internalized by shareholders and managers (if properly aligned by the right incentives). Therefore, prudential regulation and supervision should reduce the excessive risk propensity of shareholders and managers in order to guarantee the "safety and soundness" of banks.[20] Capital requirements, in particular, should reduce the incentives of shareholders to undertake excessive risks, while providing a cushion for the protection of depositors and other stakeholders, including the taxpayers to the extent that the chances of a bailout are diminished.[21]

Some recent empirical studies confirm that good governance is not enough for bank soundness. A notable example is the paper by Andrea Beltratti and René Stulz, which investigates possible determinants of bank performance measured by stock returns, for a sample of ninety-eight large banks across the world, during the crisis.[22] The authors find no evidence that failures and weaknesses in corporate governance arrangements were a primary cause of the financial crisis. In particular, they find no evidence that banks with better governance performed better during the

[18] Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence", World Bank Policy Research Working Paper 3404 (2004).
[19] Ibid., 7.
[20] Lawrence White, "Corporate Governance and Prudential Regulation of Banks: Is there Any Connection?", in James Barth, Chen Lin and Clas Wihlborg (eds.), *Research Handbook for Banking and Governance* (Elgar 2012), 344-359.
[21] Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* (Princeton 2013), 94-95.
[22] Andrea Beltratti and René Stulz, "The Credit Crisis around the Globe: Why Did Some Banks Perform Better?", Journal of Financial Economics (2012), 105, 1-17.

crisis. On the contrary, banks with more pro-shareholder boards performed worse. In their opinion, bank balance sheets and bank profitability in 2006 explain the performance of banks in the following two years better than governance and regulation. 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 generally performed better during the crisis.

However, the criteria for examining corporate governance employed by this and similar studies are debatable.[23] 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. Moreover, 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.[24] Thus, while establishing a prima facie case for excluding corporate governance as a main determinant of the crisis, these 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.

(b) A study by Ellul and Yerramilli shows that the organization of risk management at banks, including the role of boards in oversight of the same, are important in predicting risk taking

[23] Similar conclusions are reached by Renée Adams, "Corporate Governance and the Financial Crisis", International Review of Finance (2012), 12, 7–38, 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. 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. 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

[24] See Sanjai Baghat, Brian Bolton and Roberta Romano, "The Promise and Perils of Corporate Governance Indices", Columbia Law Review (2008), 108, 1803–82 (detailing the limits of corporate governance indexes for measuring corporate performance); René Stulz, "Risk Management Failures: What Are They and When Do They Happen?", Journal of Applied Corporate Finance (2008) 39–48 (detailing the complexities of risk management).

by the institutions concerned and their performance over time.[25] The authors examine the organizational structure of risk management at Bank Holding Companies (BCH) in the U.S. by constructing an index (Risk Management Index = RMI) that measures the importance attached to the risk management function within each BCH and the quality of risk oversight provided by the BHC's board of directors. RMI consists of two sets of variables: the first is intended to measure the importance within the organization of the Chief Risk Officer (CRO), i.e. the officer charged with managing enterprise risk across all business segments; the second is intended to capture the quality of risk oversight provided by the BCH's board of directors, with particular reference to either the risk management committee or the audit and risk management committee.[26] Their main hypothesis is that BCHs with strong and independent risk management functions should have lower tail risk, all else equal.[27] In fact, a strong risk management function correctly identifies risks and prevents excessive risk-taking, which cannot be controlled entirely by regulatory supervision or external market discipline.

Ellul and Yerramilli examine, in particular, whether BHCs that had strong internal risk controls in place before the financial crisis fared better during 2007 and 2008. They find that BCHs with higher pre-crisis RMI had lower tail risk, a smaller fraction of nonperforming loans and better operating performance and stock return performance during the crisis years. They also examine the association between RMI and tail risk taking over the 1995 – 2010 period and find that BCHs with higher RMI (strong organizational risk controls) in the previous year have lower risk in the following one. On the whole, their paper highlights that weakening risk management at financial institutions may have contributed to the excessive risk-taking that brought about the financial

[25] Andrew Ellul and Vijay Yerramilli, "Stronger Risk Controls, Lower Risk: Evidence from U.S Bank Holding Companies", Journal of Finance (2013), 68, 1757-1803.
[26] Ibidem, 1765-1766.
[27] Ibidem, 1762-1764. Their hypothesis is motivated by Anil Kashyap, Raghuram Rajan and Jeremy Stein, "Rethinking capital regulation", Federal Reserve Bank of Kansas City Symposium on "Maintaining Stability in a Changing Financial System," Jackson Hole, Wyoming (2008). Available at http://www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.08.08.08.pdf.; and Stulz, note … above.

crisis.[28] Indeed, they show that banks with internal risk controls in place before the onset of the financial crisis were more judicious in the tail risk exposures and fared better, in terms of both operating performance and stock market performance, during the crisis years.

B. *Studies on the optimal structure of bankers' pay*

Calls for regulating bankers' pay have been advanced post-crisis not only by legislators, but also by legal and economic scholars exploring, on theoretical grounds, the incentives to excessive risk taking created by remuneration structures and possible remedies from a regulatory perspective.

1. *Debt-based proposals*

A paper by Bolton, Mehran and Shapiro models a similar claim for regulation, starting from the proposition that the existing theory of executive compensation has been conceived mainly with respect to an all equity firm that provides incentives to its CEO.[29] This theory does not fit entirely the case of levered firms with risky debt, given that shareholders have an incentive to inefficiently shift risk to creditors. In these firms, compensation structures focussing on shareholder value maximization encourage excessive risk taking, for the value of shares increases with the volatility (riskiness) of the assets held by the firm. This is particularly true for banks, which are highly levered institutions, and explains why executive compensation has been identified by many as one of the culprits of the 2008 financial crisis. Bolton et al. suggest, therefore, that the CEO's compensation at 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."[30] In particular, they propose tying CEO compensation, at least in part, to a measure of default riskiness of the firm, such as a bank's

[28] See, amongst the policy documents, Senior Supervisors Group, Observations on risk management practices during the recent market turbulence (2008) arguing that bank executives and traders were knowingly taking excessive tail risks and could not be restrained by risk managers.
[29] Patrick Bolton, Hamid Mehran and Joel Shapiro, "Executive Compensation and Risk Taking", Federal Reserve Bank of New York, Staff Report no. 456, June 2010.
[30] Ibidem, 1.

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.

Bolton et al. also recognize that it is not obvious that a 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. In the authors' opinion, therefore, regulation should mandate the suggested structure, at least for large financial institutions.

Lucian Bebchuk and Holger Spamann recommend regulating executive pay at banks and designing a pay structure intended to avoid excessive risk taking.[31] In their opinion, "regulation of executive pay would be warranted even if banks had no governance problems," for the same reasons that traditionally underlie bank regulation, i.e. that shareholders do not internalize losses that risk taking could impose on bondholders, depositors, and taxpayers.[32] Moreover, mandating pay structures could usefully 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."[33] They argue 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. 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.[34]

[31] Lucian Bebchuk and Holger Spamann, "Regulating Bankers Pay", Georgetown Law Journal (2010), 98, 247-287.
[32] Ibid., 253.
[33] Ibid.
[34] Ibid., 283 ff.

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 risk-averse debt holders and ultimately with those of regulators in assuring banks' safety and soundness.[35] 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," i.e. "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".[36]

Both Gordon and Tung criticize Bebchuk and Spamann's proposal from various angles, focusing on its technical details, however sharing the core idea that executives' incentives at banks should take into account the interests of creditors, so as to avoid excessive risk taking. All papers considered in this paragraph also agree that 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 structures,[37] 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".[38]

2. *Equity-based proposals and Hybrid models*

Bhagat, Bolton and Romano recommend that bank executives' compensation should consist only of restricted stock and restricted stock options, "restricted in the sense that the executive

[35] Frederick Tung, "Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation", Northwestern University Law Review (2011), 105, 1205 – 1251.
[36] Jeffrey Gordon, "Executive Compensation and Corporate Governance in Financial Firms: The Case for Converticle Equity-Based Pay"", Columbia Law and Economics Working Paper 373 (2010).
[37] Bolton et al., note 29; Bebchuk and Spamann, note 31.
[38] Tung, note 35, 1249.

cannot sell the shares or exercise the options for two to four years after his or her last day in office".[39] They argue that a similar compensation package will focus bank managers' attention on the long-term and discourage investment in high-risk, value-destroying projects. However, they also admit that equity-based incentive programs of this kind may lose effectiveness in motivating managers to reduce excessive risk-taking as a bank's equity value approaches zero. In fact, an agency cost of debt derives from shareholders' potential preference to take extreme risks when close to insolvency.[40] No doubt, debt-based reform proposals like the ones just examined are better at dealing with this moral hazard problem. Nonetheless, Bhagat, Bolton and Romano contend that equity-based incentive pay is preferable in motivating managers to maximize bank value and suggest to solve the insolvency-related moral hazard problem by adopting a capital structure that contains considerably more equity than currently required, supplemented with contingent convertible debt (CoCos).[41]

An interesting alternative is to have compensation partially based on hybrid instruments, such as debt instruments which are held back by the financial institution for a period of say five years and can be forfeited if the institution's capital ratio falls below a given ratio, such as 7 per cent. The Squam Lake Group recently made a similar proposal, modifying what already suggested in their 2010 report.[42] They suggest that at systemically important financial institutions a substantial

[39] Sanjai Bhagat, Brian Bolton and Roberta Romano, "Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?", ECGI Law Working Paper Nº 241/2014. For previous versions of the same proposal see Sanjai Bhagat and Roberta Romano, "Reforming Executive Compensation: Focusing and Committing to the Long-term", Yale Journal on Regulation (2009), 26, 359; Sanjai Bhagat and Roberta Romano, "Reforming Executive Compensation: Transparency and Committing to the Long-term", European Company and Financial Law Review (2010), 7, 273.

[40] Bhagat, Bolton and Romano, note 39, 3, who specify that the moral hazard arising when equity value approaches zero is more severe for banks, as their creditors have less interest in monitoring against risk-taking because of deposit insurance and government bailouts.

[41] Ibid., 43 ff.

[42] Martin Baily et al., "Aligning Incentives at Systemically Important Financial Institutions", Columbia Business School Research Paper (2013), Nº 13/18 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239895). The new proposal makes reference to the "bonus bonds" issued by UBS, the Swiss bank, to the benefit of 6500 highly compensated employees, subject to forfeiture if the bank does not meet its capital requirements. These bonus bonds echo the recommendation made by Kenneth French et al., *The Squam Lake Group Report* (Princeton 2010), which however suggested that the deferred compensation be forfeited if the firm failed or needed government assistance during the holdback period.

share, like 20 per cent, of the compensation of employees who can have a meaningful impact on the survival of the firms should be paid in bonds that would be held back by the firm and forfeited if the firm's capital ratio falls below a specified threshold. In particular, "the deferral period - perhaps 5 years – should be long enough to allow much of the uncertainty about managers' activities to be resolved before the bonds mature. Except for forfeiture, the payoff on the bonds should not depend on the firm's performance, nor should managers be permitted to hedge the risk of forfeiture. The threshold for forfeiture should be crossed well before a firm violates its regulatory capital requirements and well before its contingent convertible securities convert to equity".[43]

C. *Should bankers' pay be regulated? A public interest view*

1. *The case against regulating pay structure*

As I argued in another paper, the case for regulating the structure of bankers' pay appears to be rather weak.[44] Firstly, it is not sure that pay structures generally contributed to excessive risk taking before the recent crisis. According to some of the studies cited above, corporate governance and compensation structures of CEOs at banks that failed were not necessarily flawed. Secondly, even assuming that compensation structures were flawed – particularly those of traders and other middle-managers taking excessive risks for banks - the need for their regulation would not be automatically established. In fact, excessive risk taking could be curbed directly through prudential regulation of banks, rather than by modelling the incentives of bank employees, also given that regulators may not be professionally qualified for designing pay structures.[45] Thirdly, mandating pay structures hampers the flexibility of compensation arrangements, which need tailoring to individual firms and managers, also in light of the latter's portfolios of their own bank securities. Moreover, bank boards lose one of their key governance functions, finding it more difficult to align

[43] Baily et al., note 42, 6.
[44] Guido Ferrarini and Maria Cristina Ungureanu, "Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks", Vanderbilt Law Review (2011), 64, 431- 502.
[45] Blinder, note 16, 84 and 284.

executives' incentives to corporate strategy and risk profile. This may also create problems in keeping and attracting managerial talent, particularly from countries that adopt a more liberal stance or from firms that are not subject to regulatory constraints (such as hedge funds or private equities).

No doubt, competent authorities should supervise bankers' compensation from the perspective of bank safety and soundness.[46] Rather than designing compensation structures *ex ante*, which is a matter for boards, they should analyse the impact of remuneration structures on risk taking and conduct their surveillance activities accordingly, for instance by imposing higher capital requirements to institutions adopting "aggressive" remuneration mechanisms. Moreover, supervisors should check bank compliance with compensation governance requirements and with the disclosure requirements concerning remuneration policies. Rather than interfering 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.

2. *The case for regulating pay governance and disclosure*

The case for regulating remuneration governance is stronger than that for mandating structure, at least to the extent that bank governance was found deficient and in need of improvement after the financial crisis.[47] No doubt, some of the studies already cited show that ailing banks were often the ones with the best corporate governance in place under international standards.[48] However, the alignment of managerial interests with those of shareholders which "good" governance determines is not enough from a financial stability perspective, for shareholders' interests are not aligned with those of other stakeholders, like depositors and

[46] Luc Laeven and Lev Ratnovski, "Corporate Governance of Banks and Financial Stability", Vox 21 July 2014 (http:voxeu.org),

47 See however for heavy criticism of post-crisis regulation, Luca Enriques and Dirk Zetzsche, "Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive", ECGI Law Working Paper No. 249/2014.

[48] See the studies by Beltratti and Stulz, note 22, and Adams, note 23.

taxpayers, who will in the end pay for the costs of a banking crisis.[49] Indeed, shareholders tend to push bank managers and boards to take risks in an amount higher than socially desirable, while the interest alignment deriving from good governance and remuneration practices makes pressure in the same direction, rather than that of financial stability.[50]

To the extent that risk management practices are flawed and board oversight on them is also deficient, an improvement of board organization and functioning is in the interest of shareholders, who would otherwise be negatively affected by excessive risk taking.[51] Therefore, some regulation of bank governance is justified from a prudential perspective; moreover, supervision should ensure that there is proper oversight of risk management within banks, not only from a shareholders' perspective, but also from a societal and systemic viewpoint. Also remuneration practices of risk takers are subject to oversight by the board, which should therefore check that they are sound from a risk management perspective, while prudential supervision could exert further pressure on boards in the same direction.[52]

In addition, mandatory disclosure of bankers' pay is justified on at least two counts. Firstly, detailed disclosure of pay structure and amounts makes boards and managers more accountable to shareholders and the capital markets. Secondly, disclosure allows shareholders to better exercise their say-on-pay rights, while enabling supervisors to perform their function more effectively.[53]

---

[49] See Laeven and Ratnovski, note 46 (better corporate governance, by itself, is unlikely to make banks safer); Marco Becht, Patrick Bolton and Ailsa Roell, "Why Bank Governance is Different", Oxford Review of Economic Policy (2012), 27, 437-463, 445 (not only shareholders, but also depositors, other creditors, transaction counterparties and the taxpayers are at risk from banks' activities; therefore, not just the interests of shareholders, but also those of other constituencies should be protected).

[50] See White, note 20, 344 (senior managers who properly respond to the interest of shareholders ought – unless restrained by the debt holders or by prudential regulators – to be undertaking activities that might otherwise appear to be excessively risky); Hamid Mehran, Alan Morrison and Joel Shapiro, "Corporate Governance and Banks: What Have We Learned from the Financial Crisis?", Federak Reserve Bank of New York, Staff Report No. 502 (2011).

[51] See Ellul and Yerramilli, note 25; Senior Supervisors Group, note 28.

[52] See Laeven and Ratnovski, note 46; Mehran, Morrison and Shapiro, note 49.

[53] See, for the role of pay disclosure and its regulation, Guido Ferrarini and Maria Cristina Ungureanu, "Executive Remuneration. A Comparative Overview", in Jeffrey Gordon and Georg Ringe (eds), *Oxford Handbook of Corporate Law and Governance* (forthcoming), also published as ECGI Law Working Paper, No. 268/2014.

III. POLITICS AND REGULATION

A. *Post-crisis approaches*

The political pressure for regulating bankers' pay has been strong on both sides of the Atlantic (but not in other continents that were not severely affected by the crisis and do not regard executive pay as a serious problem). The reasons are not difficult to understand. Lavish bonuses and astounding severance payments to bankers at the onset of the crisis were seen as scandalous by the general public, notwithstanding that they were based on long-standing employment contracts and reflected pre-crisis performance. Bankers' compensation levels were considered as too generous when confronted with the relevant institutions' disastrous performance throughout the crisis. The media amplified the debate about the role of short-term incentives in excessive risk taking and turned executive pay into a key topic for politicians in search of voters' consensus.

1. *The treatment of ailing banks*

The rescue of large banks by governments investing taxpayers' money enhanced public resentment against the 'fat cats' at the helm of international banks. Executive pay was drastically reduced and bonuses almost disappeared at ailing institutions, whilst compensation structures were tightly regulated to avoid using taxpayers' money for paying undeserving executives. Soon similar structures, including 'malus' and 'clawback' clauses, limits to severance payments and wider deferment mechanisms, were voluntarily adopted by non-ailing banks in an effort to pre-empt investors and authorities' concerns for unsound risk management. Several regulators extended the treatment originally conceived for bankers' pay at rescued institutions to all financial institutions.

As a result, crisis rules became applicable to both ailing and non-ailing institutions, either through voluntary adoption by the latter or by regulatory fiat.[54]

However, no reform could have been successful unless adopted by a majority of jurisdictions. One-sided reforms (i.e. adopted only by some countries) would not prevent contagion from other countries choosing not to regulate compensation at financial institutions. Assuming that flawed remuneration structures were allowed in a given country and ultimately led to the failure of a large institution as a result of excessive risk taking, the negative externalities from such a failure would easily impact other countries. In addition, one-sided reforms could jeopardize a country's competitive position as a financial centre, by determining a flow of financial firms' headquarters and top managers to the countries adopting a more liberal stance relative to executive compensation.

2. *The quest for international standards*

To a large extent, regulatory responses to flawed remuneration levels and structure depend on the type of equilibrium found in each country between the different interests at stake. Where public criticism of bankers and hostility to their remuneration practices are strong, the risk of regulatory capture is lower and a tougher regime for executive pay may emerge. Culture may contribute to similar outcomes, given that high levels of executive pay are less tolerated in some countries. However, no domestic regulatory solution could be effective without agreement at international level. Furthermore, politicians favour international solutions, which often require spectacular action in the global scene (think of the solemnity and publicity of some G20 meetings), at the same time allowing for core responsibilities to be shared amongst many other governments.

All this explains why the international principles for sound compensation practices were adopted and the ways in which they were formulated.[55] International fora, such as the G20 and the

[54] See Guido Ferrarini and Maria Cristina Ungureanu, "Executive Pay at Ailing Banks and Beyond: a European Perspective", Capital Markets Law Journal (2010), 5, 197–217 (analysing ailing vs. non-ailing banks' remuneration policies).

FSB, necessarily dilute the conflicts of interest concerning issues like bankers' pay. Firstly, not all governments involved have the same political agenda. While compensation at financial firms came on top of the EU and US governments' agenda immediately after the crisis, this did not occur in other countries (including Brazil, India and China) which were less affected by the financial turmoil and did not perceive executive pay as a serious problem. Secondly, interest groups, including large financial institutions, are relatively weaker in the international arena, given that they face large coalitions of governments; the G20 consists of 19 governments and the EU, while the FSB is made up of 36 members, including 24 countries. Thirdly, the types of financial firms and their problems differ according to the economic circumstances of the regions concerned. The problems of executive pay arose mainly with reference to US and UK institutions, while firms in other countries either did not undergo similar crises or did not experiment excessive compensation. Fourthly, the international financial standards are usually formulated at a sufficient level of abstraction, which allows for smoothing of conflicts between the various interests at stake and introduce some flexibility in the implementation of the standards.

B. *The FSB principles and standards*

1. *Overview*

The FSB principles are addressed to 'significant financial institutions', which more than others deserve an internationally uniform regime. They cover four main compensation areas: governance, structure, disclosure and supervision. As to compensation governance, they incorporate well-known best practices concerning the strategic and supervisory role of the board. In addition, they 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. They reiterate the role of the remuneration committee, also requiring its liaison with the risk committee to ensure compliance with the relevant requirements.

---

[55] See Ferrarini and Ungureanu, note 44.

Compensation structures are considered by the principles along lines that reflect, to a large extent, general best practices already followed before the crisis. Indeed, the role and limits of equity-based compensation, as well as the potentially perverse effects of short-term incentives, have attracted much attention over the last twenty years. However, pre-crisis practices mainly emphasised the alignment of managers' incentives with shareholder wealth maximization. The principles break new grounds by requiring financial institutions to align compensation with prudent risk taking. Accordingly, compensation should be adjusted for all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes.

Deferment of compensation, traditionally used as a retention mechanism (on the basis that a 'bad leaver' would generally lose unpaid deferrals), should make compensation pay-out schedules sensitive to the time horizon of risks. In particular, a substantial portion of variable compensation (i.e. forty to sixty per cent) should be payable under deferral arrangements over a period of not 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. Furthermore, a substantial portion (i.e. more than fifty per cent) of variable compensation should be awarded in shares or share-linked instruments, as long as the same 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 retention policy.

The principles also tackle concerns relative to bonuses, which famously emerged during the recent crisis. They require 'malus' and 'clawback' mechanisms, which enable boards to reduce or reclaim bonuses paid on the basis of results that are unrepresentative of the company's performance over the long term or later prove to have been misstated. They consider 'guaranteed' bonuses (i.e. contracts guaranteeing variable pay for several years) as conflicting with sound risk management and the pay-for-performance principle. Severance packages need to be related to performance achieved over time and designed in a way that does not reward failure.

Compensation disclosure, despite being widely practiced pre-crisis, did not always meet the relevant standards. After the crisis, there has been consensus that disclosure should benefit not only shareholders, but also other stakeholders (e.g. creditors and employees). Moreover, disclosure should identify the relevant risk management and control systems and facilitate the work of supervisors in this area. The principles add new items of disclosure, such as deferral, share-based incentives, and criteria for risk adjustment. They also require effective supervision. In the case of a failure by a firm to implement 'sound' compensation policies, prompt remedial action should be taken by supervisors and appropriate corrective measures should be adopted to offset any additional risk that may result from non-compliance or partial compliance with the relevant provisions.

2. *Critical assessment*

The FSB principles represent a political compromise between the various interests at stake in the area of compensation, incorporating traditional criteria and adapting them to new circumstances. Firstly, they focus on long-term incentives, in order to counter the role allegedly played in the crisis by short-term incentives. Since executive compensation packages at most large banks before the crisis were already balanced between short-term and long-term incentives at least for CEOs (as shown by the Fahlenbrach and Stulz paper cited above), the international principles track already existing practices, but extend the same to a greater number of bank employees. Secondly, the principles widen the powers of supervisors by explicitly making pay at financial institutions subject to prudential supervision. Thirdly, similar to other international financial standards, the principles remain at a sufficient level of generality and allow for flexibility in implementation; in several instances, financial institutions are permitted to depart from a given principle or standard, if application of the same would lead to unsound consequences.

However, the principles also interfere with compensation structures by asking banks, for instance, to defer forty to sixty per cent of variable compensation and to award at least half of variable compensation in shares. This type of "one-size-fits-all" approach is open to criticism for all the reasons indicated in section … above, where a preference for a supervisory approach was expressed. No doubt, States are free to implement the principles through either regulation or supervision and, if they adopt a supervisory approach to implementation, the interference with remuneration structures might be softer. Nonetheless, the existence of detailed principles and standards such as the ones just indicated – which are indeed "rules" rather than "standards" for their level of specificity - will inevitably shape supervisory actions producing results not entirely dissimilar from those of *ad hoc* regulation.

The FSB principles have been implemented along different models.[56] Some jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. In other jurisdictions the model includes a mix of regulation and supervisory oversight, with new regulations often supported by supervisory guidance that illustrates how the rules can be met. In jurisdictions like the EU, a regulatory approach to implementation prevails grounded on two layers of directives and leaving only a narrow scope to supervisory discretion (see the following section). In all jurisdictions, however, the law in action for remuneration at financial institutions consists of rules rather than standards. In fact, either the law foresees detailed requirements – such as those concerning the deferment of compensation over a stated period of time – or similar requirements are enforced by supervisors in practice on the basis of the standards foreseen by the law. Similar comments hold for the FSB principles and standards, which on one side offer a significant level of specificity; on the other, are enforced internationally by the FSB checking the level of compliance with the principles by individual States and making the results of similar reviews public so as to stimulate convergence by all the jurisdictions concerned.[57]

[56] Financial Stability Board, Thematic Review on Compensation: Peer Review Report 10-11 (2010), available at http://www.financialstabilityboard.org/publications/r_100330a.pdf.

[57] Financial Stability Board, Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards, Progress report, 13 June 2012; Second progress report, 26 August 2013.

IV. EU IMPLEMENTATION OF THE FSB PRINCIPLES

A. *CRD III*

The EU initially adopted a supervisory approach to remuneration through the Commission Recommendation on remuneration in the financial sector (2009) touching upon the governance and structure of pay along lines similar to those followed by the FSB principles.[58] At the same time, the Committee of European Banking Supervisors (CEBS) issued high-level principles for remuneration policies at banks.[59] However, subsequent reviews on the national implementation of these documents revealed shortcomings in several areas,[60] such as the measurement of risk-adjusted performance, the scope of the new standards, proportionality and home/host relationships. Similar differences, together with increased pressure from the media, politicians and the public, led to a change in regulatory approach. The Capital Requirements Directive (implementing the Basel capital requirements) was amended twice also to include provisions on bankers' remuneration, firstly in 2010 when CRD III was enacted[61] and secondly in 2013 when the CRD IV package was adopted, including a new Directive concerning, inter alia, bankers' remuneration.[62] In addition, CEBS issued

[58] Commission *Recommendation on remuneration policies in the financial sector,* C(2009) 3159, (April 2009). In June 2010 the Commission also published a Green Paper on corporate governance in financial institutions and remuneration policies, which analyzed the deficiencies in corporate governance arrangements in the financial services industry and proposed possible ways forward; Commission *Green Paper on corporate governance in financial institutions and remuneration policies* (May, 2011).

[59] Committee of European Banking Supervisors (CEBS), *High-Level Principles for Remuneration Policies* (April 2009).

[60] Commission *Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector*; CEBS, *Report on national implementation of CEBS High-level principles for Remuneration Policies* (June 2010).

[61] 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, Official Journal of the European Union 2010, L329/3.

[62] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 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, Official Journal of the European Union 2013, L 176/338.

supervisory guidance in order to facilitate compliance with the remuneration principles included in CRD III.[63]

Article 22(1) CRD III laid down the core principle under which credit institutions should ensure that their remuneration policies and practices are consistent with their organizational structure and promote sound and effective risk management. Paragraph 4 of the same Article required the Committee of European Banking Supervisors (CEBS) to issue guidelines on sound remuneration policies in conformity with the principles set out in points 23 and 24 of the amended Annex V, section 11, CRD III.[64] The new requirements applied to a wide array of financial institutions including banks, broker-dealers, investment advisers, and insurance companies that are part of a financial group.[65] They covered all global staff at institutions based in the EU, and EU based staff employed by non-EU institutions.

The general requirements addressed remuneration governance, including the role and composition of the remuneration committee, the involvement of control functions in remuneration policy-making and performance management, and the compensation of these functions. They also addressed performance pay, requiring that "the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution" (Article 23 (g)) and that "the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes into account the underlying business cycle of the institution and its business risks" (Article 23 (h)). Moreover, the total amount

[63] CEBS, *Guidelines on Remuneration Policies and Practices* (CP42) (December 2010). The CEBS oversaw the implementation of the CRD until the European Banking Authority (EBA) was established in 2011.

[64] The guidelines had to take into account the principles on sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector. CEBS had to issue guidelines to set, inter alia, specific criteria to determine the appropriate ratios between the fixed and the variable component of the total remuneration.

[65] CRD applies to both credit institutions and investment firms subject to the Markets in Financial Instruments Directive (MiFID). Its provisions on remuneration in fact amend Annex V of Directive 2006/48/EC, which primarily target credit institutions, in addition by reference to Directive 2006/49/EC, which applies to investment firms.

of variable pay should not limit the ability of the credit institution to strengthen its capital base. Furthermore, at least 50 per cent of variable remuneration should consist of an appropriate balance of either shares or equivalent ownership interests or other instruments that adequately reflect the credit quality of the credit institution as a going concern (possibly the kind of instruments suggested by the legal and economic scholars cited at sec. … above). In addition, at least 40 per cent of the variable remuneration component had to be deferred over a period of not less than three years and in any case aligned with the nature of the business, its risks and the activities of the employee in question.

Article 22 (2) CRD III included a proportionality principle, which refers to the nature, scale and complexity of the credit institution's activities, and is further explained by the CEBS Guidelines. Some general requirements (such as the establishment of a remuneration committee) and more specific ones (such as deferral in equity) could be fully neutralized, but only in the case of non-complex organizations and for low-risk employees.[66] Nonetheless, the minimum thresholds for deferral and equity instruments could not be lowered. On the whole, the scope for neutralization was rather limited, making EU rules on bankers' bonuses more rigorous than the underpinning FSB Principles and US regulation, to the point that the EU Parliament commented that they were "some of the strictest rules in the world".[67] The Commission's objective was in fact to generate a single rule-book and, to the extent relevant, remove national options and discretions. As a practical consequence, for European banks the international principles loose most of their flexibility.

The impact of CRD III on remuneration practices has been substantial, as shown by empirical research concerning the pay structure and level at European large companies between 2007 and 2010.[68] The data collected for financial firms indicate that both the level and the structure

[66] For a breakdown of the measures that are neutralized, see Annex 2 to the CEBS guidelines.
[67] See Plenary Session / "European Parliament ushers a new era for bankers' bonuses", available on the EU Parliament website. http://www.europarl.europa.eu.
[68] Roberto Barontini, Stefano Bozzi, Guido Ferrarini and Maria Cristina Ungureanu, "Directors' Remuneration before and after the Crisis: Measuring the Impact of Reforms in Europe", in Massimo Belcredi and Guido Ferrarini (eds), *Boards and Shareholders in European Listed Companies* (Cambridge 2013), 251 - 314.

of CEO compensation changed substantially over the sample period. Total compensation dropped from an average of euro 4.3 million in 2007 to one of 3.2 million in 2010, as result of a large decrease in variable cash pay (- 60 per cent), while in non-financial firms total compensation increased from 3.9 million to 4.1 million. Also the composition of CEO pay at financial firms changed over the sample period, in accord with the national and international regulators' claims for proportionality between variable and fixed pay, and between cash-based and stock-based compensation. Indeed, the relevant data show that the proportion of incentive-based compensation over total compensation dropped by an average 17 per cent from 2007 to 2010, as a consequence of lower variable cash-based component. Within the variable part of compensation, the weight of cash-based incentives shows a mean (median) decrease of 8 per cent (14 per cent).

B. *CRD IV*

Notwithstanding the fact that executive pay at large banks is lower and more balanced after the crisis, the European regulation in this area was deeply overhauled by CRD IV. The new regime – like the previous one - applies on a consolidated basis, i.e. to "institutions at group, parent company and subsidiary levels, including those established in offshore financial centres" (Article 92 (1)). The ratio for a EU wide scope of application is "to protect and foster financial stability within the Union and to address any possible avoidance of the requirements laid down in this Directive" (67th considerandum). Moreover, the new regime applies to different categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile (Article 92 (2)). In this regard, the Commission has recently adopted a delegated Regulation including regulatory technical standards on the identification of risk takers.[69]

[69] COMMISSION DELEGATED REGULATION (EU) No …/.. of 4.3.2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards

Article 92 (2) requires inter alia that the remuneration policy should be consistent with sound and effective risk management and should not encourage risk-taking in excess of the tolerated risk level the institution. Moreover, the remuneration policy should be in line with the business strategy, objectives, values and long-term interests of the institution, and incorporate measures to avoid conflicts of interest.

Article 94, par. 1 provides several requirements for the variable elements of remuneration. Some of them are rather generic, such as the one requiring performance pay to be based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the institution. In addition, performance should be assessed in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks. Moreover, the total variable remuneration should not limit the ability of the institution to strengthen its capital base. Furthermore, the fixed and variable components of total remuneration should be appropriately balanced and the fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component.

Other requirements in Article 94, par. 1 are more specific, particularly the cap on variable remuneration that the European Parliament asked to include in CRD IV and that will be analysed in the following paragraph. Also severance payments are covered by the provision that they will have to reflect performance achieved over time and should not reward failure or misconduct. In addition, remuneration packages relating to compensation or buy out from contracts in previous employment

---

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.

must align with the long-term interests of the institution concerned, including retention, deferral, performance and clawback arrangements.

In general, the measurement of performance used to calculate variable remuneration should include an adjustment for all types of current and future risks and take into account the cost of the capital and the liquidity required. A substantial portion, and in any event at least 50% of variable remuneration shall consist of a balance of (i) shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share- linked instruments or equivalent non-cash instruments, in the case of a non-listed institution; (ii) where possible, other instruments within the meaning of Article 52 or 63 of Regulation (EU) No 575/2013 or other instruments which can be fully converted to Common Equity Tier 1 instruments or written down, that in each case adequately reflect the credit quality of the institution as a going concern and are appropriate to be used for the purposes of variable remuneration.

V. THE CAP ON VARIABLE REMUNERATION

(A) *The Cap and its Rationale*

1. *Relevant provisions*

While CRD III simply required an "appropriate balance" between fixed and variable remuneration, CRD IV also establishes a maximum ratio between the two remuneration components. The definition of these components is found in the Directive's 64th considerandum, stating that fixed remuneration includes "payments, proportionate regular pension contributions, or benefits (where such benefits are without consideration of any performance criteria)", while variable remuneration includes "additional payments, or benefits depending on performance or, in exceptional circumstances, other contractual elements but not those which form part of routine employment packages (such as healthcare, child care facilities or proportionate regular pension contributions)". Both monetary and non-monetary benefits are comprised in the relevant definitions. The criteria for setting fixed and variable remuneration are found in Article 92 (g) stating that basic fixed remuneration should primarily reflect relevant professional experience and organisational responsibility, while variable remuneration should reflect "a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment".

Under Article 94 (1) (f), the fixed and variable components of total remuneration should be appropriately balanced and the fixed component should represent a sufficiently high proportion of the total remuneration "to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component". However, Article 94 (1) (g) further constrains this proportion by stating that the variable component should not exceed 100% of the fixed component of the total remuneration for each individual. Moreover, Member States may set a lower maximum percentage (as Belgium and the Netherlands did, by setting 50% and 20% respectively). Alternatively, Member States may allow shareholders of the institution concerned to approve a higher maximum level of the ratio between fixed and variable remuneration provided the overall level of the variable component shall not exceed 200% of the fixed component of the total remuneration for each individual. Member States may also set a lower percentage. In any case, approval of a higher percentage should occur through a special procedure that is described in detail by Article 94 (1) (g) (ii).

2. *Official justification*

The official justification for a cap on variable remuneration is "to avoid excessive risk taking" (65th considerandum). The Directive implicitly assumes that an excessive level of variable remuneration is likely to induce excessive risk taking by the managers of financial institutions, as (arguably) shown by the financial crisis. The need for capping variable pay, based on the assumption that excessive bonuses contributed to recent bank failures, was brought forward quite vigorously by France and Germany in the aftermath of the crisis, but was not recognized at international level, where the FSB rejected any suggestion of introducing a cap on bonuses also for the firm opposition of the US government.[70] However, the initial Commission proposal of the CRD IV directive did not include a similar cap, which was later suggested by the European Parliament amongst a number of amendments to the Commission's proposal.[71]

The adoption of this cap was nonetheless controversial. The UK, in particular, vehemently contested the same, reflecting City of London's concerns that capping variable pay would disrupt remuneration practices of investment banks, which rely heavily on bonuses and other types of performance-related pay.[72] The UK government also brought proceedings against the European Parliament and the Council seeking the annulment of the CRD IV provisions regarding the limits on variable remuneration, the EBA's rule-making powers in this area and the public disclosure of certain details of the material risk takers' salaries required by the CR Regulation. The UK mainly maintained that the contested provisions have an inadequate Treaty legal base in addition to being disproportionate and failing to comply with the principle of subsidiarity.[73] However, the Opinion of Advocate General Jääskinen found the UK's pleas ungrounded, firstly by arguing that the cap on variable remuneration "does not impact directly on the level of pay", rather it "merely establishes a ratio between the fixed and variable element without affecting the level of remuneration as such".[74] As we shall see in the following paragraph, this is arguable form an economic perspective, being it

[70] See Eilis Ferran, "New Regulation of Remuneration in the Financial Services in the EU", (2012) 9 European Company and Financial Law Review", 1 – 34.
[71] See European Parliament, Report on the proposal for a directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms etc. (A 7-0170/2012) of 30 May 2012, Article 90(1)(f) ("institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration *where the variable component shall not exceed one time the fixed component of the total remuneration*").
[72] See Kate Allen, "Goldman top bankers lead UK pay league with £3m packages", FT 1 January 2015: in 2013 Goldman Sachs paid its senior staff bonuses worth 5.5 times their average salary, the highest ratio among the five top banks; Citigroup was the only top bank consistent with the EU cap in 2013, paying staff bonuses averaging 1.6 times salary.
[73] Action brought on 20 September 2013 – United Kingdom of Great Britain and Northern Ireland v. European Parliament, Council of the European Union (Case C-507/13).
[74] Opinion of Advocate General Jääskinen delivered on 20 November 2014, Case C-507/13 United Kingdom of Great Britain and Northern Ireland v. European Parliament and Council of the European Union, para. 120.

likely that either the cap on variable pay will push fixed pay upwards or variable remuneration will stay below the amount that the labour market would otherwise require. Therefore, the cap has an impact both on the structure and on the level of remuneration. Secondly the AG argued that "all the procedural requirements relating to the assessment of the compliance of the proposal with the principles of proportionality and subsidiarity were duly respected by the EU legislature", which "possesses a wide margin of discretion".[75] However, his Opinion largely ignores (or is agnostic about) the important technical arguments - that I summarize in the following paragraph - against regulating the level of bankers' pay, implicitly relying on the post-crisis populist debate about excessive pay at financial institutions and on the fact that all possible arguments in favour and against regulation had been duly considered by the legislature.[76] Nevertheless, the UK – immediately after publication of the AG Opinion - withdrew its application and the case was therefore discontinued.[77]

(B) *Criticism*

1. *General arguments against regulatory caps*

The de Larosiére Report already suggested that there are two dimensions to the problem of bankers' remuneration: "one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration ... Social-political dissatisfaction has tended recently to focus, for understandable reasons, on the former. However, it is primarily the latter issue which has had an adverse impact on risk management and has thereby contributed to the crisis. It is

[75] Ibidem, para. 103.
[76] Ibidem, para. 98, focusing on procedural issues rather than substance: "… the material that was available to the decision-makers clearly demonstrated that restricting incentives to excessive risk taking by the management and staff of financial institutions was likely to reduce such risk taking and, in consequence, any risk for the stability of financial markets following therefrom. Under such circumstancezs, the question where and by whom the concrete limits to such initiatives were to be set concerned, in my opionio, the degree of regulation that was appropriate. This has clearly involved economic and political choices. However, such choices need to have been *manifestly inappropriate* before the legislative measure can be annulled".
[77] See Order of the President of the Court 9 December 2014 (Removal from the register) in Case C-507/13.

therefore on the structure of remuneration that policy-makers should concentrate reforms going forward".[78] Similar arguments are found, across the Atlantic, in a report by a committee of highly distinguished economists (the "Squam Lake Group"): "…governments should generally not regulate the *level* of executive compensation in financial institutions. We have seen no convincing evidence that high levels of compensation in financial companies are inherently risky for the companies themselves or the overall economy. Moreover, limits on pay are likely to cause unintended consequences. As a result, society is better off if compensation levels are set by market forces."[79] In a similar vein, Richard Posner argues: "… efforts to place legal limits on compensation are bound to fail, or to be defeated by loopholes, or to cause distortions in the executive labour market and in corporate behaviour".[80]

Indeed, recent experience relative to the use of "role-based allowances" by around 39 European banks shows that efforts to circumvent the EU cap are already under way. Role-based allowances are linked to the position and organisational responsibility of staff. As explained by the EBA in an opinion given to the European Commission, "allowances" are additional payments or benefits paid in addition to basic salary and variable remuneration (bonus).[81] Banks tend to consider all allowances, including role-based allowances, as fixed remuneration, arguing that they are not based on performance. However, role-based allowances are generally not part of the basic salary and are not pensionable; are initially granted for a limited period of time; can be reduced, suspended or cancelled by banks on a fully discretionary basis; include other contractual conditions which do not form part of routine employment packages. In EBA's opinion, in order to qualify as fixed remuneration "the conditions for their granting and the amount of the role-based allowance should

[78] High-Level Group on Financial Supervision in the EU, Final Report (February 2009), para 117.
[79] Kenneth French et al., *The Squam Lake Report. Fixing the Financial System* (Princeton 2010), 75.
[80] Richard Posner, *A Failure of Capitalism. The Crisis of '08 and the Descent into Depression* (Harvard 2009), 297; similar comments in Bhagat, Bolton and Romano, note 39, 35.
[81] See Opinion of the European Banking Authority on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances, EBA/Op/2014/10, 15 October 2014, 2. See also the EBA Report On the application of Directive 2013/36/EU (CRD) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances, 15 October 2014.

be predetermined, transparent to staff, permanent, i.e. maintained over time and tied to specific role and organisational responsibilities, not provide incentives to take risks and, without prejudice to national law, be non-revocable."[82] As a result, EBA believes that role-based allowance not complying with these conditions (e.g. it is not predetermined, is not permanent or provides incentives to take risks) should be classified as variable remuneration "in line with the letter and purpose of the CRD".[83]

2. *Specific arguments against the CRD IV cap*

As suggested by Kevin Murphy, several arguments show that neither the objective to reduce excessive risk taking nor the one to reduce perceived excesses in the level of banking remuneration will be achieved by capping variable remuneration.[84] Firstly, the cap will likely increase the level of fixed remuneration, making banks more vulnerable to business cycles and therefore increasing the risk of bank failure. Anecdotal evidence already shows that fixed pay at large European banks is on the rise.[85] Secondly, the traditional bonus system at investment banks, which is characterised by below-market salaries and high bonus opportunities, provides strong incentives to avoid "bad" risks and take "good" ones. On the contrary, the new system – which will be characterized by above-market salaries and "capped" bonuses – provides incentives to take "bad" risks and avoid "good" ones. In fact, if bad risks materialize, the bank manager will not suffer, for her remuneration is to a large extent fixed. But, if the bank shuns good risks and the relevant profits, the responsible

[82] Opinion, note 80, 2.
[83] Ibid., 3.
[84] Kevin Murphy, "Regulating Banking Bonuses in the European Union: a Case Study in Unintended Consequences", European Financial Management (2013), 19, 631–657.
[85] The case of Deutsche Bank is interesting. At the last AGM the bank proposed to raise the maximum bonus senior managers can receive to twice their fixed annual salary, double the current level. Deutsche Bank officials said the move was necessary so that the bank could comply with European rules on pay, while also competing for staff with U.S. rivals. They said that if the bonus increase was rejected, the bank would need to raise base salaries to retain top talent. But opposition to the proposals (which was however approved) was mounting from shareholder groups who argued the payment was excessive and fostered improper behaviour: see Eyk Henning, 'Some Deutsche Bank Shareholders Plan to Protest Bonus Proposal', *Wall Street Journal* (New York, 16 May 2014) <http://online.wsj.com/articles/SB10001424052702304908304579566140929304688> accessed 24 November 2014.

manager will not be worse off given that his bonus is capped. Indeed, the bonus cap reduces incentives to create value, which is the main purpose of variable pay.[86]

Thirdly, executive remuneration is largely set by the markets, so that a bonus-cap could have unintended consequences on the firms' ability to hire people of adequate standing in the international market for managers. In the end, remuneration "will reflect a less-talented workforce as the top producers leave for better-paying opportunities in financial firms not subject to the pay restrictions". In other words, the cap "will *not* lead to lower levels of overall remuneration after adjusting for ability and the risk of the remuneration package".[87] Furthermore, the cap on variable pay will reduce the competitiveness of the EU banking sector relative to non-EU banks and other non-bank financial intermediaries which are not subject to similar restrictions.

Fourthly, the mandatory cap reflects a "one-size-fits all" approach which is clearly too rigid, for different types of credit institutions present different levels of risk exposure, so that an incentive structure which is appropriate for one firm is not necessarily suited to another. Moreover, the EU bonus-cap applies to all credit institutions, without regard to their size and therefore to systemic risk considerations.

Additional problems may derive from the combination of different tools to deal with the same problem (excessive pay). Indeed, a good part of the CRD IV provisions are based on the international principles' approach to bankers remuneration, which is flexible and relies on pay governance, transparency and the requirement of an adequate proportion between fixed and variable pay. Other provisions incorporate the international requirements for the deferment of variable pay and the payment of a portion of the same in equity and other financial instruments issued by the bank. The juxtaposition of a cap on variable pay to similar requirements not only may appear redundant and counterproductive, for the reasons explained by Murphy, but could determine further unintended consequences. In particular, the pressure to increase fixed pay deriving from the cap

[86] See also Bhagat, Bolton and Romano, note 39, 36 (the EU cap will make pay even less sensitive to performance than it was before the crisis, which is the opposite of what is desirable in an incentive compensation plan).
[87] Murphy, note 82, …

could be enhanced by the requirement that variable pay should be deferred and partly paid in equity or other financial instruments. In fact, a similar requirement pushes variable pay to a higher level than what would be agreed if remuneration were paid in cash and without deferment; but higher variable pay determines an increase in fixed pay given the fixed ratio between the two components of remuneration. The final result of the cumulus of different criteria will be an increase of overall remuneration, including fixed and variable components.

VI. Concluding Remarks

This paper has analysed the rise of a mandatory structure of bankers' pay in Europe as a result of the financial crisis and of wide criticism of excessive remuneration at financial institutions. Whether flawed bankers' pay contributed to the crisis is still open to discussion amongst scholars. Indeed, the remuneration of CEOs at large banks was generally aligned with the interest of shareholders and incentives were predominantly long-term oriented. It is therefore questionable that short-term incentives of top executives may have led banks to take excessive risks. It appears more likely that insufficient prudential regulation and flawed risk management contributed to banks' undertaking risks that were later proven to be excessive from a societal perspective. In a similar scenario, short-term incentives of traders and middle-managers may have had some role, particularly considering that top executives were often unable to understand the activities performed at lower levels of their firms and risk managers seemed to ignore the tail risks deriving from many of the transactions that they were supposed to monitor.

All this would suggest improving risk management systems and reforming areas of prudential regulation such as capital adequacy and organizational requirements at supervised firms, rather than intervening directly on bankers' incentives. However, governments and legislators, under the pressure of the media and public opinion, moved to extensive reforms of bankers' remuneration, with reference to both the top executives and other risk-taking/high-earning employees at various levels of the institutions concerned.

The prudential regulation bankers' remuneration could rather be based on a few standards, with which boards of directors should comply under the *ex post* supervision of surveillance authorities. A similar approach would have been preferable to the extent that it is respectful of the autonomy of banks and of their individual needs, while leaving supervisors in charge of the monitoring of incentives from the perspective of the safety and soundness of the institutions concerned. Nevertheless, governments encouraged detailed regulation of bankers' pay at G20 level and the FSB adopted rules rather than standards, covering not only remuneration governance and disclosure, but also remuneration structures. As a result, both the fixed and the variable components of remuneration and the relationship between the same have been subjected to international "principles and standards", which are in fact rules also for the way in which they have been implemented especially in the US and Europe.

The EU has followed a strict approach to the implementation of the FSB principles and CRD IV has also departed from the same by introducing an unprecedented cap on variable remuneration. I have analysed this maximum ratio between fixed and variable pay from a legal and economic perspective, showing that the rationale for it is flawed and that unintended consequences may derive from the cap as a result. I also argued that the cap on variable pay is inconsistent with other aspects of the regulation of pay which reflect the international principles and are also included in CRD IV.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI produces and disseminates high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It draws on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Finance.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html