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Regulating Bankers' Pay: Systemic Risk, Proportionality and Culture

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Abstract: *In this paper, I try to answer three related questions. The first is whether bankers' pay should be regulated and how. The second is what are the main characteristics of the present regulation of bankers' pay at international and EU levels. The third question derives from the other two: assuming that bankers' pay should be regulated and given the existence of international principles, how could we improve the present EU regulation?*

In part I, I show that the grounds for regulating bankers' pay are rather weak, particularly if we consider mandating the structure of bankers' pay as currently done under the international principles and the CRD IV. Setting the structure of pay is a corporate governance function that regulation should not substitute with detailed and rigid provisions. In part II, I argue that the international principles interfere with remuneration structures in a prescriptive way, particularly with regard to deferred variable pay and pay-out in instruments. For the rest, they mostly track best practices already followed by large institutions before the financial crisis, leaving some room to flexibility. In part III, I argue that the EU law shifted from a supervisory approach to the setting of bankers' pay to a regulatory one, adopting detailed and rigid provisions on the structure, governance and disclosure of remuneration. Moreover, CRD IV introduced an unprecedented cap to variable remuneration, which may distort incentives and produce unintended consequences on bank risk-taking.

In part IV, I examine possible ways to overcome the shortcomings of CRD IV in the area of bankers pay and suggest that it should be made more flexible and proportionate within the limits allowed by the international principles. I propose to focus on systemic risk in order to identify the institutions which should be subject to the most stringent provisions as to the setting and monitoring of bankers' pay. Moreover, I suggest implementing proportionality in wider terms than recently proposed by the European Commission in its review of CRD IV. Lastly, I recommend that the governance and supervision of bankers' pay should emphasize the role of culture in the setting and monitoring of remuneration, for incentives are not set in a vacuum, but reflect both the culture prevalent in society and that of the individual firm.

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 answering three related questions. The first is whether bankers' pay should be regulated and, assuming a positive answer, how. The second is what are the main characteristics of the present regulation of bankers' pay at international and EU levels. The third question derives from the other two: assuming that bankers' pay should be regulated and given the existence of international principles, how could we improve the present EU regulation?

I deal with the first question in part I of this paper. 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 in the financial crisis is still debated in academia, as I show through a brief review of the literature. I argue therefore that the case for regulating the structure of bankers' pay is rather weak, while regulation of remuneration and risk governance, and of remuneration disclosure are to some extent justified. In parts II and III, I examine the international principles and the EU regulation of bankers' pay. I show in particular that the FSB principles and standards apply to internationally significant financial institutions and that they have the nature of rules rather than standards. I also show that the European Capital Requirements Directive (CRD IV) extended the FSB principles to all banks without giving due consideration to proportionality. Furthermore, I critically analyse the bonus cap introduced by this Directive and show that it has a different impact on different types of institutions. In part IV, I focus on systemic risk, proportionality, and culture as key drivers for assessing regulatory policy in the field of bankers' pay, and I suggest possible improvements.

I. IS REGULATION OF BANKERS' PAY JUSTIFIED?

1. *Role of incentives 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.[1] Some scholars take issue with this hypothesis, while 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.[2] 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 section 2).

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

[1] 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: Lessons to be drawn from the current financial crisis, Accompanying document to the Green Paper, Corporate governance in financial institutions and remuneration policies, 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.

[2] 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 (2010).

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."[3] 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."[4] 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.[5] 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."[6]

While the first study 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 of large equity investments in their firms.[7] It does not claim, however, that incentives in troubled banks before the

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

[4] Ibid. at 12. According to this study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006. 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.

[5] 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.

[6] Ibid., 260. 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" (274).

[7] 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

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.[8] 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".[9] 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".[10] 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.[11] When 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

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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.

[8] Raghuram Rajan, *Fault Lines*. How hidden fractures still threaten the world economy (Princeton 2010), 141 ff.

[9] Ibid., 142.

[10] 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.

[11] 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).

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.[12]

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".[13]

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 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

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

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

come up, they acquire dynastic wealth. If tails come up, OPM [other people money] absorbs almost all losses”.[14]

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.[15]

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.[16] 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

[14] Alan Blinder, After the Music Stopped. The financial crisis, the response, and the work ahead (Penguin 2013), 82.

[15] For wider treatment of the topic, see Guido Ferrarini, ‘Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda’ (2017) Ondernemingsrecht 72 – 83, also published as ECGI Law Working Paper 347/2017.

[16] 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.[17] 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.[18]

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.[19] 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.[20]

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.[21] 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

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[17] Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence", World Bank Policy Research Working Paper 3404 (2004).
[18] Ibid., 7.
[19] 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.
[20] Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* (Princeton 2013), 94-95.
[21] 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.[22] 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.[23] 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.

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 by the

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[22] 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

[23] 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).

institutions concerned and their performance over time.[24][25] Their main hypothesis is that Bank Holding Companies (BHCs) with strong and independent risk management functions should have lower tail risk, all else equal.[26] 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 similar BCHs had lower tail risk, a smaller fraction of nonperforming loans and better operating performance and stock return performance during the crisis years. 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 crisis.[27] 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.

3. *Should bankers' pay be regulated and how?*

[24] Andrew Ellul and Vijay Yerramilli, "Stronger Risk Controls, Lower Risk: Evidence from U.S Bank Holding Companies", Journal of Finance (2013), 68, 1757-1803. 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.

[25] Ibidem, 1765-1766.

[26] 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.

[27] 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.

As I argued in another paper, the case for regulating the structure of bankers' pay appears to be rather weak.[28] 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.[29] 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 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.[30] 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 which may lead to excessive risk-taking. 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

[28] 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.
[29] Blinder, note 16, 84 and 284.
[30] Luc Laeven and Lev Ratnovski, "Corporate Governance of Banks and Financial Stability", Vox 21 July 2014 (http:voxeu.org),

structures and procedures are in place for the setting of pay in compliance with safety and soundness requirements.

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.[31] 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.[32] 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 taxpayers, who will in the end pay for the costs of a banking crisis.[33] 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.[34]

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.[35] 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'

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31 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.

32 See the studies by Beltratti and Stulz, note 22, and Adams, note 23.

33 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).

34 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).

35 See Ellul and Yerramilli, note 25; Senior Supervisors Group, note 28.

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.[36]

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.[37]

II. INTERNATIONAL PRINCIPLES

1. *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 generally seen as scandalous. 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.

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

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

[37] 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.

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.[38]

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. 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.

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.

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[38] 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).

All this explains why the international principles for sound compensation practices were adopted and the ways in which they were formulated.[39] International fora, such as the G20 and the 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.

2. *The FSB principles and standards*

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

[39] See Ferrarini and Ungureanu, note 27.

remuneration committee, also requiring its liaison with the risk committee to ensure compliance with the relevant requirements.

Compensation structures are considered by the principles along lines that reflect, to a large extent, best practices generally 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.

3. *Assessment of the FSB principles*

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 by short-term incentives in the crisis. 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 II.3 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.[40] 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 (part II below).

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

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

stimulate convergence by all the jurisdictions concerned.[41] Clearly, financial supervisors are comfortable with this approach, to the extent that their actions towards the supervised institutions are based on pre-fixed standards. But also supervisees often prefer to know in advance the criteria under which their remuneration practices will be assessed, despite the fact that this inevitably reduces the space for autonomy and flexibility in the setting of bankers' pay.

III. EU REGULATION

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.[42] At the same time, the Committee of European Banking Supervisors (CEBS) issued high-level principles for remuneration policies at banks.[43] However, subsequent reviews on the national implementation of these documents revealed shortcomings in several areas,[44] 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: in 2010

[41] 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.

[42] 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).

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

[44] 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).

when CRD III was enacted [45] and in 2013 when the CRD IV package was adopted, including a new Directive concerning, inter alia, bankers' remuneration.[46] In addition, CEBS issued supervisory guidance in order to facilitate compliance with the remuneration principles included in CRD III,[47] while EBA issued new Guidelines under the new Directive.[48]

1. *CRD III*

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.[49] 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.[50] They covered all global staff at institutions based in the EU, and EU based staff employed by non-EU institutions.

[45] 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.

[46] 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.

[47] 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.

[48] EBA, *Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013,* 21 December 2015.

[49] 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.

[50] 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.

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 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. 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.[51] 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

[51] For a breakdown of the measures that are neutralized, see Annex 2 to the CEBS guidelines.

of the strictest rules in the world".[52] The Commission's objective was in fact to generate a single rule-book and, to the relevant extent, remove national options and discretions. As a practical consequence, for European banks the international principles lost their flexibility.

2. *CRD IV*

Notwithstanding the fact that executive pay at large banks was lower and more balanced after the crisis, [53] the European regulation in this area was deeply overhauled by Directive 2013/36/EU (Capital Requirements Directive - CRD IV). [54] The new regime 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.[55]

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[52] See Plenary Session / "European Parliament ushers a new era for bankers' bonuses", available on the EU Parliament website. http://www.europarl.europa.eu.

[53] The impact of CRD III on remuneration practices has been substantial, even though empirical research shows that changes also occurred before the Directive's adoption: 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.

[54] See, for my previous work on this topic, Guido Ferrarini, 'Regulating Bankers' Pay in Europe: The Case for Flexibility and Proportionality', in Festschrift für Theodor Baums (Mohr Siebeck 2017), I, 401-416; Guido Ferrarini, 'CRD IV and the Mandatory Structure of Bankers' Pay', ECGI Law Working Paper 289/2015, April 2015.

[55] Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014, supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards 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.

Article 74 (1) CRD IV requires institutions to have in place a remuneration policy for all staff, which should comply with the principles set out in Article 92 and 93 of the Directive and with EBA Guidelines on sound remuneration policies. The remuneration policy should specify all components of remuneration and include also the pension policy. It should be consistent with the objectives of the institution's business and risk strategy, corporate culture and values, long-term interests of the institution, and the measures used to avoid conflicts of interest, and should not encourage excessive risk taking. The remuneration policy should contain the performance objectives for the institution, the methods for the measurement of performance, the structure of variable remuneration, and the ex ante and ex post risk-adjustment measures of the variable remuneration.[56]

Under Article 92 (2) institutions comply with the principles just stated and other principles "in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities". As explained in recital 66: "the provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular, it would not be proportionate to require certain types of investment firms to comply with all those principles". The EBA Guidelines further specify that the proportionality principle "aims to match remuneration policies and practices consistently with the individual risk profile, risk appetite and strategy of an institution, so that the objectives of the obligations are effectively achieved".[57] However, the EBA's recent opinion on proportionality expressed the view – shared by the European Commission – that "the wording of Article 92 (2) does not permit exemptions or waivers to the application of the remuneration principles".[58]

A similar interpretation had already been adopted in EBA Consultation Paper on the draft guidelines stating: "Where the CRD sets some specific requirements with numerical criteria (i.e. the

[56] EBA, *Guidelines on sound remuneration policies*, 14 – 22.
[57] Ibidem, 75.
[58] EBA, *Opinion on the application of proportionality to the remuneration provisions in Directive 2013/36/EU*, EBA/Op/2015/25, 13.

minimum deferral period of three to five years; the minimum proportion of 40% to 60% of variable remuneration that should be deferred…), institutions should apply the criteria based on proportionality, considering that in particular for significant institutions and their senior management and members of the management body more strict criteria should be set, and in any case apply at least the minima criteria set in the CRD".[59] According to this interpretation, proportionality can only determine an enhancement of the applicable criteria, not a waiver of the same. As a result, "neutralisation" practices, which were allowed under the CEBS Guidelines with respect to the requirements previously in force,[60] are no longer admitted by the European authorities with a significant restraint of the proportionality principle.

Nonetheless, EBA opinion acknowledged that information provided by competent authorities, together with evidence gathered from stakeholders during the consultation period, shows that "there are different legal interpretations of the proportionality clause as established in Article 92(2) of Directive 2013/36/EU, which have led to different applications of the remuneration principle at national level. These approaches would be in line with the CEBS Guidelines on remuneration policies and practices".[61] As a result, EBA concluded that action is necessary at the level of the EU institutions in order to ensure that remuneration requirements are applied consistently across the Union. In EBA's view, CRD IV should be amended "to exclude certain small, non-complex institutions from the requirements to apply the remuneration principles regarding deferral and payment in instruments for variable remuneration, and to limit the scope of those remuneration principles as regards staff who receive low amounts of variable remuneration, including large institutions".[62] The European Commission has recently presented a proposal to this effect, as I explain in paragraph C below.

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

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[59] EBA, *Consultation Paper. Draft Guidelines on sound remuneration policies,* EBA/CP/2015/03, 73.
[60] CEBS, *Guidelines on remuneration policies and practices*, 20 and Annex 2.
[61] EBA, *Opinion,* note 13, 13.
[62] Ibidem, 21 – 22.

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. The EBA Guidelines specify that when the award of variable remuneration, including long term incentive plans (LTIP), is based on past performance of at least one year, but also depends on future performance conditions, institutions should clearly set out to staff the additional performance conditions that have to be met after the award for the variable remuneration to vest.[63] The additional performance conditions should be set for a predefined performance period of at least one year and, when they are not met, up to 100% of the variable remuneration awarded under those conditions should be subject to malus arrangements.[64]

Still under Article 94, par. 1, 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 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

[63] EBA, *Guidelines on sound remuneration policies*, 124.
[64] Ibidem.

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.

3. *The cap on variable remuneration*

While Directive 2010/76/EU (CRD III) simply required an "appropriate balance" between fixed and variable remuneration (Article 23), 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).

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.[65] However, the initial Commission proposal of the CRD

[65] See Eilis Ferran, “New Regulation of Remuneration in the Financial Services in the EU”, (2012) 9 European Company and Financial Law Review”, 1 – 34.

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.[66]

The adoption of a 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.[67] 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.[68]

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".[69] As I contend below, this is disputable from an economic perspective, being it likely that the cap on variable pay will push fixed pay upwards, while variable remuneration will stay below the amount that the labour market would otherwise require. Therefore, the cap may have 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

[66] 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*").

[67] 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.

[68] 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).

[69] 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.

proposal with the principles of proportionality and subsidiarity were duly respected by the EU legislature", which "possesses a wide margin of discretion".[70] However, the Opinion largely ignores (or is agnostic about) the possible arguments - that I summarize below - against regulating the level of bankers' pay, implicitly relying on the post-crisis populist debate about excessive pay at financial institutions and on the assumption that all arguments in favour and against regulation have been duly considered by the legislature.[71] Nevertheless, the UK – immediately after publication of the AG Opinion - withdrew its application and the case was therefore discontinued.[72]

4. *Criticism of the cap*

The de Larosiére Report 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 therefore on the structure of remuneration that policy-makers should concentrate reforms going forward".[73] 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

[70] Ibidem, para. 103.
[71] 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 circumstances, the question where and by whom the concrete limits to such initiatives were to be set concerned, in my opinion, 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".
[72] See Order of the President of the Court 9 December 2014 (Removal from the register) in Case C-507/13.
[73] High-Level Group on Financial Supervision in the EU, Final Report (February 2009), para 117.

result, society is better off if compensation levels are set by market forces."[74] 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".[75]

Indeed, experience relative to the use of "role-based allowances" by around 39 European banks shows that efforts to circumvent the EU cap were soon made after its introduction. 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 payments or benefits paid in addition to basic salary and variable remuneration (bonus).[76] Banks tended to consider all allowances, including role-based allowances, as fixed remuneration, arguing that they were 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 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."[77] 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

[74] Kenneth French et al., *The Squam Lake Report. Fixing the Financial System* (Princeton 2010), 75.
[75] 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; and Rui Albuquerque, Luís Cabral and José Corrêa Guedes, 'Relative Performance, Banker Compensation, and Systemic Risk', European Corporate Governance Institute (ECGI) - Finance Working Paper No. 490/2016, who argue that, without a regulatory constraint on relative performance evaluation (RPE), some of the restrictive measures on executive compensation that are found in regulation are ineffective in reducing systemic risk.
[76] 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.
[77] Opinion, note 80, 2.

incentives to take risks) should be classified as variable remuneration "in line with the letter and purpose of the CRD".[78] Similar criteria are now included in the EBA Guidelines, which in section 7 identify the categories of remuneration (fixed and variable) and in section 8.1 deal specifically with allowances.

Going back to the widespread criticism of the maximum ratio, 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.[79] 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,[80] while EBA reached similar findings for EU banks in general (as reported in the following section), even though a similar trend predates the introduction of a maximum ratio for fixed-variable pay.

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

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[78] Ibid., 3.

[79] Kevin Murphy, "Regulating Banking Bonuses in the European Union: a Case Study in Unintended Consequences", European Financial Management (2013), 19, 631–657. A slightly different position is taken by John Thanassoulis, 'The Case for Intervening in Bankers' Pay' (2012) 67 *Journal of Finance* 849–895, who argues that a modest bonus cap – "modest in that it is close to the current equilibrium rate of bonuses" – lowers default risk; however, stringent bonus caps, such as those introduced by CRD IV, enhance default risk and are value destroying.

[80] The case of Deutsche Bank is interesting. At the 2014 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.[81]

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".[82] 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 and investment firms 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 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

[81] 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).
[82] 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.

5. *Impact of the cap in practice*

EBA conducted a benchmarking exercise on remuneration practices with regard to 2014, examining the impact of the bonus cap.[83] One of EBA's main findings is that the fixed remuneration of identified staff increased, while the variable remuneration was reduced; on average, following the introduction of the cap, the ratio between fixed and variable plunged to 65.48% from 104.27% in 2013. The highest variable remuneration and total remuneration were paid in investment banking where the ratio of variable to fixed remuneration for identified staff dropped on average from 191.17% in 2013 to 88.89% in 2014. In retail banking the same ratio dropped from 35.05% in 2012 and 24.97% in 2013 to 30.29% in 2014; in asset management from 128.86% in 2012 and 107.88% in 2013 to 100.19% in 2014. Therefore, the mandatory cap introduced by CRD IV easily accommodates the average ratio between fixed and variable remuneration in retail banking, while it is close to the average ratio in asset management and investment banking. In other words, the ratio could be higher in the last two sectors in the absence of the cap.

These data were commented on by the Commission's report to the European Parliament including an assessment of the remuneration rules under CRD IV.[84] The Commission rejected the idea of a causal link between the Directive's maximum ratio and the decrease in the variable part of

[83] EBA, Benchmarking of remuneration practices at the European Union level and data on high earners (data as of end 2014), EBA-OP-2016-05, 30 March 2016.
[84] Report from the Commission, note … above. See also Commission Staff Working Document, Detailed assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No 575/2013, Brussels, 28.7.2016.

remuneration with respect to the fixed one arguing that a similar trend had already begun several years before the introduction of the maximum ratio.[85] The Commission added that there are other elements impacting on the levels and proportions of the remuneration components, such as financial performance, profitability and general prudential requirements, and that an increase in the fixed portion of remuneration has also been observed in several non-EU jurisdictions, including the US and some Asian countries. Moreover, the EBA's findings have been reached on the basis of averages mainly collected from large banking groups and need to be interpreted with care. However, the Commission conceded that "while the overall shift towards fixed remuneration cannot be clearly attributed to the maximum ratio, it is likely that in some individual cases the maximum ratio has led to a shift from variable to fixed remuneration".[86] This is consistent with the criticism of the maximum ratio advanced in the previous section on a theoretical level.

The Commission however dismissed other criticism of the maximum ratio. Firstly, it argued that it is too early to establish whether reducing the variable part of remuneration has substantially affected the risk-taking incentives at financial institutions.[87] In addition, a study made by the *Institut für Finanzdienstleistungen* for the Commission reports the answers to a questionnaire on remuneration structure and incentives sent to banks, showing that 41 % of identified staff stated that an increase in fixed pay would not affect their risk-taking behaviour and 27 % said that it would have little effect.[88] An overwhelming 94 % of respondents disagreed that more fixed pay would reduce motivation to take risks. The study comments on these data by arguing that the reaction of bankers to fixed incentives may be cultural: "Certain cultures respond to higher fixed pay as an incentive, while others are more motivated by the opportunity to earn more through more variable pay".[89]

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[85] See note … above.
[86] Ibid. 10.
[87] Ibid.
[88] Study on the remuneration provisions applicable to credit institutions and investment firms prepared by the Institute for financial services for European Commission's DG JUST (Contract JUST/2015/MARK/PR/CIVI/0001), Final Report, January 2016, 93.
[89] Ibid. 94.

Secondly, the Commission downplayed the impact of the maximum ratio on fixed costs and profitability, arguing that fixed remuneration of identified staff in the institutions examined represented in 2014 below 5% of the total administrative costs, while variable remuneration accounted for only 1% to 2% of the total administrative costs of most of the institutions examined. Moreover, the total fixed remuneration cost of identified staff on an aggregate basis was relatively small compared with the net profits of institutions: "This suggests there is a non-negligible margin for fixed remuneration to increase before reaching a level that would threaten the overall profitability of institutions".[90]

Thirdly, the Commission rejected the claim that the maximum ratio would reduce institutions' competitiveness by negatively affecting their ability to attract and retain talent. In its view, "many elements play part in a staff's member decision to move, such as job security, promotion prospects, the reputation enjoyed by the sector, taxation, family, language and living conditions".[91] Also the choice of the proportion between fixed and variable remuneration may depend on personal or cultural preferences. However, the Commission conceded that this issue may merit further assessment when more experience with the rule is gained in practice.

IV. How to improve bankers' pay regulation?

In this part, I examine possible ways to improve EU bankers' pay regulation, always assuming that there should be one, as is presently agreed at international level. I focus on three drivers that I believe should inspire regulatory policy in this area: systemic risk, proportionality, and

[90] Report, note … above, 11.
[91] Ibid.

culture. I do not discuss the bonus cap for the simple reason that I already argued that there should not be one (section III.4).

1. *Focussing on systemic risk*

The FSB principles and standards only apply to "significant financial institutions". The Financial Stability Forum (now Financial Stability Board) specified in its Introduction to the principles that "they are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms". This establishes a clear link between the principles and systemic risk. The principles do not apply only to global systemically important financial institutions (G-SIFIs) or banks (G-SIBs); however, the 'significance' of a financial institution, which is required for their application, should be assessed also from the perspective of systemic risk.

Another way to look at the principles is by focussing on institutions that are 'too-big-to-fail' (TBTF). Indeed, significant financial institutions are likely to benefit from a government bailout in the case of a crisis, despite recent reforms providing for the resolution of insolvent institutions without recourse to taxpayer money. As argued by Thanassoulis and Tanaka, in the presence of deposit insurance and the implicit possibility of government bailouts risk-taking is subsidized to the point that special rules on incentives may be justified.[92] Indeed, there are three types of agency problems which might lead to remuneration contracts that incentivise excessive risk-taking. The first runs between the bank executives and shareholders, to the extent that the former may not adequately take the long-term interests of the latter into account. This agency problem can be solved through deferred equity-linked pay, as also foreseen under the international principles. The second runs between the bank executives and debt holders: the former may have incentives to take excessive risks at the expense of the latter if the debt market cannot monitor the risks and price

[92] John Thanassoulis and Misa Tanaka, "Bankers' Pay and Excessive Risk", Bank of England Staff Working Paper No. 558, October 2015.

them accurately. This agency problem can be solved by either linking variable remuneration to the price of debt or to credit default swap (CDS) premia,[93] or by using Contingent Convertible bonds (CoCos) as part of the remuneration.

The third problem runs between the bank executives and taxpayers and the deposit insurance fund. Given deposit insurance and/or the implicit possibility of a government bailout, higher risk-taking is not reflected by a proportionally higher cost of funding and risk-taking is effectively subsidized. The mechanisms employed to solve the other two agency problems (such as equity-linked pay and pay in debt instruments) cannot help to solve this problem, because the equity prices may be inflated by the explicit or implicit guarantees on debt (deposit insurance and government bailout) and debt prices may be similarly distorted by those guarantees. Thanassoulis and Tanaka see a possible remedy to this agency problem in the pay-adjustment mechanisms, which are also foreseen by the international principles, known as bonus malus and clawback. Both mechanisms "have the effect of putting a fixed monetary value of the executive's pay at risk", in other words a "penalty".[94] Under malus arrangements, an institution may prevent the vesting of all or part of the deferred remuneration already awarded in relation to risk outcomes or performance. Under clawback clauses, staff members agree to repay variable remuneration that has already been paid by the institution under certain circumstances.[95] However, these mechanisms work imperfectly "if bankers believe that they could be applied in the event their bank suffers large losses, even if they themselves have conducted appropriate risk management".[96] As a result, the authors suggest "to

[93] Alex Edmans and Qi Liu, "Inside Debt" (2011) 15 Review of Finance, 75-102; Patrick Bolton, Hamid Mehran and Joel Shapiro, "Executive Compensation and Risk Taking" (2015) 19 *Review of Finance*, 2139–218.
[94] Ibid., 24.
[95] Ibidem.
[96] See Misa Tanaka and John Thanassoulis, "Fixing bankers' pay: punish bad risk management, not bad risk outcomes", Bank Underground, 7 December 2015, at https://bankunderground.co.uk/2015/12/07/fixing-bankers-pay-punish-bad-risk-management-not-bad-risk-outcomes/.

link financial losses imposed on bank executives through bonus malus and clawback to ex ante risk management, rather than making them depend on ex post risk outcomes alone”.[97]

These arguments shed light on the international principles from various angles. Firstly, they clarify that the deferment of variable pay and the payment of the same in equity instruments solve the first type of agency problem, but not necessarily the others. Secondly, they explicitly connect some of the FSB principles – such as malus and clawback – to systemic risk (or TBTF) by showing that the relevant mechanisms put an additional pressure on bank managers to prevent excessive risk-taking by the same. Thirdly, they help understanding why the FSB principles are addressed to significant institutions, with a special focus on “large, systemically important firms”. Fourthly, they suggest special care in the design of malus and clawback arrangements, particularly with respect to TBTF institutions, so as to avoid risk-taking which may be excessive from a social perspective.

2. *Enhancing proportionality*

The FSB principles and standards have left some room for proportionality in their implementation to the extent that they concern ‘significant’ institutions. Institutions that are not significant can be regulated under a lighter regime, which could further differentiate depending on the size and business of the relevant firms. In fact, medium-sized institutions are less risky from a systemic perspective and less likely to undergo a government bailout, while small institutions do not individually create systemic problems (which could however be generated by them collectively through herding behaviour). Medium and small institutions are therefore less problematic as to the third type of agency costs highlighted in the previous section. However, also the business model of an institution can be relevant in terms of proportionality. Deposit-taking institutions like commercial banks, for instance, are in principle less prone to compensate their executives and

[97] Ibidem. See also Albuquerque, Cabral and Corrêa Guedes, note 75, on the need to regulate RPE in order to reduce systemic risk.

employees through variable remuneration than investment banks and asset managers, which traditionally make wide recourse to bonus payments and other pecuniary incentives.

Nonetheless, proportionality has been interpreted differently across jurisdictions. US regulation, in particular, is more flexible than CRD IV. The US Federal Supervisory Agencies jointly exercised their mandate under Dodd-Frank Wall Street Reform and Consumer Protection Act of 21st July 2010 by approving a Proposed Rule on incentive-based compensation arrangements for 'covered financial institutions' in February 2011.[98] These are institutions under the supervision of the respective Federal Regulator, with total consolidated assets of US-$ 1 billion or more. As required by section 956 of the Act, the proposed Rule prohibits 'excessive' compensation, i.e. compensation that is 'unreasonable or disproportionate to the services performed by a covered person'. Moreover, compensation should not encourage the taking of 'inappropriate risks' by the covered financial institution, by providing executives or employees with incentives that could lead to a 'material financial loss' to the institution.[99] The use of standards, which are general in character, rather than rules analytically defining the compensation structure, reflects the US regulators' willingness to keep the needed flexibility in compensation arrangements.[100] Nonetheless, specific rules apply to 'larger covered financial institutions', such as bank holding companies with consolidated assets of more than US-$ 50 billion, which are required to defer at least 50% of the incentive-based compensation payments to executive officers over a period of at least three years, with the release of the deferred amount to occur no faster than on a pro-rata basis.

[98] Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Agencies (the Board of the Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Association, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the Securities and Exchange Commission) to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions (referred to as 'covered financial institutions'). In April 2011, the Agencies published a joint notice of proposed rulemaking that proposed to implement section 956 (2011 Proposed Rule).

[99] See, for a short comment of the Rule from a comparative perspective, Guido Ferrarini and Maria Cristina Ungureanu, 'Bankers' Pay after the 2008 Crisis: Regulatory Reforms in the US and the EU' (2011) 23 Zeitschrift fur Bankrecht und Bankwirtschaft 418-430, at 422 ff.

[100] Ibidem.

A 'malus' mechanism also applies, in that the deferred amount should be adjusted for actual losses incurred by the institution or other measures of performance during the deferral period.[101]

The proposed Rule is currently being reviewed by the Federal Regulators in light of their supervisory experience since 2011.[102] Like the 2011 Rule, the new Proposed Rule would apply less prescriptive incentive-based compensation program requirements to the smallest covered institutions and progressively more rigorous requirements to the larger institutions. However, three categories of covered financial institutions (rather than two) would be identified based on average total consolidated assets: Level 1 (greater than or equal to $ 250 billion); Level 2 (greater than or equal to $ 50 billion and less than $ 250 billion); Level 3 (greater than or equal to $ 1 billion and less than $ 50 billion).[103]

The EU legislator has followed a different path. As already stated (section III.2), institutions should comply with the CRD IV principles in a manner and to the extent that is appropriate to their size, internal organization and the nature, scope and complexity of their activities. Moreover, the provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. However, both the EBA and the European Commission expressed the view that CRD IV does not permit exemptions or waivers to the application of the remuneration principles.[104]

The CRD IV requirements concerning the deferral of variable remuneration and the pay-out in instruments have been particularly criticized from the perspective of small institutions and staff with low variable remuneration. This has led most member States to introduce waivers from such

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[101] Moreover, if the covered financial institution has consolidated assets of US-$ 50 billion or more, the board of directors or a board committee shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible 'substantial' losses.

[102] See the Board of the Governors of the Federal Reserve System, Incentive-based Compensation Arrangements, Notice of Proposed Rulemaking and Request for Comment, at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160502a2.pdf.

[103] Ibidem, at 40.

[104] EBA, *Opinion on the application of proportionality to the remuneration provisions in Directive 2013/36/EU*, EBA/Op/2015/25, 13.

requirements based on proportionality, which were however found as legally inadmissible by EBA and the Commission. Indeed, as recognized by the Commission in a report to the European Parliament, small institutions face high compliance costs related to the fact that they have to make considerable investments in human resources, IT and advisory services with respect to complex remuneration requirements.[105] Moreover, small institutions encounter difficulties in creating appropriate instruments to comply with the pay-out requirement for variable remuneration, often due to their corporate statute or ownership structure.

As a result, the Commission presented a proposal for a directive amending CRD IV also with respect to remuneration requirements, some of which could be waved by member States with respect to small and non-complex institutions and to staff members with low variable remuneration.[106] Under proposed new Article 94 (3) the requirements as to pay-out in instruments and deferral of variable remuneration shall not apply to "(a) an institution the value of the assets of which is on average equal to or less than EUR 5 billion over the four-year period immediately preceding the current financial year; (b) a staff member whose annual variable remuneration does not exceed EUR 50.000 and does not represent more than one fourth of the staff's member's annual total remuneration". However, a competent authority could decide that institutions whose total asset value is below the threshold referred to in point (a) "are not subject to the derogation because of the nature and scope of their activities, their internal organisation or, if applicable, the characteristics of the group to which they belong". Similarly, a competent authority may decide that staff members whose annual variable remuneration is below the threshold and hare referred to in point (b) "are not subject to the derogation because of national market specificities in terms of remuneration practices or because of the nature of responsibilities and job profile of those staff members".

The new proposal would no doubt improve on the present treatment of small institutions, but the comparison with the US regulation of bankers' pay would still show a big divide, raising the

[105] Report from the Commission to the European Parliament and the Council, Assessment of the remuneration rules under Directive 2013/36/EU and Regulation (EU) No 575/2013, Brussels, 28.7.2016, 8.
[106] See Proposal for a Directive of the European Council and of the Council amending Directive 2013/36/EU, COM(2016) 854 final, Brussels, 23.11.2016.

question whether the EU views on proportionality in remuneration matters are appropriate. Building on the US model, particularly on the recent proposals of the Federal Agencies, also in the EU institutions could be grouped in more than one category and different requirements should apply to them depending on their category. Only the largest institutions should be subject to all CRD IV requirements, which reflect the international principles (save for the bonus cap) and have therefore been designed with respect to the significant financial institutions. The threshold of EUR 5 billion still appears too low for identifying significant institutions (which in the US must possess more than $ 50 billion in consolidated assets), while it is appropriate for defining the smallest ones.

3. *Understanding the role of culture*

The goals of the FSB principles are rather limited in scope: "The Principles are intended to reduce incentives towards excessive risk-taking that may arise from the structure of compensation schemes. They are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking."[107] This statement deserves a few comments. First, the principles follow a prudential approach, even though they may have an impact on the structure of compensation, as discussed throughout this paper. Second, the design and level of compensation mainly depend on the business model and culture of the firm, but also of the country in which the firm is based. Third, prudent risk taking is the outcome of appropriate incentives and good risk management within the firm, under the oversight of boards of directors and the supervision of banking authorities.

Similar statements and comments summarize many of the arguments developed in this paper. They also highlight the importance of culture as to the level and structure of pay, suggesting

[107] See FSF (now FSB), Principles for Sound Compensation Practices, 2 April 2009, at 1.

lines for future research on the governance and supervision of bankers' compensation.[108] The relationship between culture in a given country and CEO compensation has already been studied for corporations in general.[109] From a general perspective, Tosi and Greckhamer have shown that the CEO pay structure is most reflective of the power structure in a society because "power distance" is related to all compensation variables that they studied.[110] They have also shown that total compensation and the proportion of variable compensation to total CEO compensation are related to the level of individualism in society. These and similar arguments explain the persistent and huge differences in the levels and structure of managerial pay at large banks in the US and in Europe. According to joint research from the FT and pay consultancy Equilar, "US bank chief executive pay settles at more than twice the average pay of bank bosses in Europe".[111] This may depend on the activism of institutional investors as to say-on-pay in Europe – where "shareholders are more determined than ever to prevent American norms from crossing the Atlantic"[112] – and on differences in performance between US and European banks,[113] but different cultures surely matter.

Interestingly, cultural dissimilarities are also reflected in the politics of bankers' remuneration, as evidenced by the comparison made in the previous section between the US and the EU rules in this area, showing that the former are more flexible (and less mandatory for medium and small institutions) than the latter. Clearly, social acceptance of higher pay in the US translates into less rigid rules as to pay governance and structure, save for large banks in which however rules

[108] I am developing this theme in a parallel paper with Shanshan Zhu on 'Governing Financial Institutions: The Role of Culture', which incudes a discussion of the remuneration issues.

[109] In China, for example, the weak trust that the Chinese people have on the government and future political perspectives makes some indirect and long-term benefits (such as life insurance, education subsidy and vacation leave) less attractive and motivating than short-term forms of compensation (cash, bonuses and housing): see Randy Chiu, Vivienne Luk and Thomas Tang, 'Retaining and motivating employees. Compensation preferences in Hong Kong and China' (2002) 31 Personnel Review, 402-431; Martin Conyon and Lerong He, 'CEO Compensation and Corporate Governance in China' (2012) 20 Corporate Governance: An International Review, 575–592.

[110] Henri Tosi and Thomas Greckhamer, 'Culture and CEO Compensation' (2004) 15 Organization Science 657-670. Power distance is the degree to which differences in power and status are accepted in a culture: see Geert Hofstede, *Culture's Consequences: International Differences in Work-Related Values* (Sage,1980).

[111] See Laura Noonan, 'Investors strive to keep European bank CEO pay below US levels', FT July 23, 2017.

[112] Ibid.

[113] Ibid.

similar to those in force in Europe have led to much higher total remuneration. No doubt, the EU bonus cap could have contributed to the difference in pay levels, but the resistance to a similar cap in the US confirms that there are cultural dissimilarities as to the socially acceptable level of pay across the Atlantic.

The type of culture within the firm should also be considered when setting and/or monitoring the incentives to executives and key personnel.[114] Clearly, incentives are not set in a vacuum, but reflect the values on which the corporate culture is based. Moreover, incentives should take into account all types of motivation which determine corporate actions.[115] Corporate governance scholarship emphasizes the role of culture in corporations and the responsibility of boards in this respect,[116] while a recent document by the UK Financial Reporting Council argues that the performance management and reward system should support and encourage behaviours consistent with the company's purpose, values, strategy and business model.[117]

Another document by the Group of Thirty maintains that there must be a sustained focus on conduct and culture by banks and the banking industry, boards, and management.[118] As to performance management and incentives, banks should "improve compensation and promotion processes to ensure they take account of desired behaviours, including consequences for weak management oversight or wilful blindness". Moreover, they should "develop a comprehensive set of indicators to monitor and assess the adherence of individuals and teams to firm values and

[114] See, in general, Alan Morrison and Joel Shapiro, 'Governance and Culture in the Banking Sector' (February 11, 2016), available at SSRN: https://ssrn.com/abstract=2731357; Andrew Lo, 'The Gordon Gekko Effect: The Role of Culture in the Financial Industry' (2016) FDRNY Economic Policy Review, 18; Anjan Thakor, 'Corporate Culture in Banking' (August 2016) Economic Policy Review, 5-16.

[115] See Emir Kamenic, Behavioral Economics and the Psychology of Incentives (2012) 4 Annual Review of Economics 13.1–13.26; Roland Bénabou and Jean Tirole, 'Intrinsic and Extrinsic Motivation' (2003) 70 Review of Economic Studies 489-520.

[116] See, amongst others, David Larcker and Brian Tayan, *Corporate Governance Matters* (FT Press, 2011), 32 ff.

[117] Financial Reporting Council (FRC), Corporate Culture and the Role of Boards, Report of Observations, July 2016.

[118] Group of Thirty (G30), Banking Conduct and Culture. A Call for Sustained and Comprehensive Reform, July 2015.

desired conduct".[119] Furthermore, given that incentives are closely linked to risk-taking, the risk culture of a firm is also relevant to the setting and monitoring of remuneration. Therefore, boards and supervisors, when performing their respective roles, should consider the "values, beliefs, knowledge and understanding about risk" which constitute the risk culture within a bank.[120]

4. *Concluding remarks*

In part I of this paper, I tried to show that the grounds for regulating bankers' pay are rather weak, particularly if we consider mandating the structure of bankers' pay as currently done under the international principles and the CRD IV. Setting the structure of pay is a corporate governance function that regulation should not substitute with detailed and rigid provisions. If there are corporate governance failures in the setting of bankers' pay, better to deal with them by lightly regulating the corporate governance processes, as already done under the international principles. Moreover, prudential supervision complements regulation through oversight of remuneration governance and risk management processes concerning the impact of incentives on bank risk-taking.

In part II, I argued that the international principles interfere with the remuneration structures in a prescriptive way, particularly with regard to deferred variable pay and pay-out in instruments. For the rest, they mostly track best practices already followed by large institutions before the financial crisis, leaving some room to flexibility. Moreover, they explicitly require financial institutions to focus on risk management when setting variable remuneration, so as to avoid that the relevant incentives lead them and their staff to excessive risk-taking. In part III, I argued that the EU law shifted from a supervisory approach to a regulatory one to the setting of bankers' pay, adopting detailed and rigid provisions on the structure, governance and disclosure of remuneration.

[119] Ibid., at 13.
[120] Institute of Risk Management (IRM), Risk Culture under the Microscope, Guidance for Boards, October 2012, at 7-

Moreover, CRD IV introduced an unprecedented cap to variable remuneration, which may distort incentives and produce unintended consequences on bank risk-taking.

In part IV, I examined possible ways to overcome the shortcomings of CRD IV in the area of bankers pay and suggested that it should be made more flexible and proportionate within the limits allowed by the international principles. I proposed to focus on systemic risk in order to define the thresholds identifying the institutions which should be subject to the most stringent provisions as to the setting and monitoring of bankers' pay. Moreover, I suggested implementing proportionality in wider terms than recently proposed by the European Commission in its review of CRD IV, along the US model which distinguishes between three categories of regulated institutions that are subject to proportinate sets of rules depending on their size. Lastly, I recommended that the governance and supervision of bankers' pay should emphasize the role of culture in the setting and monitoring of remuneration, for incentives are not set in a vacuum, but reflect both the culture prevalent in society and the corporate culture of the individual firm.