

Draft Chapter (January 2010) of the volume “International Executive Compensation”, edited by Jennifer Hill and Randall Thomas (Elgar, forthcoming 2011)

Bankers’ Compensation and Prudential Supervision: The International Principles

Guido Ferrarini*

In the quest for possible causes of the recent financial crisis, commentators often argue that bank executives had poor incentives.¹ Critics claim, in particular, that executive compensation was not properly aligned with long-term performance (Bebchuk and Fried 2010; Posner 2009), while regulators seek ways to change practices in order to restore this alignment. At least two questions arise with respect to incentive practices. The first is whether executive compensation at banks before the crisis was predominantly short-term oriented. Academics and politicians answer this question differently. The latter argue, with the support of the media, that widespread short-term incentives to bank managers were at the root of the recent crisis. On the academic side of the current debate, recent empirical studies reveal no proof that short-term incentives led to excessive risks. In particular, an empirical study examined in Part 1 of this Chapter shows that, in the United States at least, pay was generally aligned with the long-term interest of shareholders (Fahlenbrach and Stulz 2010). Similar studies are not available for Europe because data needed to calculate the

* Professor of Business Law, University of Genoa; Director, Centre for Law and Finance; Fellow, European Corporate Governance Institute

¹This paper draws on Guido Ferrarini and Maria Cristina Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks*, ECGI Law Working Paper (2010); Vanderbilt Law Review (forthcoming, 2011).

value of stock options and long-term incentives is generally not publicly available.² The second question, which is further analyzed in Part 1, is whether banking regulation should cover compensation arrangements, either by mandating pay structures or by requiring their adjustment in order to avoid excessive risk taking. I submit that regulators should not replace boards in setting pay structures and that regulatory intervention concerning executive pay at banks should be limited in scope, so as to maintain the flexibility of executive pay arrangements. In Part 2, I examine the Principles for Sound Compensation Practices and their Implementation Standards issued in 2009 by the Financial Stability Forum (which later became the Financial Stability Board), and critically assess the same in light of the preceding discussion (FSF 2009; FSB 2009). The Chapter concludes with some remarks on the case for regulating bankers' pay.

1. Theories and policies

This Part explores possible grounds for the regulation of bankers' pay by analyzing the empirical and theoretical literature recently developed in this area.

1.1 Bank governance and the financial crisis

Banks are different from other firms for several reasons that matter from a corporate governance perspective. First, they are more leveraged, with the consequence that the conflict between shareholders and fixed claimants, present in all corporations, is more acute for banks (Macey and O'Hara 2003). Second, 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

²However, our study shows that, before the crisis, most banks declared that their remuneration policies were fairly balanced between fixed and variable pay and included long-term incentives. This was true for both ailing and non-ailing banks, making it unlikely that, before the crisis, bank managers followed a short-term approach induced by the structure of their incentives (Ferrarini and Ungureanu 2010 (2)).

runs took place at large institutions, threatening the stability of the whole financial system. Third, 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. Fourth, asset substitution is relatively easier in banks than in non-financial firms (Levine 2004). 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.

For all these reasons, "good" corporate governance (i.e. aligning the interests of managers and shareholders) may lead bank managers to engage in more risky activities (Laeven and Levine 2009). 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). Prudential regulation and supervision aim to reduce the excessive risk propensity of shareholders and managers in order to guarantee the "safety and soundness" of banks.

Some recent empirical studies confirm that good governance may not be enough for bank soundness. An 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 (Beltratti and Stulz 2009). 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 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.

The criteria for examining corporate governance employed by similar studies are debatable (Adams 2009). 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 (Bhagat et al. 2010). 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.

1.2 Empirical studies and the regulation of bankers' pay

Empirical research focusing on executive pay and its role in the banking crisis offers results that are on the whole consistent with the Beltratti and Stulz study.

A paper by Rüdiger Fahlenbrach and René Stulz analyzes a sample of ninety-eight large banks across the world and finds “no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis (Fahlenbrach and Stulz, 2010).” 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.” According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006. 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.

A different view is offered by Lucian Bebchuk, Alma Cohen, and Holger Spamann in a paper on executive compensation at Bear Stearns and Lehman Brothers, focusing on the link between short-term incentives and risk taking (Bebchuk et al. 2010). 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." 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."

While the first study reviewed in this paragraph shows 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. It does not claim, however, that incentives in troubled banks before the crisis were mainly short-term, or that short-term incentives 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, in line with the international trends that will be analyzed in Part II.

1.3 Recent Proposals on the Optimal Structure of Bankers' Pay

Calls for regulating bankers' pay have been advanced post-crisis by financial economists and lawyers exploring, on theoretical grounds, the incentives to excessive risk taking created by remuneration structures and possible remedies from a regulatory perspective. A paper by Patrick Bolton, Hamid Mehran and Joel Shapiro models a similar claim for regulation, starting from the proposition that the traditional theory of executive compensation does not directly apply to levered firms (Bolton et al. 2010). In the presence of risky debt, shareholders have an incentive to shift risks to creditors: "Not surprisingly, structuring CEO incentives to maximize shareholder value in a levered firm tends to encourage excess risk taking." Bolton et al. suggest, therefore, that the CEO's compensation at similar firms, including financial institutions, "ought to be structured to maximize the whole value of the firm – equity and debt value – and not just the value of equity." In particular, they propose tying CEO compensation, at least in part, to a measure of default riskiness of the firm, such as a bank's credit default swap ("CDS") spread over the performance evaluation period. An increase in the CDS spread would result in lower compensation, thus limiting risk shifting by the managers. Bolton et al. also recognize that it is not obvious that a bank's shareholders will make use of similar incentive contracts to reduce risk taking by executives. Indeed, the lower riskiness of the bank should translate into a lower cost of debt and induce shareholders to tie compensation to CDS spreads. However, deposit insurance and investors' misperception of risk would work against a similar compensation structure, by reducing shareholders' incentives to limit risk taking by the

bank. In the authors' opinion, therefore, regulation should mandate the suggested structure, at least for large financial institutions.

Lucian Bebchuk and Holger Spamann recommend regulating executive pay at banks and designing a pay structure intended to avoid excessive risk taking (Bebchuk and Spamann 2010). In their opinion, "regulation of executive pay would be warranted even if banks had no governance problems," for the same reasons that traditionally underlie bank regulation, i.e. that shareholders do not internalize losses that risk taking could impose on bondholders, depositors, and taxpayers. Moreover, mandating pay structures could usefully supplement the traditional regulation of banking activities: "Indeed, if pay arrangements are designed to discourage excessive risk taking, direct regulation of activities could be less tight than it should otherwise be." They argue that, at a minimum, bank supervisors should closely monitor compensation structures and take the same into account when assessing the risks posed by a bank and exercising their supervisory powers. Bebchuk and Spamann propose, in particular, that executive pay should be tied to the aggregate value of a basket of securities (including common shares, preferred shares and bonds) issued by either a bank holding company or a bank, rather than to the value of common shares only.

Other scholars recommend a mandatory structure for executive pay at banks, similarly designed to control risk taking, but making reference to instruments different from those considered so far. Frederick Tung suggests that subordinated debt should be included as part of managers' pay arrangements, to align their interests more closely with those of risk-averse debt holders and ultimately with those of regulators in assuring banks' safety and soundness (Tung, 2010). Jeffrey Gordon refers to subordinated debt from a different perspective, suggesting that senior executives should receive a significant portion of stock-related compensation in the form of "convertible equity-based pay," i.e. "equity that will convert into subordinated debt upon certain external

triggering events, such as a downgrade by the regulators to a ‘high risk category’ or a stock price drop of a specified percentage over a limited time period” (Gordon 2010).

Both Gordon and Tung criticize Bebchuk and Spamann’s proposal from various angles, focusing on its technical details, however sharing the core idea that executives’ incentives at banks should take into account the interests of creditors, so as to avoid excessive risk taking. All papers considered in this paragraph also agree that adoption of similar pay structures would be fraught, in practice, with serious collective action problems and suggest regulatory intervention. The nature of this intervention is still unclear, with references being made either to regulators’ promoting or mandating similar structures (Bolton et al. 2010; Bebchuk and Spamann 2010), or to regulators’ encouraging “appropriate amounts of subordinated debt in bankers’ pay arrangements, while at the same time preserving the discretion of boards of directors to set pay” (Tung 2010).

1.4 Assessment

However, the case for regulating bankers’ pay appears to be rather weak, especially since it is far from proven that pay structures generally contributed to excessive risk taking before the recent crisis. According to some of the above studies, corporate governance and compensation structures at banks that failed were not necessarily flawed. Even assuming that compensation structures were flawed, the need for regulation would not be automatically established. On the contrary, mandating pay structures would hamper the flexibility of compensation arrangements, which need tailoring to individual firms – according to their circumstances – and managers – also in light of their personal portfolios of their banks’ securities.

In theory, regulators could devise different pay structures for different firms and situations, offering a menu of choices to supervised entities. However, this menu could hardly cover all situations that may exist in practice, while a broad set of choices would practically dilute the impact

of regulation. In addition, regulators may not be professionally qualified for designing pay structures and monitoring their implementation in practice. Moreover, banks' boards would partially lose setting executive pay as one of their key governance functions, finding it more difficult to align executives' incentives to corporate strategy and risk profile. This would also create problems in keeping and attracting managerial talent, particularly from countries that adopt a more liberal stance or from firms that are not subject to regulatory constraints (such as hedge funds or private equities).

No doubt, regulators should take managerial incentives into account when setting the standards for banking activities and organization, and supervise their implementation in practice from the perspective of bank safety and soundness. Nonetheless, this should be done in ways that are appropriate for prudential regulation, which typically establishes conditions and limits to risk taking, rather than by fixing the incentive structures directly. Indeed, prudential regulation establishes the conditions for the performance of banking activities, such as capital adequacy requirements and limits to risk concentration, without mandating the structure and contents of the individual transactions.³ Bankers' remuneration should be treated no differently. Rather than designing compensation structures, which is a matter for boards, regulators should analyze the impact of existing structures on risk taking and conduct their supervisory action accordingly, for instance by imposing higher capital requirements to institutions adopting "aggressive" remuneration mechanisms.

In addition, regulators could establish requirements for the corporate governance of banks, including compensation governance, and for the disclosure of remuneration policies to investors and supervisors. Rather than interfering with pay structures, this type of regulation aims to ensure

³ Regulation of structure and/or contents of transactions may be introduced for reasons other than prudential concerns, such as consumer protection. See, on the concept and scope of prudential regulation, the introductory chapter in Ferrarini (ed.), 1995.

that organizational structures and procedures are in place for the setting of pay in compliance with safety and soundness requirements. More generally, regulators should acknowledge that even good corporate governance may not be enough to avoid excessive risk taking and therefore strengthen the traditional tools of prudential supervision, which have a direct impact on risk taking by banks (such as capital requirements and risk measurement criteria). Some of these guidelines have already been adopted by the Basel Committee on Banking Supervision (BCBS 2009, BCBS 2010).

Given the political pressure to regulate executive pay arrangements at banks, which is further illustrated in Part 2, regulators – in addition to enforcing and strengthening the prudential regulation requirements along the above lines – should follow a soft approach to compensation standards by suggesting which structures, in their view, would hamper excessive risk taking by banks. From this perspective, the studies analyzed above offer useful insights to bank boards and supervisors, showing the pros and cons of different arrangements linking pay to the interests of depositors and other stakeholders. It is also clear that similar recommendations from supervisors would help solve the collective action problems relative to the adoption of pay mechanisms that are not directly tied to wealth maximization purposes and actually could run against the short-term expectations of shareholders. However, the ultimate choice of pay structures should be left to the boards, which have better knowledge both of the business and the situation of the individual bank, and of their managers' portfolio of their respective bank securities.

2. Politics and Reforms

The emergence of the FSB Principles and Standards and their rise were influenced by the national measures adopted during the crisis, when governments had to rescue banks and restructure the same in order to assure the survival of the international financial system (Ferrarini and Ungureanu 2010 (1)).

2.1 The Rise of the FSB Principles

Indeed, the financial crisis has put the banking industry's compensation policies and incentive models under severe scrutiny from investors, regulators, politicians and the wider public, on both sides of the Atlantic. Two main problems have been discussed in the political arena. One is the level of remuneration at large banks, which appeared to be excessive in the United States, but also in Europe. The other is the remuneration structure, which, according to widespread opinion, may induce excessive risk taking and encourage short-termism. Social resentment focused on the former. Lavish compensation packages paid by banks, which governments subsequently had to rescue, amplified the social debate, often provoking a populist response by politicians. Regulatory concerns concentrated on the latter, regarding remuneration design as main contributor to excessive risk taking by rewarding bankers for superior performance, whilst not penalizing failure.

The FSB adopted the Principles following coordinated action by the G-20 governments, which rapidly responded to heavy political pressure deriving, both domestically and internationally, from the financial crisis and repeated bank failures. Through swift adoption of the Principles, authorities intended to show that reforms of the international financial system were timely put in place with respect to executive compensation. Moreover, international coordination was needed to solve collective action problems amongst states, given that few governments would have been willing to regulate executive pay in the absence of similar interventions by other jurisdictions, for fear of competition from foreign financial institutions, both in the financial markets and in the market for managers.

The Principles and Standards address the areas of governance, remuneration structure and supervision and disclosure. Some principles are not new to the extent that they require a balanced pay structure and long-term approach, alignment of pay with performance, independence of the

pay-setting process and disclosure of remuneration policies. Relatively new is the emphasis on effective alignment of compensation with prudent risk taking and compensation practices that reduce employees' incentives to take excessive risk.

2.2 Compensation Governance

The Principles call for the board of directors to actively oversee the compensation system's design and operation, requiring that relevant board members are independent and have expertise in risk management and compensation. They also require the board of directors to monitor and review the compensation system, so as to ensure that it operates as intended. The compensation system should engage control functions (including human resources, finance and risk management) in its decisions, while its practical operation should be reviewed regularly for compliance with design policies and procedures by the compliance and internal audit functions (Principle 1, FSF).

The Standards specify that significant financial institutions should have a board remuneration committee to oversee the compensation system's design and operation on behalf of the board of directors (Standard 1, FSB). The remuneration committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital, and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. The remuneration committee should work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system and ensure that the firm's compensation policy is in compliance with the relevant principles and standards.

2.3 Compensation Structure

As to the alignment with prudent risk taking, the Principles state that compensation must be adjusted for all types of risks, including those difficult-to-measure, such as liquidity risk, reputation risk, and capital cost (Principle 4, FSF; Standard 6, FSB). The Standards require “significant financial institutions” to ensure that total variable compensation does not limit their ability to strengthen their capital base. Compensation outcomes should be symmetric with risk outcomes. In particular, compensation systems should link the size of the bonus pool to the overall performance of the firm; employees’ incentive payments should be tied to the contribution of the individual and business to such performance; and bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance (Principle 5, FSF). Furthermore subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm’s total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements (Standard 5, FSB).

Malus and clawback clauses are rather new in compensation contracts, although adjustments of incentives according to performance criteria were also made pre-crisis. These clauses are applicable to both cash incentives and share-based payments. They enable boards to reduce or reclaim bonuses paid based on results that are unrepresentative of the company’s performance over the long-term or later prove to have been misstated. Where cash incentives are deferred, unvested portions should be clawed back in the event of negative business performance. However, not all regulations clearly differentiate between ‘malus’ and ‘clawback’ clauses, which are still relatively rare in practice (Ferrarini and Ungureanu 2010 (2)).

Deferment of compensation was traditionally used as a retention mechanism on the basis that a “bad leaver” will generally lose unpaid deferrals. Post-crisis reforms give deferral a greater role, providing that compensation payout schedules should be sensitive to the time horizon of risks.

Therefore as profits and losses of different activities of a financial firm are realized over different periods of time, variable compensation payments should be deferred accordingly (Principle 6, FSF). Payments should not be finalized over short periods where risks are realized over long periods. As specified by the relative standard, a substantial portion of variable compensation (i.e. forty to sixty percent) should be payable under deferral arrangements over a period of years. These proportions should increase significantly with the level of seniority and/or responsibility (for most senior management staff and the highest paid employees, the percentage of deferred variable compensation should be substantially higher, i.e. over sixty percent) (Standard 6, FSB). The deferral period should not be less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question (Standard 7, FSB). Moreover, compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis (Standard 8, FSB).

“Guaranteed bonuses” caused much outrage following banks’ bailouts (Ferrarini and Ungureanu 2010 (1)). Short-term guarantees are common at banks and are regarded as relatively harmless and often necessary when hiring staff mid-year. Contracts guaranteeing variable pay for several years are, however, problematic, as they violate principles of pay-for-performance. The guarantee insulates variable pay from poor performance, which may encourage more risk taking than would otherwise be the case. Pre-crisis rules and standards did not touch upon this issue. Under the FSB Standards guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year (Standard 11, FSB).

Severance packages of senior executives fired as a result of their firms’ crisis also triggered public outrage for the excessive costs they imposed on shareholders. Consequently, the future of

severance pay is changed by the new standards. Existing contractual arrangements related to employment termination should be re-examined and maintained only if there is a clear basis for concluding that the relevant payments are aligned with long-term value creation and prudent risk taking. In perspective, termination payments should be related to performance achieved over time and designed in a way that does not reward failure (Standard 12, FSB).

The Principles further expand on remuneration structures by requiring the mix of cash, equity and other forms of compensation to be consistent with risk alignment and adjusted according to the employee's position and role. Moreover, a substantial proportion (i.e. more than fifty percent) 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 share retention policy (Standard 8, FSB).

2.4 Disclosure and Supervision

Pre-crisis compensation regimes largely focused on disclosure; however, their enforcement did not always meet the relevant standards (Ferrarini et al. 2010). Appropriate disclosure of remuneration in the firm's annual report should benefit not only shareholders, but also other stakeholders (e.g. creditors and employees). Disclosure should identify the relevant risk management and control systems and facilitate the work of supervisors in this area. The FSB Principles recommend increased transparency by adding new items of disclosure. In line with the detailed requirements on pay design, new disclosure requirements include deferral, share-based incentives, and criteria for risk adjustment (Standard 5, FSB).

The Principles also require effective supervisory oversight (Principle 8, FSF). In the case of a failure by a firm to implement "sound" compensation policies and practices, "prompt remedial action" should be taken and "if necessary, appropriate corrective measures to offset any additional

risk that may result from non-compliance or partial compliance [with the Standards]” (Standard 18, FSB). The FSB’s Commentary on the Principles explains what these measures might be by stating: “Particularly when the totality of a firm’s compensation practices are less than sound, supervisors should first exercise suasion on the affected firm, and in the absence of necessary improvement should consider escalation to firmer intervention, which may include increased capital requirements.” This approach is consistent with this Chapter’s view on a softer role for regulating bankers’ pay, in contrast to the approach implied by scholars who propose that regulators mandate a given structure of compensation in order to reduce risk taking by the managers.

2.5 A critical appraisal

The Principles represent a political compromise between the various interests at stake and the different views concerning executive compensation’s role in the crisis. Those claiming that pre-crisis pay structures were too focused on short-term gains and led to excessive risk taking by financial institutions should be satisfied with the Principles’ recognition of the need for long-term orientation and alignment of incentives with prudent risk taking. Financial institutions should not be disconcerted with the Principles’ ratifying what was known as sound compensation practice already before the financial turmoil (Ferrarini and Ungureanu 2010 (2)). They should also approve of the Principles’ rejecting a “one size fits all” approach to executive compensation issues, leaving room for differences in compensation structures based on individual circumstances. Financial regulators are no doubt amongst the winners in the political contest that led to the adoption of the Principles, which require incentives to be aligned with prudent risk taking and extend the remit of prudential supervision to compensation practices at financial institutions.

The FSB Principles incorporate some traditional corporate governance standards, like those concerning the strategic and supervisory role of the board, which also apply to the setting and

monitoring of executive pay arrangements. Additionally, the Principles reflect the post-crisis emphasis on bank risk management and its monitoring by the board of directors, who should determine the risk appetite of the firm. The Standards reiterate the role of the remuneration committee in the setting and overseeing of executive pay, requiring it to liaise with the firm's risk committee to ensure compliance with the relevant requirements. On the whole, the focus placed by the Principles and Standards on "effective governance of compensation" deserves approval and reflects a consolidated trend in bank regulation in acknowledging the role of corporate governance for financial stability purposes.

Compensation structures are considered by the Principles along lines that reflect, to a large extent, best practices already adopted before the crisis. Indeed, the role and limits of equity-based compensation, as well as the perverse effects of short-term incentives, have attracted increased attention in the last twenty years, particularly after Enron and other accounting scandals occurred at the beginning of this century (Bhagat and Romano 2010). However, the alignment of managers' incentives with shareholder wealth maximization has constantly been the main focus of the discussions. The FSB Principles break new grounds by emphasizing the alignment of compensation with prudent risk taking, as a result of the recent crisis and the problems of ailing banks.

Aligning bank managers' interests with stakeholders' interests was also pursued to some extent before the crisis, through compensation structures that included long-term incentives and stock-based compensation. In particular, the requirement that compensation includes a mix of cash, equity and other forms of compensation consistent with risk alignment, to some degree reflects pre-crisis best practices, as shown by the remuneration policies for 2007 of the European large banks (Ferrarini and Ungureanu 2010 (2)).

As clarified in their Introduction, the Principles should not be seen as too prescriptive (FSF 2009). They are flexible enough to accommodate differences between firms and amongst managers

within the same firm. Even the requirement to treat differently “two employees who generate the same short-run profit but take different amount of risk on behalf of their firm” (Principle 4, FSF) should not be construed too literally. While compensation structures and amounts should reflect differences in risk taking, other factors that justify similarities in pay, such as the need to promote new businesses within the firm or to attract new talent, could be valued.

The FSB’s ultimate goal is to prevent excessive risk taking by reducing incentives to do so created by remuneration arrangements. It is implicit in the Principles that a bank’s board should pursue a similar objective when setting and monitoring executive pay. Directors should ascertain that compensation arrangements do not lead the bank’s managers to take excessive risks. This could become, under applicable law, a discrete duty of directors, who will be accountable to supervisors for compliance with this duty. However, the difficulties in defining “excessive risk-taking incentives” should not be underestimated (Core and Guay 2010). Moreover, one should consider that “taking on the right amount of investment and operating risk is essential to successfully compete within any industry, and that even creditors want firms to prudently take on some risk.”

As discussed above, the Standards attempt to provide some guidance with regard to the equity portion of variable compensation. However, this can also be problematic. In fact, the incentives deriving from equity-based compensation depend on the individual executives’ portfolio of securities of their respective banks. In the case of executives holding substantial equity stakes in their companies, as observed for US banks, stock-based compensation could “exacerbate” the incentive alignment problems. As a result, the standard in question should be applied taking into account the managers’ equity holdings in their firms (which are in any case lower for European banks). Interestingly, neither the Principles nor the Standards attach detailed requirements to the vesting conditions of stock options and stock grants. Moreover, banks are asked to establish a share

retention policy, whilst they are free to set the terms of this policy which must be disclosed in the annual report on compensation.

Deferment of variable compensation is key to controlling risk-taking incentives. Bolton et al. conducted empirical research on the link between deferred compensation at banks and credit quality and found that disclosure of deferred compensation is priced in credit markets through a reduction in CDS spreads at proxy announcements (Bolton et al. 2010). They explain this reduction by arguing that “banks are likely to be more conservative in terms of the riskiness of their investment choices,” as a result of larger investments in CEO deferred compensation. Deferment is one of the aspects of variable remuneration more frequently found in 2007 and on the rise after the crisis (Ferrarini and Ungureanu 2010 (2)). However, the detailed requirements for deferment, such as the percentage (forty to sixty) of variable remuneration that it should cover and the time of deferral (minimum three years) may appear too rigid, as this is an area which should be left to bank boards to decide upon.

However, the success or failure of the Principles in practice will largely depend on the ways in which they are implemented and enforced at national level. Domestic regulation could either enhance or limit their flexibility. Supervisors might exert more or less pressure on financial institutions to achieve compliance. Banks could experiment with new structures, provided that sufficient discretion is left to their boards. Also in light of the recent economic literature on the role of executive pay in the financial turmoil (Roubini and Mihm 2010; Acharya and Richardson 2009), regulation should be flexible and principle-based, allowing for innovation and diversity in executive pay structures, while preventing excessive risk taking. At the same time, the role of boards and disclosure of compensation practices through harmonization of remuneration reports should be enhanced (Ferrarini et al. 2010).

3. Conclusions

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

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

also widen the powers of supervisors by explicitly acknowledging that executive pay is an area for prudential regulation.

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

References

1. Acharya, Viral and Mathew Richardson (eds.), “Restoring Financial Stability: How to Repair a Failed System”, NYU Stern (2009).
2. Adams, Renée, *Governance and the Financial Crisis*, ECGI Finance Working Paper N. 248 (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1398583.
3. Bebchuk, Lucian and Holger Spamann, *Regulating Bankers’ Pay*, 98 *Georgetown Law Journal* 2, 247-287 (2010).
4. Bebchuk, Lucian and Jesse Fried, *Paying for Long-Term Performance*, 158 *University of Pennsylvania Law Review*, 1915-1960 (2010).
5. Bebchuk, Lucian, Alma Cohen and Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 10 *Yale Journal on Regulation* 27, 257-282 (2010).
6. Beltratti, Andrea and René Stulz, *Why Did Some Banks Perform Better during the Credit Crisis? A Cross-country Study of the Impact of Governance and Regulation*, ECGI Finance Working Paper N. 254 (2009), available at http://ssrn.com/abstract_id=1433502, at 2.
7. Bhagat, Sanjai, Brian Bolton and Roberta Romano, *The Promise and Perils of Corporate Governance Indices*, 108 *Columbia Law Review* 8, 1803-1882 (2010).
8. Bhagat, Sanjai and Roberta Romano, *Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-Term*, 7 *European Company and Financial Law Review* 2, 273 (2010).
9. Bolton, Patrick, Hamid Mehran and Joel Shapiro, *Executive Compensation and Risk Taking*, Federal Reserve Bank of New York, Staff Report 456 (2010).
10. Core, John and Wayne Guay, *Is There a Case for Regulating Executive Pay in the Financial Services Industry?* Wharton University of Pennsylvania Working Paper (2010).
11. Fahlenbrach, Rüdiger and René M. Stulz *Bank CEO Incentives and the Credit Crisis*, *Journal of Financial Economics* (2010), doi:10.1016/j.jfineco.2010.08.010.
12. Ferrarini, Guido (ed.), “Prudential Regulation of Banks and Securities Firms. European and International Aspects”, 3-25 (Kluwer Law International, 1995).
13. Ferrarini, Guido and Maria Cristina Ungureanu, *Executive Pay at Ailing Banks and Beyond: a European Perspective*, 5 *Capital Markets Law Journal* 2, 197-217 (2010).
14. Ferrarini, Guido and Maria Cristina Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks*, ECGI Law Working Paper (2010); *Vanderbilt Law Review* (forthcoming, 2011).
15. Ferrarini, Guido, Niamh Moloney and Maria Cristina Ungureanu, *Executive Remuneration in Crisis. A Critical Assessment of Reforms in Europe*, 10 *Journal of Corporate Law Studies* 1, 73-118 (2009).

16. Gordon, Jeffrey, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay*, Columbia Law and Economics Working Paper 373 (2010); available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633906.
17. Laeven, Luc and Ross Levine, *Bank Governance, Regulation and Risk Taking*, 93 *Journal of Financial Economics* 2 259-275 (2009).
18. Levine, Ross, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence*, World Bank Policy Research Working Paper 3404 (2004), available at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2004/10/08/000012009_20041008124126/Rendered/PDF/WPS3404.pdf.
19. Macey, Jonathan and Maureen O'Hara, *The Corporate Governance of Banks*, 9 *Economic Policy Review* 1, 91-107 (2003).
20. Posner, Richard A., "A Failure of Capitalism. The Crisis of '08 and the Descent into Depression", Harvard University Press (2009).
21. Roubini, Nouriel and Stephen Mihm, "Crisis Economics: A Crash Course in the Future of Finance" (2010).
22. Tung, Frederick, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 *Northwestern University Law Review*(2010).
23. *** Basel Committee for Banking Supervision (BCBS), *Principles for Enhancing Corporate Governance*,(October 2010).
24. *** Basel Committee for Banking Supervision (BCBS), *Enhancements to the Basel II Framework* (July 2009).
25. *** Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (April, 2009).
26. *** Financial Stability Board, *FSB Implementation Standards* (September, 2009).