Executive pay at ailing banks and beyond: a European perspective

Guido Ferrarini and Maria C. Ungureanu*

Key points

- This article considers how the recent market turmoil affected national banking systems, thereby prompting state measures.
- It describes the remuneration problems shown by the financial crisis: rewards for failure; short-term behaviour; inappropriate design of performance incentives; practice of overstating profits reflected in cash bonuses and short-term gains through stock options; and guaranteed bonuses unrelated to financial results and severance payments.
- The article discusses the conditions relative to bankers' remuneration structures and policies imposed on ailing banks by governments in their rescue packages, providing a transatlantic perspective and an analysis of the UK, French and German frameworks.
- The changes in remuneration policies are illustrated through two case studies: one study compares the policies at Lloyds and Royal Bank of Scotland with those at non-ailing banks in the UK; the other compares remuneration policies at UBS and Credit Suisse.
- The article analyses how the debate extended internationally to the whole banking sector, with managers' pay becoming a new area for regulation and supervision post-crisis.
- The conclusion reached is that the crisis generated a race to the top in the area of bankers' pay, leading large banks to self-restraint and to a longer term, risk-cautioned approach to incentive practices.

1. Introduction

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.[1] There are two main problems with bankers' pay: first, the excessive level of remuneration at large banks; second, the remuneration structure, which may induce excessively high risk-taking and encourage short termism.[2] Social resentment has focused on the former: lavish compensation packages paid by banks, subsequently rescued by governments, have amplified the social debate, which has provoked a populist response by some politicians. Regulatory concerns concentrated on the latter: the design of remuneration contributed to excessive risk-taking by rewarding bankers for superior

* Guido Ferrarini is a Professor of Business Law at University of Genoa; Director, Centre for Law and Finance; Fellow, European Corporate Governance Institute (ECGI); Counsel, Allen & Overy, Milan. Maria C. Ungureanu is a Research Fellow at Centre for Law and Finance, University of Genoa.

1 Preliminary versions of this article were presented at the following conferences: Transatlantic Corporate Governance Dialogue (Securities and Exchange Commission, Washington, September 2009); European Capital Markets Law: Problems and Cases (CRELE, University of Bolzano, November 2009); Remuneration Policies, Risk Management and Commercial Practices: Impact on the Insurance Sector (CESIFIN Foundation, Florence, January 2010).

2 See executive compensation concerns in J Gordon, 'Say On Pay: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In' (2009) 46 Harvard J Legislation 323–67.

© The Author (2010). Published by Oxford University Press. All rights reserved. For Permissions, please email: journals.permissions@oxfordjournals.org
doi:10.1093/cmlj/kmq002 Advance Access publication 10 March 2010

performance, whilst not penalizing failure.[3] Banks that unveiled risk management weaknesses were most clearly linked with growing public concern over inappropriate levels of remuneration.[4] Recently, the total amount of (variable) pay has also become the concern of regulators, to the extent that 'excessive' compensation reduces the amount of earnings that can be used to boost the regulatory capital of financial institutions. For similar reasons, a potential conflict emerges between managers and shareholders, who share a smaller pie given the higher capital requirements imposed by supervisors.[5]

Pre-crisis reforms were rarely concerned with the design of remuneration. As a result, both banking regulators and individual firms overlooked the weaknesses of compensation systems and their negative externalities. When the crisis hit and many banks were rescued from collapse, governments dictated their conditions for bankers' remuneration in aided institutions, with regulators subsequently transforming these conditions into standards applicable to all banks. In a number of cases, banks anticipated public action by spontaneously adjusting their remuneration policies to emerging standards.

This article analyses developments in banks' compensation policies induced by the crisis, with a focus on Europe. Assuming that remuneration practices in financial institutions contributed to the banking crisis, public action was taken post-crisis to prevent similar occurrences in the future. International coordination was also carried out to identify and implement new standards for remuneration practices, given the competitive concerns of governments and larger firms. Indeed, in a global market, divergent domestic compensation requirements may cause managers to move from one financial centre (or firm) to another, thereby heavily impacting inter-bank competition.

The next section of this paper briefly describes how the market turmoil affected national banking systems and prompted state intervention. Section 3 illustrates the bankers' remuneration problems that were revealed by the financial crisis. Section 4 discusses the conditions as to bankers pay imposed by governments in their rescue packages. Section 5 presents two case studies comparing ailing banks' remuneration policies with the remuneration policies of 'healthy' banks over the 2 years that earmarked the financial crisis. Section 6 analyses how the debate extended internationally to the whole banking sector, with managers' pay becoming a new area for regulation and supervision post-crisis. Section 7 concludes with some remarks on the proper role of regulation and supervision in this area.

3 The 'Report by High-Level Group on Financial Supervision in the EU', chaired by Jacque de Larosière, February 2009 (de Larosière Report), which launched corporate governance reforms in the financial sector, provides a good overview on how financial institutions engaged in risky activities, creating perverse incentives, which eventually caused systemic failure. It also offers an understanding of the measures that were taken afterwards by regulators to counteract risky incentives, in the area of remuneration structure and incentives' risk management. See also K Murphy's Testimony (2009), 'Compensation Structure and Systemic Risk', UCS Marshall School of Business, describing the ways in which compensation in the financial industry encouraged risk-taking.

4 European Commission's statement in its Recommendation on remuneration policies in the financial services sector, C(2009) 3159 (4): 'In principle, if risk management and control systems were strong and highly effective, the risk-taking incentives provided by remuneration practices would be consistent with the risk tolerance of a financial undertaking'.

5 See Patrick Jenkins and Megan Murphy, 'Bankers Escape Bonus Blow' *Financial Times* (London, 9 December 2009).

2. State-aid to banks in Europe: a brief overview

European financial markets were deeply affected by the US sub-prime crisis.[6] First, the problems appeared in Germany, where IKB Deutsche Industriebank AG and Saschen LandesBank's exposure to collateralized debt obligations (CDOs) caused liquidity to dry up. Both banks were bailed out by the German government and other state-owned banks. The next victim was the UK's Northern Rock, a mortgage bank, which was nationalized at the beginning of 2008. The situation deteriorated further with the fall of Bear Stearns in March 2008, which hit other European banks. Westdeutsche Landesbank, a bank partly owned by the German state, incurred huge losses due to its exposure to US investments in structured credits, requiring it to be bailed out by the state and other local banks. In July 2008, the Danish government rescued and nationalized Roskilde Bank.

The bankruptcy of Lehman Brothers in September 2008 along with the serious knock-on effects this had on banks marked a critical phase for the American and European markets. The UK mortgage bank Bradford & Bingley fell into difficulties and the government intervened to nationalize it. In Germany, the government bailed out Hypo Real Estate Holding AG, following its liquidity crisis due to a short-term refinancing strategy. The turmoil among European financial institutions intensified towards the end of 2008, as Fortis and Dexia became the first Belgian banks to be bailed out. A coordination plan between several governments was necessary in both cases. The French, Belgian and Luxembourg governments injected capital into Dexia, while the Dutch and Belgian states initially tried to rescue Fortis before eventually the Netherlands nationalized the Dutch bank, while the Belgian and Luxembourg assets were sold to BNP Paribas.[7] Furthermore, the UK government injected capital and insured assets at two of the biggest British retail banks: Lloyds TSB Group (Lloyds) and The Royal Bank of Scotland (RBS), taking control of the two banks. Towards the end of 2008, banks de-leveraged and became more risk-averse. The domino continued to fall throughout Europe, with states picking up more and more of the financial system's pieces, saving them from collapse.

After the EU Heads of State Summit in Paris in October 2008, central banks and governments implemented state-aid measures aimed at safeguarding financial stability, so as to reduce the systemic dangers and restore the viability of the EU banking sector. These measures included economic stimulus packages; injections of central bank liquidity; recapitalizations of financial institutions; guarantee schemes for certain types of financial activity and, in particular, inter-bank lending; asset disposals and 'bad bank' solutions; and nationalizations of distressed financial institutions, with a view to restructuring and re-entry into the market.[8]

6 For comprehensive overviews of the banking system's turmoil, see Bank of England Annual Reports, 2008, 2009; and European Central Bank 'Financial Stability Review' Reports, 2008, 2009.

7 See Fortis Corporate website, 'History of Fortis'.

8 Communications and reports on the activities of the European Union 2008, 2009 are available at: <http://europa.eu/generalreport/en/2008/rg2.htm> accessed 26 February 2010.

Member States intervened not only to rescue distressed institutions from bankruptcy, but also to prevent further collapses that would have seriously affected the whole banking system and the real economy.[9] Since October 2008, the European Commission has approved a total of over €3.5 trillion (almost one-third of the EU GDP) of state-aid measures to support financial institutions throughout the crisis, under the four main headings of debt guarantees, recapitalization, liquidity support and treatment of impaired assets.[10] The Commission endorsed 70 banking-aid schemes across Europe.[11] By comparison, the US government and the Federal Reserve spent, lent or committed to a total of $12.8 trillion (€7.3 trillion),[12] an amount that approaches US GDP in 2008.[13]

Several governments acquired shareholdings in financial institutions.[14] The level of involvement, its timing and exit strategies vary from country to country. For instance, the UK is a controlling shareholder in RBS and Lloyds, after bailing them out, and fully owns Northern Rock after its nationalization in 2008. The German state owns a significant stake in Commerzbank, whilst the French government has important stakes in BNP Paribas and Société Generale.[15] The Swiss government acquired a 9 per cent of UBS and was the first European government to exit.[16]

3. Bankers' remuneration at ailing banks

The idea that management compensation at banks is different has been supported with the argument that banking is subject to higher risks compared with non-financial activities.[17] Bankers' pay is based on a total compensation philosophy with relatively average basic salaries, the major part being paid through the variable component.[18]

9 For an overview of Member States' rescue measures, including cases, see European Commission, 'State Aid: Overview of National Measures Adopted as a Response to the Financial/Economic Crisis', available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/305> accessed 26 February 2010; A Petrovic and R Tutsch, 'National Rescue Measures in Response to the Financial Crisis' (2009) ECB Working Paper; D Martin, O Saba and G Forrest (2009), 'European Responses to the Financial Crisis', JCP/LA Semaine Juridique – Edition Enterprise et Affaires, Forthcoming.

10 European Commission (2009), 'Economic Crisis in Europe: Causes, Consequences and Responses', European Economy 7 (provisional version).

11 Ibid, July 2009.

12 Source: Bloomberg, amount as at end of March 2009.

13 The US Emergency Economic Stabilization Act (3 October 2008) authorized the Treasury Department to acquire 700 billion of troubled assets. It became a programme in which the Treasury purchased senior preferred stock and subordinated debentures. Originally aimed at nine systemically critical banks, TARP (the Trouble Asset Relief Programme) ultimately provided assistance to over 670 companies.

14 State intervention typically takes the form of public ownership or financial support in the form of the lender of last resort, taxpayers' money or transfer of assets. State intervention falls, however, under the provisions of state-aid and has to be communicated and examined by the Commission. See E Carletti and X Vives, 'Regulation and Competition Policy in the Banking Sector', in Xavier Vives (eds), *Competition Policy in the EU. Fifty Years on from the Treaty of Rome* (Oxford University Press, Oxford, 2009).

15 As at July 2009, the UK government held 43.5% stake in Lloyds and 70% in RBS. The French state held 17% stake in BNP Paribas and 7.2% in Société Generale. The German state had a 25% stake in Commerzbank.

16 See 'Switzerland Selling UBS Stake After US Tax Accord', Bloomberg, 20 August 2009.

17 On bankers' pay, see amongst others J Houston and C James, 'CEO Compensation and Bank Risk. Is Compensation in Banking Structured to Promote Risk Taking?' (1995) 36 J Monetary Economics 405–431; R Adams and H Mehran, 'Is Corporate Governance Different for Bank Holding Companies' *FRNBY Economic Policy Review* (2003); R Fahlenbrach and R Stulz, 'Bank CEO Incentives and the Credit Crisis' *Dice Center WP 13* (2009).

18 See n 3, above. According to a Reward Partner at Deloitte & Touche, UK, CEOs of large banks would typically earn a salary between £1 and £1.25 million. In addition, they have the opportunity to earn a bonus of two and four times that amount, as well as the right to get shares based on 3 years' performance that represents between two and a half and five times their basic salary. They

Compared with the non-financial sector, banking has more performance pay.[19] Remuneration incentives received by bankers are structured differently, reflecting performance sensitivity.[20] The financial crisis revealed, however, that banks' remuneration policies failed to align rewards with performance and risk-taking.[21] In most cases, risks were neither considered nor disclosed.[22]

Remuneration problems shown by the financial crisis

The remuneration problems at banks that received taxpayers' money through the Troubled Asset Relief Programme (TARP) were highlighted by the Office of the NY State Attorney as part of an investigation of the causes of the economic downturn.[23] The Office conducted an analysis of compensation practices at nine state-aided banks,[24] concluding that these TARP recipients received $175 billion and paid total bonuses worth almost $24 billion. Three of the nine banks had suffered losses of almost $100 billion combined, while the other six banks had only made modest profits. The main conclusion of the report was that the link between pay and performance, advocated by banks in their remuneration policies, was non-existent and that banks paid high bonuses whether the performance was achieved or not. In his report, the NY attorney made a powerful statement, which in fact reflects public anger: '…when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by taxpayers and their employees were still paid well'.

In Europe, despite public concern against huge pay-checks, the situation appears somewhat different, in part due to cultural issues.[25] Most banks suffered losses during the crisis; however, those in receipt of state-aid waived bonuses to executives for the financial

will also have a pension, the most common being a defined benefit based on the career salary. See UK House of Commons, Treasury Committee, 'Banking Crisis: Reforming corporate governance and pay in the City' (2009). In Continental Europe, figures and proportions vary considerably, as variable pay, especially equity-based has had a more recent impact.

19 J Ang, B Lauterbach and B Schreiber, 'Pay at the Executive Suite: How Do U.S. Banks Compensate Their Top Management Teams?' (2000) 26 J Banking Finance 1143–63.

20 See also G Ferrarini and MC Ungureanu, 'Unique Features in the Governance of Bankers' Compensation' in Peter Essers et al. (eds) *Liber Amicorum in honor of Theo Raaijmakers* (Kluwer Juridisch, Netherlands, 2009).

21 See among others L Bebchuck, A Cohen and H Spamann, 'The Wages of Failure: Executive Compensation at Bear Sterns and Lehman 2000–2008' (forthcoming) Yale Journal on Regulation; A Raviv and Y Landskroner, 'The 2007–2009 Financial Crisis and Executive Compensation: Proposal for a Novel Structure' (2009) NYU Working Paper Fin-09-003; S Bhagat and R Romano, 'Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-Term' (2009) Yale Law & Economics Research Paper No. 393; see n 3, above.

22 See opinion expressed also by the EU Commission in COM (2009) 211: Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector.

23 Andrew Cuomo, 'No Rhyme or reason. The 'Heads I Win Tails You Loose' Bonus Culture' (2009) available at: <http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf> accessed 26 February 2010.

24 Bank of America, Bank of New York Mellon, Citigroup Inc., Goldman Sachs Group, J.P. Morgan Chase & Co., Merrill Lynch, Morgan Stanley, State Street Corp., Wells Fargo & Co.

25 An analysis of the cultural issues in the US approach to executive compensation is provided by A Levitt, 'Corporate Culture and the Problem of Executive Compensation' (2005) 17 J Appl Corporate Finance 41–3; R Posner, 'Are American CEOs Overpaid, and, If So, What if Anything Should Be Done About It?' (2009) 58 Duke L J 1013.

year 2008, pledging to reform their remuneration policies. Also, large banks that managed to bypass government funding gave up executive bonuses for 2008. Notwithstanding the potential breach of contract argument, most executives were ready to accept this waiver, given the circumstances. There were, of course, exceptions (such as paying 'guaranteed' bonuses to former or current employees), discussed later in this section. The question still to be answered is whether banks' prompt reaction was just an opportunistic response to the crisis or reflected a more responsible and sustainable behaviour as to compensation policies.

Nonetheless, the financial crisis marked a change in remuneration design, by revealing that, across the banking sector, incentives based on short-term performance had often induced executives to take greater risks.[26] For example, compensation structures at banks such as Citigroup, Bank of America,[27] Lehman Brothers, Bear Sterns[28] and UBS[29] increased the incentives of executives to take excessive risks. As a result, the policy agendas of politicians and regulators particularly addressed bankers' bonuses, especially those of investment bankers, whose pay deals were widely blamed for exacerbating risk-taking. Apparently, banks did what they had promised in their remuneration policies, linking pay with performance to produce value and growth. However, bonuses were not linked to real value and one-way bonus deals rewarding good performance failed to punish poor performance, leading to so-called 'rewards for failure'.

The short-term approach in banks' remuneration policies contributed to this outcome, undermining the safety and soundness of banks.[30] There was an excessive focus of corporate leaders, investors and analysts on short-term financial earnings and insufficient attention was paid to strategy fundamentals and to long-term value creation. Arguably, this short-term behaviour may have been caused by regulation itself: the obligation for firms to report quarter earnings put pressure on executives to meet analysts' forecasts, thus encouraging a short-term risk strategy, with the objective of obtaining immediate

26 Stock options have been found to induce executives to take excessive risks because of the asymmetry of gain and loss. See *Posner* (n 25, above); G Sanders and D Hambrick (2007), 'Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance', Academy of Management.

27 For analysis of the bankers' remuneration structure as a determinant of increased risk-taking, see L Bebchuk and H Spamann, 'Regulating Bankers' Pay' (forthcoming) Georgetown Law Journal, Harvard Law and Harvard Law School Olin Discussion Paper No. 641. The authors show that the equity-based compensation given to the executives of Citibank and Bank of America, two highly leveraged banks, heavily encouraged risk-taking, also due to insulating common shareholders from downside risks.

28 In Bebchuk et al. (n 21, above), authors show that the design of incentives at Lehman and Bear Sterns during 2000–2008 (executives cashed out significant compensation from selling their shares and options) encouraged a focus on short-term performance at the cost of maintaining an excessively high risk of large losses down the road.

29 Incentives at UBS for senior management were directly linked to profits derived from the CDO's mortgage book, which encouraged risk-taking for achieving short-term performance. See G L Clementi et al., 'Rethinking Compensation in Financial Firms' in Viral V. Acharya and Matthew Richardson (eds) *Restoring Financial Stability. How to Repair a Failed System* (NYU Stern, Wiley, Hoboken NJ, 2009).

30 Bebchuk and Fried were amongst the first to point out the short-term approach as a flaw in US compensation structures: L Bebchuk and J Fried, *Pay for Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge MA, 2004). See also M Bertrand and S Mullainathan, 'Are CEOs rewarded for luck? The Ones Without Principles Are' (2001) 116 Q J Economics 901–32.

profits.[31] The crisis exposed this problem and revealed the inappropriate design of performance incentives.

The crisis also revealed the practice of overstating profits, as the basis for huge payouts. The conspicuously high levels of compensation and the link between short-term gains and bonuses paid to investment bankers support the argument.[32] Cash bonuses awarded on the immediate results of a transaction and paid out instantly imply that individuals may pay little or no regard to the overall long-term consequences and future profitability of their transactions. Compensation structures that reward managers annually for profits, but do not claw these rewards back when losses materialize, encourage the creation of unreal gains. Banks are actually paying for something else: exposure to upside potential rather than actualized gains.

The problem with paying for upside potential is not only reflected in cash bonuses but also in short-term gains through stock options.[33] Indeed, an investor who buys stock pays for it immediately, without waiting for future performance. She pays for future cash flows, in terms of capital gains and dividends. The seller of shares, conversely, receives a kind of 'guarantee' on future performance by cashing the price immediately. In the case of stock options, however, the beneficiary only pays if the stock price goes up, by exercising her options, without being exposed to a decrease in value of the shares before the exercise date. The only way to have the options' beneficiaries exposed to the risk of a downside is to ask them to keep the shares purchased by exercising their options for a stated period of time (lock-up).[34]

Stock grants may resolve some of these issues, which explain the unprecedented shift from options to stock in the last decade. Although both stock and options can align executive incentives with shareholder interest, the two instruments have different incentive and risk traits. Those disfavouring the use of options argue that their heavy use led to excessive risk-taking, which contributed to the corporate scandals of the beginning of this century and to the recent financial turmoil. Measures for improving remuneration

31 See J W Verret, 'Unintended Consequences of Executive Compensation Regulation Threatens to Worsen the Financial Crisis' (2009) George Mason University Law and Economics Research Paper Series 09-34; the issue was also raised by the 'de Larosière Report', see (n 3, above).

32 See e.g. G L Clementi et al., 'Rethinking Compensation in Financial Firms' in Viral V. Acharya and Matthew Richardson (eds) *Restoring Financial Stability. How to Repair a Failed System* (NYU Stern, Wiley, Hoboken NJ 2009).

33 Optimal pay may emphasize short-term stock performance at the expense of long-term fundamental value. Risk-averse managers can take specific actions that boost the speculative component in stock prices. See P Bolton, J Scheinkman and W Xiong, 'Executive Compensation and Short-Termist Behaviour in Speculative Markets', (2006) The Review of Economic Studies 577–610 (n 73). Furthermore, earning manipulation viewed as a conflict between current and future shareholders, drives up short-term stock performance destroying long-term fundamental value. See P Bolton, J Scheinkman and W Xiong, 'Pay for Short-Term performance: Executive Compensation in Speculative Markets' (2006) J Corporation Law Summer 2005, 30, 4; ABI/INFORM Global 72.1.

34 See Bhagat and Romano (n 21, above); John M. Olin Center for Studies in Law, Yale Law School, Economics and Public Policy Research Paper No. 393, suggesting that incentive compensation plans should only consist of restricted stock and restricted share options with a retaining period of at least 2–4 years.

practices include replacing options with restricted stock, increasing vesting periods and retaining stock.[35]

The problem of guaranteed bonuses

The crisis also unveiled other problems. 'Guaranteed' bonuses, in particular, maintained high pay levels even after banks recorded negative results and received state-aid. The issue of 'guaranteed' bonuses caused much outrage following banks' bailouts.[36] Short-term guarantees are common at banks and are regarded as relatively harmless and often necessary to hire staff mid-year. For investment banks that are rapidly expanding their operations to new areas, similar guarantees are hardly unusual. Contracts guaranteeing variable pay for several years are, however, problematic, as they violate sound principles of pay-for-performance. These arrangements were thought to be uncommon; however, the crisis and the ensuing bailouts revealed their rather frequent recurrence.

Most commonly, executive cash bonuses are a discretionary/contractual hybrid. The parties often only agree that the executive is entitled to participate in the company's bonus scheme. Usually discretion is built into these schemes, even if the criteria for the bonus are determined in advance with reference to the performance of the individual manager, the firm or the division in question. The discretionary nature of bonuses emerges either from performance criteria (which may involve a certain degree of discretion) or from other terms of the scheme, as when a company reserves the right to take the final decision on the bonus' size. Discretion may weaken though when the performance measures are met, while the proportion between binding and discretionary elements varies. An illustration of the boundary between binding and discretionary elements is the bonus litigation against Commerzbank in 2009.[37]

Contractual bonuses are not a problem *per se*, if tied to performance. But guaranteed bonuses are problematic, being unrelated to financial results. The guarantee is a downside cushion that may encourage more risk-taking than would otherwise be the case. The level of profits sought by shareholders of financial firms before the crisis increasingly required banks to raise their level of risk-taking. Managers knowing that bonuses were guaranteed and, therefore, also paid in cases of huge losses, could afford to be daring. Guaranteed bonuses also pose other problems, such as increasing competition for talent. If bankers are easily bought out of their long-term bonus arrangements, employers may struggle to keep them. Moreover, as more bankers' pay is being deferred to the future, buying out

35 For the shift from options to stock, see D Walker, 'Evolving Equity Compensation and the Limits of Optimal Contracting' (2008) Boston University School of Law Working Paper No. 09-34; Bhagat and Romano (n 21, above); *Posner* (n 25, above), also advocates restricted stock as an important element of CEO's pay, regardless the sector the firm operates in.

36 There is no literature dealing specifically with guaranteed bonuses. The issue was raised in the USA by L Bebchuck in his article 'Bonus Guarantees can Fuel Risky Moves' *Wall Street Journal* (New York, 27 August 2009).

37 Germany's Commerzbank (together with Dresdner Kleinwort which the former acquired in 2008) was sued in several compensation lawsuits in 2009 by its investment bankers for reneging on promises to pay full bonuses. The lawsuits alleged that Dresdner Kleinwort had set aside a €400m bonus pool in August 2008 amid worries about staff quitting the investment bank ahead of Commerzbank's planned takeover. Commerzbank paid only a fraction of these bonuses. The bank defended itself by stating that claimants were entitled to be considered for discretionary bonus and that bonuses were not contractually binding. According to several media (e.g. the *Daily Telegraph*, UK), which investigated court filings, a number of bankers reached settlements. See amongst other articles 'Bankers file £15m Bonus Lawsuit against Commerzbank' *Daily Telegraph* (London, 27 November 2009).

contracts becomes more expensive, with a possible ratcheting effect. Guaranteed bonuses also show that banks did not keep a proper balance between fixed and variable pay.[38] Indeed, the fixed component of remuneration should represent a sufficiently high proportion of total remuneration, so as to allow the bank to operate a fully flexible bonus policy, withholding bonuses entirely or partly when performance criteria are not met.

The practice of guaranteed bonuses was widespread in the UK banking sector, as shown by the debate emerging from the crisis.[39] Lloyds and RBS, the two partly nationalized banks, continued to pay guaranteed bonuses to management even after being rescued by the UK government.[40] Barclays, a bank that did not resort to state-aid, attempted to 'lure' bankers from the rival JP Morgan by buying them out of their contracts. Other banks, including HSBC, opposed this practice.[41]

In the USA, for a short time, banks stopped offering guarantees, after the financial crisis had burst and the US public had begun to scrutinize the banks' use of public money. But with banks apparently rebounding at the end of 2009, the practice was resumed by some of them, arguing that guaranteed bonuses are needed to attract and retain top performers. Goldman Sachs, JPMorgan Chase and Morgan Stanley, who repaid their bailout money relieving themselves from restrictions, offered guarantees to prospect bankers.[42]

Severance pay

Severance payments were often made to departing executives who had performed so poorly that the relevant boards were compelled to replace them.[43] Similar payments, not grounded on performance, may enhance risk-taking by the managers. Nonetheless, 'golden parachutes' were generally introduced as an incentive to align the interests of managers with those of the shareholders, with the specific purpose to ensure that, in the case of a hostile bid, managers would not resist the takeover simply for fear of losing their jobs. The scope of severance pay was subsequently expanded to other situations, with the

38 The EC Recommendation for remuneration of financial institutions suggests that 'where remuneration includes a variable component or a bonus, remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components. The appropriate balance of remuneration components may vary across staff members, according to market conditions and the specific context in which the financial undertaking operates [. . .]; see n 4, above.

39 In the UK, the concerns were raised by the FSA as well as institutional investors, including the Association of British Insurers (ABI). See 'Investor Group ABI wants Guaranteed Bonuses Stopped' *Guardian* (17 August 2009). Consequently, the FSA Code on Remuneration Practices incorporates measures banning long-term guaranteed bonuses: See FSA's 'Reforming Remuneration Practices in Financial Services. Feedback on CP09/10 and final rules', FSA, PS09/15.

40 RBS continued to pay bonuses to retain and recruit talented staff against public disquiet for bonus payments at the bank. In the case of Lloyds, the bonus pool in place at the time of the crisis included contractual obligations to pay bonuses to former HBOS employees. See UK House of Commons, Treasury Committee (n 18). According to this document, Lloyds' CEO argued that the contractual obligations on Lloyds to pay bonuses to former HBOS employees were 'legally binding and could not be broken'.

41 'We intend to be competitive [but] we don't give [multi-year] guaranteed bonuses and are disappointed when others do, as we don't think it's the right thing to do'. Statement from Mike Geoghegan, HSBC chief executive, 'Barclays and HSBC defend bonus payments' *Daily Telegraph* (London, 4 August 2009).

42 See 'Guaranteed Bonuses on Wall St. Face Scrutiny' *New York Times* (10 August 2009).

43 See e.g. A Edmans and X Gabaix, 'Is CEO Pay Really Inefficient? A Survey of New Optimal Contracting Theories' (2009) 15 Eur Financial Manage J 486–496; 'Executive Pay and the Credit Crisis of 2008' (2009), HBS – Case 109-036; See also OECD's Report 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', June 2009, which documents that severance packages of around $200 million at Pfizer and Home Depot, and to a lesser extent in other countries, raised the issue of pay without performance even before the onset of the financial crisis.

argument being that departing executives should be compensated for the risks attached to their position. Severance packages of most senior managers dismissed as a result of the financial crisis triggered public outrage, highlighting the extreme level of agency costs imposed on shareholders in the financial industry.[44]

4. Pay limits for state-aided banks

Rescue packages for national banking systems followed the guidance provided by the Commission on the design and implementation of State-aid to banks.[45] The purpose of the Commission's guidance was to ensure that rescue measures could fully attain the objectives of financial stability and maintenance of credit flows, while minimizing competition distortions, either between beneficiaries with different risk profiles or between aided beneficiaries and banks that did not benefit from state-aid.[46] At first glance, financial institutions recurring to state measures appeared to benefit from a competitive advantage, being sheltered by government protection. However, this benefit was counter-balanced by several conditions: a restrictive policy on dividends (including a ban on dividends throughout the restructuring); obligations to restore and maintain an increased solvency ratio; timetables for redemption of state participation; and limitation of executive remuneration or distribution of bonuses.[47]

Pay conditions in rescue packages

Accordingly, states' efforts to rescue banking systems were in tandem with the movement to curb executive pay.[48] Flanking government interventions, provisions were generally introduced with respect to executive pay. These initially targeted banks in which governments had a block-holding as a result of recapitalization schemes;[49] however, they were subsequently extended to other financial institutions, often with the objective of applying them across the financial industry. Proposals for increasing transparency, linking remuneration with performance while managing systemic risks and strengthening shareholder rights on compensation were discussed globally.[50]

44 Although the issue of severance payments has not yet been documented in the literature, it was underlined by the several communications and reports by regulatory authorities soon after debates were raised and prior to formalizing regulations: e.g. 'Statement of the European Corporate Governance Forum on Director Remuneration', 23 March, 2009; Com(2009) 211, Communication from the Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector; Commission Staff Working Document complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector.

45 European Commission, 'Communication on the Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis under the State Aid Rules', OJ C 195/2009 of 19/8/2009.

46 European Commission (n 10, above).

47 D Martin, O Saba and F Alogna, 'European Responses to the Financial Crisis' (2009) JCP/LA Semaine Juridique – Edition Enterprise et Affairs, forthcoming.

48 In the EU, these limits are imposed on banks that applied for government schemes; in the US firms from the automotive industry also obtained state-aid, subject to certain restrictions.

49 D Martin et al. (n 47, above).

50 See, among others, *de Larosière Report* (n 3, above); 'Communication to the Spring European Council: Driving European Recovery', March 2009; UK House of Commons, Treasury Committee (n 18, above); COM(2009) 211: Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as

A transatlantic perspective

The USA opened the round of measures with the Emergency Economic Stabilization Act of 2008 (EESA), which set initial restrictions on executive compensation for senior executive officers of companies that participated in TARP. The EESA creates three sets of conditions on domestic compensation paid by financial institutions from which the Treasury purchased trouble assets: meeting appropriate standards for executive compensation and corporate governance; banning 'golden parachutes' from new employment contracts; and disallowing tax deductions for executives whose annual compensation exceeds $500,000, whether or not performance based. The American Recovery and Reinvestment Act (ARRA) of 2009 substantially tightened the executive pay restrictions on TARP recipients by expanding the number of executives covered, imposing stricter limitations on incentives and severance payments, including claw-back provisions, and adding new corporate governance requirements.[51]

In Europe, the Commission provided for principles on executive remuneration through several Communications related to national state-aid. The Banking Communication that set the framework for rescue operations finalized to prevent bank runs required management not to retain undue benefits; governments may have, *inter alia*, the power to intervene in remuneration.[52] The Recapitalization Communication setting standards and safeguards for bank recapitalization to ensure adequate levels of lending to the economy provided for limitations on executive remuneration and bonuses.[53] The Impaired Asset Communication, which offered the framework for removing toxic assets and underperforming loans, stated that caps on executive remuneration should be considered by banks applying for asset relief measures.[54]

UK

The FSA was the first regulator to publish an industry-wide comprehensive code of practice on remuneration, initially aimed at banks in receipt of public funds, and

regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector; SEC(2009) 580: Commission Staff Working Document accompanying the Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector, Impact Assessment; Joint letter preceding the Pittsburg Summit, from Gordon Brown, Angela Merkel and Nicolas Sarkozy, 3 September 2009; 'The G-20 Statement on Strengthening the Financial System', 5 September 2009, Pittsburg Summit.

51 'The American Recovery and Reinvestment Act of 2009' (February 2009) significantly rewrote the original executive compensation and corporate governance provisions of Section 111 of the Emergency Economic Stabilization Act of 2008 (12 U.S.C. 5221, EESA) applying to all institutions that have received or will receive financial assistance under the Troubled Asset Relief Program (TARP). See also presentation by J Bachelder (2009), 'US Legislative and Regulatory Developments Affecting Executive Compensation', at the Transatlantic Corporate Governance Dialogue (TCGD), available at: <www.ecgi.org>.

52 2008/C 270/02: Communication from the Commission—The application of State-aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 5 October 2008.

53 2009/C 10/03: Communication from the Commission—The recapitalization of financial institutions (1) in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15 January 2009.

54 Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector. OJ C 72, 26 March 2009. The FSA published a draft Code on Remuneration Policies in February 2009 and a revision of the same in March 2009. In August 2009, the FSA published a consultation on the code: 'Reforming Remuneration Practices in Financial Services', Feedback on CO 09/10 and final rules', FSA, PS09/15, August 2009.

subsequently extended across the UK banking sector.[55] The emphasis on governance is a striking feature of the code, with a primary focus on risk management. This is reflected in the following general requirement: 'remuneration structures of senior employees and risk takers are to be consistent with and promote effective risk management'. Consultations on the draft code led to detailed requirements for incentive pay, among which the exclusion of guaranteed bonuses for more than 1 year and the deferral of two-thirds of bonuses over a period of 3 years. In July 2009, the FSA issued a letter to the chief executive officers of banks and broker-dealers, whose operations were likely to fall under the remuneration code of practice, requiring them to comply with the code.[56] It also alerted banks that had agreed to pay their executives guaranteed bonuses for more than a year that they would risk heavy penalties. Banks were thus pressed to renegotiate contracts.

Lord Turner, in his report on UK banking regulation reform (Turner Review), highlighted remuneration as a major concern and included proposals that incentives be designed to avoid undue risk-taking.[57] Indeed, the FSA was widely criticized for failing to spot the excessive risk-taking that sparked the financial crisis. Also, the UK Treasury issued a report, arguing that bonus-driven remuneration structures had encouraged reckless and excessive risk-taking, in contrast with the interests of shareholders and the long-term sustainability of the financial system.[58] The report questioned whether the FSA had attached sufficient priority to handling remuneration at financial institutions and suggested enhanced disclosure of remuneration structures and a greater role for remuneration committees.

The UK government also imposed specific conditions on remuneration policy for those banks receiving public funds, namely Lloyds and RBS.[59] Participation in the recapitalization scheme imposed an obligation on both banks to address the remuneration of senior executives.[60] Section 5 deals with these measures in detail.

France

France has a long history of state intervention in the banking sector.[61] This helps understand French public action in the recent crisis, which though not as significant as

55 Other principles of the code detail performance criteria and the concept of risk-adjusted remuneration. The code also sets general guidelines concerning the composition of remuneration, whereby the fixed component of remuneration should be a sufficient proportion of total remuneration to allow a firm to operate a fully flexible bonus policy and the majority of any significant bonus should be deferred over a minimum period.

56 See 'Remuneration code of practice', 'Dear CEO' letters—2009, FSA website: <http://www.fsa.gov.uk> accessed 26 February 2010.

57 'A Regulatory Response to the Global Banking Crisis' *Turner Review* (March 2009).

58 The Treasury defined FSA's approach to remuneration prior to the crisis as being 'very modest'; UK House of Commons, Treasury Committee (n 18, above).

59 Other UK banks were rescued by the government, i.e. Northern Rock, Bradford and Bingley, which were fully nationalized; however, limits were only set for the two partially nationalized banks Lloyds and RBS, as the only two major commercial banks that received state-aid and were expected to restructure. See Petrovic and Tutsch (n 9); UK House of Commons, Treasury Committee (n 18, above).

60 HM Treasury Press Notice (2008): 'Treasury statement on financial support to the banking industry'; HM Treasury Press Notice (2009): 'Asset Protection Scheme and increased lending'.

61 Carletti and Vives (n 14, above).

that of other Member States, was quite effective.[62] Bankers' compensation attracted a new legislative framework. The Decree reforming the rules on compensation for senior corporate executives of state-aided companies[63] lays down the conditions for the compensation of executives at banks receiving state support through the Société de Prise de Participation de l'Etat (SPPE).[64] Under the new requirements, targeted banks cannot grant either stock options or free shares to executives and managers, whilst the board can only authorize bonuses for a period not exceeding 1 year, with performance criteria unrelated to stock market price. Additionally, banks cannot award bonuses if forced to make large 'scale-offs' because of their financial situation. A second Decree aimed at state-aided firms prohibits setting up defined benefit funds for executives until late 2010.[65] French banks resorting to state-aid also had to adopt the MEDEF/AFEP Code of Conduct, which implied a review of their remuneration policies.[66] Six major French banks participating in the state recapitalization scheme had to comply with these requirements.[67]

Germany

In 2008, the German government passed the Financial Markets Stabilization Act, which established the Financial Markets Stabilization Fund (SoFFin).[68] Corresponding regulations imposed certain restrictions on banks' business activities, including the re-examination of compensation systems and certain limits on remuneration of board members and managing directors.[69] The SoFFin regulation provided for the overall compensation of board members and managing directors to be reasonable, with monetary compensation not to exceed €500,000 per year; no compensation awarded upon termination; and no bonus payments that are not legally required. SoFFin was set

62 The first states to notify a scheme were Ireland, Denmark and UK; see European Commission authorization on 8 October 2008. The largest French recapitalization was BNP's (EUR 5 billion), which is small compared with ING's guarantee scheme by the Dutch State (€35.1 billion) or the initial recapitalization of RBS by the UK government (£20 billion). See Petrovic and Tutsch (n 9); and COM2009 (164) 'Report from the Commission State Aid Scoreboard, Spring update, Special Edition on State Interventions in the current financial and economic crisis'.

63 Decree 2009-348 of 30 March 2009, effective until 31 December 2009.

64 The Decree, however, targets not only banks receiving state support but also public companies and strategic investment funds; in particular, for all public companies, if severance pay is awarded, it is fixed at less than 2 years compensation and is only paid for forced departures, provided the beneficiary has satisfied sufficiently demanding performance criteria. It is not paid if the company is facing serious financial difficulties.

65 Decree n. 2009-445 of 22 April 2009.

66 Corporate Governance Code of Listed Corporations, December 2008 (Corporate governance principles resulting from the consolidation of the October 2003 AFEP and MEDEF report and the January 2007 and October 2008 AFEP and MEDEF recommendations concerning the compensation of executive directors of listed companies).

67 Credit Agricole, BNP Paribas, Société Générale, Credit Mutuel, Caisses d'Epargne and Banques Populaires.

68 Germany's economic bailout measures proceeded in two stages, with the enactment of the Financial Market Stabilization Act (FMSA) in October and November 2008 and of a stimulus plan in January/February 2009. Furthermore, on 9 April 2009, the Financial Market Stabilization Supplementary Act was passed, paving the way for the nationalization of some banks, such as that of Hypo Real Estate AG. The SoFFin was established as an agency of the Deutsche Bundesbank on 17 October 2008, enacted on 20 October 2008 and was effective until 31 December 2009.

69 Information on the SoFFin is available primarily at the Fund's website: <http://www.soffin.de/index.en.php?sub=1> accessed 26 February 2010; except for restrictions on compensation, restrictions concern: a re-examination of business policy and reduction or waiver of certain risky transactions; no dividend payments to shareholders other than the Fund; no repurchase of shares; no reduction of capital except for reorganization.

for German banks until the end of 2009. Commerzbank was the first major bank that turned to the government for capital and complied with these requirements.[70]

5. Changing remuneration policies: ailing versus other banks

Measures adopted by the rescuing States with respect to remuneration policies at ailing banks set criteria that were often also followed by non-ailing banks. To better illustrate the overall change in remuneration policies, we present in this section two case studies, one comparing the policies of Lloyds and RBS with those of other non-ailing banks in the UK, and the other comparing the remuneration policies of UBS with those of Credit Suisse.[71]

Lloyds, RBS and other UK banks

Lloyds is the largest retail bank in the UK.[72] RBS is one of the largest banks in the UK and used to be one of the world's largest banks by market capitalization.[73] In the wake of the crisis, RBS announced a £24 billion loss, the biggest in British corporate history. In October 2008, the UK government invested £37 billion in RBS preference shares, taking up a 58 per cent holding in the bank. As the new HBOS arm of Lloyds reported major losses, the UK government also invested £17 billion in Lloyds, which resulted in a 43.3 per cent stake in the bank.[74] The government's aim was to raise both banks' Tier 1 to above 9 per cent, compared with the minimum Basel requirement of 8 per cent. In January 2009, £5 billion preference shares held in RBS were converted by the Treasury into ordinary shares in order to boost the bank's core capital and enable it to increase its lending to the real economy; this increased the government's holding to 70 per cent.

Participation in the first round of recapitalization imposed an obligation on both banks to review the remuneration of senior executives:[75] for 2008 no cash bonuses were paid to board members; for subsequent years incentives were reviewed and linked to long-term value creation, taking into account risks and restricting the potential of rewards for failure. Potential participation in the Asset Protection Scheme carried additional conditions, such as implementing a remuneration policy consistent with the detailed principles set out in the FSA code on remuneration practices, including a

70 Commerzbank is the second largest bank in Germany. The bailout of Commerzbank was of €8.2 billion, marking the first time in the history of the Federal Republic that a major private bank was nationalized. The German state acquired a 25% stake in the company. The state provided hybrid capital to bail out the bank and ensure its takeover of Dresdner Bank. For details on the bailout, see Commerzbank Annual Reports 2008, 2009. The other important German rescues were Hypo Real Estate, Bayern LB, IKB, Saschen, WestLB and HSH Nordbank; European Commission, 'State Aid: Overview of National Measures Adopted as a Response to the Financial/Economic Crisis', available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/67&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 26 February 2010.

71 Lloyds, RBS and UBS were among the top 20 international banks by market capitalization ('World's largest banks – 2008 update', Financial Ranks). For our analysis, we checked the 2007 and 2008 Annual Reports.

72 See www.lloydstsb.com.

73 See 'World's Largest Banks' Report, 2008, Financial Ranks.

74 Lloyds Banking Group was formed by the Government-sponsored merger of HBOS and Lloyds TSB Bank plc of 16 January 2009. The bailout was largely triggered by HBOS' report of a £10.8 billion loss. For information about the UK government schemes for the two banks, we mainly used Lloyds and RBS Annual Reports and Press Releases from 2008 and 2009.

75 HM Treasury Press Notice (n 60, above).

restriction on bonuses.[76] As a result, RBS reached an agreement with the government on its payment policy for 2008 and 2009.[77] The bank agreed that no bonuses or pay increases would be made to staff associated with major losses in 2008; executive directors would receive no bonuses for 2008 and no pay increase in 2009; no discretionary bonuses would be paid in 2009 for performance in 2008 except for 'guaranteed' ones;[78] staff considered 'essential to the bank's recovery' would receive a deferred award for 2008, released in three equal annual instalments beginning June 2010 and payable in subordinated debt. At the time of this agreement, RBS executives claimed that this reduction in bonuses would be greater than at any other bank.[79] Subsequently, Lloyds secured a similar agreement with the government.[80]

Towards the end of 2009, while other European banks that had been either rescued or funded by the state were already repaying their loans, the two UK partly nationalized banks announced that they would together receive an additional £37 billion from the Government. In particular, Lloyds would raise £13.5 billion through a fully underwritten rights issue, representing the largest capital raising in UK corporate history.[81] The bank would also swap at least £7.5 billion of existing debt with a convertible bond. This process was thought of as an alternative to the original plan for Lloyds to inject £260 billion of toxic assets into the government-backed APS.[82] Following the injection of a further £25.5 billion into RBS through share purchase and the bank's participation in the APS with respect to £240 billion of toxic assets, the UK state interest in RBS increased from 70 per cent to 84 per cent.[83] This made RBS by far the world's biggest government rescue, taking as much as £53.5 billion of state money, compared with the $45 billion (£27.4 billion) absorbed by Citigroup in the USA.[84]

The latest intervention by the government at the end of 2009 carried new conditions. The two banks could not pay any discretionary cash bonuses in relation to 2009 performance to any staff earning more than £39,000 a year and all bonus payments to executive board members would be deferred to 2012. The main restrictions—banning

76 The APS was announced on 19 January 2009; the UK Treasury provided each participating institution with protection against credit losses incurred on one or more portfolios of defined assets to the extent that credit losses exceed a 'first loss' amount to be borne by the institution. The APS aims to target those assets which are most affected by market illiquidity. See 'Asset Protection Scheme and increased lending' HM Treasury Press Notice (26 February 2009).

77 UK House of Commons, Treasury Committee (n 18, above).

78 It is not clear whether the requirements refer to short-term or long-term guaranteed bonuses.

79 See n 18, above.

80 Similar to RBS, it would still pay 'guaranteed bonuses', in this case to former HBOS employees. Additionally, Lloyds would not pay any discretionary bonuses in 2009 except to the most junior staff earning on average £20,000 and would not award any annual free share award.

81 'Freshfields, Linklaters, A&O land Lloyds' Record-breaking Rights Issue' *The Lawyer* (24 November 2009).

82 Had Lloyds entered the APS, the government scheme designed to insure toxic assets, it would have faced stringent rules over how it managed its loan portfolios; see 'The Royal Bank of Scotland Group plc (RBS) – Announcement on the APS and State Aid Discussions'.

83 See Quarterly and Annual Reports of Lloyds and RBS, 2008, 2009.

84 See e.g. 'Reflections on a Year of Crisis', Chairman Ben S. Bernanke's Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming, 15 September 2009.

bonuses in cash and shares—were already in place with the initial capital injections, but have now been loosened to allow share-based bonuses.[85]

'Non-ailing' large UK banks adopted similar changes in their remuneration policies. Barclays, HSBC and Standard Chartered, despite bypassing state intervention through market recapitalizations, adjusted their remuneration levels by reducing or waiving variable compensation.[86] In 2008, the three banks froze basic salaries to their executives and reduced the total amount of annual bonuses to employees. Both Barclays and HSBC decided not to pay cash bonuses to their executives. Standard Chartered paid cash bonuses, although their levels were at least 10 per cent lower than in 2007. Both HSBC and Standard Chartered paid all or part of their annual variable compensation in restricted shares, with a vesting date 3 years from the date of the award.[87] The three banks' approach to long-term incentives varied: HSBC did not award performance shares during the year; Barclays reduced long-term awards by 64 per cent and did not make any award to its CEO and President; while Standard Chartered continued to award performance shares to its executives, although at lower levels than for the previous year. Additionally, all three banks increased their minimum shareholding requirement for executives to achieve further alignment with shareholder interest. Whilst the two partly nationalized banks communicated clear guidelines on remuneration for subsequent years in their 2008 reports, as required under the state-aid scheme, none of the non-ailing banks hinted at its future approach.

UBS and Credit Suisse

Another case highlighting remuneration practices in crisis is provided by the two biggest Swiss banks: UBS and Credit Suisse. Changes to their remuneration policies are interesting as they show a race to the top. The Swiss government agreed to inject SFr6 billion into the capital of UBS at a time when the country's largest bank faced massive write-downs and posted a loss of SFr20 billion for 2008, the largest in Swiss corporate history. UBS issued mandatory convertible notes to the Federal State, giving the latter an option for converting the notes into shares. The transaction allowed the Swiss government to get a 9 per cent stake in the bank.[88] In addition, a government bailout package permitted UBS to transfer $60 billion of toxic assets to a central bank-run fund.[89]

85 Other conditions for this round of state-aid: RBS would sell several businesses, including its insurance arm; its investment banking arm to be ranked no higher than fifth in certain league tables related to debt market activities; Lloyds would be prohibited from making certain acquisitions for a period of 3–4 years. Both banks would be barred for 2 years from paying coupons on bonds or dividends on share sales.

86 Although Barclays' 2008 profit compares favourably across the sector, other elements like share price underperformance, reduced market capitalization, weaker earnings and the decision not to pay a dividend, determined that the bank had to severely reduce variable remuneration. HSBC's 'earnings per share' (down by 72% with respect to 2007) and 'return on average total shareholder equity' (down by almost 30%) did not meet targets, determining a fall in bonus levels. Standard Chartered looked most resilient to the global turmoil. In its annual financial statements, the bank defined 2008 as the best year in terms of group income (26% increase in 2007) and operating profit (13% increase). This may explain why Standard Chartered adopted less strict measures with regard to remuneration than the other two banks.

87 Standard Chartered increased the deferral period from 1 to 3 years, as of 2008.

88 UBS Annual Report and Press Releases, 2009.

89 Ibid.

In August 2009, the Swiss government sold its stake in the bank, making a considerable profit.[90] However, the bad bank scheme remained in place, determining for UBS a heavy charge for the protection against losses on toxic assets.[91]

Credit Suisse did not require financial assistance from the Federal Government, having done relatively well throughout the crisis. However, looking at the remuneration policies of the two banks, some common features emerge: prior to the crisis, variable compensation, including cash bonuses and share-based awards, were a substantial part of total compensation.[92] In 2008, UBS did not pay variable compensation (cash or equity) to its executives, as a result of poor performance and of the failure to achieve key performance targets.[93] Credit Suisse's chairman and chief executives did not receive any variable compensation for 2008 either. The bank, however, paid variable compensation to some of its executives, considering it a 'contractual' undertaking.[94]

UBS was amongst the first to address executive compensation in the wake of the crisis,[95] explicitly seeking to improve its corporate culture through a new compensation model.[96] Credit Suisse did not carry out major changes to its 2008 remuneration policy.[97] However, despite not being a candidate to government funds, Credit Suisse was the first bank to change its remuneration policy soon after and in line with the principles of the G20 summit.[98] The bank announced a shift in the mix of discretionary bonuses and fixed compensation, resulting in the payment of an increased proportion of compensation in the form of fixed salary and some restrictions to variable remuneration.[99] Following Credit Suisse's approach, UBS announced changes in its 2009 and 2010 pay policy, also communicating an intention to pay bonuses only when the bank returns to profit.

90 The Swiss Government made a SFr1.2 billion profit; see e.g. 'Bern makes SFr1.2 billion on UBS stake sale' *Financial Times* (London, 20 August 2009).

91 Given the recent recovery in credit markets, UBS is confident that it could take the assets back on its balance sheet before the second half of 2010. See UBS Annual Report 2008 and New York Times Archives on UBS. Since the beginning of 2009, UBS has replaced both its CEO and Chairman. Its reputation suffered from massive credit losses and tax problems in the USA.

92 For UBS variable pay in 2007 amounted to 50% of total pay; see UBS 2007 Compensation Report. Credit Suisse Compensation Reports 2007 and 2008 underline the importance of the variable component in the total remuneration.

93 See UBS 2008 Compensation Report, 2008.

94 See Credit Suisse Compensation Report, 2008.

95 The bank considered its own approach as a 'pioneering approach to executive compensation practices'; see UBS Compensation Report, 2008.

96 The new compensation model to be implemented in 2009, as described by UBS includes the following measures: awards depending on the achievement of performance targets linked to long-term, risk adjusted value creation; 3-year deferral period for bonuses; bonus malus (claw back); performance equity plan linked to performance of the bank for initial 3-year period; retention by executives of a minimum of 75% of all shares for 5 years; introducing a non-binding advisory vote on the principles of executive compensation.

97 The bank maintained its approach to variable compensation, introducing only a few changes, ie introducing performance awards linked to the performance of a pool of illiquid assets, and a claw back measure applied to a portion of the cash-based component. Credit Suisse Compensation Report, 2008.

98 See press release: 'Credit Suisse announces its compensation structure for 2009 and 2010', Group's website <www.credit-suisse.com> accessed 26 February 2010.

99 Annual cash awards would be unrestricted for amounts below SFr 125,000 and higher amounts will be subject to deferral. Two new instruments for deferred variable compensation were also introduced: SISU (Scaled Incentive Share Units) had already been in place, but the new plan will deliver a base share amount on a 4-year pro-rata basis. Delivery of shares will depend on the average share price and on the RoE over 4 years. Adjustable Performance Plan Awards (APPA) is a cash-based award that has a notional value that adjusts annually based on the ROE over 3 years. By tying payouts to a specific measure like ROE, Credit Suisse will essentially be able to claw back bonuses. See Credit Suisse 2009 remuneration policy in Annual Report 2009.

Assessment

Analysis of the 'pre-crisis' remuneration policies at the seven banks examined above shows significant differences in terms of executive remuneration levels and structure.[100] On the contrary, the 'crisis' policies of the same banks reveal important similarities in approach, related in particular to the design of variable remuneration. Changes to incentive structures had an impact on total amounts paid to executives in 2008, which, by comparison with the previous year, appeared more levelled amongst the banks.[101] Nonetheless, similar changes could just be 'one-off' measures, adopted under pressure from government and supervisory authorities, as well as under competitive pressure. The banks considered no doubt wanted to prove, through their remuneration policies, a serious commitment to risk management and corporate governance. It is to be seen whether similar attitudes will be confirmed in the future, once government's intervention is over and the banking system is fully restored.

6. Extending rules across the banking sector

Various attempts were made in the last decade to address the problem of executive remuneration not aligning the interest of managers with those of shareholders.[102] The recent financial crisis prompted action to deal in a coordinated manner with the vulnerabilities that emerged from an extended period of healthy growing economies. Although international coordination is still limited, reforms have marked a change in remuneration design. Measures taken post-crisis by the relevant authorities are best encompassed in the FSB Principles for sound compensation practices issued in April 2009, with reference to 'significant financial institutions' (a still undefined category), and in the FSB Implementation standards issued in September 2009.[103] Far from prescribing pay levels, the FSB principles acknowledge that compensation systems should work in concert with other management tools in pursuit of prudent risk-taking. The FSB implementation standards provide for bonus deferral, claw-back provisions and proportionate compensation (cash and equity); effective remuneration governance, ensuring appropriate board oversight of compensation and risk through greater independence and accountability of remuneration committees; and effective supervisory

100 Differences in basic salary levels, incentive levels and the design of variable remuneration.

101 Basic salaries were more levelled, no bonuses (or lower ones, in the case of Standard Chartered) were paid to executives.

102 For example, J Gordon, 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections' (2002) 69 Univ Chicago Law Rev 1233; L Ribstein, 'Bubble Laws' (2003) 40 Houston Law Rev 77; and J Coffee, 'A Theory of Corporate Scandals: Why the US and Europe Differ', P Davies, 'Enron and Corporate Governance Reform in the UK and the European Community' and S Deakin and S Konzelmann, 'Corporate Governance after Enron: An Age of Enlightenment', all in J Armour and J McCahery (eds) *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publications, Oxford 2006).

103 Financial Services Board (FSB), 'Principles for Sound Compensation Practices' (April 2009) and 'Principles for Sound Compensation Practices. Implementation Standards' (September 2009). A definition is given by A Saunders, R Smith and I Walter in 'Enhanced Regulation of Large, Complex Financial Institutions' (2009), in V Acharya and M Richardson (eds), *Restoring Financial Stability. How to Repair a Failed System*, NYU Stern, who define 'large, complex financial institutions as financial intermediaries engaged in some combination of commercial banking, investment banking, asset management and insurance, whose failure poses a systemic risk or externality to the financial system as a whole'.

oversight through greater disclosure and transparency of the level and structure of remuneration.

Some of the above measures reflect already existing best practices; however, their formalization by the FSB is no doubt a stimulus for national regulators and financial institutions. The European Commission took the first step towards addressing problems that arise from poorly designed compensation structures at firms when, on 30 April 2009, it adopted two Recommendations on the regime for the remuneration of directors of listed companies and on remuneration policies in the financial services sector.[104] While the earlier 2004–2005 Commission recommendations sought to align shareholder and management interests,[105] the new ones, more ambitiously, seek to address the design of pay packages and to reform remuneration policies in the financial sector.[106] Moreover, the Commission proposed a revision of the Capital Requirements Directive (CRD) that would bring the remuneration arrangements of financial institutions within the scope of risk management.[107] The relevant proposal requires banks and investment firms to have sound remuneration policies that do not encourage or reward excessive risk-taking, whilst banking supervisors are attributed the power to sanction banks when their remuneration policies do not comply with the proposed requirements. The focus is clearly on risk management, as a core area of prudential regulation and supervision. Also, the Committee of European Banking Supervisors (CEBSs) adopted high-level principles on remuneration policies focusing on key aspects such as alignment of bank and employees' objectives; corporate governance with respect to both oversight and decision-making; and performance measures and types of remuneration.[108]

In countries where major banks participated in government rescue schemes, other banks endorsed the remuneration standards issued by either governments or financial regulators, determining their application across the banking sector. The UK's top five banks (Barclays, HSBC, Lloyds, RBS and Standard Chartered) gave their commitment to follow the G20 principles and the government is seeking similar support from all international banks with activity in the UK.[109] The French Banking Federation issued specific guidelines on compensation at financial institutions in August 2009, with regard to variable compensation to be paid in 2010. In November 2009, the same Federation put forward rules about 'say-on-pay' and certain

104 Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (C(2009) 3177); and Commission Recommendation on remuneration policies in the financial services sector (C(2009) 3159).

105 EC Recommendation fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC); EC Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

106 For a critical analysis of the Commission's Recommendations on Directors Pay, pre-crisis and post-crisis, see Ferrarini et al., ECGI Law Working Paper N.126/2009; G Ferrarini, N Moloney and MC Ungureanu, 'Executive Remuneration in Crisis' (forthcoming) J Corporate Law Studies.

107 Proposal for Directive amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies, 2009.

108 'High-level Principles for Remuneration Policies' (2009), Committee of European Banking Supervisors.

109 HM Treasury: 'British Banks to Lead the Way on G20 Bonus Reforms', 20 September 2009.

remuneration bans for financial institutions.[110] The latest reforms also marked a trend towards adopting corporate governance codes specific for the banking sector. The UK and the Netherlands were pioneers in this approach.[111] These codes reinforce the general corporate governance principles, with additional emphasis on design particularities for executive remuneration.[112]

Germany went further by adopting the Law on the Adequacy of Remuneration of Executive Board Members (VorstAG), which came into force on 5 August 2009 and applies to companies across all sectors,[113] while the Federal Financial Supervisory Authority's guidelines on risk management take the FSB and CEBS Principles into account.[114] The Swiss Financial Market Supervisory Authority also issued a mandatory Circular on remuneration schemes defining minimum standards for the design, implementation and disclosure of remuneration schemes in financial institutions; the application of these minimum standards is subject to the principle of proportionality.[115] Unlike other comparable international legislation, the Swiss provisions will apply not only to 'systemically important financial institutions' but also to all institutions supervised by FINMA. Also, France adopted binding principles for banks' remuneration, applicable to all employees involved in activities that may impact on the risk profile of the bank.[116]

7. Concluding remarks

In this paper, we attempted to show the impact of the recent financial turmoil on large banks' remuneration policies. We examined, first of all, the implications of governments' rescue plans for executive remuneration at ailing banks. We analysed, in particular, the requirements imposed by either governments or regulators with reference to bankers' remuneration structures and policies. The reasons for setting similar requirements were at least 2-fold. On one side, bankers' remuneration, whilst not being one of the main causes of the financial crisis, contributed to the failure of individual banks by creating incentives to excessive risk-taking. On the other side, rescue packages were financed by recourse to taxpayers' money, which justified restrictions on the levels of compensation payable to executives and other managers at rescued institutions. However, pay

110 Federation Bancaire Francaise, 'Normes professionnelles concernant la gouvernance et les rémunérations variables des professionnels des marchés financiers', 5 November 2009.

111 See FSA, PS09/15 (n 39, above); *Turner Review* (n 57, above); 'A Review of Corporate Governance in UK Banks and other Financial Industry Entities' *Walker Review* (July 2009). In the Netherlands, key corporate governance principles resulted from the initiatives of the Ministry of Finance working closely with representatives of financial institutions and the two Dutch regulatory authorities. The 2009 Dutch Banking Code (September 2009) was published by the Netherlands Banking Association following a so-called Gentleman's Agreement.

112 Specific guidelines were issued, before the G20 Pittsburg, by the Bank of Italy, which issued corporate governance provisions for banks in March 2008, including remuneration policy.

113 'Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)', 31 July 2009.

114 'New Minimum Requirements for Risk Management (MaRisk)', BaFin, 14 August 2009.

115 Circular 2010/1 Remuneration Schemes. Minimum standards for remuneration schemes of financial institutions, October 2009.

116 Arrêté du 3 novembre 2009 relatif aux rémunérations des personnels dont les activités sont susceptibles d'avoir une incidence sur l'exposition aux risques des établissements de credit et entreprises d'investissement, 3 November 2009.

requirements at ailing banks could not be too strict, given that at least some of the executives and managers concerned were essential for rendering individual institutions in the condition to recover and pay back the money received from the states. This explains why incentive pay was still permitted and caps on total pay were generally avoided (with some notable exceptions), even though compensation, particularly for top managers, was generally fixed at much lower levels than before the crisis.

As shown by our two case studies in Section 5, in the revision of their remuneration policies, non-ailing banks generally followed criteria similar to those applied by governments and regulators to ailing banks. This confirms that the guidelines adopted for rescue packages were not, in general, too restrictive, given the circumstances. It also shows that non-ailing banks tried to respond both to populist attacks to the banking system, and to investors' concerns regarding their remuneration and risk management policies. In a sense, the crisis generated a race to the top in the area of bankers' pay, leading large banks to self-restraint as to the measure of pay and to a longer term, risk-cautioned approach to incentive remuneration.

The trends followed by either ailing banks under pressure from governments or non-ailing ones responding to reputational and market concerns in the revision of their compensation policies were reflected by national and international actions of governments and regulators. The FSB, in particular, tried to solve the coordination problems that regulating bankers' pay creates at international level, given the competition concerns of both governments in the main financial centres and large banking groups operating internationally. The FSB approach is principle based and requires banking supervisors to implement the bankers' remuneration principles through their action in national jurisdictions. The international principles set by FSB were subsequently followed by the European Commission in its 2009 Recommendation on pay in financial institutions, whilst Member States have incorporated similar principles in their banking regulations (or are about to do so). At the same time, large banks have adapted their policies to the international principles, often anticipating national requirements.

The developments observed in this article leave, however, some important issues to further analysis. First, the proper role of banking regulation in the area of executive compensation needs to be better understood. Compensation has always been a matter for boards of directors to decide, so that the relationship between corporate governance and regulation should be further analysed to identify the proper boundaries between the two areas. Secondly, the role of supervision should also be better focused. If regulation is based on principles specified by the boards on one side, and supervisors, on the other, the question regards the tasks that supervisors should perform with respect to banks' governance and remuneration. Thirdly, the role of boards at banks should also be better defined, with respect to both the fiduciary duties and the goals that directors should pursue, particularly at large, systemically relevant institutions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.