The ICFR-FT Research Prize 2010

Lost in Implementation: The Rise and Value of the FSB Principles for Sound Compensation Practices at Financial Institutions

Guido Ferrarini
University of Genoa, Centre for Law and Finance, European Corporate Governance Institute

Maria Cristina Ungureanu
University of Genoa, Centre for Law and Finance

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Abstract

In this paper, we analyse the principles for sound compensation practices at financial institutions and their implementation standards (briefly PSSCPs) issued in 2009 by the Financial Stability Board (FSB). We examine, first of all, the political economy of the PSSCP. We analyze their formation as a result of the recent financial turmoil, and the way in which a sound compromise between the different interests at stake was reached at G20 level, with the contribution of the FSB. We then consider the roots of the PSSCP in pre-crisis best practices, their flexibility and adaptability, and their role in prudential regulation. We go on to examine post-crisis PSSCP implementation in the EU and the US, highlighting the different models that have been adopted. Our core argument is that the PSSCPs are only the first step in a complex global reform process that is currently underway at both regional and national levels. This process is, however, marked by political conflicts that have been only partially solved by the G20 and which may determine significant variations amongst the different legal systems, some of which, including EU law, are transforming the international standards into rigid and detailed prescriptions as to the mechanisms and structures of bankers' compensation, whilst other systems either keep the flexibility of the standards in their regulations or rely mainly on a supervisory approach.

1. Academic research on the causes of the recent financial turmoil does not offer sound grounds for current efforts to regulate bankers' pay. First of all, there is no clear evidence that pre-crisis compensation practices were predominantly short-term oriented. On the contrary, executive compensation at international banks included long-term incentives, with almost no difference between ailing and non-ailing banks. This applied both in the US, where the top managers were heavily invested in the equity of their banks (including Lehman and Bear Sterns), and in Europe.[1] Moreover, it has not been proven that short-term monetary incentives led to excessive risk taking, even in institutions that paid hefty bonuses to their managers. Non-monetary incentives may have contributed to the crisis of some banks, including pressure from institutional investors on managers to promote wealth maximization in the short run. Bad risk management was also a contributing factor, presumably as a consequence of bank risk misperception and organizational failures rather than of flawed compensation schemes.

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

[1] For US see among others: Rüdiger Fahlenbrach and René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, Charles A. Dice Center, Working Paper 2009-13 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859; Lucian Bebchuk, 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); Ing-Haw Cheng, Harrison Hong and Jose Scheinkman, *Yesterday's Heroes: Compensation and Creative Risk-Taking*, ECGI Finance Working Paper 285 (2010), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1502762. For EU see: Guido Ferrarini and Maria Cristina Ungureanu, *Economics, Politics and the International Principles for Sound Compensation Practices. A View from Europe*, ECGI Law Working Paper 169 (2010), Vanderbilt Law Review (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707344.

media amplified the debate about the role of short-term incentives in excessive risk taking and turned executive pay into a key topic for politicians in search of voters' consensus.

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

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

The 'level playing field' argument will likely be used to resist regulatory reform and protect rents from hefty compensation packages. Senior staff will threaten to move to other countries or to less regulated financial firms, such as hedge funds. Moreover, they will use their influence on politicians and the media to dilute reform efforts and protect their freedom to fix remuneration structures. Shareholders will join in these efforts, as variable pay is the main tool to put pressure on managers and induce them to maximize shareholder wealth through increased risk taking.

Regulators, on the contrary, will require incentive pay to reflect not only shareholders' interests, but also those of creditors and of financial stability in general. From their perspective, managerial incentives could usefully be linked not only to the value of equity, but also to that of debt, along the lines suggested by recent law and finance literature.[2] Moreover, regulators welcome post-crisis reforms as a unique opportunity to expand their supervisory reach to areas previously reserved to bank boards and shareholders. At the same time, they are prone to capture by their regulated industry and may be willing to accept the 'level playing field' and similar arguments in order to protect the same.

As a result, to a great extent legislative and regulatory responses depend on the type of equilibrium found in each country between the different interests at stake. Where public criticism of bankers and hostility to their remuneration practices are strong, the risk of regulatory capture is lower and a tougher regime for executive pay may emerge. Culture may contribute to similar outcomes, given that high levels of executive pay are less tolerated in some countries. However, no domestic regulatory solution could be effective without agreement at international level. Furthermore, politicians favour international solutions, which often require spectacular action in the global scene

[2] E.g. Patrick Bolton, Hamid Mehran and Joel Shapiro, *Executive Compensation and Risk Taking*, Federal Reserve Bank of New York, Staff Report 456 (2010), available at http://www.ny.frb.org/research/staff_reports/sr456.pdf; Lucian Bebchuk and Holger Spamann, *Regulating Bankers' Pay*, 98 Georgetown Law Journal 2, 247-287 (2010).

(think of the solemnity and publicity of some G20 meetings), at the same time allowing for core responsibilities to be shared amongst many other governments.

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

3. The PSSCPs are addressed to 'significant financial institutions' which, more than others, deserve an internationally uniform regime. They cover four main compensation areas: governance, structure, disclosure and supervision.

As to *compensation governance*, they incorporate well-known best practices concerning the strategic and supervisory role of the board. In addition, they reflect the post-crisis emphasis on bank risk management and monitoring by the board of directors, who should determine the risk appetite of the firm. They reiterate the role of the remuneration committee, also requiring its liaison with the risk committee to ensure compliance with the relevant requirements.

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

Deferment of compensation, traditionally used as a retention mechanism (on the basis that a 'bad leaver' would generally lose unpaid deferrals), should make compensation payout schedules sensitive to the time horizon of risks. In particular, a substantial portion of variable compensation (i.e. forty to sixty percent) should be payable under deferral arrangements over a period of not less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question. Furthermore, a substantial portion (i.e. more than fifty 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 retention policy.

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

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

To sum up, the PSSCPs represent an acceptable political compromise between the various interests at stake in the area of compensation, incorporating traditional criteria and adapting these to new circumstances. First, they focus on long-term incentives, in order to counter the role allegedly played in the crisis by short-term incentives. Since executive compensation packages at most large banks before the crisis were already fairly balanced between short-term and long-term incentives,[3] the international principles track already existing practices. Secondly, the PSSCPs widen the powers of supervisors by explicitly making pay at financial institutions subject to prudential supervision. Thirdly, similar to other international financial standards, the PSSCPs remain at a sufficient level of generality and allow for flexibility in implementation; in several instances, financial institutions are permitted to depart from a given principle or standard, if application of the same would lead to unsound consequences.

4. As shown by a recent FSB review, the PSSCPs are being implemented along different models.[4] In many jurisdictions, the model includes a mix of regulation and supervisory oversight, with new regulations often supported by supervisory guidance that illustrates how the rules can be met. Other jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. It may be difficult, therefore, to compare one system with another without analysing the compensation practices of the relevant financial institutions, particularly with regard to jurisdictions following a supervisory approach. However, useful insights can already be drawn from a brief comparison between the EU and the US approaches.

The EU adopted the former of the two models described. The recently modified Capital Requirements Directive (CRD III) includes rather detailed provisions for banks, to some extent incorporating the PSSCPs, at the same time asking the Committee of European Banking Supervisors (CEBS) to issue guidelines in this area.[5] Some of the new provisions, such as the one requiring

[3] Ferrarini and Ungureanu, *supra* note 1.

[4] Financial Stability Board, *Thematic Review on Compensation: Peer Review Report* (2009).

[5] *Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC As Regards Capital Requirements for the Trading Book and for Re-Securitisations, and the Supervisory Review of Remuneration Policies*, Official Journal of the European Union

remuneration policy to be consistent with sound and effective risk management, are general in character. Other requirements are more specific: at least 40% of the variable remuneration component is to be deferred over a period which is not less than three to five years; and at least 50% of any variable remuneration shall consist of an appropriate balance of shares or share-linked instruments (and, where appropriate, other instruments that adequately reflect the credit quality of the credit institution as a going concern). Similar requirements are subject to the 'safety valve' of proportionality (i.e. must be followed in a way and to the extent that is appropriate to the size, nature and complexity of an institution's activities). Although CEBS' guidelines under CRD III do refer to the principle of proportionality, they seem to accept a narrow concept of the same. In addition, the proposed CEBS guidelines are very detailed, more similar to a rulebook than supervisory guidance. As a practical consequence, the PSSCPs will become generally binding for European banks, with very few exceptions, once the Directive is fully implemented. Moreover, the flexibility of the PSSCPs will be lost, to a large extent, given the more prescriptive character of the European provisions and guidelines.

The US initially followed the supervisory model. Rather than issuing regulations, the authorities concerned (Fed, OCC, FDIC, and OTS) adopted, in June of this year, the Interagency Guidance on Sound Incentive Compensation Policies, applicable to all banks.[6] This document closely tracks the PSSCPs, keeping however a remarkable level of flexibility and generality.

Does this mean that the political game is more balanced in the US or, more likely, that the Wall Street lobbies have been successful? Are politicians tougher in the EU, also reflecting differences in public opinion and cultural values with respect to bankers' pay practices? Looking at the CRD III and CEBS' proposals, once could answer affirmatively to both questions.

However, the Dodd-Frank Act passed later in July includes two sets of rules on executive compensation. A first set deals with executive pay at public corporations in general, focusing on issues like shareholders' say on pay, independent compensation committees, clawback mechanisms and compensation disclosure. A second group of rules are directed at enhancing compensation oversight in the financial sector. They require federal regulators to jointly prescribe rules for compensation disclosure and prohibit certain incentive-based payment arrangements that encourage 'inappropriate' risk-taking by financial institutions. The rules issued by regulators under these provisions could indeed make the US and EU systems converge, so any final assessment should be suspended whilst waiting for full implementation of the Dodd-Frank Act.

5. As shown in this paper, the global reforms of compensation practices at financial institutions are the outcome of an intense political debate conducted against the backdrop of the international crisis and popular resentment, within countries and across the international arena. When the G20 head of governments and the FSB considered the relevant issues, some of the political conflicts were no doubt diluted by the international and diversified membership of these institutions, and solutions were found at a sufficient level of generality to allow for adaptations and exceptions. However, when the implementation of the PSSCPs is discussed at regional and national level, many of the underlying conflicts inevitably resurface, depending not only on the relative weight of the interest groups involved and the role of banks in the economy, but also on national culture and ethical values. The case of the EU is striking, given that the PSSCPs were transposed into a directive, leaving little room for flexibility and adaptability, and that the CEBS is willing to reinforce this trend. A

L329/3; Committee of European Banking Supervisors, *Guidelines on Remuneration Policies and Practices* (CP42) (December 2010).

[6] Department of the Treasury – Thrift Supervision Office [Docket ID OCC-2010-0013], *Guidance on Sound Incentive Compensation Policies* (June 2009).

similar rigidity in implementation may determine unintended consequences, by increasing the total costs of remuneration and/or making incentives less effective at European banks.

The International Centre for Financial Regulation
5th Floor
41 Moorgate

EC2R 6PP
United Kingdom
Telephone: +44 (0) 20 7374 5560
Facsimile: +44 (0) 20 7374 5570
E-mail: enquiries@icffr.org
Website: www.icffr.org