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

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ABSTRACT: *In this paper, we analyse the principles for sound compensation practices at financial institutions and their implementation standards (briefly "Principles") issued in 2009 by the Financial Stability Board (FSB). We examine, first of all, the political economy of the Principles. 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 Principles in pre-crisis best practices, their flexibility and adaptability, and their role in prudential regulation. We go on to examine post-crisis Principles' implementation in the EU and the US, highlighting the different models that have been adopted. Our core argument is that the Principles 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 that may determine significant variations amongst the different legal systems. Some of these, 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.*

KEYWORDS: **Executive remuneration. – International principles and standards. – Financial institutions. – Corporate governance. – CRD III**

Introduction

In the quest for possible causes of the recent financial crisis, commentators often argue that bank executives had poor incentives.[1] However, academic research on this topic 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.[2] 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 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.

1 A shorter version of this paper was awarded the runner-up ICFR – Financial Times Research Prize, 2010.

2 For the US see among others: Rüdiger Fahlenbrach and René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 Journal of Financial Economics, 26 (2011); 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 Europe 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), 62 Vanderbilt Law Review 2, 431-502 (2011).

The rise of the FSB Principles and Standards

The emergence and rise of the FSB Principles and Standards were influenced by the national measures adopted by the governments coming to rescue and restructure banks in order to assure the survival of the international financial system.

The FSB adopted its Principles following coordinated action by the G20 governments, which rapidly responded to heavy political pressure deriving, both domestically and internationally, from the financial crisis and repeated bank failures. Through swift adoption of the Principles, authorities intended to show that reforms of the international financial system were timely put in place with respect to executive compensation.[3]

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.[4]

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.[5] 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.[6] 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.[7] Culture may contribute to similar outcomes, given that high levels of executive pay are less tolerated in some countries.[8] However, no domestic regulatory solution could be effective without agreement at international level. Furthermore, politicians favour international solutions, which often require spectacular action in the global scene (think of the solemnity and publicity of some G20 meetings during the crisis period), at the same time allowing for core responsibilities to be shared amongst many other governments.

The provisions

The aspects presented above explain the reasons for adopting the international principles for sound compensation practices and the ways in which they were formulated. International fora, represented by 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,[9] this did not occur in other countries (including Brazil,

3 See for example *Communiqué from G20 meeting in Washington*, April 21, 2010, available at http://uk.reuters.com; see also media articles e.g. James Wilson, *German banks set to speed up pay reforms*, Financial Times, December 10, 2009 and Chris Giles and Krishna Guha, *Leaders seek to retool global economy*, Financial Times, September 25, 2009.

4 This may also be triggered by the multinational banks' target for expansion in continents such as Asia, considering the recent global economic conditions. As an example, HSBC – the top UK bank – has already moved some of its executives to Hong Kong in its aim to focus on faster-growing markets like China and India; Standard Chartered, which also has important presence in Asia, may follow HSBC's example; its case for moving to Asia has been strong for many years, and the bank may feel more pressure pushed also by the EU stricter regulation. For a brief outlook of these developments in the UK see John Menon, *HSBC's Asia Moves May Make 'Colonial' Standard Chartered Follow*, Bloomberg Businessweek, 25 February, 2010. For an analysis of the determinant factors for market-entry and barriers to new-market entry, including regulatory environment, see Raghuram Rajan and Luigi Zingales, *The Great Reversals: the Politics of Financial Development in the Twentieth Century*, 69 Journal of Financial Economics (2003).

5 This approach can already be seen in the UK, following the implementation by the Financial Services Authority (herein the "FSA") of the recent EU rules. See Sharlene Goff, Patrick Jenkins and George Parker, *Bankers stand firm on pay-outs*, Financial Times, 7 January 2011.

6 For various proposals on remuneration structure put forward by some academic studies, see Ferrarini and Ungureanu, *supra* note 2.

7 For an analysis of the influence of media on public and on political choices and the implications for the economic theory of regulation, see Alexander Dyck, David Moss and Luigi Zingales, *Media Versus Special Interests*, NBER Working Papers No. 14360 (2008).

8 For an analysis of the cultural issues in the US approach to executive compensation, see Arthur Levitt, *Corporate Culture and the Problem of Executive Compensation*, 17 Journal of Applied Corporate Finance (2005); Richard Posner, *Are American CEOs Overpaid, and, If So, What if Anything Should Be Done About It?* 58 Duke Law Journal (2009).

9 For Europe see, among others, *Report by the High Level Group on Financial Supervision in the EU*, chaired by Jacques De Larosière ("De Larosière Report") (February, 2009); *Communication to the Spring European Council: Driving European Recovery*, COM(2009) 114, Volume I (March 2009); House of Commons, Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (HC 519, 2009), Ninth Report of Session 2008-09, available at http://www.parliament.uk/business/publications/; *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*, SEC(2009) 580; *The G-20 Statement on Strengthening the Financial System*, Pittsburg Summit (5 September 2009), available at: http://www.g20.org/pub_communiques.aspx.
In the US, the American Recovery and Reinvestment Act of 2009 (February 2009) significantly rewrote the original executive compensation

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; FSB's membership is very diverse, so the financial body is already prone to internal conflicts. Built on its predecessor, the Financial Stability Forum (FSF), a tenuous group of seven countries, the FSB is made up of 36 members including 24 countries, among these the BRIC economies, which are becoming important players in global finance. FSB's powers are rather limited, in that it issues recommendations, which must be endorsed by the G20; this is sometimes viewed as a threat to its independence.[10] On another hand, the diversity of the FSB membership can benefit in achieving equilibrium in reforms.[11] Whilst the US and the EU are still the main shapers of the rules, the balance of power may gradually equilibrate as countries like China and Brazil, through their veto say, increase their influence, racing with the traditionally influential US.[12]

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, which also triggered the debate in Europe, while firms in other jurisdictions neither underwent similar crises nor experiment excessive compensation.[13] 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.

The FSB principles are addressed to 'significant financial institutions' which, more than others, deserve an internationally uniform regime. Some principles are not new to the extent that they require a balanced pay structure and long-term approach, alignment of pay with performance, independence of the pay-setting process and disclosure of remuneration policies.[14] Relatively new is the emphasis on effective alignment of compensation with prudent risk taking and compensation practices that reduce employees' incentives to take excessive risk.

The Principles 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.[15] In addition, they reflect 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 FSB Principles 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 FSB Principles break new grounds by requiring financial institutions to align compensation with prudent risk taking. Accordingly, compensation should be adjusted for all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes.[16]

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.[17] 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 in-

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). For a list of relevant regulations adopted in the US, see presentation by Joseph Bachelder (2009), *US Legislative and Regulatory Developments Affecting Executive Compensation*, at the Transatlantic Corporate Governance Dialogue (TCGD), available at: www.ecgi.org.

10 On the importance of independence and accountability in financial supervision see Lorenzo Bini Smaghi, *Independence and Accountability in Supervision: General Principles and European Setting*, in "Designing Financial Supervision Institutions. Independence, Accountability, Governance", Donato Masciandaro and Marc Quintyn (eds.), Edward Elgar Publishing (2007).

11 For a comprehensive analysis of the reformed international financial architecture, see Mario Giovanoli, *The Reform of the International Financial Architecture after the Global Crisis*, 42 New York University Journal of International Law and Politics, 1 (2009).

12 The international financial standards have a "soft law" nature, their implementation by national authorities being voluntary. However, at the EU level the major international financial standards have been transposed into directives, the implementation of which is compulsory for the Member States. See Giovanoli (2009), id.

13 For the compensation issue at US banks see report by the NY Attorney, 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. The Report conducted an analysis of compensation practices at nine state-aided banks, concluding 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.

13 In the UK, concerns were primarily 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); FSA*, Reforming Remuneration Practices in Financial Services. Feedback on CP09/10 and final rules*, FSA, PS09/15.

14 Already before the crisis, several best practice guidelines emphasised the importance of aligning incentives with long-term performance through adopting long-term incentive plans in equity form. See for example International Corporate Governance Network (ICGN), *Remuneration Guidelines* (2006); Association of British Insurers (ABI), *Executive Remuneration Guidelines on Policies and Practices* (2007); TIAA-CREF, *Policy Statement on Corporate Governance* (2004); Corporate Governance Code Monitoring Committee, *Dutch Corporate Governance Code* (2004); Luxembourg Stock Exchange, *The 10 principles of corporate governance of the Luxembourg Stock Exchange* (2006). These can be downloaded from the European Corporate Governance Institute (ECGI) website at http://www.ecgi.org/codes/all_codes.php.

15 Principle 1, FSF (2009); Standard 1, FSB (2009).

16 Principle 4, FSF (2009); Standard 6, FSB (2009).

17 Principle 6, FSF (2009); Standard 6, FSB (2009).

centives 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 FSB Principles also tackle concerns relative to bonuses, which famously emerged during the recent crisis. They require 'malus' and 'clawback' mechanisms, which enable boards to reduce or reclaim bonuses paid on the basis of results that are unrepresentative of the company's performance over the long term or later prove to have been misstated.[18] 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.[19] Severance packages need to be related to performance achieved over time and designed in a way that does not reward failure.[20]

Compensation disclosure, despite being widely practiced pre-crisis, did not always meet the relevant standards.[21] 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 FSB Principles add new items of disclosure, such as deferral, share-based incentives, and criteria for risk adjustment.[22] 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.[23]

A brief critique

The FSB Principles 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 emerged from the financial crisis. 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,[24] the international principles track already existing practices. Secondly, the FSB Principles widen the powers of supervisors by explicitly making pay at financial institutions subject to prudential supervision. Thirdly, similar to other international financial standards, the FSB Principles remain at a sufficient level of generality and allow for flexibility in implementation; in several instances, financial institutions are permitted to depart from a given principle or standard, if application of the same would lead to unsound consequences.

The focus placed by the Principles on "effective governance of compensation" deserves approval and reflects a consolidated trend in bank regulation in acknowledging the role of corporate governance for financial stability purposes. Compensation structures are considered by the Principles along lines that reflect, to a large extent, best practices already adopted before the crisis. However, the alignment of managers' incentives with shareholder wealth maximization whilst taking account of risks has constantly been the main focus of the post-crisis discussions. The FSB Principles break new grounds by emphasizing the alignment of compensation with prudent risk taking, as a result of the recent crisis and the problems of ailing banks.

As clarified in their Introduction, the Principles should not be seen as too prescriptive.[25] They are flexible enough to accommodate differences between firms and amongst managers within the same firm. While compensation structures and amounts should reflect differences in risk taking, other factors that justify similarities in pay, such as the need to promote new businesses within the firm or to attract new talent, could be valued.

The FSB's ultimate goal is to prevent excessive risk taking by reducing incentives to do so created by remuneration arrangements. It is implicit in the Principles that a bank's board should ascertain that compensation arrangements do not lead the bank's managers to take excessive risks. This could become, under applicable law, a discrete duty of directors, who will be accountable to supervisors for compliance with this duty.

However, the success or failure of the Principles in practice will largely depend on the ways in which they are implemented and enforced at national level. Domestic regulation could either enhance or limit their flexibility. Supervisors might exert more or less pressure on financial institutions to achieve compliance. Banks could experiment with new structures, provided that sufficient discretion is left to their boards. Also in light of the recent economic literature on the role of executive pay in the financial turmoil,[26] regulation should be flexible and principle-based, allowing for innovation and diversity in executive pay structures, while preventing excessive risk taking. At the same time, the role of boards and disclosure of compensation practices through harmonization of remuneration reports should be enhanced.

Implementation of the Principles

As shown by a recent FSB review, the FSB Principles are being implemented along different models.[27] In many jurisdictions, the model includes a mix of regulation and supervisory oversight, with new regulations often supported by

18 Principle 5, FSF (2009); Standard 5, FSB (2009).

19 Standard 11, FSB (2009).

20 Standard 12, FSB (2009).

21 For an analysis of remuneration disclosure regulation and practices in Europe see Guido Ferrarini, Niamh Moloney and Maria Cristina Ungureanu, *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis*, ECGI Law Working Paper No. 126 (2009) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463.

22 Standard 5, FSB (2009).

23 Principle 8, FSF (2009).

24 For a detailed analysis of the remuneration policies adopted pre- and post-crisis see Ferrarini et al., *supra* note 2.

25 "They are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm." Introduction, FSF (2009).

26 See, among others: Roubini, Nouriel and Stephen Mihm, "Crisis Economics: A Crash Course in the Future of Finance" (2010); Acharya, Viral and Mathew Richardson (eds.), "Restoring Financial Stability: How to Repair a Failed System", NYU Stern School of Business (2009).

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

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, revealing 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 Principles, at the same time asking the Committee of European Banking Supervisors (CEBS) to issue guidelines in this area.[28] The short period available to adopt the rules and guidelines (they apply from January 2011, including retroactively in respect of compensation paid in 2011 for services rendered in 2010) will likely prove challenging for both national authorities and financial institutions. Although the Directive provides that the measures on remuneration should be "*without prejudice to [...] general principles of national contract and labor law*", retrospective application of rules may force institutions to revisit existing contractual arrangements taking a view on the need to amend provisions that contravene remuneration principles.[29] As for the scope, CRD rules apply to EU credit institutions and investment firms at a wide-group level, thus covering also non-EU subsidiaries of EU financial institutions, as well as EU subsidiaries and branches of non-EU institutions.[30]

Some of the new provisions, such as the one requiring remuneration policy to be consistent with sound and effective risk management, are general in character. Other requirements are more specific, setting minimum limits for the structure of the variable pay component: at least forty to sixty percent of the variable remuneration component is to be deferred over a period which is not less than three to five years; and at least fifty percent 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,[31] 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 Principles will become generally binding for European banks, with very few exceptions, once the Directive is fully implemented. Moreover, the flexibility of the Principles will be lost, to a large extent, given the more prescriptive character of the European provisions and guidelines.[32]

Consistent in its approach towards corporate governance, the first country to rush into implementing the EU new rules was the UK. In July 2010, the FSA proposed a revised framework for regulating financial services firms' remuneration structures and an extension of the scope of its existing Code, to implement changes required as a result of the remuneration provisions in the CRD III, and to clarify its ambiguities.[33] Following the consultation process and in an attempt to ensure consistency with CEBS guidelines, in December 2010 the FSA published a Policy Statement outlining amendments to the Code – the "Revised Code" – to take account of the revised EU rules.[34] Mirroring the CRD III main principle, the Revised Code requires that firms "*establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management*".[35]

The UK Revised Code contains requirements similar to the ones incorporated in the CRD III. However, the FSA makes some interventions in an attempt to ease, where possible, the more onerous CRD rules. For example, the Code sets £500,000 as the amount of variable remuneration triggering the sixty percent deferral requirement.[36] Another of FSA's attempts to make rules more lenient is found in its decision not to require firms to apply the rules on guaranteed variable remuneration, retained shares or other instruments, deferral or performance adjustment to a particular individual if: i) individual total remuneration does not exceed £500,000, and

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

29 Recital 14, CRD III.

30 CRD applies to both credit institutions and investment firms subject to the Markets in Financial Instruments Directive (MiFID). Its provisions on remuneration in fact amend Annex V of Directive 2006/48/EC, which primarily target credit institutions, in addition by reference to Directive 2006/49/EC, which applies to investment firms. Private equity, hedge funds and other alternative investment firms will be subject to separate yet similar rules under the proposed Alternative Investment Fund Managers Directive; See *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC* (COM(2009) 270 final). Similar remuneration provisions will apply to the insurance sector and to UCITS; see European Commission, *Green Paper on corporate governance in financial institutions and remuneration policies* (2010) available at http://ec.europa.eu/internal_market/consultations/2010/governance_en.htm.

31 See in particular Recital (4) CRD III: "[...] The principles recognize that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organization and the nature, scope and complexity of their activities. In particular, it may not be proportionate for investment firms referred to in Articles 20 (2) and (3) of Directive 2006/49/EC to comply with all of the principles. [...]," and Annex V, Section 11, Directive 2006/48/EC, 23: "When establishing and applying the total remuneration policies, [...] credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organization and the nature, the scope and complexity of their activities: [...]."

32 For a critique of the lack of flexibility of EU reforms, see Guido Ferrarini and Maria Cristina Ungureanu, *Response to CEBS Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)*, available at http://www.eba.europa.eu/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP42/Responses-to-CP42.aspx.

33 FSA, *Revising the Remuneration Code* CP 10/19, (July 2010). It extends the scope of the previous version of the Code (26 large banks and building societies) to all firms within the scope of the EU Directive on capital adequacy of investment firms and credit institutions (CAD), which includes banks, building societies and investment firms. Firms that are exempt from CAD, e.g. small corporate finance firms and fund advisors are not subject to the Revised Code.

34 FSA, *Revising the Remuneration Code Feedback on CP10/19 and final rules* (herein the "Revised Code") (December 2010).

35 Section 19A.2.1, FSA, *Revised Code*.

36 Remuneration Principle 12, 19A.3.34 G, FSA, *Revised Code*.

ii) individual variable remuneration is not above 33% of the individual total remuneration.[37] The FSA's ability to provide more flexibility in the adoption of the more onerous CRD provisions succeeded in a somewhat more lax approach to the proportionality principle. The Code thus divides institutions into four tiers, each subject to decreasing "*minimum expectations of compliance*".[38]

France also implemented EU rules into a law decree adopted in December 2010, which mirrors the main CRD III provisions.[39]

The US initially followed the supervisory model. Rather than issuing regulations, the authorities concerned (Fed, OCC, FDIC, and OTS) adopted the Interagency Guidance on Sound Incentive Compensation Policies, applicable to all banks.[40] This document closely tracks the Principles, keeping however a remarkable level of flexibility and generality. These are principle-based and apply to all banking organizations supervised by these agencies, however identifying expectations that its application is scaled according to the complexity of the organization. The guidance covers not only senior executives, but also groups of employees who may expose the organisation to significant material risks. US regulations make light provisions for the remuneration structure, the aspects of high sensitiveness in Europe being approached from a more flexible perspective.

However, the Dodd-Frank Act passed later in July includes two sets of rules on executive compensation.[41] 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.[42] Swiftly, the US agencies jointly approved a proposal on incentive-based compensation arrangements" pursuant to Section 956 of the Dodd-Frank Act.[43] The proposal takes some interesting approaches to its subject. The aspect that has received the most media attention is the part that applies to the largest banks. For financial institutions with $50 billion or more in consolidated assets, the proposal requires deferral of at least fifty percent of the incentive-based compensation paid to "executive officers" for a three year minimum period.

The rules issued by regulators under these provisions could have an impact on the convergence of the US and EU systems, so any final assessment should be suspended whilst waiting for full implementation of the Dodd-Frank Act.

Conclusions

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 Principles 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 Principles were transposed into a directive, leaving little room for flexibility and adaptability, and that the CEBS (now EBA, the European Banking Authority) is willing to reinforce this trend. A similar rigidity in implementation may determine unintended consequences, by increasing the total costs of remuneration and/or making incentives less effective at European banks or, given that the US is also heading towards stricter rules, by installing a competitive disadvantage of banks vis-à-vis non-banks, globally.

37 Remuneration Principle 12, 19A.3.34 G, FSA, *Revised Code*.

38 Para 1.14 and Chapter 3, FSA, *Revised Code*.

39 *Arrêté du 13 décembre 2010 modifiant diverses dispositions réglementaires relatives au contrôle des rémunérations des personnels exerçant des activités susceptibles d'avoir une incidence sur le profil de risque des établissements de crédit et entreprises d'investissement ainsi que diverses dispositions de nature prudentielle*, available (in French) at: http://www.banque-france.fr/fr/supervi/regle_bafi/textvig/reglcrbf_1.htm.

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

41 *Dodd-Frank. Wall Street Reform and Consumer Protection Act*, 2010.

42 Section 956, *ibidem*.

43 The FDIC issued *Notice of Proposed Rulemaking on incentive-based compensation arrangements* (February, 2011) available at: http://www.fdic.gov/news/news/press/2011/pr11027.html. In similar lines with the FDIC proposal, the SEC issued *Rules on Incentive-based Compensation for Large Broker-Dealers and Investment Advisors* (March 2011); available at: http://www.sec.gov/news/press/2011/2011-57.htm.