

Reforming remuneration schemes in the financial industry: some governance and implementation issues

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Introduction

One of the major and most contentious issues in the current debate on how to restore financial stability is the design of remuneration schemes in financial institutions. Excessive risk-taking by banks was one of the underlying causes of the credit crisis, and it appears that remuneration schemes for key bank personnel (e.g., CEOs, senior management, traders) may have encouraged such risk-taking.

The basic concern is that remuneration schemes have biased decisions towards activities yielding short-term gains and shielded the decision-makers from the downside risk. This problem seems to have gone beyond the executive level in financial institutions, affecting many divisions including the trading room and the business units in which structured finance products were arranged and issued. Employees in certain areas appear to have been more highly rewarded for maximising the volume of transactions and recording up-front profit than for accurately assessing the underlying risk. In addition, the top management of some institutions sought to increase profit by expanding activities which were fast-growing but for which the risk was not well understood. The important role of compensation in the crisis and the need for change are now widely recognised. Indeed, one of the recommendations made by policy-makers at the end of 2008 was for regulators and supervisors to work with market participants to design compensation schemes that avoid rewards for excessive risk-taking.

An illustration of the potential effects of compensation based on short-term profit is the incentive that it provided institutions to issue and securitise (potentially low-quality) loans, rather than holding them on balance sheet. Whereas banks earn origination fees when issuing loans, these fees are typically only recognised over the life of the loan when it is held on balance sheet. In contrast, the origination fee is recognised immediately when the loan is securitised and sold, for example, to an off-balance-sheet entity. Moreover, the bank may earn an additional fee from packaging the loans into the securitised pool. Finally, the bank may be able to record a gain on sale of the loans, thereby “front-loading” the revenues (and the associated bonuses).⁽¹⁾

This article considers some conceptual issues relating to the role of remuneration in financial institutions and discusses current policy proposals in light of these issues. We first observe that remuneration plays an important role in the corporate governance of firms, both nonfinancial and financial. Remuneration is traditionally viewed as one of the key mechanisms for aligning the interests of managers with those of shareholders, thereby helping to resolve agency problems linked to the separation of control and ownership of the firm. Yet, as is discussed in Section 1, the degree to which remuneration will actually succeed in aligning the interests of these two groups will depend upon the power that shareholders have to approve

(1) See Goldman Sachs (2009) for a discussion of other regulatory and accounting advantages of packaging (and re-packaging) loans into structured products rather than retaining them on balance sheet.

(or veto) proposed compensation schemes. This power varies considerably across institutions and countries. In this respect, the design of remuneration schemes may be considered as an agency problem in itself, in that managers may be able to influence “friendly” boards of directors to shape executive remuneration packages to suit their interests. Indeed, one recent observer has suggested that rather than focusing on the symptoms of poor governance (e.g., compensation schemes), it would be preferable to concentrate directly on improving shareholders’ ability to discipline management.⁽¹⁾

Yet, the notion of shareholder interests also includes risk appetite. Financial institutions differ from nonfinancial firms in that excessive risk-taking by the former can have more severe impacts on the financial system and the economy. In fact, the potential externalities associated with the failure of financial institutions provide one of the justifications for regulating them. While prudential regulation is designed to limit risk-taking by financial institutions, the flexibility of financial markets and the speed of innovation mean that regulation will never be able to completely eliminate all excessive risk-taking. It is therefore important to understand the potential links between the compensation schemes for the senior employees of a financial institution and the risk profile of that institution. Prior to the crisis, too little account was taken of the influence of remuneration schemes on risk-taking. Compensation schemes need to provide incentives for behaviour that is consistent with the goals of regulation.

Section 2 discusses the risk appetites of different stakeholders in financial institutions and the implications of aligning managers’ and shareholders’ risk appetites via remuneration schemes. It observes that remuneration schemes which succeed in aligning the interests of managers with those of shareholders may result in either more or less risk-taking than schemes which serve only managerial interests. In addition, since shareholders would prefer a higher level of risk than would debt holders or depositors, it may be desirable to adopt a more conservative approach to the design of remuneration schemes for financial institutions than the traditional corporate governance view of remuneration would suggest. Stated differently, whose risk appetite should remuneration schemes of financial institutions’ managers reflect?

Another feature of financial institutions is that remuneration contracts of non-executive employees (traders, senior employees in investment banking, etc.) are often characterised by a high variable cash component. As a consequence, non-executive personnel sometimes earn considerably higher cash bonuses than the executives. These personnel also often engage in activities that can

have a significant impact on the risk profile of the institution. Moreover, remuneration for non-executive employees is often influenced by the desire to retain staff in the face of labour-market competition. For example, remuneration schemes of traders for institutions’ proprietary trading desks in recent years came to resemble those of hedge funds, whose compensation contracts typically involve an “incentive” component consisting of anywhere between 10 and 25 p.c. of the fund’s return, sometimes above a threshold rate (which can be near the risk-free rate).⁽²⁾ This influence of hedge funds on the compensation of non-executive employees in financial institutions also likely had a “contagion” effect on executive compensation. The resulting implications for compensation schemes and risk-taking within regulated financial institutions suggest that the rise of hedge funds may have played a more central role in the crisis than has previously been acknowledged.

To date, corporate governance codes and regulations have focused on the remuneration of directors and executives, and less attention has been paid to the remuneration schemes of non-executive staff. Disclosure relating to non-executive employees’ compensation is generally not required by regulation nor provided by financial institutions. The circumstances in which special attention needs to be paid to remuneration of non-executives and the degree to which current policy proposals focus on remuneration at all levels within financial institutions are among the issues discussed in the remaining sections of this article.

The article is structured as follows. Section 1 discusses the traditional view of executives’ remuneration in corporate governance and the process through which managerial remuneration is determined. Section 2 considers implications of the pay-setting process for risk-taking in financial institutions and discusses the potential role for regulation. Section 3 discusses a number of current policy proposals relating to remuneration practices in financial institutions and identifies some potential difficulties with respect to implementation, including the challenge of linking compensation to measures of risk.

(1) Charles Calomiris, “Financial Reforms We Can All Agree On”, *The Wall Street Journal*, April 23, 2009.

(2) See, for example, Stultz (2007).

1. The remuneration-setting process: corporate governance and agency problems

Designing a remuneration scheme is not only a means to resolve an agency problem between firm managers and shareholders but is also an agency problem in itself, because of the potential conflicts of interest between shareholders and board members, who in practice set the pay on behalf of shareholders but who may not be an effective agent for the shareholders. Consequently, it is important to understand the process through which remuneration is set and the factors that determine the degree of control shareholders may exert over managers' pay.

The appropriate governance arrangement with regard to remuneration policy should give the responsibility for designing and overseeing pay schemes to independent remuneration committees set up within the board of directors. In addition, it is important to have adequate involvement of shareholders and, in the case of financial institutions, the risk and compliance functions should also play a direct role in setting and moderating remuneration policy. The current crisis has in fact revealed that in the past, management and governance of risk were generally considered to be unrelated to compensation schemes. Little attention was given by banks' control bodies or by supervisory authorities to the implications in terms of risk of the compensation systems in financial institutions.

The remuneration package of executive directors and senior management is normally set by non-executive board members (or supervisory board members in companies with a two-tier board structure⁽¹⁾). In practice, conflicts of interest in compensation decisions arise because executives have the possibility of influencing the decision of the board (supervisory board) on their level of remuneration, particularly in the cases where best practice is ignored and they sit on remuneration committees. A board affected by conflicts of interest may have a poor incentive to bargain in shareholders' interests on the optimal incentive pay.⁽²⁾ Rather, it may use the pay-setting process to influence pay and extract rents. According to best practice in corporate governance, firms should establish within the board a remuneration committee which should be composed exclusively of non-executive directors, the majority of whom should be independent. The role of independent directors or of an independent remuneration committee is to manage conflicts of interest in compensation decisions by bringing an objective view to the pay-setting process. Moreover, these committees should seek advice from independent outside experts.

The possibility for shareholders to adequately manage the conflicts of interest becomes important, especially since managers' interests are often different from those of shareholders. Moreover, as discussed in more detail in Section 2, the risk appetite of managers may also be quite different from that of shareholders. Yet, the actual degree of control shareholders have over executive compensation will depend on a number of factors, including the rights accorded by the corporate governance rules and the regulatory framework to shareholders in the remuneration-setting process, the ownership structure of the firm, and the level of disclosure by the firm of its pay levels and policies. These factors are discussed in the remainder of this section.

1.1 Corporate governance rules

Having a binding vote on directors' remuneration provides shareholders with some control over executive pay. Hence, provided they have sufficient information and expertise to evaluate the remuneration package and sufficient weight in the firm's decisions (i.e. voting rights), shareholders can in fact limit the conflicts of interest arising via compensation structures. When shareholders have only an advisory vote, however, the level of disclosure by the firm becomes important, as it signals the accountability of the firm, and it may also allow shareholders to publicly express an informed (advisory) view regarding the remuneration package or to apply pressure on the board to justify its decisions in terms of pay choices.

The regulatory strategies adopted by European countries differ in the rights granted to shareholders with respect to approval of remuneration schemes.⁽³⁾ Box 1 discusses some of the observed differences, with reference both to regulation and to corporate governance best practice, on the role given to shareholders on remuneration issues.

In general, with respect to the regulatory framework governing directors' and executives' remuneration in European countries, it appears that regulation more frequently covers disclosure of directors' pay, while corporate

(1) Within any institution, there are two functions that must be fulfilled: supervision and management. Some countries (for instance Italy and the UK) use a single-tier board structure, in which both functions are performed within the board of directors. The supervisory function is performed by the non-executive directors of the board and the management function is performed by the executive directors of the board. Normally, shareholders elect board members at the general meeting. Board members appoint executive directors within the board. Other countries (for instance the Netherlands or Germany) use a two-tier board structure. The supervisory function is performed in this case by the board of directors (or supervisory board) and the management function is carried out by the senior management. Shareholders elect the supervisory board members at the general meeting. The supervisory board appoints the senior management.

(2) A board may become passive or "captured" by management for a variety of reasons including: conflicts of interest where directors form the senior management group; board dynamics which often result in deference and politeness towards the chief executive; social ties; and the influence of the chief executive over the appointment of directors.

(3) It should be noted that these rules have been applied only to listed firms.

governance codes have increasingly tended to be applied with respect to the manner in which directors' and executives' compensation is set and disclosed for listed companies.⁽¹⁾

The "comply or explain" principle has formed the basis of the European, code-based approach to corporate governance for listed firms. This approach means that companies adopting the code either confirm that they have complied with the code's provisions or – where they have not – provide an explanation. Differences exist across European countries with regard to adoption of corporate governance codes. In the UK, for instance, the adoption of the *Combined Code* is mandatory under the Listing Rules; companies are required to report on how they have applied the *Combined Code* in their annual report and accounts. In most of the other European countries, adoption of the code is recommended as best practice and companies adopt it on a voluntary basis. However, doubts have recently been expressed concerning the

effectiveness of the principle of "comply or explain" for banks, and sentiment appears to be building for making certain principles legally binding.⁽²⁾

Both regulation and corporate governance code guidance with respect to executive pay appear to have developed earlier and more extensively in the UK (followed by Ireland) than in continental Europe. The tighter regulation in the UK may, to some extent, reflect the ownership structure of UK companies, in light of the fact that diffuse ownership systems give rise to more problems in remuneration-setting. The role that ownership structure may play on shareholders' ability to influence remuneration packages is discussed further in the Section 1.2.

(1) See Ferrarini and Moloney (2005).

(2) In March 2006, the European Corporate Governance Forum, which examines best practices in Member States in the field of corporate governance, issued a public statement on the "comply or explain" principle, which was welcomed by Internal Market and Services Commissioner Charlie McCreevy. There is agreement that "comply or explain" can work only if its surrounding regulatory framework ensures that companies respect the obligation to give reasons for deviations from the applicable corporate governance codes.

Box 1 – Public regulation and corporate governance codes

In several European countries, such as Belgium⁽¹⁾ and Italy⁽²⁾ for instance, shareholders are required by law to approve non-executive directors' fees on a regular basis (normally every two or three years depending on the country and the company). Shareholders, however, are not required to vote on the executives' remuneration package. Nevertheless, share option plans (and similar equity-based plans) require simple majority approval by shareholders prior to implementation.

In Spain and the UK, shareholders have an advisory vote on remuneration schemes. The UK is the most advanced European country in terms of remuneration disclosure and practice.⁽³⁾ As a result of the 2002 revision of the 1985 Companies Act, directors of a listed company are required to submit to shareholders a detailed annual directors' remuneration report for each financial year. The vote of shareholders, however, is purely advisory. The UK also imposes shareholder approval requirements on the adoption of certain option and long-term incentive plans via the Listing Rules. Applicable from 2008, the corporate governance code in Spain recommends that companies submit a remuneration report to shareholders for an advisory vote.⁽⁴⁾

The Netherlands is the only European country (closely followed only by the Scandinavian countries), where, as of 2004, listed companies were legally required to submit the remuneration report for the next financial year and subsequent years for shareholders' approval under a binding resolution.⁽⁵⁾

(1) Under Royal Decrees. The Belgian Corporate Governance Code (Code Lippens 2004, as amended in 2009) contains non-binding provisions regarding executive and non-executive directors' pay, as well as on the level of transparency of the procedure through which executives' remuneration is set and the level of disclosure about directors' remuneration, on an individual basis for all executives and non-executive directors.

(2) Under the Italian Civil Code, Legislative Decree 58/1998. The Italian Corporate Governance Code (Preda Code 1999, as amended in 2006), based on the "comply or explain" principle and adopted by listed companies on a voluntary basis, contains recommendations on directors' remuneration (pay packages aligning the interests of executive directors and shareholders in a medium- to long-term timeframe; majority independent remuneration committee).

(3) Remuneration/incentive schemes in the UK for financial institutions are governed by the following legislation and bodies: the Companies Act 2006, the Combined Code on Corporate Governance, the guidelines issued by the Associations of British Insurers (ABI) and the National Association of Pension Funds (NAPF), UK Listing Rules.

(4) The Unified Code of Good Practices (Código Unificado de Buen Gobierno of the CNMV 2006) for firms traded on the stock market represents the main source of guidelines for the compensation policy in Spain. Compliance with these recommendations is voluntary.

(5) Under the Dutch Civil Code. The Dutch Corporate Governance Code (Tabaksblat Code 2003, as amended in 2008) contains provisions on remuneration policy for directors (supervisory and management board members), disclosure of individual remuneration, and setting up remuneration committees within supervisory boards.

In other countries, such as France, Germany or Switzerland, shareholders have no vote on directors' remuneration, nor on equity-based plans, but do have a binding vote on any capital increase or repurchase of own shares linked to the implementation of share-based plans. In Germany, for instance, a shareholders' vote on equity-based plans is recommended by the corporate governance code, but not all listed companies comply with it.⁽¹⁾ Since 2007, shareholders in France have been able to vote on executives' severance pay.⁽²⁾ In Switzerland, the current provisions contained in the Civil Code are under review.⁽³⁾ The new provisions will strengthen the rights of annual general meetings on compensation issues, by requiring, among other things, that shareholders have a binding vote on compensation packages of non-executive board members and an advisory vote on compensation package of executive board members.

- (1) Directors' remuneration for listed companies in Germany is governed by the following laws/best practices: Stock Corporation Act 1965 (Aktengesetz – AktG), the German Corporate Governance Code (Cromme Code 2002, as amended in 2008), the Commercial Code (Handelsgesetzbuch – HGB), 2005 Management Board Remuneration Disclosure Act (Gesetz über die Offenlegung der Vorstandsvergütung – VorstOG). Remuneration of the members of the supervisory board, in general, is fixed by a resolution of the general meeting by the simple majority or the (higher) majority provided for in the articles of association. The supervisory board fixes the remuneration of management board members.
- (2) L. 2007-1223 (TEPA law of 21 August 2007) governs the severance pay allowances for listed companies ("No rewards for failure"). Under the pressure of government, in October 2008, professionals adopted principles concerning the compensation of executive directors of companies whose shares are admitted to trading on a regulated market. These principles will become effective by 2010.
- (3) Schweizerische Obligationenrecht (OR). The Swiss Code of Best Practice for Corporate Governance (2002, as revised in 2008) is a non-binding, self-regulatory framework established by the Swiss business association "economiesuisse" for listed companies. Recommendations on compensation principally concern the governance process and the structure of variable compensation to be geared to the mid- to long-term performance of the company.

The coverage of corporate governance rules, however, may not be sufficient. While the existing regulatory strategies mainly focus on remuneration schemes for executives and senior management in listed companies, there are no specific legal requirements nor best practice recommendations regarding remuneration of employees at lower hierarchical levels in the organisation. This may be crucial in the case of financial institutions.

In fact, the remuneration contracts of non-executive employees (traders, etc.) in financial institutions are often characterised by a high variable cash component. As a consequence, traders sometimes earn much more than the executives in terms of cash bonuses. Shareholders have no impact on the design of these schemes, which are decided by the business units' managers or by human resource departments and are normally not disclosed. This may not be a problem if senior management's interests are fully aligned with those of shareholders, since in that case it should be in managers' interest to similarly align compensation packages for key employees. On the other hand, to the extent that senior managers' interests are not perfectly aligned with those of shareholders, agency problems associated with the remuneration of non-executive staff may be magnified.

In addition, competition in the labour market can influence compensation packages, and this appears to have been a potentially important factor in recent years for certain key non-executive employees with influence over the risk-taking of the institution. This type of development, however, introduces the possibility that

unregulated financial institutions, such as hedge funds, can exert an indirect influence on the structure of compensation (and activities) of regulated institutions. A study that provides some support for this idea is that of Philippon and Reshef (2009), who compare wages, education and occupations in the US financial and nonfinancial sectors over the past century (1909-2006). These authors observe that the relative rise in the pay and skill levels of finance workers in the US after 1980 was almost identical to that prior to 1930. The analysis suggests that the prime cause of this phenomenon in both periods was financial deregulation. Increases in corporate IPO activities and credit risk were also significant determinants of the relative wage differential between the financial and nonfinancial sectors. In addition, economic "rent" appears to account for between 30 and 50 p.c. of the wage differential observed since 1990. By examining the role of different subsectors of the financial industry, the authors observe that the share of employment and the relative wage both increased rapidly after 1980 in the subsector "other finance" (which includes venture capital, private equity, hedge funds and investment banks), compared to the subsectors "credit intermediation" and "insurance".

1.2 Structure of share ownership

The structure of ownership, or the dispersion of shareholders, will influence the degree to which shareholders can control managerial remuneration. Managers will have more power in firms where share ownership is widely

dispersed and where there is no large shareholder to impose discipline. In the case of dispersed (or diffuse) ownership, one might argue that managers also have more opportunity to fill the board with “friendly” members. This would allow managers to exert influence on the remuneration-setting process and engage in strategies that are suboptimal for shareholders, as they may deviate from the latter’s interests.⁽¹⁾ In such a situation, remuneration schemes might be less performance-sensitive or based on measures of performance that can be manipulated or are easily achieved.

Large shareholders have greater means than dispersed owners to exercise control over managerial compensation. For instance, large shareholders can send a representative to the board of directors or attempt to influence the views of existing board members with respect to the design of remuneration schemes. In addition, in countries where ownership is more concentrated, shareholders may be better able to monitor managers and should also have more incentive to do so in that they suffer less from the collective action problem faced by shareholders under dispersed ownership;⁽²⁾ therefore, there may be less need to rely on the remuneration scheme to align interests. However, large shareholders will vary in terms of their expertise, information, risk appetite, and monitoring capabilities.

1.3 Transparency

The principle of transparency with respect to executive and non-executive directors’ remuneration in listed companies is already well accepted by most countries as good corporate governance. However, different firms and countries apply this principle with varying degrees of intensity, which may also depend on the different ownership structures of listed companies and the ways in which the agency costs problem is perceived in each firm or country. Moreover, even when firms disclose the level of their directors’ remuneration, they usually do not disclose how they actually measure top management performance. Lack of transparency with respect to remuneration is generally justified by confidentiality arguments.

Transparency is even lower for remuneration of non-executive staff. While the existing rules mainly focus on remuneration schemes for board members and senior management in listed companies, no specific disclosure is required by law nor recommended by best practice for remuneration packages of employees at lower hierarchical levels in the organisation. However, the role of disclosure is particularly important in the case of financial institutions, given that the remuneration of certain non-executive staff

may exceed that of executives. As noted above, these pay schemes can in fact have a significant impact on the level of risk-taking of the institution, particularly if the interests of managers who set them are not perfectly aligned with those of shareholders.

Greater disclosure and transparency regarding directors’ and employees’ remuneration and the procedure through which remuneration of executives and other employees is determined could help stakeholders to assess the incentive structure and the extent to which risk-taking is being controlled. Transparency is all the more important given that proposed principles on compensation tend to take the form of general principles and do not provide specific guidelines concerning implementation. These principles recognise flexibility as an important feature, since firms differ in their goals, culture and business models, as well as the regulatory framework and labour markets in which they function. Remuneration policy is still a field in a state of flux, and financial institutions will want to tailor compensation schemes to their own needs. Nevertheless, transparency should facilitate the emergence of best practices, and it may give some power to the principle of “name and shame” in the case of excessive risk-taking or failure to respect the best practices.

To the extent that performance pay schemes will be implemented on a voluntary basis, an ongoing and open dialogue between financial institutions and regulators will be necessary in order to facilitate the development of practices that address both financial stability concerns and the institutions’ need for competitive pay schemes. Effective disclosure will increase firms’ accountability and can sharpen monitoring and enforcement by shareholders, regulators and investors alike.

2. Remuneration and risk-taking

The previous section has discussed the role of remuneration in the context of the agency problem that exists between the shareholders and managers of a firm. To the extent that shareholders have a say in determining managers’ pay, the remuneration scheme can help align the interests of managers with those of the shareholders. On the other hand, to the extent that factors such

(1) See also Bebchuk and Fried (2003).

(2) Collective action problems arise in the dispersed ownership context because shareholders have a common interest in monitoring board and managers’ activities, but no one owner has sufficient private incentive to do it himself, since individual shareholders only receive a small percentage (corresponding to the shareholding) of the total benefits they generate, and monitoring is costly. These problems are exacerbated in the case of executive pay as individual shareholders are unlikely to see great gains from a reduction in pay costs, but they may suffer if management incentives are damaged as a result. In this case, exposure to public scrutiny through increased transparency and shareholders’ voice may induce the board of directors to take greater care in setting executive remuneration.

as lack, or bad implementation, of corporate governance rules, ownership structure or opaque disclosure of pay schemes prevent shareholders from exerting control over remuneration, the remuneration scheme may serve managers' interests. The impact of this situation on the risk profile of the financial institution, however, is uncertain.

An important aspect of the "interests" of shareholders of a financial institution is their risk appetite. This section explores the implications for risk-taking of financial institutions when remuneration schemes are aimed at aligning the interests of managers and shareholders. In order to do this, it is useful first to recall that different stakeholders have differing risk appetites. The optimal level of risk for the financial institution will depend upon the stakeholder whose point of view is being considered. This observation then gives rise to the question of the desirability of aligning managers' and shareholders' risk appetites.

2.1 Financial institutions' stakeholders and their risk appetites

Shareholders are residual claimants on profits and are the formal owners of the bank. Due to the differing payoff structures associated with equity and debt, shareholders and debt holders have differing views with respect to risk-taking. Shareholders may seek to "shift risk", implying for example that the firm will invest in assets that are riskier than those that the debt holders expected. The greater preference of shareholders for risk can be illustrated by considering an increase in the volatility of the firm's business, which is equivalent to a simultaneous increase of the upside and downside risk. While shareholders cash in fully on the higher profits associated with the higher upside risk, they do not incur the additional losses from realisations of the greater downside risk when the firm's revenues are so low that claims of debt holders cannot be met.⁽¹⁾ Hence, shareholders prefer strategies involving a higher degree of risk than is socially desirable. To the extent that management is making the investment decisions and they try to maximise the wealth of shareholders, they will attempt riskier strategies than debt holders would desire.

Debt holders and depositors. Debt holders have fixed claims and only limited control rights, which are typically triggered upon default on debt repayment. Due to the fixed nature of their claims, debt holders do not gain from the increase in the upside risk of a risky strategy but may recover even less due to realisation of the extra downside risk if the firm's revenues do not fully cover the debt repayments. Hence, debt holders are mainly concerned

about the bank's solvency and are averse to a high level of risk-taking. However, they are not able to completely prevent shareholders from taking on risky projects because shareholders have the control rights over the institution. Debt holders often seek to limit excessive risk-taking by including covenants in debt contracts. Depositors can be considered to be uninformed debt holders and may thus be considered to be "represented" by regulators (see Dewatripont and Tirole, 1994).

Regulators are concerned with the impact of bank failure on systemic risk and seek to limit risk-taking by banks that is deemed excessive from a social viewpoint. The specific nature of financial systems, in fact, makes contagion effects more likely and the macro-economic consequences of a shock to the sector more widespread than for non-financial firms.

Managers may be more or less risk averse than shareholders. One may argue that, typically, managers are more risk averse than shareholders, as managers have specific human capital and potentially substantial wealth invested in the firm, and they have limited possibilities to diversify this specific risk, in contrast to shareholders who are assumed to be able to diversify their holdings. This argument implicitly assumes a fixed compensation scheme for managers. The situation can change when managers receive performance-based pay.⁽²⁾ With regard to shareholders' "risk-shifting" discussed above, managers, too, may benefit from the "extra" upside more than they suffer from the "extra" downside and hence might pursue excessively risky strategies. Emphasis on stock price performance in pay packages tends to align managers' interests more closely with those of shareholders. However, managers may be induced to take on even more risk than shareholders would like if the managers are paid with financial instruments that are particularly sensitive to the volatility of the underlying stock (e.g., stock options). Managers and shareholders may also differ with respect to their time horizons. Managers may not see their tenure with the firm as long-term and this may affect their decisions regarding the activities or the strategy of the institution. Finally, these decisions may also be influenced by the managerial labour market and the desire to acquire status.

These observations suggest that shareholders cannot perfectly monitor managers and that a remuneration scheme that succeeds in aligning the interests of managers and shareholders may result in either more or less risk-taking than a managerial remuneration scheme over which

(1) In other words, shareholders can be seen as holding a call option on a firm's stock whose value increases with volatility (Jensen and Meckling, 1976).

(2) See also Devriese, Dewatripont, Heremans and Nguyen (2004) for further discussion on corporate governance of banks and risk attitudes.

shareholders have no control. Variable remuneration above a certain threshold could give managers incentives to take very risky decisions. It is sometimes argued that the pressure on bank managers to maintain shareholder value prior to the crisis pushed them to take on additional risk. It is an open question as to whether this risk was consistent with shareholders' preferences or whether it exceeded shareholders' desires.

2.2 Issues with aligning managers' and shareholders' risk appetites: whose risk appetite should the remuneration scheme reflect?

Given the potential externalities created by bank failures and the greater appetite for risk of shareholders than debt holders, depositors or regulators, one may ask whether it is desirable for bank executives' remuneration schemes to serve to align the interests of shareholders and managers. Alternatively, should remuneration policy for financial institutions be used as a regulatory instrument, designed to limit bank risk-taking perhaps below the level desired by the bank's shareholders? If so, whose preferred level of risk should be the target?

Apart from this normative issue, in practice it may be difficult for shareholders, especially in the case of dispersed ownership, to obtain enough information about remuneration (or business strategy) to judge whether the level of risk of the institution is consistent with their own risk appetite. Furthermore, in the case of dispersed ownership, individual shareholders may have only weak incentives to monitor managers, preferring to free-ride on the monitoring activities of others. In the case of concentrated ownership, large shareholders, when able to exert control, have more power to better align risk-taking with their risk appetite.

In addition, as already noted above, remuneration schemes are often designed to attract, motivate and retain key talent in highly competitive markets. Hence, the structure of compensation may also be influenced by the labour market. One potentially adverse outcome could be a situation where managers or traders take on risky positions or activities in order to influence the short-term performance of the company, receive higher bonuses and thereby increase their value on the labour market. In line with this idea, Sabourian and Sibert (2009) develop a theoretical model that provides an explanation for "how the reward structure in the financial services industry led to a seemingly irrational behaviour of bankers and other employees of financial institutions prior to the financial crisis". Bonus systems that depend on perceived talents, rather than on long-term results, give bankers incentives

to rationally distort their behaviour so that it makes them look competent in the period when they act, even though this may lead to poor results for the firm in the long run.

The potentially significant impacts of risk-taking in financial institutions suggests that there is a need to design compensation schemes that are based on long-term firm-wide profitability and that also take account of regulators' concerns with minimising the risks of systemic crisis which can be triggered by a bank failure.

3. Policy issues

There are currently several policy initiatives underway in Europe to improve corporate governance and compensation schemes as key elements in the effective management of financial institutions and as complements to banking regulation. Table 1 provides an overview of some of the recent proposals relating to remuneration. The proposals are described along the following dimensions: coverage within the financial institution; governance of compensation; alignment of compensation schemes and performance measures; and supervisory oversight and transparency.⁽¹⁾

As can be seen from the table, current policy proposals focus on principles that are important for designing pay schemes that align managers' interests and long-term objectives. Important factors for achieving this include adequate disclosure on remuneration, the balance among different pay package components, the use of appropriate risk-adjusted performance metrics, and the role of independent remuneration committees in setting and overseeing the remuneration policy. However, the proposed guidelines on remuneration schemes tend to be general and often do not provide guidance for supervisors on implementation, as for example with regard to the specific performance measures to be used. In addition, some of the issues discussed in Sections 1 and 2 of this paper do not seem to be explicitly addressed. In particular, the effectiveness of remuneration as a mechanism to align incentives and risk appetites, as well as the question of whose risk appetites should be aligned, is related to the management of agency problems between boards, shareholders, and managers and to monitoring by independent directors, by shareholders, and by regulators.

(1) In several European countries (the Netherlands, etc.), regulatory requirements/principles on corporate governance and more specifically on remuneration schemes are currently under revision.

TABLE 1 PROPOSED GUIDELINES ON REMUNERATION SCHEMES IN FINANCIAL INSTITUTIONS

Policy proposals	<p>Bank of Italy: <i>Regulation on Banks' Organisation and Corporate Governance</i>, March 2008.⁽¹⁾</p> <p>International Institute of Finance (IIF): <i>Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations</i>, July 2008.⁽²⁾</p> <p>de Larosière Committee (de Larosière): <i>Report by the High-Level Group on Financial Supervision, Chaired by J. de Larosière</i>, February 2009.⁽³⁾</p> <p>Committee of European Banking Supervisors (CEBS): <i>High-level principles of Remuneration Policies</i>, April 2009.⁽⁴⁾</p> <p>Financial Stability Forum (FSF): <i>General principles for sound compensation practices in the financial sector</i>, April 2009.⁽⁵⁾</p> <p>The UK Financial Services Authority (FSA): <i>FSA draft code on remuneration practices</i>, March 2009.⁽⁶⁾</p> <p>European Commission (EC): <i>Commission Recommendation on remuneration policies in the financial services sector</i>, April 2009.⁽⁷⁾</p>
Coverage	<p>Bank of Italy: to banks and parent companies of banking groups. The provisions govern the role and functioning of managers and control bodies (bodies charged, with "strategic supervision", "management" and "control" functions) and the relationship between these bodies and the company's structure.</p> <p>IIF: to senior management, investment banking, and wholesale sales and trading of IIF member firms.</p> <p>de Larosière: to management, as well as to proprietary traders and asset managers, in the financial services industry.</p> <p>CEBS: CEBS-regulated firms, to all levels of the organisation and all categories of employees, including members of the management body, with special emphasis on senior employees and other risk-takers and risk-managers in the institution.</p> <p>FSF: to all financial centres; to all bank employees who could impair a bank's financial soundness through their behaviour.</p> <p>FSA: remuneration at all levels in FSA-regulated firms.</p> <p>EC: to risk-taking staff in financial undertakings; a financial undertaking includes, but is not limited to, credit institutions, investment firms, insurance and reinsurance, undertakings, pension funds and collective investment schemes.</p>
Governance of compensation	<p>Bank of Italy: majority independent remuneration committee performs advisory tasks on directors' and managers' remuneration.</p> <p>CEBS: the supervisory body should determine the overall remuneration policy, ideally with the aid of an independent remuneration committee; independent review on the implementation of the pay policy to avoid excessive risk-taking.</p> <p>FSF: board of directors must actively oversee, monitor and regularly review the compensation systems at all levels of the organisation; back-office and risk-control employees should not receive variable compensation strongly linked to high revenue or short-term profits.</p> <p>FSA: a formal remuneration committee should reach independent judgements on the implications of remuneration for risk and risk management; this committee should include at least one non-executive member with practical skills and experience of risk management; the Risk and Compliance functions are required to have a significant input in setting the remuneration for other business units.</p> <p>EC: the board should have responsibility for oversight of the operation of the remuneration policy for the financial institution as a whole with an adequate involvement of internal control functions and human resources departments or experts. Board members and other staff involved in the design and operation of remuneration policies should be independent.</p>

- (1) It contains provisions that aim at strengthening the minimum standards of banks' corporate organisation and governance: clear distinction of roles and responsibilities, appropriate checks and balances, balanced composition of governing bodies, effectiveness of controls, monitoring of all company risks and adequacy of information flows. The corporate governance arrangements adopted by banks and banking groups must ensure full, substantial compliance with these provisions by 30 June 2009.
- (2) The report represents the broad industry agreement on the need to address the many shortcomings highlighted by the market turbulence. It contains seven principles of conduct on compensation practices.
- (3) The de Larosière report analyses the causes of the financial crisis and contains policy proposals on financial regulation and supervision.
- (4) The CEBS has developed five general principles on remuneration policy within banking institutions.
- (5) The FSF Principles for Sound Compensation Practices issued in April 2009 focus on the way the structure of remuneration can create incentives towards excessive risk taking.
- (6) The code contains ten principles followed by guidance on each principle on possible means of compliance. The FSA will use these principles to assess the quality of a firm's remuneration policy.
- (7) The European Commission has issued principles on remuneration of risk-taking staff in financial institutions on 30 April 2009. The Commission has also adopted a Recommendation on directors' pay of listed companies.

TABLE 1 PROPOSED GUIDELINES ON REMUNERATION SCHEMES IN FINANCIAL INSTITUTIONS (continued)

<p>Alignment of pay schemes/performance measures/form of pay</p>	<p>Italy: remuneration schemes must be consistent with prudent risk management and the company's long-term objectives.</p> <p>IIF: compensation policies should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.</p> <p>de Larosière: bonuses should reflect actual performance, assessed over a multi-year framework.</p> <p>CEBS: pay structures should align personal and company objectives over the long term, avoiding excessive risk-taking; performance pay should be based on individual, business unit and the overall company's performance; performance measures for bonus awards should be adjusted for risks and cost of capital; the bonus should contain a deferred component, based on the risk horizon of the performance (no big bonuses awards purely in upfront cash).</p> <p>FSF: compensation should be adjusted for all types of risk, different risk outcomes, and the time scale of the risk; the structure of pay (cash/equity mix, etc.) should be balanced and consistent with the firm's goals and prudent risk-taking.</p> <p>FSA: remuneration policies must be consistent with effective risk management, including long- and short-term risk, cost of capital and liquidity requirements, and should not encourage excessive risk-taking by employees; financial measures should entail the adjustment of profit measures to reflect the relative riskiness of different activities and should relate to more than one financial year; a significant proportion of the bonus award should be paid in a deferred form, with a deferral period appropriate to the nature of the business and its risks, and should be subject to upward-downward performance adjustments over the deferral period.</p> <p>EC: remuneration policies for risk-taking staff should be consistent with and promote sound and effective risk management; they should strike an appropriate balance between the level of the core pay and the level of the bonus. The payment of the major part of the bonus should be deferred in order to take into account risks linked to the underlying performance through the business cycle. Performance measurement criteria should privilege longer-term performance of financial institutions and adjust the underlying performance for risk, cost of capital and liquidity.</p>
<p>Supervisory oversight and engagement by stakeholders Internal/External Transparency</p>	<p>Bank of Italy: the shareholders' meeting must be provided with adequate information on the implementation of remuneration policies; well-designed internal flows of information that allow management decisions to be taken on an informed basis; the Bank of Italy will judge the conformity of compensation and incentive schemes with the set standards.</p> <p>IIF: the approach, principles, and objectives of compensation incentives should be transparent to stakeholders.</p> <p>de Larosière: supervisors should oversee the suitability of financial institutions' compensation policies, in order to avoid excessive risk-taking.</p> <p>CEBS: remuneration policy should be transparent internally and adequately disclosed externally.</p> <p>FSF: supervisors should include compensation practices in their risk assessment; appropriate and timely disclosure on compensation practices (and risk position) toward all stakeholders.</p> <p>FSA: the FSA will use these principles to assess the quality of a firm's remuneration policy, which will be taken into account when assessing a firm's approach to compliance and risk-taking.</p> <p>EC: remuneration policy should be transparent internally and adequately disclosed to stakeholders. Supervisors should ensure that financial institutions apply the principles on sound remuneration policies, taking into account of the nature and scale of the financial institution and the complexity of its activities.</p>

In terms of the institutions covered by the proposals, one notable feature of virtually all of the proposals is that they apply specifically to financial institutions, both listed and non-listed. This signifies a recognition that previous regulatory concerns with compensation and risk-taking, which were usually either implicit or only piecemeal, needed to be transformed into explicit principles.

One of the key and innovative issues tackled by these policies is that within the institution, the principles apply not only to pay schemes for senior management but also to employees at lower levels, particularly those whose

actions may have an impact on the risk-taking of the institution. There appears to be agreement, for example, that the compensation schemes for key nonexecutive staff should no longer be determined by the business unit managers or by human resource departments. The overall compensation policy should be formulated at the top of the institution's control hierarchy and applied at all levels of the institution.

In terms of governance with respect to oversight and decision making, there seems to be broad agreement on the important role of independent remuneration committees in setting and regularly reviewing the remuneration

policies. Most of the proposed principles also recognise the need for including members in the committee who have the necessary expertise in risk management, in order to avoid excessive risk-taking through pay practices. For the first time, the risk and compliance functions are assigned significant input by certain proposals in setting the remuneration for other business units.

With respect to performance measures, many of the proposed guidelines suggest that compensation policies should be consistent with the desired risk profile of the financial institution, over the long-term. In other words, and in particular with respect to performance-related pay, the financial measures on which the variable part of remuneration is based should be adjusted for risk and sensitive to the time horizon of risk. Only one of the proposals suggests that remuneration should be symmetric in risk outcomes (i.e., adjusted in both positive and negative directions as a result of performance).

One specific issue that arises in relation to this discussion is the difficulty of measuring risk. That fact that compensation schemes for financial institutions currently do not make use of risk-adjusted metrics is perhaps due in part to the limitations in measuring risk. Performance criteria used by banks for determining the variable or the equity-based portion of remuneration have tended to include measures such as share performance, gross operating income, net income, revenues, or earnings per share, which may be subject to financial manipulation⁽¹⁾ or do not provide employees with sufficient incentives to consider the risk undertaken.

In principle, there are at least two ways of mitigating excessive risk-taking by employees, and they are not mutually exclusive. One is to put in place effective risk limits that are independent of compensation. The other is to adjust pay for risk, thereby curbing incentives to take excessive risk in the first place. In either case, it is important to assess the risks taken in a reliable fashion and to make sure that the limits that are imposed are effective. Failure by either of these methods to capture the true risk is likely to result in excessive risk-taking. The proposals, by recommending that variable pay is linked to risk, refer to measures of risk and also to measures of risk outcomes. However, they do not offer guidelines regarding implementation. Adjusting remuneration for

risk, while desirable in principle, may be quite difficult to achieve in practice.⁽²⁾

Moreover, one issue which is not explicitly addressed in these proposals is the meaning of the term “excessive” risk, which again raises the question of whose risk appetite should be used as the benchmark.

Finally, concerning disclosure, most policy proposals recognise transparency with respect to remuneration schemes at all levels as important for assessing pay scales and incentive structures. Disclosure should be related to risk management as well and should make it easier for all stakeholders to assess the relation between pay and risk-adjusted performance. At the same time, exposure to public scrutiny encourages the board of directors to take greater care in setting remuneration.

In terms of the possibility for shareholders to review the board’s actions in this area and to react to any potential abuse, only the regulation issued by the Bank of Italy specifically states that the shareholders’ meeting will approve remuneration policies for directors, employees, and external collaborators, as well as equity-based plans.

Conclusions

The current financial crisis has put remuneration schemes in the financial sector at the heart of ongoing debate on corporate governance reform and financial stability. The structure of variable pay schemes is in fact seen as one factor that has aggravated the crisis (and according to some observers, directly contributed to it). Compensation schemes appear to have resulted in excessive risk-taking by financial institutions.

This article has considered some conceptual issues relating to the role of remuneration in financial institutions and discussed current policy proposals in light of these issues. One of the first observations is that remuneration has traditionally been viewed in the context of the corporate governance of firms, serving to align the interests of firm managers and shareholders. Rules that have been developed in this context have generally applied only to the executives of listed firms, both non-financial and financial. In this framework, improving shareholders’ powers to approve or veto remuneration schemes, their incentives to monitor firm management and the information they receive regarding the firm’s remuneration policies will all contribute to the effective alignment of managerial and shareholders’ interests.

(1) For instance, increasing leverage is a technique that can be used to boost earnings per share.

(2) The FSA specifically recommends basing financial performance measures principally on profits, which are a better measure than revenues or turnover from this point of view, but they should be adjusted for risks. Common techniques to adjust profits and capital for risks are based on the calculation of economic profit or economic capital. However, accounting profits do not capture adequately future risks and the FSA acknowledges that a certain degree of judgement in decisions on the performance-related part of remuneration is necessary.

However, the importance of risk-taking in financial institutions, together with their regulated status, raises questions regarding the degree to which the traditional corporate governance approach to remuneration design in financial institutions is actually desirable. Shareholders prefer greater risk-taking than do debt holders and depositors, suggesting that it may be desirable to adopt a more conservative approach to the design of remuneration schemes for financial institutions. For instance, the level of risk that was taken at some institutions prior to the crisis may have been consistent with shareholders' risk appetites, but "excessive" from the regulator's or the social point of view.⁽¹⁾ This issue has received relatively little attention to date.

Another important issue for financial institutions is the link between remuneration schemes for key non-executive staff (such as traders) and the risk profile of the institution. The potential impact of compensation on risk-taking at all levels in a financial institution and the resulting effects on the risk profile of the entire institution argue for formulating remuneration policy proposals specifically for financial institutions. Such proposals should also foresee the integral involvement of risk and compliance personnel in the design and implementation of remuneration schemes within the institution.

The proposals reviewed in Section 3 embody these ideas. They apply directly to financial institutions, both listed and non-listed; they envisage a significant role for the risk management function in the design of remuneration schemes; and they specify that the institution's remuneration policy should apply to all staff engaged in risk-taking activities. These proposals make explicit the role of compensation in the internal risk governance of financial institutions.

Finally, there is a need to design compensation schemes that are based on long-term profitability and that also take account of regulators' concerns with minimising the risk of systemic crisis which can be triggered by a bank failure. In fact, most of the proposals discussed in Section 3 call for linking compensation with risk or with risk-adjusted measures of long-term performance. Yet, the proposals do not provide guidelines for implementation. This is significant, since reliance on imperfect risk measures may not achieve the intended effect and, more importantly, may create arbitrage-like opportunities for taking on risk that is unrecognised by the measures. Adjusting remuneration for risk, while desirable in principle, may be quite difficult to achieve in practice.

(1) As is pointed out in the FSA's Turner report, many senior managers of financial institutions that have suffered from the crisis were large shareholders in their firms and had invested large proportions of their cash bonuses in their firms' shares.

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