Article:

Johnston, A. (2014) Preventing the Next Financial Crisis? Regulating Bankers' Pay in Europe. Journal of Law and Society, 41 (1). 6 - 27 . ISSN 0263-323X

https://doi.org/10.1111/j.1467-6478.2014.00654.x

Preventing the Next Financial Crisis? Regulating Bankers' Pay in Europe

Andrew Johnston

Professor of Company Law and Corporate Governance, School of Law, University of Sheffield

Introduction

This paper offers a critical appraisal of the European scheme that regulates executive remuneration in financial institutions. This scheme is an important part of the wider response to the financial crisis, and an essential complement to the ongoing reforms to the Basel system of banking regulation, because remuneration schemes provide the most important incentives for bank executives to 'innovate' in ways which get around banking regulation. Before the crisis, innovations such as wholesale off-balance sheet financing of loans and the use of complex derivatives increased bank profitability by creating risks which were not visible to regulators or other actors, and undermined the financial stability goal of the Basel system. While the recent revisions of the Basel system specifically target some of these practices, regulation of remuneration is still required to prevent as-yet unidentified practices leading to future financial sector instability.

The main obstacle to the necessary far-reaching reforms is the ideology of shareholder value, which insists that increases in shareholder value within the law can be equated with the common good. This ideology continues to dominate policy debates about corporate governance, despite recent failures, such as Enron, which resulted in massive costs for both shareholders and employee stakeholders, or the various bank failures which led to the current financial crisis, which imposed huge losses on shareholders and taxpayer stakeholders. The driving force behind both of these economic disasters was the practice of paying executives for increasing the share price or return on equity, a practice justified by the ideology of shareholder value. Even though this practice has repeatedly led to enormous social costs, and has been widely identified as a central cause of the crisis, key policy-makers remain in thrall to shareholder value and are reluctant to introduce the regulation which appears necessary. As this article will show, they were happy to leave remuneration primarily to bank boards and shareholders, while the national regulators, who failed to even notice the massive expansion of credit and risk that preceded the crisis, were charged with the impossible task of identifying when remuneration schemes give executives incentives to take 'excessive' risks. Policy-makers even recognised that this regulatory scheme would be likely to fail. This was unacceptable to the European Parliament, which forced a more prescriptive regulatory scheme into the Capital Requirements Directive, maintaining the requirement that national regulators oversee remuneration schemes, but against the backdrop of a quantitative cap on variable remuneration.

This article argues that the cap is a vital addition to the regulatory scheme. In a broader sense the cap demonstrates an important shift in the debate about whether markets or regulation should shape corporate governance. For the first time, policy makers have recognised that prescriptive regulation may be required to prevent companies setting pay in ways that produce unacceptable social costs. This is a significant intervention into an area which has, to date, been left to corporate boards (under the constraints of soft law alone), a policy justified by the assumptions of shareholder value ideology.

The structure of the paper is as follows. The first part examines the contribution of executive pay to the crisis. The second part offers an overview of the original regulatory scheme. The third part critiques the original scheme. The fourth part outlines and evaluates the cap. A brief conclusion follows.

Executive remuneration and its contribution to the crisis

It is widely recognised that the practices and structures of executive pay played a central role in the financial crisis, although there is less consensus on its exact contribution. The De Larosière report concluded that 'Remuneration and incentive schemes within financial institutions contributed to excessive risk-taking by rewarding short-term expansion of the volume of (risky) trades rather than the long-term profitability of investments.'[1] The European Commission noted a 'broad consensus that compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, contributed to the incentives that led to financial institutions' engagement in overly risky business practices'.[2] Elsewhere, it noted that executive pay was 'one of five driving forces of the financial crisis', along with credit rating agencies, and regulatory and supervisory failures.[3] These views are echoed in numerous other reports.[4]

What is lacking from these policy documents and reports is any explanation of *why* remuneration came to be a problem and *how* it contributed to the crisis. Remuneration practices were justified and driven by the ideology of shareholder value, which assumes that, in order to increase social wealth, executives should be prevented from imposing 'agency costs' on shareholders.[5] The most important means of ensuring that executives will further the interests of shareholders is to pay them for doing so. Other interests are assumed to be fully protected by regulation, and it is assumed that regulation is not undermined by pay practices. These arguments were applied to banking without regard for the peculiarities of the sector.

The core function of banks is to issue short term liabilities to pay against long term promises to pay from borrowers. Risk-taking is inherent in banking. Minsky notes that 'commercial banks are the prototypical speculative financial organization' because they engage in the 'short financing of long positions'.[6] Unlike normal industrial companies, banks are able to increase the riskiness of their balance sheets very quickly in ways which are not observable by outsiders, including regulators and shareholders. Increases in risk-taking make banks vulnerable to changes in the economy which affect borrowers' ability to pay, and to changes in financial markets which affect their ability to obtain short-term liquidity to discharge their liabilities. Assuming willing borrowers, there are two main limits on the otherwise virtually unlimited expansion of bank balance sheets.

First, individuals and businesses must be willing to be creditors of banks (that is, hold banks' liabilities). The effectiveness of this first limit is significantly reduced because, in order to ensure the

---

[1] See *Report of the High Level Group on Financial Supervision in the EU*, Chaired by Jacques de Larosière, 25 February 2009, Brussels, Para 24.

[2] Commission Communication accompanying Recommendations on Executive Remuneration, COM(2009) 211 final, Brussels, 30.4.2009

[3] Impact Assessment, Commission Staff Working Document accompanying the Commission Recommendations on Remuneration Policies (SEC(2009) 580, 30.4.2009).

[4] See for example, the Financial Stability Forum's *Principles for Sound Compensation Practices*; the conclusions of the OECD's Steering Group (Kirkpatrick, G, 'The Corporate Governance Lessons from the Financial Crisis' at 12); and *Changing Banking for Good*, Report of the Parliamentary Commission on Banking Standards (London, House of Commons and House of Lords, 2013), particularly at Vol II, para 836 noting that 'Remuneration lies at the heart of some of banks' biggest problems'.

[5] For critical overviews, see A. Johnston, EC Regulation of Corporate Governance (Cambridge, Cambridge University Press), Chapter Two; L. Stout, The Shareholder Value Myth (San Francisco, Berrett-Koehler, 2012).

[6] H. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill Professional, 2008), 231.

stability of the financial system, the state guarantees bank liabilities through explicit and implicit deposit guarantee schemes, and acts as lender of last resort to banks. Unlike normal companies, banks cannot be allowed to become insolvent and default on their liabilities. Second, as guarantor of the banks, the state introduces banking regulation to limit balance sheet expansion and risk-taking, which is absolutely crucial to protecting the public interest because guarantees remove the incentive of bank creditors to evaluate the riskiness of banks.

Shareholder value ideology glosses over these matters of regulation and insists that bank executives should be incentivised to maximise returns to shareholders, just as they are in other types of company. Accordingly, senior executives in financial institutions were remunerated with stock options, which allowed them to purchase shares in the parent company,[7] and bonuses linked to return on equity (RoE). When translated to the banking context, these forms of remuneration encouraged bankers to 'seek bigger and riskier bets.'[8] As Haldane shows, by increasing leverage, banks could increase RoE even while return on total assets remained the same. The other side of those returns was an increase in risk. Executives sought to increase leverage and risk in any way which was not explicitly prohibited by regulation, encouraging bank employees to make riskier loans to meet revenue targets, their conventional concern that borrowers will repay their loans overridden by their 'high-powered incentives'.[9] The effect was to neutralise the best means of controlling risk: bankers are better placed than any other actor (including regulators) to ensure that lending practices are prudent.

The existence of these powerful incentives to increase leverage and risk made banking regulation even more critical. The adequacy of bank capital is regulated internationally by the Basel Accords.[10] Their stated aim is to 'further strengthen the soundness and stability of the international banking system'[11] by controlling risk-taking by individual banks. Banks are required to hold a ratio of capital to risk-weighted assets of 8%.[12] Different types of loans are accorded standardised risk-weightings. For example, under Basel II, loans secured against residential mortgages are risk-weighted at 35%,[13] so banks have to hold capital amounting to 8% of 35%, ie 2.8%, of the total loan. While this allows banks to make £100 worth of loans against £2.80 in capital, which is a leverage ratio of over 35, it does prevent unlimited expansion of balance sheets, and so places some limit on risk-taking.

Yet even this was considered too prescriptive, and Basel II permitted national regulators to authorise larger banks to use the 'Internal Ratings-Based Approach' (IRB) and determine risk-weightings for themselves using their own internal models. For example, if an IRB-authorised bank used a model which placed a lower risk-weighting on residential mortgages than the standardised 35%, then they would be able to back those loans with even less capital.[14] Relatively little is known publicly about banks' internal models – and their risk-weightings in particular – because, despite their central role in this system of public interest regulation, they are considered proprietary. This is problematic because the IRB method creates a number of risks: first, that the credit risk assumptions made by

---

[7] L. Bebchuk and H. Spamann, 'Regulating Bankers' Pay' 98 Georgetown Law Journal 247, 258

[8] A. Haldane, 'Control Rights (and Wrongs)' (2012) 32 Economic Affairs 47, 50-1.

[9] See for example, FSA, Final Notice to Peter Cummings (PJC 01301), 12 September 2012, concluding at 4.32 that in HBOS 'staff were incentivised to focus on revenue rather than risk' and at 4.48 that 'under Mr Cummings' [executive] direction all areas of the business focused on revenue generation.'

[10] See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Comprehensive Version), June 2006 (Basel II).

[11] Basel II, para 4.

[12] Id, para 40.

[13] Id, para 72. In Basel I, residential mortgages were risk-weighted at 50%: see *International Convergence of Capital Measurement and Capital Standards*, July 1988 updated to April 1998, Annex 2, page 18.

[14] There were de minimis provisions which applied to banks' models and prevented them from concluding that their loans were risk-free. For example, banks were not permitted to assume a probability of default of below 0.03% (Basel II, para 331).

the banks might turn out to be inaccurate; second, there is 'potential for intentional distortion of model inputs'; and third, there is a 'dearth of useful historical data' on which to base the risk models, making it difficult to backtest the models.[15] As Satiyajit Das presciently noted, the IRB approach created the 'illusion of precision', whilst in reality 'most of the inputs were either unavailable or difficult to verify.'[16]

It is not known whether banks deliberately manipulated their models to allow them to take on more risk. What is clear is that executives had employment contracts which gave them powerful incentives to increase return on equity by taking on more risk, which would be easier if their banks' internal models indicated that their operations were less risky than the standardised approach. Northern Rock's response to the FSA authorising it to use the IRB Approach is an interesting example. The UK House of Commons Treasury Committee concluded:

> 'Northern Rock was told by the FSA that its application for a Basel II waiver had been approved... Due to this approval, Northern Rock felt able to announce... an increase in its interim dividend of 30.3%. This was because the waiver and other asset realisations meant that Northern Rock had an "anticipated regulatory capital surplus over the next 3 to 4 years".'[17]

In his evidence to the Select Committee, Chief Executive Applegarth said that Northern Rock's IRB approval 'saw our risk weighting for residential mortgages come down from 50% to 15%. That clearly required less capital behind it, so that links to why we were able to increase the dividend.'[18] He confirmed that executives' 'salaries incentives were linked to profit growth and total shareholder returns'.[19] As they were intended to do, these incentives encouraged executives to increase the dividend, and with it, their remuneration.

More generally, remuneration schemes encouraged banks to take advantage of the inevitable lacunae and gaps in the Basel Accords. For example, Basel II did not prohibit banks from moving loans off their balance sheets into bankruptcy-remote entities such as conduits and structured investment vehicles. This 'shadow banking system' freed up regulatory capital to back fresh loans, thereby increasing return on equity. It doubled in size between 2002 and 2010,[20] yet 'regulators seemed only vaguely aware of what the banks were really doing.'[21] Crucially, however, banks still bore a – difficult to quantify – measure of residual responsibility for these formally separate entities through the provision of lines of credit, guarantees and 'liquidity backstops', which committed them to bring the assets back onto their books in the event of financial difficulties. These devices were binding either legally or for reputational reasons.[22] Similarly, banks used credit default swaps (essentially insurance) to reduce or even eliminate the need to hold any capital against securitised loans.

This shadow banking system was the locus of a massive build-up of risk outside the scope of the Basel Accords. The motivation to establish these complex structures was provided by executive remuneration schemes that rewarded increased return on equity. Whilst formally complying with

---

15 D. Tarullo, Banking on Basel: The Future of International Financial Regulation (Peterson Institute 2008), 153.
16 S. Das, Traders, Guns & Money (Harlow, Pearson Education, 2006), 159-60.
17 See House of Commons Treasury Committee, 'The Run on the Rock', Fifth Report of Session 2007-08, HC 56–I and II, 26 January 2008, paras 43-44.
Available online at http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf
18 Ibid, response to question 689
19 Ibid, response to question 540
20 European Commission, Green Paper on Shadow Banking (COM(2012) 102 final, 19.3.2012) at 4.
21 G. Tett, Fool's Gold (London, Abacus, 2010), 116.
22 R. Hetzel, The Great Recession: Market Failure or Policy Failure? (Cambridge, Cambridge University Press, 2012), 181; G. Gorton and N. Souleles, 'Special Purpose Vehicles and Securitization' in M Carey and René M. Stulz (eds), The Risks of Financial Institutions (Chicago, University of Chicago Press, 2007), 551.

Basel II, banks could increase the riskiness of their operations, and with them, interdependence and systemic risk. The Basel Accords were not the only aspect of banking regulation that failed. As noted, national regulators failed too, doing nothing about the massive build-up of leverage and risk in the banking system, or the exponential growth of the shadow banking system. The FSA concedes that 'many aspects of [its] approach to the supervision of systemically important firms in the pre-crisis period were inadequate'.[23]

The Basel Accords are undergoing revision to deal with some of the shortcomings revealed by the crisis,[24] requiring banks to hold more capital against off balance sheet exposures, and more high quality liquid assets. In the UK, responsibility for prudential supervision has been reallocated to a newly constituted subsidiary of the Bank of England, the Prudential Regulatory Authority. However, these essential reforms must be complemented by regulation of remuneration because the new rules address the causes of the *last* crisis, and will inevitably contain gaps. Without regulation of remuneration, the same incentives will remain to exploit those gaps, increase complexity and take on more risk wherever this is not explicitly prohibited.

The ideology of shareholder value, coupled with a belief that market-correcting regulation cannot be justified, creates powerful pressure on policy-makers not to intervene in pay, even though pay practices incentivised behaviour which created enormous social costs. Indeed, policy makers have not even attempted to quantify the costs to taxpayers of bank bailouts and compare it with the benefits to social wealth in the form of returns to shareholders. However, the IMF estimated in 2009 that the UK's government's support to the banking sector would total some 81.6% of 2008 GDP, with an upfront cost of 18.9%.[25] Even excluding the wholesale destruction of shareholder value wrought by the financial crisis, these costs to the state are surely many times higher than total shareholder returns during the boom years.[26] In any other area where the past social costs of a practice so far exceeded its benefits, there would be a prima facie case for prohibiting the practice entirely. However, policy-makers continued to resist this conclusion, framing the issue of pay in financial institutions as the technical one of 'optimal contracting', that is, aligning bankers' incentives with the long term interests of shareholders,[27] an interest which is never articulated in corporate governance processes, but the pursuit of which has repeatedly resulted in enormous social costs.

---

[23] Financial Services Authority, The Failure of the Royal Bank of Scotland at 29.

[24] See Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (rev June 2011). A non-risk-weighted leverage ratio of 3% should come into force in 2018, restricting banks to maximum leverage of 33 times equity. Most banks had leverage below this level when the GFC began, with even Lehmann Bros only at 33.7 times equity.

[25] See IMF Staff Position Note, 'Fiscal Implication of the Global Economic and Financial Crisis', 9 June 2009 at 7. There are 'significant uncertainties' about the medium term net costs of the support for the banking sector, which will depend on whether assets recover their pre-crisis values; the IMF estimated that, for the advanced economies of the G20 which on average spent 5.8% of GDP on supporting financial institutions, the average medium term cost of the crisis was likely to be some 2.5% of GDP. However, the UK's costs would be likely to be considerably higher than this, given that its upfront spending was much higher.

[26] Discussing the 1982 banking crisis, which was dwarfed by the current crisis, Taleb notes that 'large American banks lost close to all their past earnings (cumulatively), about everything they ever made in the history of American banking—everything.' See N. Taleb, The Black Swan (London, Penguin, 2007), 43-4. Similarly, it has been estimated that the pay of the top bankers in Iceland amounted to around ISK6bn, some 0.1% of the total losses to Iceland (five times GDP, or ISK 7trn).

[27] See similarly *Changing Banking for Good*, op cit, n4, which recognises that 'unbalanced incentives... pervade banking' but seeks to correct them with ex post remedies such as enforcement schemes and deferral of bonuses (Vol I, paras 167 and 234), even whilst admitting that 'risk and remuneration are subjective'. It insists that 'individual rewards should be primarily a matter for banks and their owners', and 'encourages shareholders to take a more active interest in levels of senior remuneration' (Vol I, paras 208 and 180), yet

Overview of the original regulatory scheme

Background to the EU initiatives

The most important policy documents display a marked reluctance to consider prescriptive regulation, and an astonishing willingness to contemplate the failure of their weak regulatory proposals, despite the enormous social costs this would entail. The De Larosière Report[28] reflects the dominant aversion to regulatory intervention, emphasising the need 'to re-align compensation incentives with shareholder interests and long-term, firm-wide profitability', but stressing the importance of not 'impinging on the responsibility of financial institutions in this field'. It concluded that 'supervisors should oversee the adequacy of financial institutions' compensation policies', and should require boards to reassess them where they conflict with 'adequate risk management or are systematically encouraging short-term risk-taking'.[29] Similarly, the Financial Stability Forum (FSF) began by emphasising the 'theoretical' role of 'stock-based compensation' in motivating employees 'to act in the interests of the firm's shareholders'.[30] Despite the clear failure of both boards and shareholders to control risk-taking in the build-up to the crisis, the FSF insisted that remuneration schemes should remain primarily the responsibility of the board, whilst shareholders should also contribute to effective governance. In their view, the perennial corporate governance problem of shareholder passivity can be overcome merely by disclosure of the 'general design philosophy of the system'; the scheme's risk adjustment provisions; and the way the scheme links compensation to performance over time.[31] While 'rigorous and sustained' supervisory review of compensation practices is essential, 'the industry must experiment' with risk adjustment.[32] The FSF openly acknowledges that risk-takers will still be able 'to boost short-term performance' by concealing tail risks, and accepts that risk adjustment will only work 'if the tail risks the employee business unit takes are measured well'.[33] The challenges that tail risks, and uncertainty more generally, pose for prudential oversight of remuneration are discussed below.

The Commission's Recommendations

In its March 2009 Communication, 'Driving European Recovery',[34] the Commission responded by announcing that it would issue two recommendations and propose legislation to include 'remuneration schemes within the scope of prudential oversight.'[35] Those Recommendations provide 'principles and best practices' addressed to Member States to ensure that companies implement 'pay policies which reward long-term sustainable performance', and emphasise the need for 'culture change in the businesses concerned'.[36] The accompanying Impact Assessment

later admits that 'it would be a mistake to expect greater empowerment and engagement of shareholders to lead to the exercise of profound and positive influence on the governance of banks.' (Vol II, Para 666).

[28] op cit, n1.

[29] Id, paras 118-120.

[30] FSF, *Principles for Sound Compensation Practices* (April 2009), 10. This body is now known as the Financial Stability Board.

[31] Id, 14.

[32] Id, 9.

[33] *Implementation Standards* (April and September 2009), 12 and fn10.

[34] COM(2009) 114 final, 4 March 2009.

[35] Id, 7-8.

[36] Id, 2.

demonstrates that the crisis has not changed the Commission's operating assumption that remuneration should be understood in shareholder value terms.[37]

The Recommendation on Remuneration Policies in the Financial Sector[38] claims that it will 'increase the likelihood' that risk management and control systems will become effective.[39] Member States should ensure that financial institutions have remuneration policies which promote 'sound and effective risk management' and do not 'induce excessive risk-taking'.[40] Bonuses should be deferred, with the deferred element 'taking into account the outstanding risks associated with the performance'; boards should determine remuneration relying on members with 'relevant expertise and functional independence from the business units they control'; and national competent authorities should monitor whether these principles are followed.[41]

Like the FSF Principles, which it implements, this Recommendation offers no meaningful guidance on how regulators are supposed to ensure that remuneration schemes identify and 'take into account the outstanding risks associated with the performance'.[42] We will see below that a good deal of guidance has been published since the Recommendation, but it too fails to address this question.

Reform of the Capital Requirements Directive

The most important aspect the original regulatory scheme is the amendment of the Capital Requirements Directive (CRD III),[43] to implement the De Larosière and FSF recommendations.[44]

Information Disclosure

CRD III requires financial institutions to disclose certain information about remuneration to the national regulator, which is then to transmit that information to the Committee of European Banking Supervisors (CEBS),[45] which is to use it to benchmark remuneration practices at EU level.[46] Institutions are also required to make public disclosure of information on an annual basis about remuneration policies and practices for staff 'whose professional activities have a material impact on its risk profile'.[47] The hope is that shareholders will take a more activist approach in relation to matters of remuneration than they have in the past.[48]

---

[37] 'Whether, and the extent to which, an executive director, will fully pursue shareholders' interests depends on finding an appropriate way to motivate the executive director', with agency theory suggesting that 'the performance-based pay contract, which links pay to the company's wealth via performance indicators, is the most appropriate way.' (op cit, n3, 7).
[38] Commission Recommendation on remuneration policies in the financial services sector, C(2009) 3159, 30.4.2009. The second Recommendation (C(2009) 3177, 30.4.2009) deals with remuneration in listed companies generally and is not considered further here.
[39] Id, Para 5.
[40] Id, Para 3.1.
[41] Id, Paras 4, 6 and 10.
[42] Id, preamble, para 14
[43]See Directive 2010/76/EU 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 (OJ L 329, 14.12.2010). The CRD implements the Basel Accords in the EU.
[44] In turn, in the UK, the FCA's Remuneration Code implements the prudential oversight requirements of CRD III.
[45] Such is the pace of change that the CEBS has been superseded by the European Banking Authority.
[46] Art 1(3)(b) of Directive 2010/76/EU inserting Arts 22(3)-(5) into Directive 2006/48/EC
[47] Article 15 is added to Annex XII of Directive 2006/48/EC.
[48] Directive 2010/76/EU, preamble paras 17-18.

Prudential oversight of remuneration schemes

CRD III requires national competent authorities to ensure that financial institutions have 'robust governance arrangements', including 'remuneration policies and practices that are consistent with and promote sound and effective risk management'.[49] Supervisors are to 'assess whether those policies and practices are likely to encourage excessive-risk-taking',[50] with Member States giving them 'power to impose financial and non-financial penalties or other measures'.[51] Annex V sets out a number of principles, requiring, inter alia, that remuneration policies do not 'encourage risk taking that exceeds the level of tolerated risk of the credit institution'; that at least 40% of variable remuneration should be 'deferred over a period which is not less than three to 5 years' and 'correctly aligned with the nature of the business, its risks and the activities of the member of staff in question'; and that remuneration should only be paid or vest 'if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.' These principles reflect both the FSF Guidelines and the Commission's Recommendation, while the more detailed components, such as the deferral requirements are taken straight from the Basel Committee's *Compensation Principles and Standards Assessment Methodology*.

The CEBS was charged with drawing up guidelines to assist national supervisors, and delivered its *Guidelines on Remuneration Policies and Practices* in December 2010. The most important section of the *Guidelines*, headed 'Specific Requirements on Risk Alignment',[52] advises national regulators to ensure that institutions 'take into account both current and future risks that are taken by the staff member', 'whether on or off balance sheet',[53] and that their risk adjustment measures include 'difficult-to-measure' risks.[54] Regulators should ensure that institutions 'consider the full range of current and potential (unexpected) risks associated with the activities undertaken', including 'severe risks or stressed conditions' and make ex ante risk adjustments which take account of them.[55] The *Guidelines* recognise that ex ante risk adjustments may fail 'due to uncertainty',[56] making ex post adjustments of remuneration, such as malus or clawback,[57] 'absolutely necessary' to allow financial institutions 'to adjust... variable remuneration as time goes by and the outcomes of the staff's actions materialize.'[58] Accordingly, regulators are encouraged check that 'ex post risk adjustments are defined and detailed.'[59]

The difficulty with reliance on ex post adjustments is that, if institutions and regulators fail to identify risks ex ante, and those risks materialise causing banks to fail, various stakeholders, including states, and ultimately taxpayers, will be exposed to losses. While ex post adjustments are a useful means of aligning executive incentives with the shareholder interest, they do nothing to

[49] Id, Art 1(3)
[50] Id, preamble, para 16
[51] Id, Art 1(4)
[52] *CEBS Guidelines* at 37-69
[53] Id, 49 and 51
[54] Id, 51. The Guidelines strongly echo the BCBS *Compensation Principles and Standards Assessment Methodology*: see for example paras 40-1.
[55] For example, at 52, the *Guidelines* discourage the use of profits, volume, share price, total shareholder return and other measures which 'do not incorporate explicit risk adjustment and are very short-term', and so 'are not sufficient to capture all the risks of the staff member's activities'.
[56] Id, 59
[57] Malus 'operate[s] by affecting the vesting process and cannot operate after the end of the deferral period', while clawback 'typically operates in the case of established fraud or misleading information'. These measures should be 'based on both quantitative measures and informed judgment' (Id, 67-8).
[58] Id, 66
[59] Id, 69.

protect stakeholder interests if excessive risk-taking results in bank failure. This point is discussed in more detail in the next section, which assesses the CRD III regulatory scheme.

The CEBS was also required to lay down 'specific criteria' for determining the ratio between fixed and variable pay. The *Guidelines* note that 'the higher the possible variable remuneration, the stronger the incentive will be to deliver the needed performance, and the bigger the associated risks will become.'[60] The CEBS recommended that policies set out 'explicit maximum ratio(s) on the variable component in relation to the fixed component'[61] but declined to 'decree one optimal relationship between the fixed and variable components'.[62] In so doing, the CEBS left identification of an appropriate ratio almost entirely to the discretion of individual financial institutions.[63] This put the onus back on national regulators to determine the appropriateness of those ratios from a prudential perspective.

The Impact Assessment which accompanied the original proposal justifies this approach, blaming the 'lack of express requirements to supervise risks arising in connection with remuneration policies' for the 'insufficient supervisory oversight' of remuneration before the crisis.[64] In other words, it assumes that, if prudential regulators had been explicitly instructed to ensure that remuneration did not create incentives for excessive risk-taking, they would have been able to achieve this and demand appropriate changes. A perfunctory cost-benefit analysis simply assumes the scheme will be effective and head off the 'risk that systemic shocks of a similar scale [occur] in the future', 'subjecting a wide range of stakeholders, including bank creditors (e.g. depositors), shareholders, employees, borrowers and taxpayers, to unprecedented economic costs'.[65] The 'most material expected benefit' of the scheme is the 'containment' of banking losses in the future, and this 'by far outweighs the costs' of the scheme. Comfortingly, the scheme will not create a danger of a 'drain of talent abroad' which may 'impact on the supply of talent to the industry'.[66] The crucial assumption here – which is questioned in detail in the next section – is that regulators will be able to identify incentives for excessive risk-taking. For now, it is worth noting that, without that assumption, the same cost-benefit analysis could be used to justify an absolute ban on bonuses in financial institutions.

In summary then, CRD III assumes that preventing remuneration from contributing to the next financial crisis requires only that prudential regulators be given a clear instruction to ensure that financial institutions do not incentivise excessive risk-taking. This neat and unintrusive solution will allow banks to attract talent and continue to generate shareholder value with the least possible interference. As we will see in the next section of this paper, there are considerable doubts about whether this regulatory scheme would be likely to prevent enormous social costs in the future.

Assessment of the CRD III Regulatory Scheme

[60] Id, 45.
[61] Id, 46.
[62] Id, 46.
[63] Para 23(l) of Annex V of Directive 2010/76/EU states that 'Credit institutions shall set the appropriate ratios between the fixed and variable component of the total remuneration'.
[64] Commission Staff Working Document, Impact Assessment (SEC(2009) 974 final, 13.7.2009), 18. It notes that investment firms were arguably already obliged 'to ensure that remuneration policies and practices do not expose the firm to unmanageable risks that exceed the level tolerated by the firm', but that these obligations were 'insufficiently explicit'.
[65] Id, 20.
[66] Id, 32.

This regulatory scheme is wholly inadequate. It depends on national supervisors identifying incentives for 'excessive risk-taking', and then making appropriate adjustments to remuneration policies to correct those incentives. This section will argue that policy-makers gave national supervisors an impossible task.

Its first main weakness is that it depends on regulators being less deferential to the practices of banks than they were before the crisis. For example, the House of Lords Economic Affairs Committee noted that 'supervisors and regulators were very reliant upon risk assessments provided by credit ratings agencies, or created by banks using their own mathematical risk models.'[67] For its part, the FSA accepts that it offered 'insufficient challenge to management assumptions and judgements', as well as failing to address obvious risks arising from RBS's dependence on 'non-sterling short-term wholesale funding'.[68]

A number of explanations have been advanced for the various pre-crisis regulatory failures. The first is (cognitive) regulatory capture.[69] Regulators internalised the models put forward by banks and believed the story that financial markets were allocating risk away from the banking sector towards those who were willing to hold it.[70] The second focuses on information asymmetry and cognitive limitations. The banks' operations were simply too complex for regulators to grasp and control effectively.[71] The third emphasises implicit and explicit political considerations. Implicitly, there are powerful political pressures not to intervene in a banking boom, because credit growth drives asset prices and GDP upwards, creating wealth effects that benefit incumbents. Explicitly, at least in the UK, the regulator was instructed to have one eye on the competitiveness of the financial sector in discharging its regulatory function.[72] The dynamics of the integrated European market probably increased the political pressure on national regulators not to intervene because banks respond to even a hint of unilateral regulatory intervention with threats to relocate.

A more fundamental weakness of the CRD III scheme is that, even if they are willing, it is very unlikely that regulators will be able to distinguish between remuneration which encourages 'normal' risk-taking, which is the core business of banks that fund long-term assets with short-term liabilities, and remuneration which encourages 'excessive' risk-taking. First, regulators must obtain sufficient current information about the activities and exposures of banks. Gathering this information will be

---

[67] House of Lords Select Committee on Economic Affairs, *Banking Regulation and Supervision* (HL Paper 101-I), para 18.

[68] Op cit, n23, 27 and 23.

[69] This expression appears to have originated with Willem Buiter in 'Lessons from the global financial crisis for regulators and supervisors', Paper presented at 25th Anniversary Workshop of the Advanced Studies Program of the IFW, Kiel on "The Global Financial Crisis: Lessons and Outlook". See also J. Kwak, 'Cultural Capture and the Financial Crisis' in D. Carpenter and D. Moss (eds), Preventing Capture: Special Influence in Regulation, and How to Limit it (Cambridge, Cambridge University Press, forthcoming 2013).

[70] See E Engelen *et al*, After the Great Complacence: Financial Crisis and the Politics of Reform (Oxford, OUP, 2011), Chapter Two, and 178-9, arguing that 'regulation develops within broader frameworks of understanding, where narratives frame what is possible or necessary'. Even by 1986, Minsky was remarking on the influence of neoclassical economics, noting that 'fashionable economic theory argues that markets are stable and efficient', which puts the regulators 'under pressure to allow financial practices to evolve in response to "market forces"', notwithstanding their 'right and responsibility' as lender of last resort and insurer of the financial system to 'control and prevent business practices that tend either to create or to worsen financial crises' (op cit, n6, 51-2).

[71] Op cit, n67, 18.

[72] Op cit, n23, 29, noting that the FSA operated in a context 'which entailed... a strong focus on the importance of the "competitiveness" of the UK financial services sector and so of avoiding "unnecessary" regulation' a focus which 'reflected in part' section 2(3) of the Financial Services and Markets Act 2000, which instructed the FSA to 'have regard to' the proportionality of benefits and burdens, and the possible adverse effects on competition of its activities.

expensive: the complexity and interdependence of the existing financial system, with special purpose vehicles, securitisation, tranching of cash flows and widespread use of derivatives will make tracing the various cash flows and the ultimate allocation of risk very time-consuming. Willem Buiter doubts that this is even possible, but adds that, even if it were, the regulator in this scheme would face an almost impossible task:

'Understanding the effect of a heterogeneous collection of individual employment contracts on the risk-return performance of the whole bank is a complex task that may well be beyond the ability of the regulator.'[73]

However, the problems run deeper than this: the scheme glosses over the fairly well-known economic distinction between risk and uncertainty. Under uncertainty, the parties can foresee the different possible outcomes but do not know the distribution of probabilities, because 'there is no valid basis of any kind for classifying instances'. Under risk, they know the distribution of probabilities either a priori or statistically.[74] The regulatory scheme emphasises the importance of including 'difficult to measure' risks within the scope of oversight, forcing the issue into a conventional risk management framework, in which regulators use information about past distributions of outcomes in order to quantify the future risks facing banks. This is entirely unconvincing as regards tail risks, which are ultra-rare but very costly events. Taleb, for example, argues that the rareness of tail risk events makes it impossible to assess the likelihood of their future occurrence.[75] Is it really plausible that regulators will be able to evaluate the probability of tail risk events such as closure of securitisation markets or the failure of systemically important counterparties to derivative transactions? If it is not, regulatory risk assessments are almost certain to be incorrect.

Going further, Keynes reserved the term 'uncertain' for matters for which there is 'no scientific basis on which to form any calculable probability whatever'.[76] The complexity and opacity of financial markets, the constant quest for 'innovation' in response to incentives, and the interdependence of financial actors make it impossible even to identify *how* the system might fail, let alone calculate the probability of this. Past data is not merely insufficient to identify the likelihood of tail risks; it is irrelevant in light of the constant changes in the institutional structure of markets. Before the last crisis, the massive increase in securitisation, the rise of the credit default swap and changes in the risk-weightings of various assets under the Basel Accords created unidentifiable dangers for the stability of the financial system.[77] As we saw above, these developments were driven by remuneration practices, which incentivised executives to evade regulation and increase return on equity.

If financial markets are characterised by uncertainty, regulators cannot distinguish between 'normal' and 'excessive' risk-taking. Minsky divided loans into 'hedge finance', where the parties expect the cash flow from the assets to service interest and repayment obligations, and 'speculative and Ponzi finance', where the parties do not expect adequate cash flow and will be dependent upon access to financial markets to fund principal and interest payments respectively. While this scheme is

---

[73] Op cit, n70, 23 and 38. Buiter's preferred solution is a binding shareholder vote on remuneration.
[74] F. Knight, Risk, Uncertainty, and Profit (New York, Cosimo, 2006, originally published 1921), 225.
[75] See for example, N.N. Taleb, 'Black Swans and the Domains of Statistics' (2007) 61(3) The American Statistician 1.
[76] J.M. Keynes, 'The General Theory of Employment' (1937) 51 *Quarterly Journal of Economics* 209. In a similar vein, see G. Shackle, 'Economic Theory and the Formal Imagination' in Epistemics and Economics: A Critique of Economic Doctrines (New Jersey, Transaction Publishers, 2009), 3-4.
[77] Zalm, for example, argues that the creation of the securitisation market amounted to a 'regime change' in which 'all the statistics of the past become irrelevant', but which was 'overlooked by investors and risk-managers'. G. Zalm, 'The Forgotten Risk: Financial Incentives' (2009) 157 De Economist 209, 210.

fundamental to understanding the causes of financial instability, it cannot be used as the basis for regulation. The category to which a particular loan is assigned will change over time, being based on the expectations of the parties, which evolve in line with the broader productive economy, which itself is strongly influenced by the lending activities of banks and their effect on the supply of broad money. As Minsky puts it, 'the risks bankers carry are not objective probability phenomena; instead they are uncertainty relations that are subjectively valued.'[78] Since objective probabilities cannot be assigned to the chances of default on particular loans, the regulator's assessment of whether risks are 'excessive' will be as subjective as those of the bankers who made the original loan. Accordingly, the factors which led to regulatory passivity in the build-up to the crisis are likely to come back into play, leaving banks very broad scope to determine how executives are to be remunerated.

We saw above that, in their technical documents, policy makers recognise the difficulty of making ex ante adjustments for 'difficult-to-measure' and tail risks, and that these issues should be addressed by means of deferrals and ex post adjustments instead. For example, the BCBS recognises that 'ex ante risk adjustment is less likely to work effectively' where risks are 'difficult to measure, to model or are simply not known at the time of the award', but suggests hopefully that 'deferral *could* help reduce incentives to take such risks'.[79] In other words, the BCBS recognises that some risks cannot be prevented by ex ante risk adjustment, and that deferral and ex post adjustments to remuneration will be required. Ex post adjustments and deferral certainly accord with notions of justice, and realign the interests of risk-takers with those of shareholders. However, they will not prevent banks from becoming insolvent if risk-takers take excessive risks that are not picked up on by regulators. Nor will they help if moral hazard leads risk-takers to decide to take the chance of an ex post risk adjustment in order to benefit from the massive upside of a particular action, knowing that their losses will not exceed their bonus. This is a grave weakness from the perspective of preventing social costs: if, as seems likely, ex ante risk assessment is incomplete, and those risks eventuate and imperil the financial system, deferral and ex post adjustment will do nothing to change this.[80]

Recent events highlight the limitations of a regulatory scheme that relies on ex post adjustments. The Financial Times reported that remuneration committees in financial institutions are imposing more ex post adjustments to 'strip staff of awards they received for past performances that no longer look so favourable'. Over the last three years, 'big European banks... have enforced clawback dozens of times' in relation to excessive risk-taking which ultimately produces losses, such as JP Morgan's massive losses on a credit derivatives position, as well as in relation to frauds of various kinds, such as the LIBOR fixing scandal or pension mis-selling, and for breaches of money-laundering regulations.[81] None of these risks were picked up by bank remuneration committees, or by regulators who were overseeing the banks' remuneration schemes in line with the CRD, yet the actions which led to these losses were arguably incentivised by remuneration schemes. It is fortunate that JP Morgan's derivative losses did not bring down the bank, because if they had, enforcing clawback on the errant traders in question would have done nothing to protect taxpayers and other stakeholders from further catastrophic losses.

[78] op cit, n6, 267
[79] BCBS, 'Range of Methodologies for Risk and Performance Alignment of Remuneration', Para 37, emphasis added.
[80] The recent recommendations of the Parliamentary Commission for Banking Standards suffer from the same weakness: longer deferral and the threat of ex post confiscation of bonuses in the event that a bank needs a bail out will not prevent the enormous social costs of a bank bailout should one become necessary (see op cit, n4, Vol I, paras 168 and 245).
[81] 'Banks ready to claw back more bonuses', *Financial Times*, 27th August 2012. In its *Range of Methodologies* paper, op cit, n79, the BCBS notes at para 21 that 'most clawbacks are triggered only when the firm learns that information previously provided by an employee was misstated, or when the firm learns that the employee had violated internal policies'. This is not entirely reassuring.

The reluctance to intervene prescriptively in remuneration is best explained by reference to the ideology of shareholder value, which assumes that it is possible to draft an incentive contract which will perfectly align the interests of executives with those of shareholders; once that contract is written, the common good will be achieved with no need for any regulatory intervention. This is an aspect of the wider belief and operating assumption of policy-makers that markets self-correct and that the social benefits of contracts exceed their social costs, whereas regulation only makes things worse. It is testament to the strength of that ideology that, even after the social costs occasioned by the financial crisis, policy-makers preferred explicitly to contemplate the probable failure of ex ante risk adjustment, rather than consider more far-reaching regulatory intervention. CRD III could have prohibited particular metrics, or even stock options altogether, as the Commission once canvassed.[82] Less prescriptively, it could have required bonuses to be paid in subordinated debt, aligning the incentives of executives with more risk-averse creditors,[83] or in a broader basket of the bank's securities.[84] In refusing to approach bank remuneration practices in a more precautionary way, CRD III created the conditions for the political backlash discussed in the next section.

2013 Reform of the CRD: A Cap on Variable Remuneration

In the event, the flawed CRD III regulatory scheme proved not to be the last word on remuneration in financial institutions. The European Parliament's Economic and Monetary Affairs Committee proposed an important amendment to a draft directive (CRD IV) consolidating the provisions of the Capital Requirements Directives into a single directive and regulation, implementing certain aspects of Basel III and making changes to risk governance.[85] The amendment provided that 'in order to avoid excessive risk taking, the variable part of the remuneration should be limited to one time the fixed income. The fixed income should be set in a manner that in case of a claw back, it will still be sufficient to ensure a proper remuneration of the employee.'[86] The Financial Times reported that Parliamentary approval at first reading was likely, and that the Parliament was 'in an unusually strong bargaining position', with 'solid cross-party consensus' behind it.[87] It also received cautious support in the Liikanen Report, which recommended that consideration be given to 'further restrictions (for example to 50%) on the level of variable income to fixed income'. It added that a 'clear regulatory cap' on remuneration would 'substantially ease the task of the supervisory authorities in screening out undesirable remuneration policies.'[88]

---

[82] European Commission, *Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies* (COM(2010) 284 final, 2.6.2010), 18.
[83] F. Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation' 105 Northwestern University Law Review 1205.
[84] Op cit, n7.
[85] See Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (COM(2011) 0453).
[86] Preamble para 48, Report of EP on proposed directive, 30 May 2012, PE 478.506v02-00 A7-0170/2012. Article 90(2a) then provides that 'The Commission shall come forward by the end of 2012 with a legislative proposal setting a fixed workable ratio between the fixed and variable components of the remuneration in the financial sector.'
[87] 'Banks bow to EU over limit to bonuses', Financial Times, 13 June 2012.
[88] *Final Report of the High-level Group on reforming the structure of the EU banking sector*, Brussels, 2 October 2012, 79 and 106.

At the time of writing, the Council had reached political agreement on CRD IV.[89] For the most part, CRD IV simply transposes national prudential oversight of remuneration policy from CRD III, and sets out the same guidance. It includes a new – albeit less than prescriptive – provision that 'up to 100% of the total variable remuneration shall be subject to malus or clawback arrangements', in particular where 'the staff member... participated in or was responsible for conduct which resulted in significant losses to the institution'.[90] However, by far the most significant change is the cap on variable remuneration of 'senior management, risk takers, staff engaged in control functions' and certain other employees,[91] which is imposed by law, rather than being left to individual financial institutions under prudential regulatory oversight.[92] CRD IV also draws a functional distinction between fixed remuneration, which is supposed to reflect 'relevant professional experience and organisational responsibility... as part of the terms of employment', while variable remuneration should 'reflect a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description.'[93]

As under CRD III, institutions are still required to set 'appropriate ratios' between fixed and variable remuneration, but CRD IV then specifies that 'the variable component shall not exceed 100% of the fixed component of the total remuneration for each individual', with Member States free to set a lower maximum or to allow shareholders to approve a higher maximum percentage of up to 200%.[94] Detailed rules are laid down regarding the process of shareholder approval. The financial institution should make a proposal to shareholders, which must be justified by reference to information about the number of staff involved and its likely impact on 'the requirement to maintain a sound capital base.' Shareholders must then approve the proposal by unfamiliar (at least to English company lawyers) supermajorities of 66% where 50% of shares are represented, or 75% where less than 50% of shares are represented.[95] The national competent authority must be informed of the proposal and its justification, as well as the shareholder decision. This information can then be used for benchmarking.

Assessment of the CRD IV Reforms

The decision to cap variable pay in this way has been strongly criticised by financial sector lobby groups.[96] However, the decision can also be justified as follows. It was not acceptable to leave ratios between fixed and variable pay to financial institutions under prudential regulatory oversight because of the difficulties discussed above. The frequency of significant ex post adjustments since

[89] See Council of the European Union, Interinstitutional File 2011/0203 (COD), 7746/13, 26th March 2013, available online at http://register.consilium.europa.eu/pdf/en/13/st07/st07746.en13.pdf (checked 26 June 2013)

[90] Art 90(1)(l).

[91] The EBA is currently consulting on criteria by which to identify categories of staff who 'have a material impact on the institution's risk profile': see EBA, Consultation Paper EBA/CP/2013/11, 21.5.2013.

[92] See Art 90(1)(f)

[93] Art 88(2)(fa). Contrast PwC's evidence, cited in *Changing Banking for Good* (op cit, n4, Vol II, para 843), that 'a "bonus" is not an added extra for outperformance. It is part of an employee's expected total pay if they and their business area perform adequately.'

[94] There is also some further flexibility, with Member States permitted to allow institutions to apply a discount rate (to be set by the EBA) to up to 25% of variable remuneration as long as it is paid in instruments deferred for at least five years. This may have been introduced in response to the UK's solitary opposition to the provision: see 'Bonus Cap is a Bad Omen for Britain', *Financial Times*, 18th February 2013.

[95] Directly concerned staff may not exercise any voting rights they may have: Art 90(1)(f)(d).

[96] For example, the Association for Financial Markets in Europe warned that the cap created 'a risk of material unintended consequences for the European economy.' See 'Bankers fight new EU cap on bonuses', Daily Telegraph, 12 May 2012.

the financial crisis suggests that pay practices are still incentivising extreme risk-taking, and that regulators are not picking up on this ex ante. A cap on bonuses will not prevent financial institutions from giving incentives to their risk-takers to increase profitability and therefore shareholder returns; however, it will eliminate the current practice of financial institutions giving their bankers incentives to increase risk indiscriminately in pursuit of ever higher returns on equity and associated personal rewards; to hide risks in complex off balance sheet structures; and to game the Basel Accords in other, as yet unknown, ways. This is very important because the financial crisis showed that the hidden risks that accompany these activities cannot be detected by institutional investors, regulators or boards. It is strongly arguable that the best way of eliminating them is to take away the incentive to create them.

It should also be recognised that these new rules will be likely to result in higher fixed pay, which will eat into shareholder returns in years where profitability is low. The effect of this might be to trigger shareholder activism, something which has been strikingly lacking both before and since the crisis.[97] In other words, remuneration would go from being a means to correct for the passivity of shareholders to being a mechanism for spurring them into action. If the European Union is able to agree on the Commission's promised proposal to give shareholders in listed companies a binding say on pay,[98] this would strengthen shareholders' capacity for activism and therefore complement the cap. Finally, the cap will reduce the difficulties facing national regulators when they attempt to identify incentives for excessive risk-taking, and will avoid the problem of regulators taking a passive approach and falling back on the ideology of shareholder value when confronted with the radical uncertainty inherent in this area. Accordingly, from the perspective of preventing social costs, the Parliament's amendment is to be welcomed.

Finally, proposals to regulate bankers' pay are commonly met with threats to relocate key bankers and even bank headquarters to other jurisdictions.[99] It is unclear whether the threat to relocate headquarters is credible, given the interdependence between banks and the states, with states controlling the currencies in which banks' assets and liabilities are denominated, and backstopping the banks in the name of financial stability. It is also far from clear that other states with regulatory regimes that appeal to bankers would be willing to backstop the liabilities of banks where they are denominated in foreign currencies.

Conclusion

Minsky emphasised the need for regulators 'to control, constrain, and perhaps even forbid the financing practices that caused the need for lender of last resort activity'; if they did not do this, they would essentially validate the practices that caused the last crisis and create the conditions for the

[97] Some accounts emphasise the role of shareholders actually pressing banks to take on more risk before the crisis: see *Changing Banking for Good*, (op cit, n4, Vol II, para 665) and De Larosière (op cit, n1, para 24), while few shareholders avoided the 'herd instinct' (id, para 112). This would certainly be in line with the incentives provided by limited liability: see Haldane (op cit, n7, 49). While bonuses have fallen in the years since the crisis in UK banks, total remuneration has not, because fixed pay has risen, and institutional investors have done nothing to challenge this shift, despite the much vaunted 'shareholder spring': (op cit, n4, Vol II, paras 106-110 and 824).

[98] Commissioner Barnier stated publicly that he would propose a directive before the end of 2013. At the time of writing, the proposal was unavailable, but some reports suggested that it would give shareholders a power to fix the maximum ratio between fixed and variable pay, and between the highest and lowest paid workers in the company. See http://www.worker-participation.eu/Company-Law-and-CG/Latest-developments/European-Commission-proposal-on-say-on-pay.

[99] See for example, 'Swiss vote for corporate pay curbs', Financial Times, 3 March 2013.

next one.[100] Given widespread recognition that executive remuneration in financial institutions contributed significantly to the financial crisis, it is perhaps surprising that it took so long for regulators to get to grips with the practice of executive pay in financial institutions. This article has argued that the ideology of shareholder value, and an associated aversion to regulation, was the principal obstacle to more far-reaching intervention in remuneration practices. Its influence can be seen in the CRD III, which gives regulators an impossible task: they have to make ex ante adjustments to remuneration schemes by reference to dangers that are fundamentally uncertain. It was explicitly recognised in guidance given to regulators that these ex ante adjustments would be likely to fail, and that ex post adjustments would be required. The apparent readiness of regulators to contemplate another serious misalignment between bankers' incentives and the public good so soon after the last one is astonishing. The hand of shareholder value ideology is clearly visible here: it conflates protection of the shareholder interest with the public good, two interests which part company when the taxpayer is exposed to the cost of clearing up after another financial crisis. Ex post adjustments of remuneration can do much to realign executive remuneration with shareholder returns; however, if executives respond to their incentives by increasing bank risk-taking in ways which are not apparent to regulators and cause their banks to become insolvent, this will do nothing to protect the taxpayer from catastrophic losses.

Accordingly, the European Union's proposed cap on bonuses is to be welcomed. It is certainly a crude piece of regulatory intervention, which expresses public outrage at the return of business as usual in banks, and will lead to distortions. However, it also shows that, after the crisis, it is no longer tenable to argue that bankers' incentive contracts are a private matter, which can be left to bank boards, subject only to a fragile system of oversight by under-resourced and pliant regulatory authorities. The cap removes the unlimited upside given to bankers to take and conceal risks, safe in the knowledge that most of the downside will accrue to shareholders and the taxpayer. If, as many predict, it leads to fixed pay moving higher, it may even force large shareholders to take on the activist role that has been expected of them for so long.

[100] Op cit, n5, 59.