Regulating executive compensation in the financial service industry

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1. Introduction- Financial crisis and sector overall societal importance

As L. Bebchuk, A. Cohen and H. Spamann calculate in their article "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", in said period executives of cited financial institutions received compensation worth $1.4 billion and $1 billion, and top five managers in the entities were paid $300 million and $150 million respectively. The numbers, contrasted with the wide impact of the financial crisis that broke out in 2007, raise a question whether such generous remuneration schemes encouraged extensive risk taking and misconduct that brought many banks and financial institutions of the time on the verge of bankruptcy and put at risk the stability of the financial sector, and with that, stability of everyday life of the society that entrusts banks with its savings.

The outbreak of the global financial crisis (GFC) reminded all stakeholders of the significance of the role financial institutions play in the economy. Their primary focus is facilitating the flow of funds between the ultimate lender and the ultimate borrower- in other words, between households that are willing to invest their surplus money and those that seek additional funding (Adrian & Song Shin, 2010). Banks traditionally bear a significant societal role, as they guard deposits of millions of households all around the world and guarantee easy access to one's savings.

The global financial crisis is considered to be one of the deepest economic downfalls in recent history. Between 2007 and 2012, numerous financial institutions collapsed or had to be nationalized. Equally many required extensive financial support from the governments, utilizing taxpayers' money (Helleiner, 2011). The steps taken by the governments at the time reflected the "too big to fail" (TBTF) doctrine. An idea that can be understood in two complementing ways (Moosa, 2010). Firstly, according to this school of thought, thanks to their immersive size, some financial institutions are simply too far-reaching, internally diversified, and economically powerful on the market to fail (Moosa, 2010). Alternatively, TBTF reflects conviction that some entities simply cannot be allowed by the government to cease existing due to their importance for the economy and society (Moosa, 2010). Should they fail, the cost of filling the void left behind would

simply be catastrophic. The too big to fail concept does not encompass smaller and local financial institutions that are (mostly) left out of the scope of regulation and therefore of this report.

The financial crisis first started in the United States, initiated by the fall of several hedge funds and widespread market panic initiated in the summer of 2007, when markets begun to question financial health of American and European financial institutions heavily involved with mortgage-based financial products (Helleiner, 2011), such as MBS, Mortgage Based Securities (Adrian & Song Shin, 2010). The unrest was caused by the bursting of the housing bubble on the American market and an immediate sharp fall of real estate prices, which in turn caused the instability in financial institutions that used mortgage-based financial products as important constituents of their balance sheet. As a result, in 2008 American investment bank Bear Sterns had to be rescued by the US government, two biggest US mortgage lending entities, Fannie Mae and Freddie Mac were placed under "conservatorship" due to extensive losses they were facing, and investment bank Lehman Brothers bankrupted (Helleiner, 2011).

A single most important cause of the financial crisis cannot be easily identified. Experts, however, propose three main factors that help explain the origin and severeness of the GFC: increased borrowing by banks and investors, erroneous policies and regulations in the financial sector, and extensive risk taken by the management (RBA, n.d.). The problem of excessive risk accepted by bankers has also been profoundly described by L.A Bebchuk and H. Spamman in their article "Regulating Bankers' Pay". The paper identifies that connecting bank executives' pay to short-term performance of the institution allows for a rapid bonus cash-in, even before long-term effects of the decisions taken become visible, and encourages taking additional risk and myopic behavior. Additionally, bankers' risk appetite is fed by a lack of symmetry between potential gains and losses which create a moral hazard. The imbalance can be easily seen in the following simplified example – a bank utilizes capital equal to $10M and guards deposits of $50M, its executives face a decision that may with an equal probability bring a gain or a loss equal to $20M. In the event of success, a bank attains an additional $20M and raises its capital to $30M; in the opposite scenario – it loses all its capital ($10M) and the rest has to be covered by the depositors.

The global financial crisis of 2007-2012 shook the global economy and overturned the financial situation of many households all around the world, evoking insecurity in financial institutions which regulators and governmental bodies quickly sought to diminish. This was done through financial bailouts and increased regulation, of which the following report discusses the latter. The report aims to analyze the topic of executive compensation in financial institutions and its theoretical background. It seeks to identify the main problems regarding executive compensation in the financial sector, present their root causes and describe applicable post-crisis regulations. Finally, we look at the possible consequences, both intended and unintended, of implemented regulation, such as the UK Remuneration Code and EU bonus cap and reflect on their beneficiality in practice through financial theory and academic research. The objectives of regulations are compared to what has taken place in the sector in practice after their implementation.

2. The role of executive compensation

Executive compensation contracts are part of the governance internal to a firm that includes, among other things that often are industry-specific, provisions guaranteeing salary and benefits, a short-term bonus plan based on the manager's ability to attain certain performance goals of the corporation, and an equity-related long-term incentive plan. Additional compensation based on some measure of firm performance in combination with salaries is typically paid to top managers all over the world, whereby compensation plays an important role within firms' governance structure. (Rehnert, 1985; Roe, 2004.)

Executive compensation is an institution used for alleviating the agency problem in publicly traded companies with a separation of ownership and control. The objective is mainly to reduce vertical governance problems (Roe, 2004). The continuously rising level of compensation for top executives has issued a concern of "overcompensation" and subsequent calls for regulation. This has led to the imposition of numerous disclosure requirements, reforms, and legislation (Murphy & Jensen, 2018). According to Rehnert (1985) and highlighted by other researchers such as Sepe (2011), the more pressing issue is the incentives created by compensation and the fact that existing compensation plans exacerbate the separation of ownership and management. The design of compensation for executives is hindered by a two-dimensional moral hazard problem. The

manager should be incentivized to make the optimal amount of effort as well as choose the optimal level of risk, which previous legislation has failed to convey. (Sepe, 2011.)

To induce effort, i.e., incentivize managers to strive towards the direction of the shareholders' interests, has previously been the main "issue" for both practitioners and researchers to which performance-based compensation was said to be the answer. The financial crisis is a focal turning point in the executive compensation debate. The problem of risk emerged and the established argument (use of equity-based compensation in addition to a fixed salary) led to short-term excessive risk-taking. Regulators also started to combat that issue, but the presence of a two-dimensional moral hazard problem has not been considered in such a design of efficient compensation. (Sepe, 2011.)

One part of the moral hazard problem is linked to the agency problem within a firm. The shareholders (principals) are unable to monitor the actions taken by the managers (agents) which creates an environment where shirking, entrenchment and extraction of private benefits are made by the manager who has incentives to pursue her own interests. Managers are averse to taking action that could impose costs on their interests, without considering the effect on the firm – by researchers called the effort problem. If financial pay is guaranteed, managers don't have any reason to bear additional costs imposed by increasing their effort. Therefore, compensation should align the shareholders' interest with the managers' as the managers then will maximize profits and reach an optimal level of effort. However, the shortcomings of searching for such an optimal effort by the managers, when they in fact often act in a suboptimal way, are harming social welfare. By choosing projects that do not incur a cost for the manager, alternative projects that maximize the value of shareholder claims are overlooked. (Sepe, 2011.)

The other part of the moral hazard problem is the problem of excessive risk-taking and underinvestment, i.e., the problem of inefficient risk-taking. Both over- and underinvestment create, in the same way as suboptimal effort, reductions in welfare. Even though consequences such as jeopardizing the efficiency of all compensation are prevalent when ignoring or limiting the discussion of risk to underinvestment within compensation design, that is exactly what has happened in previous research. Underinvestment has been used as justification for using more

equity incentives, and the aim is to hinder the possibility of a manager transferring wealth from shareholders to debt holders. Overinvestment is optimal for managers whose financial rewards are linked to equity value and shareholders of companies with outstanding debt. In that case, the creditors to a firm are not able to distinguish whether the debtors engage in overinvestment and as a result, all debt is priced on the average risk of overinvestment. Following that is an increase in the cost of debt for all debtors and other social costs appear. In other words, a high level of debt leads to a willingness for both the shareholders and the managers to take more risk than is socially efficient, which especially with performance-based compensation leads to overinvestments and externalities for debtholders. (Sepe, 2011.)

The problem of such overinvesting became evident in the aftermath of the financial crisis and the focus on executive compensation design became to strengthen the long-term incentives. A shareholder-centered approach provides only partial solutions to the moral hazard problem, whereby Sepe argues for a stakeholder-center approach. Further reasons why shifting to a stakeholder viewpoint is especially interesting in terms of the banking sector, as banks inherently have a large debt component and therefore are subject to severe concerns about excessive risk-taking. (Sepe, 2011.) In the following sections of this report, the focus will be on the financial service industry and regulation within it for that reason.

As stated earlier, in the financial services industry executives' bonus pays were tied to short-term incentive plans which resulted in them taking higher risks, but these risks' consequences were visible only in longer time horizons (Bebchuk & Spamann, 2010). The enormous risk taking, and the remuneration levels were raised before the financial crisis (Hilscher et al., 2021). Executives received significant bonus payments, arguably at the cost of society. Therefore, there was a clash between the executives and their benefits and costs and society's benefits and costs (Kleymenova & Tuna, 2016). Another problem was that because the largest banks were not allowed to fall due to the TBTF policy, governments were seen as 'protectors' of executives, who were ultimately not made to bear the risks they took. Lastly, it was usual for banks to take more risks since their operations were constructed to be levered and adding more risk was not considered to ultimately make a difference. (Bebchuk & Spamann, 2010.) These problems are generally attempted to be minimized through regulation. Johnston (2014) states that if there are no regulations of

compensation in place, the same incentives will be left in place and will therefore encourage executives to take risks in the future.

3. Regulation of executive compensation from the bundle perspective

Both executive compensation and local laws and regulations are important institutions that try to tie managers' actions together with the actions and desires of shareholders, but at the same time, it is important to note that there are other institutions part of corporate governance as well. Examples of institutions with such objectives are, among others, markets, the board of directors and information disclosure etc. (Roe, 2004.) In an open systems approach, used by researchers such as Aguilera et al. (2008), corporate governance institutions both interrelate with external and internal strategic resources and interact with each other. The former is what Aguilera et al (2008) call contingencies and it explains how e.g., a firm's life cycle stage and internal capabilities make the effectiveness of one particular institution, in our case compensation and regulation, more or less effective as a governance tool. Garcia-Castro (2013) mentions studies that adopt a contingency approach in order to find trade-offs. They argue that managerial compensation might work as a substitute for board monitoring in certain risk and strategy conditions.

The latter (the fact that institutions interact) is explained by Aguilera et al (2008) as the complementarities existing within the governance structure of a firm that creates the overall bundle. For example, executive pay incentives are especially in an Anglo-American system complementary element together with information disclosure, takeover markets, and independent directors. Disruption in one element negatively affects the other complementary elements as they mutually enhance the ability of effective corporate governance. In terms of compensation and compliance with regulations, there are also large systematic costs that affect each firm's cost-benefit analyses. Aguilera et al (2008) point to the fact that many, or at least two as Garcia-Castro (2013) argue, institutions need to be implemented at the same time in order to limit the opportunistic behaviors of the managers. However, both the contingencies and complementarities (i.e., bundles) are what make firms' different paths and trajectories unique in their aspiration for effective corporate governance – the essence of equifinality. All told, it is important to note the actual small part of a larger whole institutions such as compensation and local laws in and of

themselves incur, and that it is in fact its interaction and interdependencies with a specific organization and environment that essentially makes the difference.

4. Regulation of executive compensation in the financial services industry

4.1. Introduction: Regulation as a corporate governance institution

After the financial crisis, there have been arguments that the executives' incorrect compensation customs were in some part responsible for the crisis. Since then, especially in the financial services industry, there have been many suggestions for regulating executive pay. (Core & Guay, 2010.) The aim of regulation is to govern and control the executive compensation in the financial services industry by e.g., preventing compensation schemes where extremely high risk-taking is encouraged and schemes where the losses resulting from risky decisions made by executives to be not only carried by the external stakeholders such as governments. In the USA and Europe for example, it has been suggested to have regulations which would alter and supervise the executives' pay composition or level (Kleymenova & Tuna, 2016).

The idea of regulation is basically to have an executive compensation scheme which also takes into consideration society as a large, which usually bears the consequences of losses in the end. The second idea behind regulating executive compensation in the financial services industry, is to have regulations in place which would hinder unrecognizable customs which could lead to new crises (Johnston, 2014). Hilscher et al. (2021) states that the aim of regulators is to set risk levels to the remuneration schemes which would also be optimal from the society's perspective. However, there are still policy makers who think that the shareholders should be the priority and the policy makers can be reluctant to decree necessary laws (Johnston, 2014).

4.2. EU regulation

Placing shareholders first has been a popular mindset amongst policy makers hence decreeing regulations has not met the requirements which some find necessary. Compensations schemes were largely left to shareholders and board members to decide on. However, at the same time policy makers found that this compensation system was unlikely to work, which wasn't admissible

to the European Parliament. Hence, in the Capital Requirement Directive was included a demand that the national regulators must monitor pay and reward systems whilst having a compensation cap regarding variable pay. (Johnston, 2014.)

In 2013, the European Union approved a new regulation, referred to as the EU bonus cap, regarding bank executives' variable pay compared to total compensation. The main objective was to restrict the amount of the variable compensation (Hilscher et al., 2021). This incentive cap had an impact to the compensation of employees, which were interpreted as having a material impact on the institution's risk profile and employees with annual compensation more than 500 000 euros or who worked in senior positions of the company (Kleymenova & Tuna, 2016). Some consider the bonus cap, which restricts the variable portion of pay, an acceptable remuneration policy since it is argued that having limitless bonus pay will result in excessive risk-taking to gain bigger profits.

The EU bonus cap applied to all banks operating in the European Union, capped the ratio of variable and fixed pay at the one-to-one level, with flexibility to increase the ratio to one-to-two with supermajority shareholders approval. (Kleymenova & Tuna, 2016.) The variable compensation pay should not exceed the fixed compensation amount when having one-to-one ratio, meaning the variable pay should be the same amount as the fixed pay amount, or if Member States of EU has permitted then the variable compensation pay portion can be higher but the maximum level being still 200 % of the fixed compensation pay (2013/36/EU).

However, in the directive 2013/36/EU there is a statement that the compensation pay portion which is variable should be 100 % under clawback or malus arrangements. So, in the EU they do not only regulate the remuneration policy's variable pay portions, but they also regulate the possibility of having these variable pays to be 'pulled back' if necessary. According to Johnston (2014) the caps however don't suspend the institutions of rewarding employees based on increases in shareholder profits, but they will disallow the financial institutions of implementing reward schemes that would encourage enormous risk taking.

Additionally, in the Directive 2013/36/EU it's stated that the compensation practices should take into consideration e.g., the institution's values and targets, and that the compensation schemes

should not result in risk-taking which is not able to be carried by the institution. The compensation schemes should be assessed and based on long run performance, and the payments of the compensation schemes, which are based on company's performance, should be distributed in time horizons which take into consideration the institution's business cycle. The compensation practices should also be checked annually. (2013/36/EU.)

4.3. US regulation

Similar to the European cap for bonuses, one prominent regulation in the US that has been a cornerstone for the evolution of executive pay all over the world since the 1980's is the Section 162(m) rule including a 1-million-dollar deductibility cap on the top executive officers in all publicly traded corporations. The section was expanded under the Trump administration and previously established exceptions for performance-related pay were eliminated. Another key regulation with the same originating decade and objective – limiting the amount of pay companies are allowed to deduct as business expenses in the corporate tax, is the so-called golden parachutes. They are regulated through Section 280G and 4999 of the tax code (Murphy & Jensen, 2018).

Another distinct regulation in the US is the "Say on Pay" policy which includes the right for nonbinding advisory shareholders to vote on executive compensation. The policy was signed into law in 2009 and applies to companies receiving assistance from the government under the treasury's troubled asset relief program ("TARP") which later was amended by the American Recovery and Reinvestment Act of 2009 (ARRA). (Murphy & Jensen, 2018) TARP imposed restrictions on executive compensation with a focus on the financial industry and the program has been reflected in many subsequent US legislations (Bebchuk & Sparmann, 2010). In terms of banks, however, researchers such as Bebchuk and Spamann (2010) argue that increased attentiveness to common shareholder views, making compensation more aligned with their interests, will not exclusively eliminate the managers' incentives to take excessive risks.

After the Great Depression, the most comprehensive regulation aimed at the financial industry in the US is the Dodd-Frank Wall Street Reform and Consumer Protection Act. The measures include attempts to address public concerns over executive compensation. Compensation committee and risk committee rules, say-on-pay and say-on-golden-parachutes provisions and restrictions on

compensation structures are examples of policies that the act either developed or initiated. The Act requires, for example, all publicly traded companies to get approval on the executive compensation arrangements by the shareholders (compared to earlier when the approval only applied to TARP companies). The act also regulates limits on executive pay, similar to the bonus cap mentioned earlier in this section. (Sepe, 2011.)

In addition, drawing on the previously stated fact in this report – that excessive risk-taking can have especially large consequences within the financial sector – regulation on clawbacks is the final key aspect in US regulation of executive compensation notes in this report. In order to combat the problem of managers' overinvestment, one part of the Sarbanes Oxley act intends to develop the use of clawback provisions. CEOs and CFOs were under the initial Sarbanes Oxley act required to recompensate the company for bonuses, profits realized from selling shares and equity-based compensation received during the next 12 months after the filing of financial statements that are being restated as a result of corporate misconduct. This policy was deemed ineffective, and the regulation was further strengthened. The Securities and Exchange Commission (SEC) became more aggressive in its supervision after the financial crisis and forced companies to act on clawback rules more broadly. The provision was also further developed in the Dodd-Frank Act, applying now to all current or former executive officers and any payment made in a three-year period after a restatement of financial statements. (Murphy & Jensen, 2018.)

4.4. UK regulation

The UK Remuneration Code, implemented in August 2009 initially for large banks and later all financial institutions with some flexibility due to proportionality criteria, seeks to curb manager risk-taking behavior by changing the time horizon of compensation, introducing risk-adjusted incentive-based pay and reducing cash-based compensation. The code focuses on bonus compensation, requiring at least 50 % of bonuses be deferred for at least three years and have vesting conditions attached. The rule applies to executives receiving more than 33 % of total remuneration in variable pay and whose total remuneration exceeds 500 000 pounds, thus affecting the pay of a wider range of employees, not just top management. Due to proportionality criteria, it

does not affect all firms equally. Proportionality criteria allows for less onerous criteria for smaller banks. (Kleymenova & Tuna, 2016.)

The United Kingdom was the only EU member state that voted against the proposal of EU wide regulation of financial service sector compensation (the EU bonus cap). The UK also appealed the European Parliament decision at the European Court of Justice but dropped the appeal, bringing bonus caps to effect in the UK starting from 1st of January 2015. (Kleymenova & Tuna, 2016.) Although, Brexit will allow for the UK to move away from the widely opposed principle. The UK government proposed to scrap the cap on bonuses inherited from the EU on the 24th of September 2022 (Le Monde). UK regulators will move to consult the public on the proposition in the following months. (Reuters). What makes the UK and its regulation relevant in the discussion of EU financial service sector is the significant role it plays, particularly London, as a financial centre despite Brexit induced power-shifts.

4.5. Optimal regulation

Legislating executive compensation in the financial services industry is not an easy task. The numerous regulations that have been implemented in the US as well as in Europe and their proposed versus actual consequences show that regulation as an institution within corporate governance is not as straightforward as it might seem. If regulations are too 'loose' it could result in inordinate risk taking or if regulations are too tight it can lead to avoiding taking risks (Hilscher et al., 2021). It's good to note that when banks are more 'important' due to their impact on society (e.g., possible losses' amount), regulating these banks is more beneficial to social welfare (Hilscher et al., 2021).

Hilscher et al. (2021) state that there have been many suggestions as to how risk-taking could be restrained, out of which few are mentioned here: Bolton et al. (2015) have suggested that risk-taking could be lowered if the CEO's remuneration policies would be linked with the bank's default. Thanassoulis and Tanaka (2018) on the other hand concentrated on clawbacks. Having clawbacks in the compensation schemes would result in the managers also having to carry the possible losses. Eufinger and Gill (2017) has combined compensation's regulation to e.g., capital requirements. (Hilscher et al., 2021.) Core and Guay (2010) state that a priority when setting

remuneration schemes should be to have the focus on those who are the ones setting the compensation schemes. As we can see, there are many suggestions for how the executives' compensation should be regulated in order to have the optimal regulation which enables making profit but regulates enormous risk-taking.

Minimizing the financial distress' expenses is in the interest of the public. However, regulators' task is to ensure that the costs originating from regulations are not too immoderate. Immoderate expenses could result in forcing banks to lower their risk levels substantially. The remuneration should be lower than the management's loss when the bank is going to fail in order to have a stronger incentive to decrease the risk. (Hilscher et al., 2021.) Effective bank systems are important as the banks have an important role in creating financial wealth for societies.

Although the focus in this report has been to examine how different regulations aim to have an impact on the financial sector's executive compensation to mitigate the possible consequences resulting from excessive risk-taking, one should remember that there are also other regulations that have the same goal of minimizing the risk-taking in the financial sector. In addition, there are e.g., regulations to have caps on asset risk to result in more optimal risk-taking (Hilscher et al., 2021). For some of the banks, using two tools (caps on executive compensation and caps on asset risks) together may be more optimal but for other banks having one of these two tools may be already effective enough to mitigate the excess risk-taking. For example, when regulators monitor many banks at the same time, it could be more effective to simultaneously use caps on asset risks and caps on executive compensation in order to enhance social welfare. (Hilscher et al., 2021.)

4.6. The consequences of regulating executive compensation

Regulations seek to fix a misalignment between private benefits and costs, and social benefits and costs. Compensation contracts may resolve the principal-agent problem, but still lead to socially excessive risk-taking. This is due to the managers' and shareholders' failure to internalize the full costs associated with resolving potential bank failure. Due to the overall societal importance of large financial service provider's, executives, and shareholders only bare part of the costs of bank failure, the rest is borne by depositors and taxpayers, therefore leaving executives and shareholders with a lack of incentive to consider the full costs. Regulation seeks to limit managers' and

shareholders' ability to form compensation contracts that lead to excessive private benefits at the expense of taxpayers and debtholders. Compensation may also be subject to rent-extraction behavior (Thanassoulis, 2012), in which a manager exercises their bargaining position in relation to the board of directors for both less governance and greater compensation, leading to above optimal compensation and excessive risk taking. Regulation often seeks to address both concerns.

Like most regulations, the regulation of executive compensation in the financial services industry can be expected to have both intended and unintended consequences. Academic research has sought to both predict and examine the consequences of post-2010 regulation of executive compensation in the industry based on financial theory and by comparing evidence from differing regulatory environments, such as Europe, the United Kingdom, and the United States. Some potential consequences such as endogenous costs, are rather evident, like the costs incurred due to increased informational requirements and the overall increased complexity of compensation contracts, but others are more debated. Curbing bank default costs carried by society at large is widely desired but as discussed earlier, not all regulation is optimal and most regulation carry unintended costs, which should be weighed against the perceived benefits of implemented regulation.

The perceived value of regulation also differs according to the viewpoint being considered, e.g., shareholders vs. society at large. In the viewpoint of shareholders and managers, post-2010 regulation can be seen as mostly costly as it limits their activities, such as the alignment of the principal-agent problem, and as regulation leads to private costs which are relatively easy to trace. The implied societal costs of bank failure or overall excessive executive compensation in the sector if no regulatory changes were to take place, and respectively the social benefit of post-2010 regulation, are much harder to quantify. This makes it challenging to compare the perceived benefits with implied costs of post-2010 regulation at a societal level. Overall, research on the regulation of financial service industry compensation and their objectives provides varying results of post-2010 regulations beneficiality in practice due to differing views of perceived benefits and unintended costs, both from the viewpoint of shareholders and society at large.

4.7. Shareholders' viewpoint on post-2010 regulation

Kleymenova & Tuna (2016) study the consequences of regulating executive compensation at financial institutions. The study analyzes stock market reactions to the introduction of the UK Remuneration Code and EU bonus cap, possibly indicative of the perceived benefits and implied costs of regulation from the perspective of shareholders. The initial market reaction to the introduction of the Remuneration Code was positive, which could indicate that regulation was perceived as beneficial for shareholders or that the regulation was perceived as having fewer restrictions on financial institutions than anticipated. The market reaction to the EU bonus cap was negative, which could imply that shareholders expect a loss of company value due to the pay restrictions imposed.

According to Kleymenova & Tuna (2016), the perceived loss of value could be due to the expectations, shared by Murphy (2013), Thanassoulis (2012), and Andrés, Reig & Vallelado (2019), that firms will increase fixed pay increasing fixed costs, a larger share of fixed pay creates an incentive to take 'bad risks' and avoid 'good risks', excess pay is not effectively decreased as firms will increase other components of pay not subject to the cap, and specialized talent will mitigate to unregulated companies within the sector or to unregulated countries, ultimately decreasing sector competitiveness. (Kleymenova & Tuna, 2016.) These are the main unintended costs of implied regulations highlighted in academic research.

4.8. Criticism of post-2010 regulation

Thanassoulis (2012) studies the default risk of banks generated by investments and remuneration pressures with a model of banker remuneration in a competitive market for banker talent. The study shows that competition for bankers generates an empirically relevant negative externality that drives up rival banks' default risk, thus optimal financial regulation would involve some intervention in the competitive labor market, in particular weak caps on the proportion of the balance sheet used for bonus payments. However, the study also finds very stringent bonus caps, or a requirement to use wages rather than bonuses, could increase bank default risk. Banks under the regime, such as the EU per-person cap on bonuses, are forced to use fixed wages while the

high competition for bankers keeps wages high, resulting in high fixed costs for the bank to be paid regardless of investment performance. (Thanassoulis, 2012.)

Murphy (2013) provides an ex-ante economic analysis on the consequences of the EU bonus cap and concludes it is unlikely to achieve objectives of reducing excessive risk-taking and perceived excesses in the level of banking renumeration. Aligned with Thanassoulis (2012), Murphy predicts an increase in the level of fixed remuneration and goes as far as saying, that the increase in fixed costs makes the banks more vulnerable to business cycles and downturns thus significantly increasing the risk of bank failure. The study also argues regulation will increase rather than decrease incentives for excessive risk taking. According to Murphy, pre-regulation bonus systems, characterized by below-market salaries and high bonus opportunities, provide strong incentives to avoid 'bad' risks and to take 'good' risks, while 'capped' bonus systems provide incentives to do the opposite. Murphy continues to argue the EU bonus cap will reduce incentives to create value by overfocusing on excessive risk-taking and thus neglecting the pay-for-performance purpose of bonuses, reduce the competitiveness of the EU banking sector due to reduced flexibility, profitability, and shareholder value, and result in a general quality degradation of EU investment bankers due to non-competitive pay, thus decreasing access to capital and increasing the cost of capital. (Murphy, 2013.)

Andrés, Reig & Vallelado (2019) argue the EU bonus cap could produce perverse incentives, such as those highlighted by Murphy (2013) and Kleymenova & Tuna (2013), in which underperforming managers would accept negative NPV projects ('bad risks') and high performers could stop their activities before the end of the year, rejecting risky, positive NPV ('good risks') projects or delaying them to the following year. They also argue the cap could lead to an adverse selection problem. This refers to best managers wanting to have their compensation tied to performance, therefore preferring banks with higher variable pay, whereas poorly performing managers will be delighted to work for fixed pay, independent of performance and risk management capabilities. Ultimately making banks under stringent bonus caps attractive to worst performers, damaging long-run bank performance. (Andrés, Reig & Vallelado, 2019.)

4.9. What has changed in practice after the implementation of post-2010 regulations

Kleymenova & Tuna (2016) also study the consequences of post-2010 regulation in the UK banking sector. Due to the EU bonus cap being implemented in the UK in 2015, the study focuses on the UK Remuneration Code. They find that, in line with the intent of the Remuneration Code, UK banks defer more bonuses and reduce risk. A higher percentage of bonus deferral in the post-2010 period is associated with a reduction of risk across measures (idiosyncratic volatility, total volatility, and leverage). Although, when compared to their US counterparts and UK firms in other sectors, UK banks experienced higher CEO turnover. The compensation contracts of UK banks also became more complex after regulation. They conclude that while regulation may have had the desired consequences in terms of risk-taking, it may have also created unintended costs.

Kleymenova & Tuna (2016) also compared practices and perceived risk of UK firms to US and EU firms. They find on average in comparison to US banks' CEOs have higher total compensation, smaller take-home pay (at the time of vesting), higher incentives-based pay and lower salaries. They also found US banks have higher leverage and higher idiosyncratic risk. The fact that US banks are highly leveraged is also underlined in Sepe's (2011) research paper. Kleymenova & Tuna find on average EU banks' CEOs have lower total compensation, lower take-home compensation, a higher component of pay based on salary, and a lower portion of incentive-based pay.

The European Banking Authority (EBA) report on remuneration practices published in 2016 reports that the number of high earners, identified by organizations due to regulatory requirement, increased significantly in 2014 after applicability of the EU bonus cap, while the average variable to fixed remuneration ratio dropped significantly for high earners as well as for other identified staff. The average ratio between the variable and fixed salary paid for identified staff was 65 % in 2014 (down from 104%) and for high earners 127 % (down from 317%). Therefore, the EU bonus cap could be seen as having achieved its somewhat controversial target of decreasing variable compensation. According to EBA's 2022 report, the ratio of variable to fixed remuneration has kept decreasing since the implementation of the cap. According to the EBA 2016 report, the introduction of the bonus cap was also found to have no significant effect on institutions' financial stability and cost flexibility. For most institutions, the fixed salary of identified staff accounted for

less than 1% of their own funds and on average accounted for 3 % of administrative costs. Thus, the increase in fixed remuneration was found to not be material compared to the administrative costs of institutions.

Although, when assessing the consequences of post-2010 regulation, one must keep in mind that the changes discussed above, such as the changes in compensation practices and implied risk of the financial services institutions, could be due to other factors aside from implemented regulations, such as the EU bonus cap and UK Remuneration Code.

5. Examples of executive compensation schemes in our case companies

After discussing executive compensation in financial institutions through financial theory and regulations, the following section includes a couple of examples how executive compensation practices are composed in our case companies.

At Handelsbanken, one of the major banks in Sweden with a nationwide branch network, executive officers are paid in the form of fixed cash salary, pension provision and customary benefits, e.g., a car allowance and housing. Variable remuneration is applied with great caution, as in 2021 the proportion of fixed remuneration of total remuneration was 100% for majority of the executive officers. Pension benefits are defined contributions and may correspond to a maximum of 35 % of annual fixed cash salary. There are no equity-related or equity price-related incentive programmes. Executive officers are included in the Oktogonen profit-sharing scheme on the same terms as all employees of the Bank. Oktogonen is a foundation into which an equal allocation of profits is made for each employee, if the Group achieves its corporate goal in the given year, these sums are predominately invested into Handelsbanken shares. The accumulated allocations and investment growth are not accessible before the age of 60, thus steering both executives and non-executive employees towards a long-term perspective. (Handelsbanken, 2022.)

However, if we compare Handelsbanken to Deutsche Bank (German bank), Deutsche Bank's Management Board's remuneration scheme is tied to the long-term (60 %) and short-term (40 %) objectives. Compensation can be paid e.g., through monthly payments, annual contributions, and share-based remuneration. The short-term based pay is generally paid in cash, but the payments of

the short-term variable pay are made over several time periods of which the longest one being seven years after the evaluation time. The long-term compensation portion is evaluated in the three-year time horizons. These are generally paid as Restricted Equity Awards (share-based component) with having a five-year deferral period. During the deferral period the equities are affected by the company's share price changes. The company also has in place a compensation cap for the Management Board's remuneration, which is currently 12 million euros, and it covers all the pay components such as pension plan and base salary. (Deutsche Bank, Compensation Report 2021.)

Despite these two companies operating in similar regulatory environments (within the European Union), we can conclude that the implementation of the regulation, for example the EU bonus cap, differs. One could argue that the differentiations could be explained by the national regulations the banks' 'home' countries have legislated regarding executive compensation. Alternatively, the differences could be a result of different corporate governance practices these banks have e.g., Deutsche Bank uses share-based compensation in order to align management's interest with shareholders' interests. As a conclusion, it is hard to distinguish whether the remuneration policies in different banks are due to the regulation or due to the cultural differences regarding corporate governance characteristics and bundles that these banks have in place. This suggests that there is a need for further research in the area of regulating executive compensation in the financial service industry, especially since the implementation of regulations may differ in the same legislative environment. The need for more research stems from getting a more comprehensive overview of whether the regulations themselves have had the desired results.

6. Conclusion

Without any doubt, the global financial crisis of 2007-2012 shook the global economy and raised questions regarding the changes that needed to be imposed in the area of compensation offered to key executives in the sector of financial services. The importance of the matter stems from the wide impact banks and especially large banks have on the global economy and life of people all around the world.

The aim of the report was to analyze the topic of executive compensation in financial institutions and its theoretical background. It sought to identify the main problems regarding executive compensation in the financial sector, present their root causes and describe applicable post-crisis regulations. In the text, authors looked at the possible consequences, both intended and unintended, of implemented regulation, such as the UK Remuneration Code and EU bonus cap and reflected on their beneficiality in practice through financial theory, academic research, and changes in practices in the sector.

The report identified incentivizing short-termism leading to socially extensive risk-taking undertaken by bank executives as the biggest shortcoming of the remuneration system offered to said managers in the financial sector. Lead by academic literature, authors recognized bonus caps, clawbacks and bonus deferrals as examples of regulatory solutions imposed as means to combat the main problem of extensive risk-taking.

Post-2010 regulation has received both thanks and criticism in academic research, yet within the European Union, due to slow and unharmonized implementation of regulatory requirements (The EBA, 2016), the consequences of regulations are still to be fully determined. In addition, the regulatory environment in which financial institutions operate is ever changing. As the UK takes its first steps towards financial deregulation in its plans to remove the EU bonus cap post-Brexit, the consequences of regulating compensation practices on sector competitiveness become an increasingly important topic. This could indicate a possible shift in regulatory trend, previously dictated by the financial crisis and its impact.

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