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‘Bonus Bonds’ for Bankers: A New Type of Debt-Based Remuneration in the Financial Industry

by

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Remuneration involving shares or options was long thought to provide optimal employee incentivisation, aligning employee interests with those of shareholders. However, the numerous failures of financial institutions during the financial crisis have given rise to a concern that equity-based remuneration may have encouraged excessive risk-taking. Therefore, some scholars now recommend that ‘key risk takers’ in banks be induced to think like bondholders, e.g., by compensating them via debt-based instruments. It is suggested that, due to their characteristics in financial distress, contingent capital bonds are better suited for this task than straight bonds.

This article explores the emergence of debt-based remuneration in banks and its evaluation in the literature. We examine international and selected national regulatory frameworks and inquire into current market practice. Our comparative analysis reveals that, despite occasionally misleading terminology, none of the observed remuneration programmes technically uses ‘bonus bonds’. Rather, they involve cash awards subject to adjustment during a deferral period upon drops in certain financial metrics. Convincing by their flexibility, we consider these malus-structures appropriate tools for curbing bankers’ risk appetites as they allow banks to set largely identical incentives as ‘bonus bonds’ without having to procure securities in illiquid markets when awards vest.

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I. Introduction

In the aftermath of the financial crisis, financial institutions began to issue bonds that, upon the occurrence of pre-specified trigger events, would either be converted into equity securities or be completely or partially written down.[1] Thanks to their allegedly improved loss-absorbing capabilities over other forms of hybrid debt, these contingent capital securities also found support from the Basel Committee on Banking Supervision and subsequently from regulators across the world, particularly in Europe, where contingent capital securities have been recognised as regulatory capital under current regulatory capital requirements. Such new regulations in Europe and elsewhere, coupled with stronger capital requirements in general, have in turn led to a steady increase in issuances of contingent capital securities.

The emergence of this new form of hybrid capital has coincided with, and may have facilitated, the development of incentive schemes revolving around debt-based instruments that involve write-down mechanisms. Such write-down mechanisms put the investment of the employees at risk in a fashion that would otherwise be characteristic of equity-based remuneration as the employees will stand to lose their entire claim upon occurrence of a write-down trigger. At the same time, unlike some equity-based instruments, debt-based

1 Triggers in contingent capital securities now usually refer to the issuer's capital ratio for the timing of conversion or write-down, but other design options have been discussed in the literature. See, e.g., John C. Coffee, Jr., 'Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight' (2011) 111 Columbia Law Review 795, 830—832. In the following, we use the term of 'contingent capital securities' indiscriminately for instruments featuring either a conversion or a write-down mechanism.

instruments are not thought to incentivize employees to take on excessive risk as the return on their investment being independent of the profit of the firm. Furthermore, awarding debt-based remuneration to the management is an attractive proposition to shareholders as it does away with either or both the dilution of their voting power or the requirement to share dividends that usually comes with traditional equity-based incentives schemes.[2] Beginning in 2011, some banks in the UK[3] and in Switzerland[4] have thus introduced 'bonus bonds' as a means of remuneration.

However, we find that these banks have yet to pay their employees in actually issued bond securities. Instead, they have added special malus provisions to what are essentially cash-based incentive plans, whereby the terms of contingent capital securities were, to some extent, replicated on a contractual basis. Some banks have reserved the right to fulfil their obligations under their schemes by handing out contingent capital securities, but in all cases we reviewed, cash remains the default payment option. This begs the question of why contingent capital securities have not proven to be a more popular tool for the purposes of remuneration, and whether awarding contingent capital securities in kind would be preferable to cash-based awards that replicate the terms of contingent capital securities on a contractual basis.

To examine the viability of contingent capital securities as a tool for remuneration, we start out by taking a look at the literature on debt-based remuneration (II.), showing that it is highly controversial among scholars whether contingent capital securities, or other debt-based instruments for that matter, should be included in remuneration packages. Whereas global standards on remuneration are rather silent on the matter, quite the opposite is true for EU regulations. Our examination thereof (III.A) is followed by a review of UK (III.B), German (III.C) and Swiss (III.D) regulatory frameworks, in each case juxtaposed to a survey of debt-based remuneration schemes in use in each such country's financial sector. Based on the findings we gather from these jurisdictions, it appears that debt-based remuneration schemes are, in general, becoming increasingly popular with banks. We conclude that the current propensity of banks to award synthetic 'bonus bonds', i.e., deferred cash awards subject to special malus provisions, rather than contingent capital securities, is justified mainly for two reasons. First, such cash-based awards can be struc-

2 See Agne Eriksson & Harry McVea, 'The Vexed Issue of Bankers' Pay: Is it now time for CoCos?', (2013) 13 Journal of Corporate Law Studies 97, 100 and 101; Reto Schiltknecht & Christopher McHale, 'Entwicklungen des regulatorischen Bankenkapitals' [2015] Swiss Journal of Corporate and Capital Markets Law and Reorganizations (GesKR) 8, 17.

3 For details on Barclay's contingent capital plan, see nn 104–110 and accompanying text.

4 For further discussion of Swiss banks' remuneration structures, see nn 180–187 and accompanying text.

tured so as to set incentives virtually identical to those associated with contingent capital securities whilst giving institutions a much greater deal of flexibility in structuring awards. Second, although the market in contingent capital securities is growing, liquidity in the market may be a concern because banks may need large quantities of contingent capital securities available when awards made to employees vest. Unless they can issue contingent capital securities on an as-needed basis, banks might find it hard, or at least expensive, to come by a sufficient amount of contingent capital securities in the market.

II. The Case for Using Debt-Based Instruments as Incentives

A. Overview of the Academic Debate

For decades, studies on the remuneration of (bank) executives[5] concentrated almost exclusively on equity instruments.[6] From a corporate governance perspective, equity-based remuneration has long been considered superior to other forms of remuneration due to its perceived effect of aligning the interests of managers with those of shareholders, thus helping to bridge the gap between principal and agent. However, one of the findings from examining remuneration structures before the financial crisis was that this alignment only takes real effect when grants of stock or stock options are subject to considerable deferral, ideally with employees precluded from hedging or other measures that aim to mitigate the risk associated with their holdings.[7] Accordingly,

5 Up until recently, studies had been largely oblivious to the remuneration of non-executive employees. For two current studies on remuneration of non-executives, see Viral Acharya, Lubomir P. Litov & Simone M. Sepe, 'Seeking Alpha, Taking Risk: Evidence from Non-Executive Pay in U.S. Bank Holding Companies' (2014) Wharton Financial Institutions Center Working Paper Series No. 13–18 <http://fic.wharton.upenn.edu/fic/papers/13/p1318.htm> accessed 5 June 2015; Simone M. Sepe & Charles K. Whitehead, 'Paying for Risk: Bankers, Compensation, and Competition' (Cornell Law School Legal Studies Research Paper Series No. 13–87) (2015) 100 Cornell Law Review (forthcoming), manuscript at 38ff <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2307216> accessed 5 June 2015 (arguing that non-cash based awards may also be advantageous in respect of non-executive employees).

6 See Michael C. Jensen & Kevin J. Murphy, 'CEO Incentives – It's Not How Much You Pay, but How' [1990] (3) Harvard Business Review 138, 141. See also Simone M. Sepe, 'Response. Give 'Em Enough Rope: Optimal Design of Executive Pay and Rent Extraction' (2011) 89 Texas Law Review *See Also* 143, 144.

7 See, e.g., Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004), ch 14 (highlighting this issue well before the financial crisis began in 2007); Kenneth R. French et al, *The Squam Lake Report. Fixing the Financial System* (Princeton University Press 2010), 50.

many international and national guidelines now recommend for variable remuneration, or at least a large portion thereof, to be deferred.[8]

More recently, the previously undisputed notion of the overall advantageousness of equity-based remuneration has been called into question in the context of financial firms. The most recent financial crisis has shown that shareholders' interests can diverge significantly from those of creditors, such as bondholders and depositors, let alone those of taxpayers, who were called upon repeatedly to bail-out institutions deemed to be too big to fail. As *Bebchuk & Spamann*[9] show in a series of stylised examples, shareholders will often be willing for their bank to take on more risk than is socially desirable, especially when the bank is already in turmoil, i.e., when equity is decreasing at a high pace. Once the shareholders are faced with losing their capital contributions, they can only benefit from risky projects as they will rake in the upside. Meanwhile, the downside risk of such projects will largely be borne by creditors, or, in the event of a bail-out, the taxpayers. *Bebchuk & Spamann* and other authors[10] have therefore called for incentives in banks to be linked in some way or another to the firm's debt, bringing interests of bank executives more in line with those of creditors and taxpayers. Their proposals often turn on specific debt-based instruments.[11] While differing in the details, all of those proposals

8 See, e.g., FSF, 'FSF Principles for Sound Compensation Practices' (2 April 2009) Principle No. 6 <http://www.financialstabilityboard.org/publications/r_0904b.pdf> accessed 5 June 2015.

9 Lucian A. Bebchuk & Holger Spamann, 'Regulating Bankers' Pay' (2010) 98 Georgetown Law Journal 247, 255 ff.

10 The idea was originally developed in the 1970s by Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure (1976) 3 Journal of Financial Economics 305, 352ff, but has only recently found larger resonance within the literature. See, e.g., Patrick Bolton, Hamid Mehran & Joel Shapiro, 'Executive Compensation and Risk Taking' [2010] Federal Reserve Bank of New York Staff Report no. 456 (June 2010, revised November 2011); Jeffrey N. Gordon, 'Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay' [2012] Columbia Business Law Review 834, 848; French et al, n 7, 50; Wulf A. Kaal, 'Contingent Capital in Executive Compensation' (2012) 69 Washington & Lee Law Review 1821, 1825; Eriksson & McVea, n 2, 112; Frederick Tung, Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation, (2011) 105 Northwestern University Law Review 1205, 1206.

11 Bebchuk & Spamann, n 9, 284 (basket of equity and debt securities); Bolton, Mehran & Shapiro, n 10, 1 (linking of CEO's compensation to CDS spread); Gordon, n 10, 854 (conversion of executives' equity holdings in the event of the firm's experiencing turmoil); Kaal, n 10, 1826 (high trigger contingent capital securities); Eriksson & McVea, n 2, 116, 118 (standard trigger contingent capital securities coupled with potential expost adjustment); The Squam Lake Group, 'Aligning Incentives at Systemically Important Financial Institutions. A Proposal by the Squam Lake Group' (2013) 25(4) Journal of Applied Corporate Finance 37, 40 (portion of remuneration held back and subject to

have at their core a better alignment of interests of employees with those of bondholders. These proposals also add to the broader discussion on 'inside debt',[12] a term that is commonly understood to encompass all financial obligations of a corporation towards its staff, including pension and deferred remuneration claims employees hold against the firm, as opposed to debt held by other creditors. Whereas equity incentives are to induce employees to avoid bankruptcy, inside debt additionally provides employees with an incentive to maintain a high recovery value in bankruptcy for they will only then be able to recover a part of their claim against their employer.[13] This does of course not apply to contingent capital securities that will be written off when the capital ratio drops below a pre-specified threshold, which may happen well before bankruptcy.

However, some commentators put forward some valid concerns regarding the introduction of new remuneration incentives, especially when forced upon banks by the regulators,[14] and also warn against an overreliance on debt-based remuneration. They contend that new incentive instruments will only add further layers of complexity to remuneration systems, thereby increasing the likelihood that bank employees will be unable to discern what behaviour is expected of them.[15] Furthermore, the main beneficiaries of bail-outs during the financial crisis were not the shareholders but the bondholders. Therefore,

forfeiture in the event of capital ratio dropping below specified threshold); Tung, n 10, 1229ff (publicly traded subordinated debt securities).

12 Alex Edmans & Qi Liu, 'Inside Debt' (2011) 15 Revue of Finance 75, 75 fn 1; Chenyang Wei & David Yermack, 'Investor Reactions to CEOs' Inside Debt Incentives' (2011) 24 Review of Financial Studies 3813 (defining inside debt as debt held by 'corporate insiders' as opposed to debt held by 'corporate outsiders'). For a recent study on the favourable correlation between inside debt and (lower) corporate failure rates, see Ngoc Giang Hoang, 'Inside Debt and Corporate Failure' (unpublished manuscript) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2351718> accessed 5 June 2015.

13 Edmans & Liu, n 12, 77; Eriksson & McVea, n 2, 99.

14 Guido Ferrarini & Maria Cristina Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks' (2011) 64 Vanderbilt Law Review 431, 451 (arguing that regulators should leave the design of remuneration schemes to company boards and rather resort to more traditional means of regulation to curb excessive remuneration, e.g., by imposing stronger capital requirements on institutions adopting inadequate remuneration schemes).

15 Kelli A. Alces & Brian D. Galle, 'The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation' (2012) 38 The Journal of Corporation Law 53, 72ff; Sanjai Bhagat, Brian Bolton & Roberta Romano, 'Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?' (EGCI Working Papier Series in Law Nº 241/2014) (2014–2015) 32 Yale Journal on Regulation (forthcoming), manuscript at 37 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2395982> accessed 5 June 2015.

the reasonable expectation that they will be bailed out along with other holders of corporate debt may cancel out any positive impact inside debt is deemed to have upon the behaviour of employees.[16] As long as equity-based instruments remain part of the remuneration package, employees might also be inclined to make up for potential losses suffered on the debt-based portion of remuneration by assuming additional risk that can increase the value of their equity-based portion.[17] Lastly, it is evident from the financial crisis that the overall interest of social welfare also requires inter-bank lending to continue in times of financial turmoil. Executives that are too risk-averse due to the incentives set through debt-based remuneration might exacerbate an imminent crisis.[18]

B. The Role of 'Bonus Bonds' in Particular

Taking inspiration from new incentive plans in a few major European banks,[19] some authors[20] have recently advocated the use of contingent capital securities[21] for purposes of remuneration. It is argued that providing remuneration in the form of contingent capital securities improves the link between risk taking and decision making by aligning interests due to the automatic trigger mechanism, and that contingent capital securities are therefore to be considered superior to straight bonds without such conversion or write-off features. With a view to

16 Alces & Galle, n 15, 68ff; Bhagat, Bolton & Romano, n 15, 39.

17 Bhagat, Bolton & Romano, n 15, 40. See also Eriksson & McVea, n 2, 116.

18 Bhagat, Bolton & Romano, n 15, 42. See also Simone M. Sepe, 'Making Sense of Executive Compensation' (2011) 36 Delaware Journal of Corporate Law 189, 222ff (criticising 'perverse incentives' set by long-term debt-based remuneration, supporting instead a mix of fixed remuneration and equity instruments).

19 See nn 104–114 (Barclays PLC) and nn 180–187 (UBS AG and Credit Suisse Group AG) and accompanying text.

20 Eriksson & McVea, n 2, 118 (recommending standard trigger contingent capital securities that convert to equity); Kaal, n 9, 1826 (recommending high trigger contingent capital securities that convert to equity); Erkki Liikanen et al, 'Report of the European Commission's High-level Expert Group on Bank Structural Reform' (2 October 2012), 104 <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 5 June 2015; Bank of England, 'Financial Stability Report' (November 2012), 57 <http://www.bankofengland.co.uk/publications/Documents/fsr/2012/fsr32sec5.pdf> accessed 5 June 2015; Vanessa Brahmi, 'Contingent Convertibles – Die Auswirkungen von Basel III auf Bankanleihen' in Henrik Schütt (ed) *Deutsches Institut für Bankwirtschaft Schriftenreihe Band 7* (2011), at 6.

21 Sometimes referred to as 'bonus bonds'. See, e.g., The Squam Lake Group, n 11, 37. For a concise description from a legal point of view of the mechanisms behind contingent convertible bonds, with a view to their potential for utilization as remuneration, see Eriksson & McVea, n 2, 98—104.

further improving incentive structures, *Kaal* recommends the use of high trigger contingent convertible bonds, i.e., bonds that convert to equity once the bank's capital ratio drops below a pre-specified threshold set above the threshold used for contingent convertible bonds issued to external investors.[22]

Referring to UBS AG's remuneration scheme as a particularly laudable example, some senior economists strongly advocate holdback, or deferral, of a cash-based portion of remuneration that is to be forfeited in the event of the firm becoming distressed.[23] In terms of incentives, this proposition is somewhat reminiscent of awarding write-down bonds to employees in the sense that holders of write-down bonds are similarly exposed to losing their investment in the firm's financial downturn. Financial institutions can implement the economists' proposal by exposing cash-based awards to a special malus provision during a pre-defined deferral period, i.e., the time before payouts to employees occur. Typically, malus, and thus forfeiture of awards, would be made contingent upon the occurrence of a pre-specified event. Where such event is defined exclusively in relation to the capital ratio, or where express reference is made to the performance of a contingent capital instrument, the incentives for the individual employee are broadly identical to awarding him or her with actual contingent capital securities. After all, employees are unlikely to care whether they lose remuneration due to a write-down trigger in a bond or a malus clause in an employment contract or other kind of agreement. Therefore, having cash-based remuneration schemes replicate contingent capital instruments on a purely contractual basis, i.e., synthetically, may be a valid alternative to handing out contingent capital securities to employees.

However, it has to be noted that contingent capital securities and, to a somewhat lesser extent perhaps, contractual replications of contingent capital securities, pose an array of issues, which have frequently been discussed in economic literature[24] and may also take into question their usability for purposes of remuneration. Some scholars even question the viability of the con-

22 Kaal, n 9, 1853ff (arguing that without a conversion feature executives do not have a stake in the liquidation value and are thus just as prone to excessive risk-taking as when paid in equity-based instruments). But see Eriksson & McVea, n 2, 118 (warning that too high a trigger would be likely to severely limit tradability in the secondary market, and therefore preferring the standard trigger of 5.125% provided for in EU regulations with regard to AT 1 capital).

23 The Squam Lake Group, n 11, 39 f.

24 E.g., regarding pricing and the design of the conversion trigger. See, e.g., Stefan Avdjiev, Anastasia Kartasheva & Bilyana Bogdanova, 'CoCos: a primer' (2013) BIS Quarterly Review (September 2013) 43, 44ff; Charles W. Calomiris & Richard J. Herring, 'How to Design a Contingent Convertible Debt Requirement That Helps Solve Our Too-Big-to-Fail Problem' (2013) 25 Journal of Applied Corporate Finance 39, 46ff; Robert L. McDonald, 'Contingent capital with a dual price trigger' (2013) 9 Journal of Financial

cept of such hybrid capital as a whole, advocating significantly tougher equity requirements instead.[25]

Up to now, proposals for the inclusion of contingent capital securities in remuneration structures have found little resonance both within the global academic debate and the global standards on remuneration.[26] Neither the FSF Principles for Sound Compensation Practices nor the accompanying Implementation Standards address the use of debt-based securities for purposes of remuneration. They do, however, encourage a broad use of malus and clawback arrangements,[27] which, as discussed above, in conjunction with deferral, transforms cash-based remuneration into inside debt.

Bearing in mind the alleged advantages as well as shortcomings of debt-based remuneration, we now turn to analysing the extent to which the notion of 'bonus bonds' has been taken into account in European standards on remuneration.

III. Regulatory Frameworks and Market Practice with Regard to Debt-Based Remuneration in Europe

A. European Union Legislation and Regulations

1. Regulatory Efforts in the Wake of the Financial Crisis of 2007–2009

The European Commission (Commission) had already issued recommendations concerning directors' remuneration well before the financial crisis.[28] However, neither these recommendations nor regulatory efforts[29] that imme-

Stability 230, 231 ff; Edward Simpson Prescott, 'Contingent Capital: The Trigger Problem' (2012) 98(1) Federal Reserve Bank of Richmond Economic Quarterly 33, 34 ff.

25 See Anat Admati & Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about It* (Princeton University Press 2013) 187 ff.

26 See FSF Principles, n 8; FSB, 'Principles for Sound Compensation Practices. Implementation Standards' (25 September 2009) <http://www.financialstabilityboard.org/publi cations/r_090925c.pdf> accessed 5 June 2015. For a concise discussion thereof, see Yannick Hausmann & Elisabeth Bechtold-Orth, 'Changing Remuneration Systems in Europe and the United States – A Legal Analysis of Recent Developments in the Wake of the Financial Crisis' (2010) 11 European Business Organization Law Review 195, 198 ff.

27 FSF Principle No. 6 and Implementation Standard No. 9.

28 Commission, 'Recommendation (2004/913/EC) of 14 December 2004 [...]' [2004] OJ L385/55 and Commission, 'Recommendation (2005/162/EC) of 15 February 2005 [...]' [2005] OJ L52/51. See also Ferrarini & Ungureanu, n 14, 474 ff.

29 CEBS, 'High-level principles on remuneration policies' (20 April 2009) <https:// www.eba.europa.eu/documents/10180/16094/High-level principles for remuneration

diately followed the release of the FSB Principles dealt with the utilisation of debt-based instruments for remuneration purposes.[30]

In spring 2010, a report of the Commission revealed that member states' efforts at implementing the Commission's recommendations on remuneration left a lot to be desired.[31] In November 2010, an amendment to the Capital Requirements Directive, commonly referred to as Capital Requirements Directive III (CRD III),[32] was introduced mainly to deal with issues of remuneration. The rules on remuneration were to cover so-called 'material risk takers'.[33] Acting on a mandate laid down in CRD III,[34] CEBS published its Guidelines on Remuneration Policies and Practices (CEBS Guidelines) on 10 December 2010. CRD III and the CEBS Guidelines reinforced the Commission's previous Recommendation[35] and expanded on issues such as better alignment of risk, performance and remuneration, deferral of bonuses and the appropriate relationship between variable and fixed pay. To accommodate smaller financial institutions, national legislators were instructed to account for differences in terms of size and complexity of the business of regulated financial institutions when implementing CRD III.[36] As regards 'bonus bonds', point 23(o) of Annex II to CRD III stipulated:

'*(o) a substantial portion, and in any event at least 50%, of any variable remuneration shall consist of an appropriate balance of:*

(i) [. . .], and

policies.pdf> accessed 5 June 2015; Commission, 'Recommendation (2009/384/EC) of 30 April 2009 [. . .]' [2009] OJ L120/22 (merely noting, at para 4.5, that deferred portions of remuneration can consist of 'equity, options, cash, or other funds'). On the same day, the Commission issued a new recommendation supplementing its previous recommendations on directors' remuneration. See Commission, 'Recommendation (2009/385/EC) of 30 April 2009 [. . .]' [2009] OJ L120/28.

30 In the following, we focus on the role debt-based instruments have come to play in EU financial market regulation. For more comprehensive accounts of the regulatory efforts of the EU in the field of remuneration since the financial crisis, see Eilís Ferran, 'New Regulation of Remuneration in the Financial Sector in the EU' (2012) 9 European Company and Financial Law Review 1, 15–28; Tom Dijkhuizen, 'The EU's Regulatory Approach to Banks' Executive Pay: From "Pay Governance" to Pay Design' (2014) 11 European Company Law Review 30, 33–35.

31 Commission, 'Report of 2 May 2010 [. . .]' (COM(2010) 285 final), 3.

32 Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 [2010] OJ L329/3. See also Eriksson & McVea, n 2, 109—111.

33 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 [2006] OJ L177/1 (as amended by Directive 2010/76/EU), Annex V, point 23.

34 Directive 2006/48/EC (as amended by Directive 2010/76/EU), art 22(4).

35 Directive 2010/76/EU, recital 13.

36 'Proportionality principle'; see Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23.

(ii) where appropriate, other instruments within the meaning of Article 66(1a) (a), that adequately reflect the credit quality of the credit institution as a going concern.'[37]

The requirement that a minimum of 50% of bonuses be paid in non-cash instruments was already contained in FSB Implementation Standards No. 8.[38] However, the novelty here lay in point (ii). This was the first express acknowledgment in EU legislation that contingent capital securities[39] can serve as a means of remuneration.[40] Missing from the Commission's original proposal, the reference to contingent capital securities only found its way into CRD III immediately before parliamentary discussions. The corresponding report by the Committee on Economic and Monetary Affairs had even proposed prescribing a much wider use of contingent capital securities in remuneration in financial institutions.[41] In retrospect, this seems fairly remarkable, with only one contingent capital bond having been issued on the market at the time.[42] However, the text eventually adopted by Parliament and the Council of the EU was considerably less bold, also lacking the bonus cap proposed in the report.[43] Nevertheless, in a resolution passed on the same day as CRD III, EU Parliament encouraged the use of 'non-cash instruments such as subordinated debt, contingent capital, shares or share-linked instruments' for purposes of variable remuneration[44] as well as 'pension bonuses'.[45]

37 Directive 2010/76/EU, recitals 7, 9 and Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23(o).

38 The minimum pertains to both the deferred and the non-deferred portions of variable remuneration. See CEBS, 'Guidelines on Remuneration Policies and Practices' (10 December 2010) para 133 <https://www.eba.europa.eu/documents/10180/106961/Guidelines.pdf> accessed 5 June 2015.

39 Directive 2006/48/EC (as amended by Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 [2009] OJ L302/97), art 66(1a)(a) read: 'instruments that must be converted during emergency situations and may be converted at the initiative of the competent authority, at any time, based on the financial and solvency situation of the issuer into items referred to in Article 57(a) [i.e., equity instruments] within a pre-determined range [...]'.

40 Moreover, Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23(r), allowed institutions to pay discretionary pension benefits in contingent capital securities.

41 European Parliament, 'Report of the European Parliament Committee on Economic and Monetary Affairs (ECON) (Rapporteur: McCarthy) of 28 June 2010 (A7-0205/2010)' amdts 3 (recommending use of contingent capital securities to better align interests), 6 and 87 (pension allocations to managers in contingent capital securities), 84 (90% of non-deferred bonuses in contingent capital securities).

42 See also Ferran, n 30, 25 (noting the difficulties associated with the design of contingent capital securities and recommending for regulators to proceed with caution).

43 ECON Report of 28 June 2010, n 41, amdt 81.

44 European Parliament Resolution of 7 July 2010 [2010] OJ C351 E/56 para 25.

45 Ibid para 26.

Despite the audacious efforts of the EU legislators, CRD III failed to induce financial institutions to use such securities for purposes of remuneration.[46] Instead, bankers' variable remuneration continued to consist of cash, shares, share-linked instruments and equivalent instruments.

2. *Current Regulatory Framework*

After a two-year consultation process, the European Commission submitted proposals to the European Parliament regarding a comprehensive overhaul of the CRD framework in summer 2011. The proposals consisted of a directive replacing the original CRD (CRD IV)[47] and a new regulation (Capital Requirements Regulation; CRR).[48] The primary purpose of the proposals was to transpose the Basel III rules into EU law. To achieve a level playing field across member states, prudential rules previously contained in the directive, such as provisions on capital requirements, were henceforth to form part of the directly applicable regulation, whereas 'the access to the activity of the business of credit institutions'[49] as well as supervisory powers of national regulatory authorities and general principles of supervision were to be addressed in the directive. In addition, the new directive was to cover both credit institutions and investment firms.[50] The differences between these two types of financial firms were no longer thought to justify having two separate directives with largely the same content.[51]

46 European Banking Authority, 'Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices' (12 April 2012) 23 <https://www.eba.europa.eu/documents/10180/106961/Implementation-survey-on-CEBS–Guidelines-on-Remuneration–final-.pdf> accessed 5 June 2015.

47 Commission, 'Proposal for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending [CRD]' (20 July 2011) COM(2011) 453 final (Commission Proposal for CRD IV).

48 Commission, 'Proposal for a Regulation on prudential requirements for credit institutions and investment firms' (20 July 2011) COM(2011) 452 final (Commission Proposal for CRR).

49 This includes the authorisation of credit institutions, the exercise of the freedom of establishment and free movement of services. See Commission Proposal for CRR, n 48, 1.

50 However, investment firms are additionally subject to other EU legislation. For instance, the access to the activity of investment firms is largely governed by MiFID (Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 [2004] OJ L145/1).

51 Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006 [2006] OJ L177/201 for large parts merely replicated or referred to Directive 2006/48/EC.

The provisions on remuneration were thus due for yet another revision, less than one year after the entry into force of CRD III. The Commission's proposal for CRD IV was based on, and largely adhered to, CRD III as far as the rules on remuneration were concerned. To start with, the definition of the personal scope of application of CRD IV's rules on remuneration was by and large carried over from CRD III.[52] The Commission's proposal for CRD IV also essentially stuck with the provision on the use of contingent capital securities for purposes of remuneration that had been introduced with CRD III. It merely suggested it be moved from the Annex of CRD[53] into the main body of the new directive.[54]

However, remuneration[55] once again proved to be a highly contentious topic and was therefore, among a few other issues, the subject of a special trilogue between the three EU legislative bodies.[56] As a result of this process, EU legislators[57] eventually came up with a compromise. As far as the topic at hand was concerned,[58] the compromise text survived the legislative procedure virtually unchanged and was eventually adopted as article 94(1)(l) of CRD IV. Point (ii) of this provision adopts an ostensibly more liberal approach than the Commission's proposal when it comes to defining what debt-based instruments can be used. It reads as follows:[59]

'*(ii) where* **possible** [appropriate], other instruments within the meaning of Article 52 **or 63** of Regulation (EU) No. 575/2013 **or other instruments which can be fully converted to Common Equity Tier 1 instruments or**

52 Compare Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23, with Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 [2013] OJ L176/338, art 92(2). See also Commission Delegated Regulation (EU) No. 614/2014 of 4 March 2014 [2014] OJ L167/30.

53 Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23(o).

54 Commission Proposal for CRD IV, n 48, art 90(1)(j). The provision referred to in point (ii) sets forth the requirements for additional tier 1 instruments.

55 The most controversial issue related to the fixed ratio between base pay and variable remuneration ('bonus cap'), which was advocated by the European Parliament (see European Parliament, 'Report on the proposal of CRD IV (Rapporteur: Karas)' (30 May 2012) A7-0170/2012, art 90(1)(f)) and initially opposed by the Commission and the Council.

56 Council of the EU, 'Report of the Presidency to the Council re Revised capital requirements rules (CRD IV) [First Reading]' (2 March 2013) doc. 6947/13 EF 32 ECOFIN 161 CODEC 455, 5.

57 Council of the EU, 'Note of the Secretariat of 26 March 2013' doc. 7746/13 EF 50 ECOFIN 214 CODEC 649.

58 Council of the EU, 'Note of the Secretariat of 26 March 2013' doc. 7746/13 EF 50 ECOFIN 214 CODEC 649, 199, art 90(1)(j)(ii).

59 Bold text and brackets indicate changes from Commission Proposal for CRD IV, n 47, art 90(1)(j)(ii).

written down, that **in each case** adequately reflect the credit quality of the institution as a going concern **and are appropriate to be used for the purposes of variable remuneration.**' (emphasis added).

To alleviate the uncertainty and set out what makes an instrument 'appropriate to be used for the purposes of variable remuneration', the European Banking Authority (EBA) was given the task of drafting regulatory technical standards.[60] This draft was published in February 2014[61] and was subsequently adopted by the Commission without further changes by way of a delegated regulation (Regulation on Classes of Instruments).[62] The Regulation on Classes of Instruments is directly applicable in member states and came into effect on 9 June 2014.

3. *Debt-Based Instruments Suitable for Variable Remuneration*

a) *Main Features of the Regulatory Technical Standards*

The Regulation on Classes of Instruments sets out in more detail the requirements which debt-based instruments need to meet to be considered appropriate for remuneration purposes. Under the Regulation on Classes of Instruments, instruments awarded by way of variable remuneration must convert to equity instruments or be written down when the Common Equity Tier 1 (CET 1)[63] capital ratio drops below a pre-specified threshold of at least 7%. Remuneration paid in instruments with a lower trigger does not count towards the 50% portion of overall variable remuneration to be made up of instruments.[64] The trigger level of 7% uniformly applies to own funds instruments and 'other instruments',[65] exceeding the trigger of 5.125% laid down in CRR[66] with regard to Additional Tier 1 (AT 1) instruments. According to the EBA,[67]

60 Directive 2013/36/EU, art 94(2).

61 See EBA, 'Final Draft Regulatory Technical Standards on classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of Directive 2013/36/EU' (19 February 2014) (EBA Draft RTS), 19ff, <http://www.eba.europa.eu/documents/10180/589319/EBA RTS 2014 02 (RTS on instruments for variable remuneration).pdf> accessed 5 June 2015 (discussing the responses received in the consultation process).

62 Commission Delegated Regulation No. 527/2014 of 12 March 2014 [2014] OJ L148/21.

63 Within the meaning set out in article 26(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 [2013] OJ L176/1.

64 Commission Delegated Regulation No. 527/2014, arts 2(1)(b) (AT1 instruments), 3(c)(1) (Tier 2 instruments) and 4(2)(e)(i) (other instruments).

65 See nn 75–83 and accompanying text for more detailed discussion of this class of instruments.

66 Regulation (EU) No. 575/2013, art 54(1)(a)(i).

67 EBA Draft RTS, n 61, 6 and 32.

the higher trigger level is justified for two reasons. Firstly, CRD IV[68] requires that own funds instruments used for remuneration purposes reflect the credit quality of the institution as a going concern. The EBA takes the view that this qualification would not be met by regular own funds instruments with a trigger of 5.125%. Secondly, a higher trigger level is thought to provide a more effective incentive for employees to take risks prudently.[69]

The Regulation on Classes of Instruments further requires that instruments used for purposes of remuneration comply with the arm's length-principle in terms of valuation and interest rate[70] and feature adequate deferral and retention periods.[71] They also provide additional guidance regarding conversion/write-down mechanisms by borrowing from the relevant provision in the Regulatory Technical Standards on own funds,[72] according to which it is for the management body of the institution to determine that a trigger event has occurred and to convert or write down the instrument. The Regulation on Classes of Instruments expands thereon where the specific nature of instruments used for remuneration so requires, e.g., with respect to the notification of staff.[73] In line with the respective provisions in the CRR and the Regulatory Technical Standards on own funds,[74] the Regulation on Classes of Instruments also sets out the conditions for a write-up.

b) 'Other Instruments' in Particular

Well before the enactment of CRD IV, there had been at least one cash-based scheme that provided for write-down on a contractual basis rather than involving payment in contingent capital securities.[75] As set out above, such

68 Directive 2013/36/EU, art 94(1)(l)(ii).

69 The increase regarding the minimum trigger drew considerable criticism in the consultation process, see, e.g., European Banking Federation, 'EBF response to EBA Consultation Paper on Draft Regulatory Technical Standards on classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of the Capital Requirements Directive' (27 October 2013) 5 <http://www.ebf-fbe.eu/uploads/EBF_004791%20-%20EBF%20response%20to%20EBA%20consultation%20on%20classes%20of%20instruments%20%20%20%20.pdf> accessed 5 June 2015 (noting that 5.125% already represents a 'going concern' trigger).

70 Commission Delegated Regulation No. 527/2014, arts 1(2)(c), (e) and (f), 2(c), 3(d) and 4(2)(f).

71 Commission Delegated Regulation No. 527/2014, arts 3(1) and 4(3)(f).

72 Compare Commission Delegated Regulation (EU) No. 241/2014 of 7 January 2014 [2014] OJ L74/8, art 22(1) with Commission Delegated Regulation No. 527/2014, art 5(6).

73 Commission Delegated Regulation No. 527/2014, art 5, in particular para 6.

74 Regulation (EU) No. 575/2013, art 52(1)(n); Commission Delegated Regulation (EU) No. 241/2014, art 21.

75 See nn 104–110 and accompanying text (Barclays PLC).

instruments can provide their holder with incentives similar if not identical to contingent capital securities, depending on the contractual provisions governing the payments made thereunder. Yet, lacking recognition as own funds instruments under CRD III, they did not count towards the 50% portion of variable remuneration to be paid in instruments.[76] New capital requirements introduced in the CRR[77] did not resolve the issue. The relevant provisions can hardly be construed in a way that would allow classification of debt arising from synthetic instruments as regulatory own funds, perhaps unlike other legislation implementing the Basel III Accord.[78]

To facilitate a broader use of synthetic 'bonus bonds', EU legislators therefore included 'other instruments which can be fully converted to Common Equity Tier 1 instruments or written down' (Other Instruments)[79] in the classes of appropriate instruments. According to the Regulation on Classes of Instruments, Other Instruments are either debt instruments that neither qualify as AT 1 nor as Tier 2 regulatory own funds, but are subject to comparable conversion or write-down mechanisms, or synthetic instruments that are linked to AT 1 or Tier 2 instruments.[80] Therefore, Other Instruments can also be based on a contract between the institution and staff instead of being issued in the market. This not only eliminates the requirement for a prospectus under the EU prospectus directive, but also enables the banks to add specific provisions specifically applicable to employees, such as clauses on retention and deferral, providing a much greater degree of flexibility. Such employee-related clauses would run counter to the principle of equal treatment of investors laid down in the EU prospectus directive were they to be incorporated in the terms and conditions of a capital instrument issued in the market.[81] As for the necessary link to an own funds instrument, this requires that the synthetic instrument must not at any time exceed the reference instrument in terms of value and payouts. In other words, the reference instrument provides a ceiling to payouts to be made under the synthetic instrument. The reference instrument must either be issued through an entity included within the group consolidation under CRR[82] or, in the case of an EU-based subsidiary to a parent under-

76 Directive 2006/48/EC (as amended by Directive 2010/76/EU), Annex V, point 23(o)(ii).

77 Regulation (EU) No. 575/2013, arts 28(1)(b), 52(1)(a) and 63(a).

78 See nn 161–179 and accompanying text on the implementation of Basel III in Switzerland.

79 Directive 2013/36/EU, art 94(1)(l)(ii).

80 See EBA Draft RTS, n 61, 5.

81 See also Commission Delegated Regulation No. 527/2014, recital 11; EBA Draft RTS, n 61, 23.

82 Commission Delegated Regulation No. 527/2014, art 4(1)(b), (3).

taking based outside the EU, through a parent undertaking that is subject to equivalent consolidated supervision.[83]

4. Conclusion with Regard to EU Legislation

At first glance, it would seem that European legislators wanted to encourage banks to increasingly use debt-based instruments over other forms of remuneration. As discussed above, a growing body of research suggests that there might be valid reasons to do so.[84] However, a more in-depth evaluation reveals that CRD IV and, to an even larger extent, the accompanying regulatory technical standards somewhat inhibit the use of debt-based instruments for purposes of remuneration.

Next we shall examine how, and the extent to which, the British and German legislators have implemented the relevant EU provisions as well as the effect this legislation has already had in the respective banking sectors, if any.

B. Implementation of CRD IV and Remuneration Practice in the United Kingdom

1. Implementation of CRD IV

The United Kingdom was the only EU member state that did not support the text of CRD IV on its adoption in the Council of the EU.[85] Being home to Europe's largest financial hub, the United Kingdom feared that tough rules on bonuses would undermine the competitiveness of its banking sector, in particular in overseas markets, where not all competitors are subject to comparable restraints. Consequently, in autumn 2013, the United Kingdom lodged a challenge with the European Court of Justice on CRD IV, inter alia, on the grounds that the rules on the bonus cap lacked a sufficient Treaty base.[86] Obligations under EU law forced the United Kingdom to implement CRD IV's rules on bonuses by 1 January 2014, irrespective of the fate of the challenge.[87]

83 Commission Delegated Regulation No. 527/2014, art 4(1)(c), (4).

84 See nn 9–13 and accompanying text.

85 See Council of the EU, 'Bank capital rules: Council confirms agreement with EP' (27 March 2013) fn 1 <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/136581.pdf> accessed 5 June 2015.

86 See HM Treasury, 'Legal challenge launched into new rules on bankers' pay' (25 September 2013) <https://www.gov.uk/government/news/legal-challenge-launched-into-new-rules-on-bankers-pay> accessed 5 June 2015.

87 The Advocate General recommended for the action to be dismissed. See Case C-507/13

Exercising the rule-making powers granted under the amended Financial Services and Markets Act 2000,[88] the UK regulators Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA)[89] implemented the relevant provisions by amending the Remuneration Code,[90] which is contained in both regulators' handbooks.[91] Regarding the use of debt-based instruments as variable remuneration, the UK regulators[92] did not go into further detail. This is hardly surprising, given the degree of detail already provided in the relevant CRD IV provision, let alone the accompanying regulatory technical standards. However, citing proportionality considerations, FSA guidance that was issued upon the implementation of CRD III in 2011 limited the scope of the rule by exempting staff otherwise subject to the Remuneration Code who were awarded no more than £500,000 in total remuneration, out of which no more than 33% constituted variable remuneration.[93] Furthermore, small[94] banks and investment firms were also excluded from the

United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union, Opinion of Advocate General Jääskinen [2014]. The United Kingdom eventually withdrew its challenge in November 2014.

88 Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), ss 137A, 137G and 137H.

89 Pursuant to the HM Treasury's The Financial Services and Markets Act 2000 (PRA-regulated Activities) Order No. 556 2013, arts 2 and 3, the PRA, which is a part of the Bank of England, regulates a number of specified activities, such as accepting deposits or dealing in investments as principal by credit institutions and major investment firms. Other financial conduct is being regulated by the FCA.

90 The Remuneration Code was originally released by the Financial Services Authority (FSA) in autumn 2009. It came into effect in early 2010, transposing the FSF Principles and the FSB Implementation Standards into UK regulation.

91 PRA Handbook, High Level Standards, SYSC (Senior Management Arrangements, Systems and Controls) 19A <http://fshandbook.info/FS/html/PRA> accessed 5 June 2015; FCA Handbook, High Level Standards, SYSC 19A <http://fshandbook.info/FS/html/FCA> accessed 5 June 2015. According to PRA Handbook, SYSC 19A.1.1R(1)(d) and (2), the Remuneration Code also applies to UK staff of overseas firms headquartered outside the EEA. The rules on remuneration will soon be moved from the PRA Handbook to the new PRA Rulebook. See PRA/FCA, 'Consultation Paper (PRA CP15/14/FCA CP14/14), Strengthening the alignment of risk and reward: new remuneration rules' (July 2014) para 1.14 <http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1514.pdf> accessed 5 June 2015.

92 PRA Handbook, n 91, SYSC 19A.3.47R.

93 FSA, 'Finalised Guidance 11/22: Remuneration: Proportionality guidance – changes to the boundary between Tiers 2 & 3 for banks and building societies' (12 December 2011) para 39(3) and (4)(b) <http://www.fsa.gov.uk/library/policy/final_guides/2011> accessed 5 June 2015.

94 For criteria currently applicable see PRA, 'Supervisory Statement (LSS8/13), Remuneration standards: the application of proportionality' (April 2013) paras 24 to 26 <http://www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/remunerationstandardslss8-13.pdf> accessed 5 June 2015.

relevant rule's scope.[95] These exemptions have been carried over into the current regulatory framework and remain applicable.[96] This is of course not to say that exempted staff are barred from participating in incentive schemes involving debt-based instruments. Equally, exempted institutions are free to use debt-based instruments for purposes of remuneration on a voluntary basis.

The UK regulators are currently taking further steps that will help align interests of managers with those of creditors. Such steps involve extending minimum deferral periods during which variable remuneration is subject to malus, as well as requiring regulated firms to amend employment contracts with material risk takers to allow recovery of vested bonuses (clawback).[97]

2. *Practice*

Faced with the new EU rules on variable remuneration, various UK banks publicly announced in spring 2014 that they were intent on circumventing the bonus cap by introducing a new class of pay, commonly referred to as 'allowances'[98], which purports to be neither salary (i.e., not pensionable) nor a bonus.

95 FSA, 'Finalised Guidance 11/22', n 93, para 34(1).

96 PRA Handbook, n 91, SYSC 19A.3.34G.

97 PRA, 'Policy Statement (PS 7/14): Clawback' (July 2014) <http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps714.pdf> accessed 5 June 2015 (amendments to PRA Handbook, in effect since 1 January 2015); PRA/FCA, 'Consultation Paper (PRA CP15/14/FCA CP14/14)', n 91, para 2.10. However, the final PRA rules have been narrowed from the original proposal as far as malus is concerned, removing 'a material downturn in [a financial institution's] financial performance' from the mandatory grounds for applying clawback. Compare PRA, 'Policy Statement (PS 7/14)', Appendix 1, Annex, SYSC 19A.3.51A and 19A.3.51B with PRA, 'Consultation Paper (CP6/14), Clawback' (March 2014) para 2.2(b) <http://www.bankofengland.co.uk/pra/Documents/publications/policy/2014/clawbackcp6-14.pdf> accessed 5 June 2015; PRA Handbook, n 91, SYSC 19A.3.52E.

98 The terminology used has varied across institutions. See, e.g., Barclays PLC, 'Annual Report 2013', 92 (all Barclays reports cited herein are available at: <http://www.barclays.com/barclays-investor-relations/results-and-reports/annual-reports.html> accessed 5 June 2015) ('role based pay'); HSBC, 'Annual Report 2013', 381 <http://www.hsbc.com/investor-relations/financial-and-regulatory-reports> accessed 5 June 2015 ('fixed pay allowance'); Lloyds Banking Group, 'Annual Report 2013', 102 <http://www.lloydsbankinggroup.com/globalassets/documents/investors/2014/2013_lbg_interactive_annual_report.pdf> accessed 5 June 2015 ('fixed share award'); Royal Bank of Scotland, 'Annual Report 2013', 69 <http://investors.rbs.com/~/media/Files/R/RBS-IR/2013-reports/annual-report-and-accounts-2013.pdf> accessed 5 June 2015 ('fixed share allowance'); Standard Chartered, 'Annual Report 2013', 180 <http://reports.standardchartered.com/annual-report-2013/pdf/2013-Annual-Report.pdf> accessed 5 June 2015 ('fixed share allowances').

Combined with raising the ratio between variable and fixed remuneration from 1:1 to 2:1,[99] UK banks were hopeful that this new class of pay was going to help them retain and attract talent, especially in non-EU markets. However, following a probe into these allowances, the EBA found in October 2014 that in many cases these allowances represented variable rather than fixed remuneration. The EBA therefore advised that banks using such allowances are expected to change their remuneration policies before the end of 2014.[100]

As of autumn 2013, UK financial institutions had issued the largest share in the global market in contingent capital securities.[101] Yet, only Barclays, Lloyds Banking Group and a couple of building societies such as Nationwide[102] had contributed to the total amount of $20.7 billion that were outstanding in such instruments in the UK as of September 2013.[103] While these institutions have yet to include contingent capital securities in remuneration packages, in 2011 Barclays introduced the so-called Contingent Capital Plan,[104] which was to govern awards of deferred cash bonuses to staff subject to the deferral requirements imposed by the Remuneration Code.[105] Although the scope of the Contingent Capital Plan was not limited to 2011,[106] Barclays did not make any further awards thereunder in subsequent years.

In accordance with the Remuneration Code, cash-based awards under the Contingent Capital Plan made up 50% of all deferred variable remuneration

99 This requires shareholders' approval. See PRA Handbook, n 91, SYSC 19A.3.44A R (transposing Directive 2013/36/EU, art 94(1)(g)(ii) into UK regulation).

100 EBA, Opinion of the European Banking Authority on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances, 15 October 2014, paras 14 f.

101 Avdjiev, Kartasheva & Bogdanova, n 24, 48.

102 Further building societies which have issued contingent capital securities include Yorkshire Building Society and Chelsea Building Society (on the occasion of their merger at the end of 2009) and Newcastle Building Society (see press release at: <http://www.company-newcastle.co.uk/wp-content/uploads/2011/09/CorsicaCompletionAnnouncement10-5-10.pdf> accessed 5 June 2015.

103 Amount cited after Avdjiev, Kartasheva & Bogdanova, n 24, 48. In September 2014, HSBC issued its first contingent capital securities, raising approximately $5.6 bn. See Christopher Thompson, 'HSBC joins "coco" bond revival' *The Financial Times* (London, 12 September 2014) <http://www.ft.com/intl/cms/s/0/c2bad96e-38d5-11e4-a53b-00144feabdc0.html#axzz3GnlKqGG3> accessed 5 June 2015.

104 Barclays PLC, 'Annual Report 2010', 167 and 182.

105 Now found in PRA Handbook, n 91, SYSC 19A.3.49 R.

106 See Barclays PLC, 'Rules of the Barclays Group Share Value Plan' (last amended on 17 February 2014) (Barclays Share Value Plan) <https://www.sec.gov/Archives/edgar/data/312069/000119312514099379/d686589dex49.htm> accessed 5 June 2015, to which the Contingent Capital Plan apparently continues to form schedule 3.

in 2011, with the residual 50% being granted in shares or share-based instruments.[107] Payments were made over a three-year schedule, with awards vesting in three annual tranches. Vesting of these tranches would have been suspended if the group core tier 1 capital ratio had fallen below 7% as of the vesting date. Had the capital ratio failed to recover within five years of the suspension, the awards would have been considered forfeited.[108] The Contingent Capital Plan also provided for payment of a 'discretionary benefit' equivalent to a coupon upon vesting of an award, which was set at 7% for all vesting periods up to 2014.[109]

In essence, the Contingent Capital Plan merely exposed deferred cash awards to a new kind of malus provision in exchange for a rather substantial coupon. As indicated above, it was motivated by regulations that required for deferral of variable pay. Since abandoning the Contingent Capital Plan in 2012, i.e., merely one year after its inception, Barclays has been granting deferred cash incentives to staff under the terms of the so-called Cash Value Plan, which had already been introduced alongside the Contingent Capital Plan in 2011.[110] The Cash Value Plan ties deferred cash awards to a given number of notional securities, being either shares or other capital instruments, both in terms of value and additional payments. Unlike the Contingent Capital Plan, the Cash Value Plan could therefore meet the standard laid down in the Regulation on Classes of Instruments on synthetic plans[111] if awards were to reference one of Barclays' outstanding own funds instruments, provided that such reference instrument was subject to a trigger of at least 7%. Barclays' Share Value Plan would even allow paying employees in capital instruments.[112] However, to date, Barclays has neither used regulatory own funds instruments as reference instruments, nor has it made awards in contingent capital securities. As of 2014, the firm's capital ratio continues to be one in an array of measures used to determine awards and to subsequently adjust unvested awards by way of malus,[113] albeit in much less obvious fashion than with the Contingent Capital Plan.[114]

Nationwide uses a malus provision whereby outstanding deferred cash awards under Nationwide's medium term bonus scheme are to be cancelled if the

107 See Barclays PLC, 'Annual Report 2010', 172.
108 Barclays PLC, 'Notice of Annual General Meeting 2011', 12 <http://reports.barclays.com/content/dam/barclayspublic/docs/InvestorRelations/PrivateShareholders/2011AGM/notice-of-meeting.pdf> accessed 5 June 2015.
109 Barclays PLC, 'Annual Reports 2010', 182; '2011', 60; '2012', 100; '2013', 124.
110 Barclays PLC, 'Annual Report 2010', 180.
111 See nn 80–83 and accompanying text.
112 Barclays Share Value Plan, n 106, Rule 2.10.
113 See Barclays PLC, 'Annual Report 2013', 102 ff.
114 See Barclays Share Value Plan, n 106, Rule 3.3 (providing that 'significant deterioration of the group's financial health' may give rise to malus).

CET 1 capital ratio falls below 10%.[115] Lloyds Banking Group apparently reserves the right to pay a part of deferred annual bonuses to its directors in contingent capital securities.[116]

Although it has yet to issue proper contingent capital securities in the market, RBS was the first to use junior debt-based instruments for purposes of remuneration, announcing as early as February 2009 that, in lieu of discretionary cash bonuses, it would pay deferred bonuses in subordinated loans.[117] However, in the following year RBS returned to using cash and equity for its bonus awards to its directors.[118] In retrospect, it therefore seems more likely that immense pressure from the public and the UK government to curb remuneration was the crucial factor in leading majority state-owned RBS to pay bonuses in subordinated debt rather than the alleged benefits of debt-based remuneration in terms of aligning bankers with interests of creditors.[119]

115 Nationwide Building Society, 'Annual Report 2013', 75, <http://www.nationwide.co.uk/~/media/MainSite/documents/about/corporate-information/results-and-accounts/annual-report-2013.pdf> accessed 5 June 2015 (further noting, at 81, that mutuals may find it particularly difficult to devise non-cash instruments that are suitable for remuneration).

116 Lloyds Banking Group PLC, 'Annual Report 2014', 86 <http://www.lloydsbankinggroup.com/investors/financial-performance/lloyds-banking-group> accessed 5 June 2015.

117 Royal Bank of Scotland, 'Annual Report 2008', 159, <http://www.investors.rbs.com/~/media/Files/R/RBS-IR/annual-reports/rbs-group-accounts-2008.pdf> accessed 5 June 2015. Apparently Lloyds Banking Group operated a similar scheme, albeit on a voluntary basis. See Lloyds Trade Union, 'LTU & Bank Agree Bonus Deferral Arrangements' (Members Newsletter, 19 May 2009) <http://www.ltu.co.uk/download/638,dynamic> accessed 5 June 2015.

118 Media reports suggest that RBS continued to pay bonuses in subordinated debt in 2012. See Philip Aldrick, 'BoE tells banks to crack down on bonuses' *The Telegraph* (London, 30 November 2012) <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9715818/BoE-tells-banks-to-crack-down-on-bonuses.html> accessed 5 June 2015; Louise Bowman, 'Bankers' pay: Bonds. The bonus is in bonds.' *Euromoney.com* (November 2012) <http://www.euromoney.com/Article/3110604/Bankers-pay-Bonds-The-bonus-is-in-bonds.html> accessed 5 June 2015. But see Royal Bank of Scotland Plc, 'Annual Report 2012', 325 <http://www.investors.rbs.com/~/media/Files/R/RBS-IR/annual-reports/annual-report-2012.pdf> accessed 5 June 2015 (only mentioning deferred cash awards without divulging whether sums outstanding thereunder were subordinated to other debt).

119 See, e.g., Guido Ferrarini & Maria C. Ungureanu, 'Executive pay at ailing banks and beyond: a European perspective' (2010) 5 Capital Markets Law Journal 197, 210–212 (showing that the designs of remuneration systems at RBS and Lloyds were heavily influenced by the intervention of UK government). See also Patrick Wintour & Jill Treanor, 'RBS bonuses to reach £775m despite Treasury tough talk' *The Guardian* (London, 18 February 2009) <http://www.theguardian.com/business/2009/feb/18/rbs-bonuses> accessed 5 June 2015; Peter Thal Larsen & Jean Eaglesham, 'RBS to

C. Implementation of CRD IV and Remuneration Practice in Germany

1. Implementation of CRD IV

In August 2013, German Parliament passed the CRD IV Implementation Act,[120] whereby the Banking Act[121] and other legislation were amended. Some parts of the CRD IV provisions on remuneration, such as the cap on bonuses, were incorporated in § 25a(5) of the Banking Act, while other, more technical issues, such as the requirement that half of variable remuneration be paid in instruments, were to be implemented in an ordinance by the Federal Ministry of Finance. To this end, the Federal Ministry of Finance amended the Remuneration Ordinance for Institutions (German Remuneration Ordinance),[122] which had originally been introduced to implement CRD III.

For reasons of proportionality, the German Remuneration Ordinance divides institutions into two categories. A number of provisions, including the one[123] implementing the requirement for 50% of variable remuneration to be paid in instruments, only apply to 'significant' institutions.[124] Their scope is thus limited to roughly the fifty largest banks in Germany.[125]

Unlike CRD IV or the relevant provision of the UK Remuneration Code, the German Remuneration Ordinance does not name the instruments considered suitable for remuneration. Instead, it rather opaquely requires that at least 50% of variable remuneration be contingent upon the sustained welfare of the institution.[126] Additional guidance on this provision published by the German regulator *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) advises institutions to primarily use shares or share-like instruments to satisfy the

pay bonuses worth up to £950m' *Financial Times* (London, 17 February 2009) <http://www.ft.com/cms/s/0/81d2f4b8-fd08-11dd-a103-000077b07658.html> accessed 5 June 2015.

120 German CRD IV Implementation Act of 28 August 2013, Federal Gazette (BGBl.) 2013 I p 3395.

121 German Banking Act (Kreditwesengesetz, KWG) of 28 September 2008 (restatement), Federal Gazette (BGBl.) I p 2776 (German Banking Act).

122 Ordinance on the Supervisory Requirements for Institutions' Remuneration Systems (Instituts-Vergütungsverordnung, InstitutsVergV) of 16 December 2013 (restatement), Federal Gazette (BGBl.) 2013 I p 4270.

123 German Remuneration Ordinance, § 20(4).

124 ie institutions whose balance sheet reaches or is in excess of €15bn, as well as certain other institutions. See German Remuneration Ordinance, § 17(1).

125 For rankings by assets see <http://www.die-bank.de/fileadmin/images/top100/die-bank_Top100_2013.pdf> accessed 5 June 2015 (based on balance sheets at the end of 2012).

126 German Remuneration Ordinance, § 20(4) ('mindestens 50 Prozent [der variablen Vergütung müssen] von einer nachhaltigen Wertentwicklung des Instituts abhängen').

standard set by the Ordinance, adding in passing that debt instruments subject to write-down or conversion should be used where possible.[127]

The German approach to implementing article 94(1)(l) of CRD IV seems rather casual, making no mention of the balance of shares and contingent capital securities in variable remuneration packages required thereunder,[128] and therefore possibly falls short of the standard of implementation under EU law. However, this may be due to the fact that German banks have only begun to issue contingent capital securities after the relevant legislation was enacted. References to contingent capital securities in the context of remuneration may have appeared somewhat premature at the time the German Remuneration Ordinance was drawn up. While the flexibility German legislation seems to afford to institutions in designing remuneration structures should be welcomed, it has to be noted that it is by and large derogated by the directly applicable and exceedingly detailed Regulation on Classes of Instruments.[129]

2. *Practice*

As noted above, German banks have only begun to issue contingent capital securities very recently. Their hesitance was largely caused by apprehension towards possible tax implications. More specifically, there had been doubt as to whether interest payments made under contingent capital instruments would be deductible under German tax law. After the German Ministry of Finance confirmed the tax-deductibility in April 2014, Deutsche Bank went ahead and issued its first contingent capital instruments.[130] Although initially eager to follow suit,[131] other banks seem to have shelved their plans to issue contingent capital securities for the time being.

127 BaFin, 'Auslegungsentscheidung: Auslegungshilfe zur Institutsvergütungsverordnung' (1 January 2014) § 20 <http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/BA/ae_140101_institutsvergv.html> accessed 5 June 2015.

128 See also Stefan Lunk & Friederike Besenthal, 'Die neuen EU Regelungen zu Banker Boni' [2013] Neue Zeitschrift für Gesellschaftsrecht 1010, 1011 (noting, with respect to Directive 2013/36/EU, art 94(1)(l), that there must be a reasonable balance between equity-based instruments and debt-based instruments within the meaning of Directive 2013/36/EU, art 94(1)(l)(ii)).

129 See n 60ff and accompanying text.

130 See Deutsche Bank AG, 'Press Release: Deutsche Bank successfully completes issuance of Additional Tier 1 capital' (20 May 2014) <https://www.deutsche-bank.de/medien/en/content/4666_4939.htm> accessed 5 June 2015.

131 Markus Frühauf, 'Emissionswelle an Risikoanleihen der Banken steht bevor' *Frankfurter Allgemeine-Zeitung* (Frankfurt a. M., 12 April 2014) <http://www.faz.net/aktuell/finanzen/anleihen-zinsen/eine-emissionswelle-an-risikoanleihen-der-banken-steht-bevor-12891961.html> accessed 5 June 2015.

Considering the above, it is not surprising that incentive structures at large German banks have so far exclusively revolved around more traditional means of remuneration, i.e., cash, equity or equity-linked cash awards.[132] While Deutsche Bank continues to use equity-based instruments to satisfy the minimum of 50% of variable remuneration that must be paid in instruments, it broke new ground in 2014 by introducing a firm-wide malus provision involving the firm's capital ratio. Should the CET 1 capital ratio at any time drop below a threshold consisting of the applicable regulatory minimum requirement plus an additional 200 basis points, all equity-based awards unvested at that time will be forfeited.[133] Unlike other malus or clawback provisions, this not only applies to staff subject to the Remuneration Ordinance for Institutions, but also to non-regulated employees. Additionally, the CET 1 capital ratio is a measure for the calculation of the initial awards.[134]

The German banking sector traditionally features many state banks and cooperative banks. As a rule, variable remuneration is less common and generally makes up a smaller share of total remuneration in German cooperative and state banks. Unable to link remuneration to equity instruments, state banks tend to pay variable remuneration in cash, subject partially to deferral and adjustment provisions to factor in sustained changes in value in order to live up to the standard laid down in the German Remuneration Ordinance.[135]

132 See, e.g., Commerzbank AG, 'Annual Report 2014', 31, 35 <https://www.commerzbank.com/media/aktionaere/service/archive/konzern/2015_2/00_CAA_Geschaeftsbericht_2014_Konzern_EN.pdf> accessed 5 June 2015 (variable remuneration made up of straight cash and equity-linked deferred cash awards), DZ Bank AG, 'Annual Report 2014', 348 <http://www.annualreport.dzbank.com/static/export/docs/DZBANK_Group_AR2014.pdf> accessed 5 June 2015 (deferred cash awards subject to reductions if share price drops below pre-specified thresholds).

133 Deutsche Bank AG, 'Annual Report 2013', 235 <https://annualreport.deutsche-bank.com/2013/ar/servicepages/downloads/files/dbfy2013_entire.pdf> accessed 5 June 2015. See also Deutsche Bank AG, 'Annual Report 2014', 268 <https://www.db.com/ir/en/download/Deutsche_Bank_Annual_Report_2014_entire.pdf> accessed 5 June 2015.

134 Deutsche Bank AG, 'Annual Report 2013', 244.

135 See, e.g., Landesbank Baden-Württemberg, 'Annual Report 2014', 28 <http://www.lbbw.de/media/en/investor_relations/pdf_investorrelations/2015/LBBW_Annual_Report_2014.pdf > accessed 3 June 2015 ('50% of this deferred remuneration is based on sustained performance') and Landesbank Baden-Württemberg, 'Remuneration Report 2013', 8 <http://www.lbbw.de/media/en/investor_relations/pdf_investorrelations/2013/LBBW_Remuneration_Report_13.pdf> accessed 3 June 2015 ('50% of the deferred amount is frozen for a period of one year and tied to sustained changes in value'); BayernLB, 'Vergütungsbericht 2013', 8 <http://www.bayernlb.de/internet/media/de/internet_4/de_1/downloads_5/0821_investor_relations_1/geschaeftsbericht/geschaeftsbericht_1/2013_16/verguetungsbericht.pdf > accessed 5 June 2015.

D. Debt-Based Instruments as a Means of Remuneration in Switzerland

1. Swiss Approach towards Contingent Capital Securities

With its financial market in considerable turmoil and one of its two global banks even teetering on the brink of collapse, Switzerland was clearly badly affected by the financial crisis of 2007–2009. This experience caused Swiss lawmakers and regulators to embark on a radical overhaul of financial market regulations, primarily by amending existing legislation such as the Swiss Banking Act[136] and the Capital Adequacy Ordinance[137], but also by passing new legislation.[138] Not being a member state of the EU, Switzerland has been trying to pursue a fairly independent regulatory approach, whilst still keeping abreast of, and taking part in, international regulatory activities. Faced with banking behemoths like UBS AG and Credit Suisse Group AG, whose combined assets in 2011 amounted to roughly four times the Swiss GDP,[139] tackling the apparent 'too big to fail'-problem associated with its two big banks was obviously a top priority for Swiss lawmakers and regulators. One key measure to enhance financial stability was the prescription of increased capital requirements for all Swiss banks with additional requirements for systemic important financial institutions (SIFIs).[140] These new capital requirements, strengthened in terms of quantity and quality (loss-absorbency), even exceed the requirements laid down in the Basel III Accord and must be implemented gradually by 2019.[141] In the discussions on the optimal regulatory capital mix,

136 Swiss Federal Act on Banks and Savings Banks of 8 November 1934 (Swiss Banking Act), Classified Compilation of Federal Laws (SR) 952.0.

137 Swiss Federal Ordinance Concerning Capital Adequacy and Risk Diversification for Banks and Securities Dealers of 1 June 2012 (Capital Adequacy Ordinance), Classified Compilation of Federal Laws (SR) 952.03 (in force since 1 January 2013).

138 This process is far from over, with various draft bills concerning financial markets currently about to be discussed in Swiss Parliament. See the index of regulatory projects at: <https://www.sif.admin.ch/sif/en/home/dokumentation/finweb/regulierungs projekte.html> accessed 5 June 2015.

139 See Swiss National Bank, '2011 Financial Stability Report' (June 2011) 14 <http://www.snb.ch/en/mmr/reference/stabrep_2011/source/stabrep_2011.en.pdf> accessed 5 June 2015.

140 See Swiss Federal Council, 'Dispatch on an Amendment of the Banking Act (Strengthening Stability in the Financial Sector; Too Big To Fail) of 20 April 2011' (TBTF-Dispatch), Swiss Federal Gazette (BBl.) 2011, 4717, 4719; see also Robert Breikreuz & Jens Vollmar, 'Contingent Bonds zur Krisenprävention, Eigenmittelvorschriften des E-BankG zur Begrenzung der Too-Big-To-Fail-Problematik in der Schweiz' [2011] Der Schweizer Treuhänder 148, 148; Reto Schiltknecht, 'Die 'Too Big to Fail'-Problematik – neueste Entwicklungen in der Schweiz' [2010] 82 Swiss Review of Business and Financial Market Law 435.

141 See Capital Adequacy Ordinance, art 143 ff.

the Swiss Federal Council proposed, *inter alia,* the creation of a legal foundation for contingent capital securities,[142] which were deemed capable of strengthening banks' capital bases due to their loss-absorbing characteristics.[143] In contrast to the Basel III Accord, Swiss law explicitly recognises contingent capital securities as an independent category of regulatory capital.[144] It allows banks, and SIFIs in particular, to satisfy part of their increased capital requirements with such instruments, namely up to 3% for the capital buffer and a significant part of their progressive component.[145] Regulatory recognition is, however, subject to certain eligibility criteria. For a contingent capital instrument to be recognised as AT 1 capital, the terms of such instrument must provide for two kinds of triggers causing either conversion or write-down: (a) a trigger based on the CET 1 capital ratio[146] and (b) a so-called legal trigger. The latter is to secure that a conversion or write-down occur whenever the financial institution has reached a so-called 'point of non-viability' (PONV), i.e., when either (i) a drawdown of emergency financial aid from public authorities is imminent, or (ii) the Swiss Financial Supervisory Authority (FINMA) determines that a conversion or write-down is necessary to avoid the bank's insolvency or bankruptcy.[147] By contrast, Tier 2 capital instruments only need to be subject to conversion or write-down upon a PONV-event, while triggers based on capital ratios are optional.[148]

Even before the formal adoption of the relevant provisions in September 2011,[149] Credit Suisse Group AG set a precedent in February 2011 by success-

142 See Final Report of the Commission of Experts for Limiting Economic Risk Posed by Large Companies (30 September 2010), 24ff <https://www.sif.admin.ch/sif/en/home/themen/finanzmarktregulierung-und–aufsicht/staerkung-der-stabilitaet-im-finanzsektor–too-big-to-fail-/expertenkommission–too-big-to-fail-.html> accessed 5 June 2015; TBTF-Dispatch, n 140, 4751 ff.

143 TBTF-Dispatch, n 140, 4768 ff., in particular 4774 ff.

144 TBTF-Dispatch, n 140, 4752; see Reto Schiltknecht & Christopher McHale, 'Erste Erfahrungen mit dem bedingten Wandlungskapital (CoCos)' [2012] Swiss Journal of Corporate and Capital Markets Law and Reorganizations (GesKR) 507, 511; René Bösch & Benjamin Leisinger, 'Contingent Convertible Bonds – CoCos' [2012] 84 Swiss Review of Business and Financial Market Law (SZW) 2, 5; Peter Böckli, 'CoCos, Write-offs: Eigenkapitalbeschaffung mit dem Zauberstab' [2012] 84 Swiss Review of Business and Financial Market Law (SZW) 181, 185.

145 Capital Adequacy Ordinance, art 129(2) (re capital puffer) and art 130(2) (re progressive component). See also Theodor Härtsch, Contingent Convertibles – Practical considerations and implementation' [2011] Swiss Journal of Corporate and Capital Markets Law and Reorganizations (GesKR) 193, 194.

146 See Capital Adequacy Ordinance, art 27(3).

147 See Capital Adequacy Ordinance, art 29(2).

148 See Capital Adequacy Ordinance, art 30(3) in connection with art 29(1) and (2).

149 See Swiss Banking Act, art 11(1)(b) in connection with art 13 (re conversion) and art 11(2) (re write-down).

fully issuing contingent capital securities with a conversion mechanism to external investors. Further issuances by different Swiss issuers followed.[150] The subsequent eligibility of contingent capital securities as regulatory capital only added further to the popularity of these instruments.

2. *Debate on Remuneration and Current Regulatory Framework*

In light of the described Swiss regulatory approach, remunerating bank executives with contingent capital securities seems appealing for financial institutions, not only to improve incentive structures for their executives, but also to meet the imposed increased capital requirements. So far, however, the current debate on remuneration in Switzerland has not yet focused on this new means of remuneration. Academic discussion has only recently begun to analyse this idea. Although the financial crisis intensified the debate in Switzerland on management remuneration, the political discussions primarily concentrated on the limitation of excessive management remuneration rather than on the actual design of remuneration schemes. One prominent offspring of these discussions was the successful federal popular initiative against rip-off salaries of 2013 (the Minder Initiative[151]), seeking to control executive pay of listed companies and to increase shareholders' say in corporate governance.[152] However, the constitutional amendment brought about through the adoption of the Minder Initiative does not address the design of remuneration schemes and nor does the federal legislation enacted as a result of the adoption do so either.[153] Other popular initiatives that were arguably more radical (in particular on determining a hard cap on management remuneration) did not find support in the Swiss population.[154]

150 For some examples thereof, see Schiltknecht & McHale (2012), n 144, table at 523.

151 Named after its initiator, Thomas Minder, who is now a member of the upper chamber of Swiss Parliament, the Council of States.

152 The Minder Initiative was passed by a majority of Swiss population on 3 March 2013. It was subsequently temporarily implemented by way of an ordinance (Ordinance Against Excessive Remuneration in Listed Companies of 20 November 2013, Classified Compilation of Federal Laws (SR) 221.331) until a final law will be adopted. This new legislation is not specifically tailored to financial institutions, but concerns listed companies in general. Its primary objective is to strengthen the shareholders' rights with a view to improving corporate governance in listed companies rather than actually cutting or limiting management remuneration.

153 See n 152.

154 The '1 : 12 – for fair salaries'-initiative, which aimed at fixing the top management's remuneration at a maximum of 12 times the remuneration of the lowest paid employee in the same firm, was clearly rejected by the Swiss population on 24 November 2013.

Stricter guidelines, including specific rules on the design of remuneration schemes, have been set in place for financial institutions in the regulatory context. Inspired by the FSF Principles, the Swiss Financial Market Supervisory Authority (FINMA) published in its circular 2010/1 'Remuneration Schemes' ten principles on remuneration schemes of financial institutions.[155] No. 7 of these Principles requires financial institutions to defer payment of part of the remuneration[156] in such a way that it optimally promotes the risk awareness of the beneficiaries and encourages them to operate the business in a sustainable manner.[157] Akin to the international standards briefly discussed above, the FINMA-Circular provides only vague guidelines as to the recommended deferral time period.[158] It should be pointed out in this context that the functioning of the incentive structure envisaged by remunerating bank executives in contingent capital securities is always going to be very much dependent on an appropriate deferral period. For regulatory reasons in connection with the recognition of these capital instruments, it might additionally be necessary to coordinate deferral time periods with required minimum terms.[159] Similarly opaque are FINMA's directions on the proportion of variable remuneration to total remuneration and the relationship between immediate and deferred remuneration.[160] The said FINMA-Circular is, however, silent on the forms of financial instruments to be used in remuneration schemes of financial institutions, neither encouraging nor prohibiting debt-based remuneration schemes. It needs to be added, though, that the increased complexity associated with debt-based remuneration schemes is only recon-

155 These principles are considered minimum standards for the design, implementation, and disclosure of remuneration schemes in financial institutions. See FINMA, 'Circular 2010/1 Remuneration Schemes, Minimum standards for remuneration schemes of financial institutions' (21 October 2009) (in force since 1 January 2010), margin note 2 <http://www.finma.ch/e/regulierung/Documents/finma-rs-2010-01-e.pdf> accessed 3 June 2015. They are aimed at setting up an optimal incentive structure in remuneration schemes in order to promote the long-term success and stability of the company. See FINMA-Circular, n 155, margin note 1.

156 See FINMA-Circular, n 155, margin notes 48 ff.

157 See FINMA-Circular, n 155, margin note 51.

158 As the deferral should link remuneration with the future development of performance and risk, the time period for the deferral should be tied to the time horizon of the risk the beneficiary of the remuneration is responsible for. For members of senior management, other persons with a relatively high total remuneration, and key risk takers, the time period for the deferral should be at least three years. The greater the responsibility of a beneficiary and the greater her or his total remuneration, the greater the percentage of her or his remuneration should be deferred. Compare FINMA-Circular, n 155, margin notes 51 ff.

159 See n 172 (Tier 2 instruments) and nn 175 ff. (AT 1 instruments) and accompanying text.

160 See FINMA-Circular, n 155, margin note 38 in connection with margin notes 30 ff.

cilable with difficulty with Principle No. 2 of the FINMA-Circular according to which the remuneration scheme should be simple and comprehensible for current and potential beneficiaries. In conclusion, the current regulatory framework in Switzerland seems to be at least neutral towards the use of contingent capital securities in remuneration schemes of financial institutions, even supporting their implementation due to their regulatory treatment.

3. Treatment of Debt-based Remuneration Schemes in Terms of Capital Adequacy

Pursuant to the Basel III Accord, an inclusion of capital instruments in Tier 1 or Tier 2 regulatory capital components requires, *inter alia,* that such capital instruments be 'issued and paid-in'. Unlike the relevant CRR provisions,[161] article 20(1) of the Capital Adequacy Ordinance does not strictly adhere to the Basel III Accord, but takes a more liberal approach by requiring own funds instruments to be 'either fully paid-in or *internally generated*'. The rationale behind the insertion of the words 'internally generated' is not entirely clear. In any event, they give rise to the question whether debt obligations under synthetic remuneration schemes[162] may qualify as regulatory capital if they are subject to appropriate write-down or conversion[163] mechanisms.[164]

Under a literal interpretation of the term, deferred awards under a synthetic remuneration scheme would arguably qualify as 'internally generated' to the extent they have been expensed[165] prior to the vesting date of the respective award, reducing the profit available for distribution in a manner similar to provisions for future liabilities.[166] By repeatedly referring to the narrower term

161 See nn 77–78 and accompanying text.

162 Such instruments would fall within the category of 'Other Instruments' under EU regulations. See nn 75–83 and accompanying text.

163 In a purely contractual setting, such write-down can be implemented relatively easily by subjecting deferred cash bonuses to an appropriate malus provision. See nn 104–110 and accompanying text (re Barclays' Contingent Capital Plan). Designing conversion mechanisms might be significantly more complex.

164 The latter would be in line with the favourable stance of lawmakers towards the adoption of contingent capital securities-based remuneration schemes by banks. See TBTF-Dispatch, n 140, 4774 (suggesting the use of contingent capital securities to avoid adverse incentives inherent to other means of remuneration).

165 The point in time when the actual expenditures are made (e.g., a minimum term of five years) determines the eligibility of the instruments for recognition as Tier 2 or AT1 capital. See Schiltknecht & McHale (2015), n 2, 17.

166 For regulatory recognition, it is not sufficient to only commit to remuneration payments. Regulatory recognition will only be available when the payment obligations towards the employees have been recorded as expenditures. See Schiltknecht & McHale (2015), n 2, 17.

'conversion capital'[167] in lieu of the broader term 'capital instrument', the pertinent provisions in the Capital Adequacy Ordinance on capital requirements for SIFIs would rather suggest a strict interpretation, prohibiting an extension on synthetic remuneration schemes. This understanding would also be in line with the narrow language used in the Basel III Accord. Adopting a more functional approach, it could be argued that synthetic remuneration schemes incorporating write-down or conversion mechanisms generally have loss-absorbency capabilities comparable to issued capital instruments and should therefore be treated equally. Their loss-absorbency capabilities could, however, be drawn into question by the fact that awards to different employees under a synthetic remuneration scheme are typically not governed exclusively by one single document of terms and conditions. It is therefore quite conceivable that, in addition to the terms of the scheme and the agreement under which the award was granted, there exist further agreements between the financial institution and an employee participating in the scheme that could come to have a bearing on the outcome of a court case. Furthermore, it cannot be ruled out that local labour laws in the countries in which beneficiaries to the plan reside[168] may void contractual malus or clawback mechanisms that are based on the financial institution's capital ratio if, e.g., such mechanisms are considered to constitute an unlawful transfer of the business risk from employer to employee.

The annual reports of 2013 und 2014 from Switzerland's largest banks, however, clearly indicate that FINMA seems to recognise synthetic remuneration schemes as own funds instruments[169] and consider remuneration liabilities eligible for recognition as AT 1 or Tier 2 capital, as the case may be, provided that they contribute to loss-absorbency upon the occurrence of a trigger

167 As per the definition given in Capital Adequacy Ordinance, art 126(1), this term only encompasses contingent capital securities that have been issued in the market.

168 Whether restrictive provisions of local labour laws can be circumvented via appropriate choice-of-law clauses depends on the choice-of-law rules of the relevant jurisdiction.

169 UBS AG, 'Annual Report 2014', 252 ff. <http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting/2014.html> accessed 3 June 2015; Credit Suisse Group AG, 'Annual Report 2014', 205, <https://www.credit-suisse.com/media/cc/docs/publications/annualreporting/2014/csgag-csag-ar-2014-en.pdf> accessed 3 June 2015; see also UBS AG, 'Annual Report 2013', 231 <http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting/2013.html> accessed 3 June 2015. Although neither report states approval by FINMA on the respective scheme specifically, it is all but certain that such approval had been given because Swiss regulations require the banks to obtain prior approval from FINMA on all AT 1 instruments as well as Tier 2 instruments that are to count towards the progressive capital buffer. This observation is confirmed by a recent article of Schiltknecht & McHale (2015) (n 2), 16ff, two FINMA executives.

event.[170] Such recognition is in any event contingent upon prior FINMA approval, allowing FINMA to check whether all requirements set out in the Capital Adequacy Ordinance for recognition as AT 1 and Tier 2 capital, respectively, are met.[171]

As far as Tier 2 capital is concerned, an up-front expenditure of the entire remuneration amount is required. Partial expenditures, e.g., conducted on an annual basis, are not permissible since each partial expenditure would *per se* not meet the requirement of the five year minimum term.[172] A legal amortisation obligation requires that the eligible amount of Tier 2 instruments be reduced by 20% each year in the last five years of their term.[173] Absent a trigger event and after expiration of the minimum term, payouts to employees may, in contrast to AT 1 instruments, not be refused on the grounds of an inappropriate capital base.[174] This is a significant advantage of Tier 2 instruments.

When it comes to AT 1 capital, the requirement for perpetual duration[175] may confront financial institutions with further difficulties in designing synthetic remuneration schemes for the purposes of generating regulatory capital: as financial institutions are not obliged by law to repay the principal of perpetual AT 1 capital instruments prior to entering into liquidation, beneficiaries of remuneration schemes designed for recognition as AT 1 capital would *de facto* be doomed to remain invested in the instrument forever, unable to monetise their claims by offloading them in the market.[176] From an incentive point of view, this hardly seems to be an attractive proposition for employees.[177] However, it could be argued that, from an economic perspective, prior cash payouts to beneficiaries generally do not impair the loss-absorbing capabilities of such instruments as long as the total amount of liabilities under the remuneration scheme – the total 'notional principal' if considered as a pool of several 'notional bonds' – remains unaffected over time. This could be reached either (i) by transferring 'notional bonds' from the recipient of a cash payment at

170 Capital Adequacy Ordinance, art 127.

171 Swiss Banking Act, art 11(4); see also Capital Adequacy Ordinance, arts 27(5) and 127(2).

172 Schiltknecht & McHale (2015), n 2, 18.

173 Capital Adequacy Ordinance, art 30(2).

174 See Schiltknecht & McHale (2015), n 2, 18.

175 Basel III Accord, para 55(4) and Capital Adequacy Ordinance, art. 27(1)(b).

176 Eriksson & McVea (n 2, 104) (noting that the risk of conversion/write-down is increased due to the perpetual duration requirement; accordingly, a higher coupon yield is required to reflect this higher risk).

177 There is a problematic tension between the obligation to pay out vested awards and the concept of a regulatory perpetual capital instrument. See Schiltknecht & McHale (2015), n 2, 18.

vesting to another beneficiary, or (ii) by replacing existing 'notional bonds' with new ones ahead of payouts, i.e., by awarding additional 'notional bonds' to the same beneficiary before the original ones vest.[178] According to this line of argument, a financial institution would be allowed to make payouts to beneficiaries of the remuneration scheme at the vesting date of their interests, provided the overall 'rolling pool of notional bonds' has been sufficiently replenished. In line with the above, such pool of 'notional bonds' will in any event only be recognised as AT 1 capital up to a certain level to control for payouts to beneficiaries. In contrast to Tier 2 instruments, there will always be uncertainty for the remuneration scheme beneficiaries whether payouts would be refused by FINMA referring to an inappropriate capital base.[179]

4. Practice

Probably because of the illiquidity of Swiss contingent capital securities markets and the problem related thereto of timely procuring such capital instruments, remuneration schemes involving actually issued contingent capital securities have not been in use in Switzerland until now. However, both major Swiss banks, UBS AG and Credit Suisse Group AG, currently maintain synthetic remuneration schemes with write-down mechanisms under which bank managers are paid in 'notional bonds'.

The mandatory Deferred Contingent Capital Plan (DCCP) of UBS AG was initially (in 2012–2013) set up as a Tier 2 capital instrument. In the beginning of 2015, UBS AG announced[180] the plan's redesign into a Tier 1 capital instrument and declared that it would continue running it as a AT 1 instrument as of the end of 2014. Under the current plan, employees whose total remuneration is in excess of USD/CHF 300,000[181] are annually awarded part of their remuneration[182] in the form of interest-bearing[183] 'notional additional Tier 1 (AT1)

178 Schiltknecht & McHale (2015), n 2, 17-18.

179 Capital Adequacy Ordinance, art 27(1)(d).

180 UBS Media Release dated 23 January 2015 <http://www.ubs.com/global/en/about_ubs/media/switzerland/releases/news-display-media-switzerland.html/en/2015/01/23/compensation.html> accessed 5 June 2015; see also UBS AG, 'Annual Report 2014', n 169, 245.

181 For 2014, over 5,000 employees received DCCP awards. See UBS Group AG, 'Compensation Report 2014', 34 <http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting/2014.html> accessed 5 June 2015.

182 In general a portion of 40% of their variable remuneration.

183 Employees may receive discretionary interest payments at a notional interest rate of 7.125% for awards denominated in USD and 4% for awards denominated in CHF for grants in 2015. Interest rates are based on the current market rate for such AT 1 instruments.

instruments' (notional bonds), which can, at the discretion of UBS, be settled either in the form of a cash payment or a perpetual, marketable AT 1 instrument.[184] This current design contrasts the ancient Deferred Contingent Capital Plan, under which the awards granted qualified as Tier 2 capital, requiring the instruments to have a minimum duration of five years and to be fully expensed up-front.[185] Under both plans, awards granted are forfeited if the CET 1 capital ratio falls below 10% for members of the group executive board and 7% for all other bank employees respectively. In addition, awards are forfeited if a PONV-event occurs, i.e., (i) if a write-down will be prescribed by FINMA to prevent the bank's insolvency or bankruptcy, or (ii) if UBS AG receives a commitment of extraordinary support from the public sector. Awards vest in full after five years subject to there being no trigger event.

Credit Suisse Group AG, in turn, went from the outset for recognition of their Contingent Capital Awards as AT 1 capital.[186] For 2014, the total Contingent Capital Awards awarded to 5,891 employees had a fair value of CHF 360 million. Contingent Capital Awards are scheduled to vest on the third anniversary of the grant date and will be expensed gradually over the vesting period. As a result of its ongoing grant practice, the volume of the recognised AT 1 capital will steadily increase in an initial work-up phase. For payouts of the initial awards to be permissible at their vesting date (i.e., at the end of 2016 for the awards granted in 2013), recognition of the scheme as AT 1 capital will need to be limited to the combined amount outstanding under the unvested awards (i.e., awards granted in 2014, 2015 and 2016), or, in other words, to what will be left in the 'rolling pool' after the payout has been made. Contingent Capital Awards provide a conditional right to receive semi-annual interest payments[187] and will be written down either (i) if the Credit Suisse Group's reported CET 1 capital ratio falls below 7%, or (ii) if a PONV-event occurs. At settlement, employees will receive, at the discretion of Credit Suisse Group AG, either contingent capital instruments or a cash payment based on the Contingent Capital Awards' fair value.

184 If UBS does not achieve an adjusted profit before tax for any year during the vesting period, group executive board members will lose 20% of their award each loss-making year. See UBS Group AG, 'Compensation Report 2014', n 181, 34.

185 UBS AG, 'Annual Report 2013', n 169, 231. Vesting of the awards was accordingly aligned with the term of the instrument and thus only occurred upon maturity of the instrument (cliff vesting).

186 Credit Suisse Group AG, 'Annual Report 2014', n 169, 205.

187 For Contingent Capital Awards granted in January 2015, interest rate equivalents are paid until settlement at a rate of 4.85% p.a. over the six-month CHF LIBOR for CHF-denominated awards or 5.75% p.a. over the six-month USD LIBOR for USD-denominated awards.

IV. Analysis

Inventory – Our observations above show that contingent capital securities have so far remained fairly limited in their practical application for the purpose of remuneration. European financial institutions have, up to now, not been keen on using them for purposes of remuneration. Barclays set a precedent in 2011 by designing a cash-based remuneration plan modelled on contingent capital securities, only to abolish it just one year later. The idea of 'bonus bonds' has had more legs in Switzerland where the two major banks, UBS AG and Credit Suisse Group AG, have recently implemented synthetic remuneration schemes that contractually replicate contingent capital securities. Thanks to a broader definition of regulatory capital in Swiss capital adequacy regulations, the two banks even managed to obtain recognition of their remuneration schemes as regulatory capital.

While the notion of contingent capital has yet to catch on with U.S. legislators and regulators, several incentive plans in place at large U.S. financial institutions involve the Tier 1 capital ratio as a measure for adjusting awards made under these plans.[188] The same applies to financial institutions in other EU jurisdictions.[189] Some of these arrangements have already been in place for multiple years.[190] The adjustments to be carried out under the respective plans are mostly confined to unvested awards (malus) but occasionally also cover vested awards (clawback). A closer look reveals that the remuneration schemes of Barclays, UBS AG and Credit Suisse Group AG, that have at times been referred to as 'bonus bonds', also operate by imposing such malus provisions on what are essentially deferred cash awards.

Appraisal – We do not think there is anything wrong with this preference of banks for synthetic remuneration schemes. There being no efficient secondary

188 See, e.g., The Goldman Sachs Group Inc., 'Proxy Statement 2014', 37 (Tier 1 capital ratio below regulatory minimum for 90 consecutive days leading to forfeiture of equity-based awards made to named executive officers); Bank of New York Mellon Corp, 'Proxy Statement 2014', 34 (Basel I Tier 1 ratio of 9% at end of calendar year as a minimum funding requirement for annual incentives); The PNC Financial Services Group, Inc., 'Proxy Statement 2014', 46, and Form of Performance Based Stock-Payable Restricted Stock-Units Award Agreement, S 6.2 (failure to meet regulatory minimum tier 1 capital ratio as of a year-end date resulting in forfeiture of tranche of equity-based remuneration attributed to that year).

189 Société Générale SA, '2013 Remuneration Policies and Practices Report', 15 <http://www.societegenerale.com/en/about-us/governance/annual-general-meeting> accessed 5 June 2015 (noting that deferred share-based awards to chief executives will be forfeited if CET 1 ratio drops below 8%).

190 Goldman Sachs and Bank of New York Mellon first referred to the Tier 1 capital ratio as a ground for forfeiture in 2010. See The Goldman Sachs Group Inc., 'Proxy Statement 2011', 24; Bank of New York Mellon Corp, 'Proxy Statement 2011', 53.

market as yet for contingent capital securities awarded as remuneration and with awards presumably continuing to be subject to vesting or otherwise restricting provisions, employees are unlikely to have a strong preference for either awarded contingent capital securities or deferred cash bonuses when either will lose their value in the event of a material deterioration of the CET 1 capital ratio.

Furthermore, synthetic schemes afford greater flexibility to institutions, e.g., by enabling them to contractually attach further employee-specific malus provisions that would not be permissible in an issued instrument. They are also easier to implement, especially if the financial institution has yet to issue contingent capital securities. However, this contractual flexibility in designing synthetic remuneration schemes may also have substantial drawbacks when it is abused to the disadvantage, or even detriment, of the employees. They might have been better protected against the bargaining power of their employer if they were remunerated in rigid issued contingent capital securities. Another issue inextricably connected with complex synthetic remuneration schemes is the conflict of interest that the 'designers' of such a scheme will find themselves in when they personally stand to benefit from it.[191]

Another argument in favour of synthetic remuneration schemes is grounded on the fact that bank employees, and in particular bank executives, form (as recipients of contingent capital instruments) a special group of investors, distinguishing themselves from external investors through their ability to exert influence on the issuer and their privileged access to information by virtue of their functions.[192] In light of this insider knowledge, it is advisable to avoid the existence of tradable claims during the term of the instrument, allowing a dangerous split between economic interest and insider position. Exerting control over such claims seems to be more feasible in a synthetic remuneration scheme than in the event of issued and therefore tradable instruments.

But even where the institution has previously issued contingent capital instruments, trading in these securities may often be rather infrequent due to the still nascent market in these kinds of securities. This market illiquidity may make it difficult, or at least expensive, to timely obtain the securities needed to satisfy claims arising under a remuneration scheme. In conclusion, it is in our view this substitutability that compellingly explains the fairly limited proliferation of contingent capital securities in remuneration schemes of financial institutions.

191 Gaurav Tosniwal, 'Contingent Convertible Bonds and Banker Compensation: Potential Conflicts of Interest?' (2011) 1, Harvard Business Review Online, 80 <http://www.hblr.org/2011/04/contingent-convertible-bonds-and-banker-compensation-potential-conflicts-of-interest/> accessed 5 June 2015.

192 See Schiltknecht & McHale (2015), n 2, 19.

Outlook – If deferred cash awards subject to appropriate malus conditions were to become eligible for recognition as regulatory capital not only in Switzerland but on a global scale, this would of course only add to their popularity with banks, many of which are still in dire need of regulatory capital. However, this does not currently seem a likely prospect, given the narrower definitions of regulatory capital in both the Basel III Accord and European legislation. Moreover, it is still untested whether malus and clawback indeed provide the same loss-absorbing capabilities as contingent capital instruments. It remains thus to be seen whether EU legislation, coupled with the ongoing surge in the issuance of contingent capital securities, will be enough to convince European banks to more frequently include 'bonus bonds' in remuneration packages and which form[193] they will choose in doing so.

193 Interestingly, the draft Guidelines on sound remuneration policies recently published by the EBA suggest that institutions lacking a 'sound capital base' should apply malus or clawback to previously awarded variable remuneration. Naturally, this would only further contribute to the proliferation of malus and clawback arrangements relying on the CET 1 capital ratio, should the draft Guidelines be enacted in their current form. See EBA, 'Consultation Paper. Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No. 575/2013', 4 March 2015, para 112 <http://www.eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies/-/regulatory-activity/consultation-paper> accessed 5 June 2015.